

INDONESIA

Systematic Country Diagnostic:

Connecting the Bottom 40 percent to the Prosperity Generation



THE WORLD BANK GROUP

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INDONESIA

SYSTEMATIC COUNTRY DIAGNOSTIC: CONNECTING THE BOTTOM 40 PERCENT TO THE PROSPERITY GENERATION

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East Asia and Pacific Region

ABBREVIATIONS AND ACRONYMS

| | |
|-----------|--|
| BKPM | Investment Coordinating Board |
| BPJS | Social Security Organizing Agency |
| BPS | Central Bureau of Statistics |
| BSM | School Scholarship Program |
| Bulog | State Logistics Agency |
| DAK | General Allocation Fund |
| DAU | Special Allocation Fund |
| FHH | Female-headed household |
| GHG | Green House Gas |
| GIC | Growth Incidence Curve |
| IUU | Illegal, unreported, and unregulated fishing |
| Jamsostek | Social Insurance Agency |
| JKN | National Health Insurance Program |
| KPK | Corruption Eradication Commission |
| MMAF | Ministry of Maritime Affairs and Fisheries |
| MOF | Ministry of Finance |
| MSMEs | Micro, small and medium enterprises |
| NBFI | Non-bank financial institution |
| NTR | Natural resource non-tax revenues |
| OECD | Organization for Economic Cooperation and Development |
| OJK | Financial Sector Regulator |
| OSS | One-stop shop |
| PISA | Program for International Student Assessment |
| PKH | Human capital conditional cash transfer |
| PPP | Public-Private Partnership |
| PNPM | National Program for Community Empowerment |
| REDD+ | Program to Reduce Emissions from Deforestation and Degradation |
| RPJMN | Medium-Term Development Plan |
| SJSN | National Social Security System |
| SMA | General Senior Secondary School |
| SME | Small and Medium-sized Enterprises |
| SMK | Vocational Senior Secondary School |
| SOE | State-Owned Enterprise |
| Susenas | National Socio-economic Survey |
| TEU | 20 Foot Equivalent Unit (cargo capacity) |
| TFP | Total Factor Productivity |
| TI | Transparency International |
| TIMSS | Trends in International Mathematics and Science Study |
| TNP2K | National Team for the Acceleration of Poverty Reduction |
| UDB | Unified database (household targeting for social assistance) |
| UKP4 | Presidential Delivery Unit |

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Executive Summary

The Systematic Country Diagnostic (SCD) is designed to identify the most critical binding constraints and opportunities facing Indonesia in ending extreme poverty and boosting shared prosperity. In line with the World Bank Group's new country engagement model, the findings of the SCD will provide inputs for the preparation of the Country Partnership Framework (CPF), which will outline the WBG's engagement with Indonesia to achieve the twin goals. This SCD has four main conceptual elements. First, we analyze past trends in growth, poverty and inequality to highlight their "deep" drivers. Second, we identify the key channels for reducing poverty and boosting the prosperity of the Bottom 40 percent. Third, we highlight the major challenges and opportunities along each of the key channels and, finally, we identify prioritized areas of intervention to accelerate progress toward ending extreme poverty and boosting shared prosperity for each of the channels identified. This diagnostic exercise was conducted in consultation with national authorities and other stakeholders in Indonesia, and is based on the current available body of knowledge.

Poverty reduction and inequality: contrasting performance

Thanks to a strong recovery in growth, poverty in Indonesia has fallen dramatically since the Asian financial crisis of the late 1990s. From 1999 to 2012 the national poverty rate was cut in half, from 24 percent to 12 percent, largely through sustained economic growth and job creation. Following a 13 percent contraction in 1998, output growth rebounded strongly, grounded on gradually increasing private sector investment and robust domestic consumption. Real GDP growth averaged 4.7 percent in 2000-05, 5.7 percent in 2006-10 and 6.0 percent in 2011-12, demonstrating Indonesia's resilience to the global economic downturn in 2008. The country's GDP almost doubled from USD 580 billion in 2001 to USD 1.1 trillion in 2012, making Indonesia the 15th largest economy in the world and member of the G20.¹ Remarkably, healthy growth has gone hand-in-hand with low fiscal deficits (average 1.4 percent of GDP in 2000-12), a sharp decline in the debt-to-GDP ratio (from over 100 percent in 2000 to just 25 percent in 2012), and external surpluses until mid-2013, when an annual current account deficit opened for the first time since 1997.

There is strong evidence that growth and poverty reduction were strongly influenced by global commodity markets in the first decade of the new millennium.² Indeed, the significant rise in commodity prices in 2003-11 led to massive income and wealth effects in Indonesia. These fed into corporate revenues, household incomes and government revenues, leading to a significant jump in domestic demand for goods and services. On the supply side, the (largely non-tradable) services sector rose considerably, contrasting with a quasi-stagnant manufacturing sector, which lost competitiveness due to a sharp appreciation of the real exchange rate and high logistics and trade costs. Changes in the labor market reflected this differentiated sectoral dynamics, as 17 out of the 21 million jobs created between 2001 and 2011 were in the services sector, mostly in its low value-added, low-wage segments (e.g., retail trade, restaurants, tourism and construction). Since 2012, weaker global commodity prices and demand, and tighter domestic financing conditions, have combined to slacken growth momentum (5 percent in 2014). Consistently over several years, the pace of poverty reduction has slowed considerably, with a near zero decline in poverty in 2014, the smallest reduction in over a decade. As measured by the current national poverty rate of 11.3 percent, there are 28 million poor people in Indonesia. An additional 27 percent of the population (65 million people) lives between the official

¹ All in constant 2005 USD, PPP.

² World Bank, 2014, *Avoiding the Trap*. Development Policy Review 2014

poverty line and less than 50 percent more than that poverty line, forming a large group of “vulnerable” people.³ Throughout this report, we denote the “vulnerable” and the poor collectively as Indonesia’s “Bottom 40 percent”.

The relative success in poverty reduction contrasts with a dismal performance in sharing prosperity. Between 2003 and 2010, consumption of the bottom 40 percent grew at 1-2 percent annually, while that of the two richest quintiles grew by about 6 percent. Consequently, the Consumption Gini coefficient, an indicator of inequality, rose from 30 to 42 over this period, one of the fastest cases of widening inequality seen in East Asia. **Education and ownership of assets are the key factors explaining inequality in Indonesia.** Inequality increased because members of rich Indonesian households have access to higher education and assets, such as real estate and stocks that allowed their wealth to grow rapidly. With better education, they are able to find better jobs and benefit from the increasing “skills premium” in the labor market. Compared with workers with a primary education or less, those with junior secondary education now enjoy a 20 percent premium, those with senior secondary a 40 percent premium, while those with tertiary earn double.⁴ Furthermore, because richer households own real and financial assets, they benefit when the returns on those assets rise, as they have over the past decade. Individuals from poor households, however, lack financial assets and can only improve their income through work. Most of the jobs created in Indonesia since 2001, and indeed most current jobs, are in low productivity sectors, resulting in low real labor incomes. In addition, these workers have limited access to formal worker protection.

Digging deeper, about one-third of inequality in recent years can be traced back to circumstances that children are born into, or develop soon after, or in other words inequality of opportunity. The latter can be seen by comparing a child born in Jakarta to non-poor parents who have at least high school education with a child born in a rural area of Papua or Maluku to a poor family with little education. The former has only a 6 percent chance of lacking proper sanitation, compared with 98 percent for the latter child. These differences extend across all other indicators of opportunity, such as access to clean water, decent housing, primary school enrolment, birth by skilled attendant and immunization coverage.

Three pathways to shared prosperity

The SCD identifies three pathways to reducing poverty and increasing shared prosperity in Indonesia: strong economic and jobs growth, improved access to key services, and better natural resource management. **First, a strategy that generates strong growth and jobs is fundamental for Indonesia.** While the private sector is the main engine of economic growth, the first pathway, the Government nonetheless plays a critical role by devising and implementing policies that encourage private sector participation and through the provision of key public goods. Four key factors have constrained productivity and GDP growth and the creation of jobs in the higher value-added sectors over fifteen years:

- **Large infrastructure gaps** leading to serious congestion on roads and in ports, and forcing private firms to invest in electricity generators, thereby reducing their competitiveness. For instance, with an insufficient number of, and poor and congested access to, modern ports, airports, railways and road-based logistics transportation, shipping costs within Indonesia are often more expensive than

³ The poor are those beneath the official poverty line; the vulnerable are those between the poverty line and 1.5 times that line. The Bottom 40 percent is composed of the fifth and fourth quintiles combined.

⁴ World Bank, 2014, *Hard Choices*, Indonesia Economic Quarterly, World Bank, July 2014.

the costs of importing from Thailand or China (e.g., logistics costs in Indonesia are estimated at 24 percent of GDP, against 16 percent in Thailand). Infrastructure constraints have cost Indonesia more than 1 percentage point of annual GDP growth over the past decade.⁵

- *Weak business environment* with generally restrictive, and often inconsistent investment and trade regulations; time-consuming and costly procedures for obtaining permits and licenses; and limited access to bank credit or market financing forcing firms to rely heavily on retained earnings for the expansion of their activities.⁶ These constraints have kept private investment well below its full potential.
- *Skills gaps*, with more than 60 percent of Indonesian firms reporting that finding suitable employees for professional and managerial positions is either “difficult” or “very difficult”, and almost 70 percent of employers in manufacturing reporting that they find it “very difficult” to fill skilled professional-level positions (i.e., engineers). Skills constraints have delayed Indonesia’s move toward higher value-added production in many sectors.
- *Little transformation of agriculture due to weak policies.* Although agriculture “released” labor to higher productivity sectors over the past fifteen years, the sector still employs 35 percent of the work force but contributes only 12 percent to total GDP. This represents a significant drag to overall productivity of the economy. It reflects agricultural policies that provide limited incentives for efficient use of land, labor and capital resources. Agricultural policies continue to focus on achieving self-sufficiency in rice, maize, and sugar based upon fertilizer subsidies and restricted trade. Yet, with rising incomes and urbanization, food consumption and expenditure patterns are shifting to higher value and processed foods. Between 1998 and 2013, animal product consumption more than doubled, while the consumption of cereals declined. Over the same period, the share of processed foods in urban food expenditure rose from 15 percent to more than 30 percent. Much of the rising demand in processed food is satisfied by imports, since agricultural policies have not created enough incentives for Indonesian farmers, manufacturers, and services sector companies to boost domestic production. At the same time, the focus on rice production has not allowed a reduction in rice prices for consumers. From 2009 to 2014, Indonesian’s average rice consumer prices (USD 0.67/kg) were 30-50 percent higher than in some regional countries (wholesale prices: USD 0.47/kg in Thailand, and USD 0.40/kg in Vietnam). During this period, overall consumer food price inflation was considerably higher than that seen in the region’s other middle-income countries.

The second pathway to poverty reduction and shared prosperity, supported by the growth path, is service delivery and opportunity for all. The provision of decent housing, transportation services, water and sanitation, and quality education and health care is constrained by a combination of weak tax collection leading to sub-optimal levels of public expenditure, a poor public spending mix and spending delivery challenges at the central and sub-national levels.

- *Sub-optimal public spending.* Indonesia’s revenue-to-GDP (15.2 percent in 2014) and tax-to-GDP (11.3 percent) ratios are very low by international standards. This is not due to lower tax potential: by one estimate, Indonesia is collecting less than 50 percent of its total potential tax revenue.⁷ With continued moderation in oil and other commodity prices, revenue-to-GDP may fall to as low as 13.4 percent in 2015 and remain at this level in the medium term under a “business-as-usual” scenario due to significantly lower revenues from oil, gas and other commodities. Over the past decade, low levels of revenue (as a percentage of GDP), coupled with a fiscal deficit that is legally

⁵ World Bank, 2014, *Avoiding the Trap*. Development Policy Review 2014.

⁶ Indonesia currently ranks at 114 (out of 189 economies) in the World Bank’s *Doing Business* indicators.

⁷ Fenochietto, R. and Pessino, C., 2013, “Understanding Countries’ Tax Effort”, IMF Working Paper WP/13/244.

capped at 3 percent of GDP, have induced sub-optimal levels of total public spending (17.3 percent of GDP in 2014 compared with an average 28 percent of GDP for middle-income countries in Asia). In other words, greater revenue mobilization could have allowed Indonesia to spend more on development priorities within the limits of its legal fiscal deficit cap.

- *Poor spending mix at the central government level.* Before the introduction of a major fuel subsidy reform in January 2015 (move to market-based prices for gasoline), central government spending on infrastructure and health programs were significantly crowded out by large energy subsidies.⁸ The latter have remained generally elevated since the mid-2000s, attaining unsustainable levels in recent years despite several ad hoc, episodic price increases. In 2014, spending on energy subsidies accounted for more than one-fifth of the central government's budget. This was more than three times the allocation for infrastructure such as roads, water, electricity and irrigation networks, and three times government-wide spending on health.
- *Poor spending mix and service delivery constraints at the sub-national government level.* In Indonesia, service delivery (health, education, local infrastructure, water, sanitation, etc.) is mainly a responsibility of sub-national governments since the decentralization reforms launched in 2001. District and provincial governments now spend about 51 percent of the national budget (net of subsidies and interest payments). The evidence is however that the majority of them have failed to deliver the improvements in local public services that were expected. This reflects in part poor spending choices. For instance, in 2012, district governments spent 52 percent of their budgets on personnel and only 3 percent on capital. However, the quality of services is persistently low and unevenly distributed across regions, even in those areas where spending has increased significantly over the past decade. For instance, (total) government spending on education has tripled in the past 10 years but little has changed in the classroom—more than half of teachers do not meet minimum competency levels, contributing to 40 percent of 15-year-olds, mostly poor, performing below the lowest competency level in PISA-math. The fundamental causes of weak local service delivery thus are, in addition to technical financial capacity and coordination constraints, weak incentive structures and low accountability of sub-national governments for delivering results.

Finally, the special nature of poverty in forest and coastal areas suggests that pathways 1 and 2 need to be supplemented by a third one: natural resource management. Indonesia is endowed with one of the most valuable forest capital levels of wealth and the largest mangrove and sea-grass ecosystems in the world. Yet poverty is highest in forest and coastal areas. Six million out of the 32 million people who live in remote forest areas are poor. This is just over one-fifth of the total number of poor in Indonesia. Similarly, poverty rates among the 140 million people who depend on marine and coastal resources for their livelihoods are high.⁹ Clearly, eradicating poverty in Indonesia requires improving the well-being of households living in forest and coastal communities. Poverty reduction efforts in these areas are however constrained by the challenges imposed by remoteness, low population density and dispersed locations, as well as poor governance leading to an overexploitation of natural resources.

⁸ Thanks to a fuel subsidy reform introduced in January 2015, the energy subsidy bill is budgeted to fall sharply from 3.4 percent of GDP in 2014 to 1.2 percent in 2015. The fiscal savings have been reallocated to infrastructure – reflected in the increase in planned capital spending from 1.3 percent of GDP in 2014 to 2.5 percent in 2015. Revenue collection is however projected to be much lower than expected and only a fraction of the initial increase in capital spending may actually materialize (see World Bank, 2015, *Smaller Gains*, Indonesia Economic Quarterly, World Bank, July 2015).

⁹ While the poverty rate of this population scattered around the archipelago is not available, it is deemed high. According to the Ministry of Maritime Affairs and Fisheries about 90 percent of coastal fishers live in poverty.

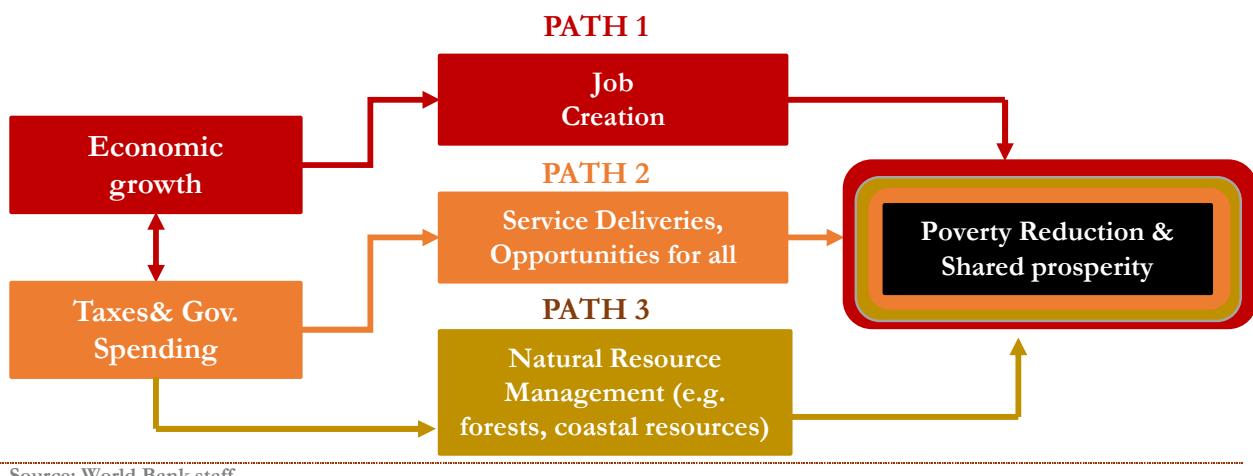
- *The challenges imposed by remoteness, low population density and dispersed locations.* Forest and coastal communities are characterized by remoteness, low population density and dispersed locations. This implies that connections with, and externalities from, urban growth centers are weak; and the provision of services such as education, health and infrastructure is costly. For instance, Indonesia's village surveys (PODES) show that in 2012, only 12 percent of forest villages had maternity facilities and midwives, 38 percent had a primary school within 6 km and only 8 percent had a secondary school. This does not help break the intergenerational transmission of poverty.
- *Poor governance leading to overexploitation of natural resources.* The United Nations Framework Convention on Climate Change (UNFCCC) estimates that annual deforestation and degradation are 670,000 and 425,000 ha/year, respectively. Deforestation results from many factors, including significant growth in oil palm plantations and mining production, but substantial governance issues in land-use licensing and law enforcement processes are the main cause.¹⁰ Similarly, coastal deforestation, water pollution and overfishing have also reached high, unsustainable levels. Close to 65 percent of Indonesia's coral reefs are considered threatened by overfishing and more than 40 percent of Indonesia's mangroves have already been lost. As a result of these degradations, about 58 percent of the population in Java lives in water insecure areas, with water and soil pollution levels (mercury and lead) that are among the highest in the world. Rapid deforestation and overexploitation of marine resources (especially on Java) have disproportionately undermined the livelihoods of people living in forest and coastal areas.

In addition to the above constraints, climate change hazards are likely to disproportionately affect the poor. Thus environmental sustainability is an integral part of the shared prosperity agenda. Indonesia ranks among the top greenhouse gas (GHG) emitting countries in the world. Roughly one-third of Indonesia's GHG emissions originate from land-use changes and forest degradation, 26 percent from peat fires and 22 percent from fossil-fuel emissions, which are also rising steeply. Thus about half of all GHG emissions are associated with poor governance of land use and rising commodity production (e.g., palm oil) and resource extraction. Oil use contributes most to current fossil-fuel emissions, but coal emissions have grown fastest over the past decade due to the increasing use of coal in power generation. The rise in GHG emissions is exacerbated by rapid urbanization (4 percent annual increase in urbanization) and rapid growth of aggregate consumption (and with it rapid energy demand growth). Overall, air pollution is high in large urban areas and generates negative health impacts that cost billions of dollars. As an equatorial and archipelagic country, Indonesia is expected to begin experiencing significant impacts from climate change over the next 20 years. The Asian Development Bank projects that by the end of the century climate change will cost Indonesia between 2.5 and 7 percent of GDP.¹¹ The most severe impacts will fall on the poorest people, specifically those who live in areas susceptible to drought, flooding and/or landslides and who are dependent on climate-sensitive livelihoods such fisheries and agriculture.

¹⁰ Indonesia manages its forests through concessions and through centralized management structures without local monitoring and ownership. The allocation of concessions for timber, pulp and paper production and, increasingly, oil palm plantations, is opaque and the enforcement of spatial and environmental planning is ineffective.

¹¹ Asia Development Bank, 2009, *The Economics of Climate Change in Southeast Asia: A Regional Review*. ADB, Manila.

Figure 1: Pathways of poverty reduction in Indonesia



Source: World Bank staff

Four mega-trends that will shape long-term prospects

Looking ahead, four mega-trends will shape economic prospects, which policy reforms can turn into powerful drivers of growth and long-term economic transformation. These factors are: (i) commodity prices; (ii) the developments in China; (iii) Indonesia's demographics and; (iv) Indonesia's rapid urbanization.

- *Global commodity prices.* The softening of commodity prices since 2011 poses challenges for Indonesia in the short term, as seen in the impact on Indonesia's trade balance and revenue collection. However, it also offers an opportunity to enhance the quality and diversity of investments in Indonesia. Over the past decade, high commodity prices tilted investment incentives in favor of the resource sector and non-tradable sectors (e.g., the real estate sector) and against manufacturing and other tradable sectors. Going forward, lower commodity prices should increase the relative profitability and attractiveness of manufacturing and could be used to help Indonesia to develop its industrial base. With reforms to reduce the constraints faced by manufacturing firms, weaker commodity prices could be a blessing in disguise.
- *Developments in China.* China's rapidly rising wages present Indonesia with an opportunity to regain a comparative advantage in labor-intensive export sectors. China's nominal wages have grown by an annual average of almost 15 percent since 2001 which, together with slowing productivity growth in low-skilled sectors in recent years, has seen Chinese unit labor costs grow by almost 70 percent since 2005 (Economist Intelligent Unit, 2012). This pressure, combined with slower overall economic growth as China rebalances, is likely to prompt investors to look beyond China's coastal areas, including toward ASEAN countries.
- *Demographic factors.* Indonesia is fortunate to have abundant labor. Between 2013 and 2020, the working-age population will increase by 14.8 million, reaching 189 million from the current 174 million. Today, 50 percent of the population is under the age of 30. This increasingly educated and IT-savvy youth is an asset that can be used to boost overall productivity and economic growth. With the right policies in place to utilize this labor, Indonesia is poised to benefit from a demographic "dividend", before the population starts to age from 2025-30 and beyond.
- *Rapid urbanization.* Indonesia's urban population is increasing at an annual pace of about 4 percent and, by 2025, 68 percent of the population is projected to live in urban areas, compared with 52 percent in 2012. As incomes rise and existing large metropolitan areas such as Jakarta

and Surabaya become saturated, the demand for consumer durables, shopping space and housing will increase significantly in smaller cities. Connecting these cities and their inhabitants to rural areas, metropolitan areas and the global economy will be essential in attracting firms and achieving shared prosperity. Empirical evidence shows that urbanization supports growth and poverty reduction in Indonesia, but only in the presence of adequate infrastructure (Lewis, 2014).

SCD prioritization and selectivity framework

The three pathways discussed above accompanied by two “pre-requisites” provide a useful framework to consider priority reform areas. Reforms under growth-jobs, service delivery-opportunity for all and natural resource management pathways are complementary and mutually supportive. For instance, reforms to boost non-commodity sector growth can indirectly help service delivery through greater government revenues and may reduce pressure on natural resources. This complementarity among the different pathways suggests that shared prosperity should be addressed using a comprehensive but coherent reform agenda. Reforms under the three pathways should be supported by two important underlying, cross-cutting pre-requisites: domestic revenue mobilization (“collecting more”) and “governance” reforms to improve policy coordination, project implementation and transparency. In this SCD, we attempt to prioritize reforms based on impact (evidence-based), complementarity/synergy, sequencing and feasibility:

- *Evidence on the salience of a constraint for achieving the twin goals.* The degree to which constraints to achieving shared prosperity through the three identified pathways are binding, based on existing empirical evidence;
- *Reform complementarities and synergies.* The extent to which reforms addressing the most binding constraints have significant impacts on, and relevance for more than one pathway; such reforms are considered “high priority” or “transformational”; and
- *Reform sequencing and feasibility.* Some reforms may not be feasible before the full implementation of higher order reforms, while other reforms may be pertinent but lack the minimum political support needed to implement them.

Economic growth and job creation

Enhancing prosperity for the Bottom 40 percent rests in large part on the implementation of structural reforms to shift the economy to a productivity-based growth path. The structural reform agenda ultimately aims to boost productivity in agriculture by increasing cereal yields, reducing post-harvest waste and shifting to higher-value crops, while also accelerating investments in manufacturing and services, including tourism, thereby reducing dependence on mineral commodities for exports. Urgent actions to support this shift include reforms that can be expected to generate “quick wins”, while recognizing that the full benefits of such a shift will accrue only over the longer term.

Infrastructure. Large investments in infrastructure (*roads, seaports, railways, irrigation and drainage*) to better connect the economy domestically, reduce logistics costs, support productive activities and improve access to services are clear priorities.¹² Investment in infrastructure is “transformative” in Indonesia in that it supports growth and competitiveness, is crucial to providing key services to the population and is supportive of human capital development and social inclusion. Indonesian cities are

¹² For a summary of the evidence on this, see World Bank, 2014, *Avoiding the Trap*. Development Policy Review 2014.

growing fast and a key challenge for sub-national governments is to rapidly put in place the *infrastructure to support economic activities, ease urban mobility and provide water, sanitation and other services* to a growing population. Infrastructure gaps in rural areas are also large. Priority infrastructure there includes *community-level production-supporting infrastructure, irrigation investment*, with complementary R&D and extension services, and enhancing governance to increase user participation and sustainability of investments.

A special focus on *energy* is warranted. Demand for energy is growing by 7-8 percent annually requiring a rapid supply response to avoid an energy crisis in the years to come. About 35 million Indonesians lack access to electricity. It is estimated that meeting the energy needs of the economy and closing the access gap would require 66.8 GW of incremental generation capacity and 477 TWh power supply capacity for a total investment over USD 200 billion. If the objective were to close the gap in the next 10 years, that would mean an investment of USD 20 billion per year. Furthermore, with energy contributing almost a quarter of total CO₂ emissions, reducing the heavy reliance on fossil fuel sources to meet rising demand would help Indonesia contribute to the global climate change agenda. To improve the efficiency and sustainability of the energy sector, a reduction of the large electricity subsidy bill (USD 10 billion in 2014) is needed to boost investments in the sector, while policy and regulatory bottlenecks to investments by all players would need to be overcome. Likewise, a special emphasis on Indonesia's *maritime and logistics sector* will be central in addressing the infrastructure gaps that are impeding a transformation toward higher productivity and job-based growth. In addition, it will be necessary to address these issues as part of the natural resources management and poverty focused reforms needed for coastal regions.

The scale of investment needs in national, urban and rural infrastructure is huge (estimated at about USD 500 billion for the next 5 years). *The private sector should thus play a crucial role* since the national budget will be insufficient to finance it. There is however ample evidence that *closing the infrastructure gap in Indonesia is not only about money*: it will be crucial to improve the framework for private sector participation (e.g., the *PPP scheme*), *address land acquisition issues, reduce red tape related to licensing and permitting, and ensure effective coordination across various agencies and between central and sub-national governments*.

Major investment in new infrastructure presents an opportunity to drive an overall decrease in disaster risk through growth. The flip side is that under-investing in resilient infrastructure would by default result in increased risk. Indonesia faces medium to high risk across the whole country from multiple natural hazards. Therefore, *risk-sensitive planning and design standards are essential to protect growth that depends on critical infrastructure assets*. Indonesia has good examples of “building back better” after major disasters. This is now the chance to be a *global leader among MICs in “building better” ex-ante*. Key approaches include risk-sensitive land use planning, adequate budgeting to provide sustainable operations and maintenance, and insurance options for public assets.

Business environment. *More consistent and less restrictive trade and investment regulations* are needed to boost private investment, following a string of inconsistent rules and a flurry of restrictive sector-specific legislation seen in recent years. Abrupt and arbitrary regulatory changes need to be avoided and a different more consensus-based and evidence-based approach is needed, consistent with broader efforts to improve the investment environment. In addition to consistent business regulations, *faster processing of business licenses and permits (including across “doing business” areas)* is crucial. The importance of streamlining business licensing is recognized by the government to be a major policy priority. A central “one stop service” for investment and business licenses is being established, with the objective of integrating all licensing processes at the national level under one roof, and simplifying the currently

complex web of business licensing across the different national and sub-national agencies. The intended result is a quick, simple, transparent and integrated licensing service. The reform at the central (BKPM) level should however be complemented by the implementation of effective sub-national one stop services. Finally, *better functioning capital, labor and land markets* are required for higher job-rich growth. For capital markets, the need to mobilize more domestic capital for infrastructure investment is well-recognized, but will require sustained efforts to strengthen the role of the segmented banking sector and deepen non-bank lending, including over the long term by reducing the aversion to long-term local currency lending, and the psychological impacts of the 1997/98 crisis. Labor market reforms could have relatively immediate benefits, but negotiating the “grand bargain” necessary will be at least a medium-term effort. Land, and its ownership and management, is perhaps the area in which implementation would be most arduous, requiring major institutional and governance reforms. The benefits, however, can be cross-cutting for infrastructure development, agriculture, urban development and environmental sustainability.

Skills. Closing Indonesia’s skills gap requires a three-pronged reform strategy. First, there is a clear need to *improve access to and quality of early childhood and basic education* to build a strong base of cognitive, social and behavioral skills necessary to acquire the higher-level skills needed in the labor market. However, this is a very long-term agenda. It is therefore essential to find short- and medium-term solutions for the current skills constraints: the second and third prongs of the strategy are thus improving the relevance of feeders into the labor market (technical and vocational education, and tertiary education) and upgrading the skills of the existing workforce (reform of the training system). Policies that could support this strategy include: improvements in the *efficiency of public education spending; raising levels of teacher competency, which are central to the success of efforts to increase levels of educational attainment in Indonesia; making vocational education and tertiary responsive to employer needs; improving information flows and strengthening incentives to improve the responsiveness of tertiary education; and accelerating the expansion of good quality training opportunities in higher value-added skills* in strategic sectors.

Agriculture. There is a need to *better align agricultural policies with Indonesia’s transition as a middle-income country*. Current policies have inhibited rather than facilitated the structural transformation within agriculture and the broader agro-food system. This entails broadening policy goals (competitiveness, nutritional balance, and environmental protection); strengthening regulatory and facilitative roles related to food safety and plant and animal health; and tackling supply bottlenecks (land, irrigation infrastructure, and agricultural innovation systems). Enabling these growth-critical investments requires the *phasing down of sector subsidies and complementary (non-agricultural) policies to improve the competitiveness of high value perishables subsectors and promote investments in food processing, cold chain logistics, etc. The provision of public goods* is also critical for improving the productivity and sustainable livelihoods of the 5 million households involved in the production of oil palm, coffee, cocoa, and tea.

Access to key services and opportunities for all

Local service delivery. Improving local service delivery will require *building the capacities of local governments to deliver services, moving toward a more performance-based transfer system, providing the tools for citizens to monitor local service delivery, as well as differentiated approaches to regional development adapted to different types of regions*. It also requires combining the current top-down approach to reform, whereby local governments implement national policies, with a more frontline approach, which uses the frontline service as the entry point to develop solutions, working out from there to identify and align supporting interventions at each levels of government. Ultimately, improving local service delivery is about enhancing the way in which central, provincial, district, and village governments work together to deliver results on the ground.

Social protection and social security. To achieve the twin goals in Indonesia, greater social protection is needed to shield the vulnerable from shocks that push them into poverty, while helping those beneath the poverty line to climb above it. This entails *strengthening social assistance programs* and *making the ongoing social security reforms effective and sustainable*. Improving social assistance will likely require far more resources than are currently spent by the Government, at roughly 0.5 percent of GDP. Other large middle-income countries spend, on average, three times as much on these programs. At only 1 percent of GDP in 2012, total government outlays on health were the fifth-lowest out of the 188 countries for which data are available: only South Sudan, Pakistan, Chad and Myanmar had lower ratios. Because only 41 percent of the Bottom 40 are covered, Indonesia is committed to and putting significant effort into attaining *universal health coverage (UHC) by 2019*. The country launched a National Health Insurance Program in 2014 (JKN) and is making health insurance free for the poorest 40 percent of the population—a key policy of the administration of President Joko Widodo (“Jokowi”).¹³ UHC could be instrumental to boosting shared prosperity and reducing poverty in Indonesia, where 93 million Indonesians (40 percent of the population) live under USD 2 per day and where inequality is also rising.

Natural resources management and environment sustainability

Removing constraints to shared prosperity include beginning the difficult task of improving natural resources management and environment sustainability. A key priority in improving natural resources management and environmental sustainability in Indonesia is a *reform of the governance of land allocation, land rights access and spatial planning*. Good management of these is a pre-requisite for improving the livelihoods of local communities, but will also influence food production, urban and infrastructure development, and mining and forestry resource management, environment degradation and pollution, as well as the prevalence of social conflicts. For this policy priority, accelerating programs such as land registry and implementing REDD+ would be a good start. With land use changes, forestry and peat fires generating more than 70 percent of CO₂ emissions, efforts in this area could decisively increase Indonesia’s contribution to global climate change initiatives, while supporting resilience to natural disasters, which disproportionately impact the poor. Building greater resilience to natural hazards could be supported by the establishment of a national program on hazardous micro-zoning providing detailed instruments for incorporating resilience into site design and construction standards; providing a financing framework for both urban, housing and property development that incentivizes investment with built-in resilience linked to disaster insurance; and a national program on urban upgrading and ecosystem rehabilitation to increase the resilience of existing settlement and urban infrastructure as part of the greening of Indonesia’s future growth.

For marine and fisheries resources, priorities include (i) *implementing control and surveillance over sovereign marine and fisheries resources to support the eradication of illegal overfishing (IUU)*; (ii) *improving marine natural resources and fisheries management* to improve the sustainability of the natural capital, while accommodating an expansion of commercial wild capture fisheries, and sustainable aquaculture production and tourism; (iii) *improve the investment climate and support PPP for sustainable capture fisheries and aquaculture* to increase production and the sector’s contribution to GDP, reduce poverty among fisher and coastal communities as well as improve national food sovereignty and food security and, finally; (iv) *investing in maritime and logistics both in terms of infrastructure and ‘software’, as well as necessary electrification in order to create the enabling environment for commercial fisheries, cold storage and processing plants* to increase

¹³ The other components of the social security reforms comprise universal employment insurance coverage by July 2015 and an important institutional overhaul to reduce the fragmentation of the social security system.

overall economic value of fisheries sector, increase exports and diversify and create jobs, particularly in eastern Indonesia.

Cross-cutting pre-requisite 1: collecting more and spending better

There is a strong political consensus that boosting reforms and investment in infrastructure, energy, health and social protection is the right course but this needs to translate into sustained fiscal reforms in the medium term. Indeed, even if there is no policy reversal of the fuel subsidy reforms and that the fiscal savings will be reallocated to development priorities, additional fiscal space is needed to fund a sustained increase in the above priority areas. Given the large infrastructure deficit, the Government should aim to increase total government infrastructure spending (reflected as increased capital spending) from 2.3 percent of GDP in 2013-14 to 3.8 percent by 2019.¹⁴ The investment required on the supply-side to implement fully the universal healthcare coverage program by 2019 requires public health spending, excluding National Social Security System (SJSN) spending, to increase to around 1.4 percent of GDP per year (from 1.0 percent of GDP in 2014); this will be reflected by higher material spending. On top of the health-related increase in social assistance spending, social assistance spending on the poor and vulnerable should double, equivalent to an increase of 0.5 percent of GDP, by 2019 to enable expansion of programs for the poor and vulnerable. Simulations using a medium-term fiscal framework show total expenditure will need to increase from 17.3 percent of GDP in 2014 to 20.0 percent by 2019.¹⁵ This places **reforms to collect more revenue** in intense focus. Indeed, assuming a “business-as-usual” situation with no significant reforms on revenue policy or administration, baseline revenue for 2015-19 is projected to stay level at between 13.3 and 13.4 percent of GDP due to expected continued moderation in commodity prices reducing non-tax revenues from oil and gas. In other words, Indonesia is forced to mobilize more government revenues in order to adequately finance priority development areas within the legal fiscal limit of 3 percent of GDP.

Cross-cutting pre-requisite 2: Governance (implementation, coordination and transparency)

Getting the reform priorities right is a first step. Effectively implementing them to efficiently achieve shared prosperity is a key challenge in Indonesia. Some of the systems and practices within the public administration that have been part of Indonesia’s development process over the past decades may not serve its future needs and could undermine future growth. Despite, the substantial changes in the roles and responsibilities of the public institutions since 1998, many of the core elements of the pre-1998 era remain. While there are now multiple stakeholders formulating and implementing policy at both the national and sub-national levels, there are, so far, no effective coordination mechanisms across government. The outcome has been poor delivery of services by government institutions, inconsistent policy settings across sectors, and a lack of responsiveness of the administration to the priorities of the Government and citizens. The failure to adapt old institutional arrangements and policies to reflect the new environment is an impediment to the effectiveness of the public administration, and poses a threat to Indonesia’s future ambitions.

To support a rapidly developing economy attention needs to be given to refocusing the public administration to establish: (i) a stronger Center of Government (CoG) to manage the policy process and resolve policy conflicts; (ii) an enhanced selection process (including allocation between

¹⁴ Estimate based on scenario of getting above 6 percent growth through an infrastructure big push and assuming two-thirds of the increase in infrastructure spending is publicly financed.

¹⁵ Even assuming that fuel subsidy reforms are not reversed.

private/public sectors) and management of major capital projects to remove obstacles to their implementation; and (iii) a streamlined bureaucracy for enhanced accountability, among other goals. These reforms are notoriously difficult to implement. However, given the costs of not acting to the economy, to citizens and to the country's ambitions, Indonesia cannot afford not to consider implementing some of these reforms in the short term. Perhaps the most urgent reform is the need for a stronger Center of Government. In 2004, OECD/Sigma provided an outline of some of the core functions one would expect to be effective. These functions include: (i) policy document review, quality assurance and inter-ministry mediation; (ii) monitoring government performance; (iii) coordination of horizontal policies/priorities; (iv) legal conformity of draft laws; (v) communication with media and the public; and (vi) coordinating with other branches of the state.

In Indonesia several different institutions play some role in the coordination of policies, including the Coordinating Ministries, the Vice-President's office, the delivery units (UKP4 and TPN2K) and others. However, this fragmentation of CoG roles and functions has not, so far, served Indonesia well. On the contrary, ministries have been able to implement new policies and regulations that conflict with other regulations. Policy management is also more difficult because of the challenges to coordinate separate planning and budgeting processes for different parts of the budget. In the future, Indonesian authorities may want to consider how to refine the mandates and functions of the various institutions that support the CoG, and to empower the President's office (or its designate), or another institution, to play a stronger role in managing the policy process.

Hand-in-hand with high quality of spending is the effort to improve transparency and accountability so as to maximize funding flows to the most vulnerable and the areas of most pressing need. Indonesian public policy faces governance problems that weaken its effectiveness and delay the impact of public spending. Corruption detection and enforcement have received relatively more attention than corruption prevention in the public sector space. The Indonesian Corruption Eradication Commission (KPK) has been engaged in investigating, prosecuting, supervising, preventing and coordinating efforts to combat corruption, with some palpable high-profile results. Strengthening the KPK as a well-funded independent body is critical. Weaknesses remain in the judiciary for establishing a viable legal system to enforce contracts and increase investment security. In addition, more attention should be given to corporate governance, also important for improving the overall investment climate, with issues in the enforcement capabilities of regulators, weak boards and corporate governance culture, and little participation of institutional investors.

The next decade represents the most favorable window for eradicating extreme poverty and increasing the prosperity of the Bottom 40 in Indonesia. The country's ongoing "demographic dividend" will end by around 2030, when the population above 65 years of age will start increasing faster than the population of working age. When Indonesia reaches that point, potential growth is expected to decline as a result of reduced labor supply, lower savings rates and perhaps less entrepreneurial innovation. Thus, reforms and growth levels in the next decade or so will determine whether Indonesia will climb the income ladder and become "rich" before starting to get "old". That is, whether Indonesia will be able to mimic the experience of Japan, Hong Kong SAR, China, Singapore and South Korea, all of which became "rich" before becoming "old". World Bank calculations show that reaching high-income status by 2030—i.e., a per-capita income of USD 12,000—requires growing by 9 percent annually over the next 16 years.¹⁶ Short of this exceptionally

¹⁶ Using constant 2013 US dollars.

high rate of growth, growing at least above the current 5 percent “trend” growth rate would be required to position the country well to move onto the next level.

With China shifting away from commodity-intensive investment, the commodity tailwinds that have supported Indonesia’s growth are morphing into headwinds and the authorities’ focus is both on the short-term and the long-term agendas. While implementing structural reforms for shared prosperity, Indonesia has been managing the macro-fiscal impacts of the end of the commodities boom to safeguard hard-won gains in poverty reduction and maintain macro-stability. The exchange rate has depreciated by more than 30 percent since mid-2013; monetary policy has tightened; fuel subsidies, a key source of fiscal risk over the past few years, have been dramatically reduced. This response has achieved the goal of maintaining stability at the cost of adding to the slowdown in domestic demand. This brings to the fore the two cross-cutting pre-requisites discussed above. Policy measures to strengthen tax and non-tax compliance and the removal of expenditure execution constraints are both crucial if growth is to rebound in the near term and the proceeds are to be focused on the shared prosperity agenda in a less supportive global environment. The country can do it as its impressive long-term growth and poverty reduction trajectory attests. But the clock is ticking.

Table 1: Summary of Indonesia SCD Priorities

| Pathway | Key Area | Indonesia SCD Priorities |
|---|---------------------------|---|
| Pathway 1 – Economic Growth and Job Creation | Infrastructure and Energy | <ul style="list-style-type: none"> • Increase investment in both urban and rural infrastructure, given rapid urbanization and significant infrastructure gaps in rural areas. • Increase investments in the energy sector given the need for a rapid supply response to growing energy demand, while also focusing on enhancing the efficiency and sustainability of the sector. • Increase mobilization of private investments for infrastructure, given that public financing will be insufficient to address the significant investment needs. • Mainstream disaster risk resilience in infrastructure investments. |
| | Business Environment | <ul style="list-style-type: none"> • Enhance the openness and consistency of trade and investment regulations. • Improve the business climate, particularly by streamlining business licensing. • Deepen financial markets, given severe credit constraints. • Ensure flexible labor markets, by addressing potential constraints in severance payments and moving to a formula-based minimum wage setting. • Close the country’s skills gap, by strengthening early childhood and basic education and technical and vocational training. • Modernize agricultural policies, away from the current narrow focus on ‘food sovereignty’ in rice to higher value-crops and processing. |

| | | |
|---|--|--|
| Pathway 2 - Service Delivery and Opportunities for All | Service Delivery and Opportunity for All | <ul style="list-style-type: none"> • Collect more fiscal revenues (see “pre-requisites” below) • Incentivize performance of LGs by increasing the share of the DAK in the total allocation and refocusing the DAK’s targeted sectors to a few critical ones (e.g., water supply, sanitation, transport and health) • Tailor fiscal policy (e.g. transfers) towards sub-national governments to the challenges faced by different “clusters”, namely large municipalities, small- and medium-sized cities, and rural districts • Eliminate perverse incentives in the grant allocation system in order to encourage more spending on local services and infrastructure and less on personnel and administration • Build capacity and enhance the performance of local governments; and adopt a more bottoms-up approach to management and reforms of local services. • Expand social assistance, given that social assistance spending is about a third of comparable countries, while ensuring fiscal sustainability of the programs and focusing on programs which have been most effective in reducing poverty and inequality. |
| Pathway 3 - Natural Resources and Environment | Natural Resource Management | <ul style="list-style-type: none"> • Reform the governance of land allocation, land rights access and spatial planning, including by accelerating programs on land registry and REDD+. • Adopt a more integrated approach to agriculture, energy and water management, given their linkages. • Strengthen the sustainable management of marine and fishery resources, in order to increase the overall economic value of the resources and diversify and create jobs, particularly in Eastern Indonesia. |
| Cross Cutting Prerequisite 1 – Collect More and Spend Better | | <ul style="list-style-type: none"> • Implement sustained fiscal reforms, in particular reforms to collect more revenues given the large spending needs envisioned for infrastructure and social assistance programs. |
| Cross Cutting Prerequisite 2 – Governance | | <ul style="list-style-type: none"> • Update and modernize public sector institutions, particularly in order to strengthen coordination across different stakeholders and levels of the government. • Strengthen the Center of Government, especially in regard to the management of major capital projects. • Streamline the bureaucracy in order to address fragmentation of roles and functions and enhance accountability. • Expand anti-corruption efforts, including by strengthening the Indonesian Corruption Eradication Commission (KPK), the judiciary and corporate governance. |

I. Introduction

Indonesia is the largest economy in Southeast Asia, fifteen largest in the world and a member ASEAN and the G20. With a GDP per capita of USD 3,510 (current prices), it ranks slightly above that of Guatemala, but significantly behind neighboring Malaysia (USD 10,452).

Indonesia is a vast nation with a population of over 250 million, the fourth largest in the world. While it is the world's largest Muslim-majority nation, its population includes 300 distinct native ethnic groups with over 700 languages and dialects. It is the world's largest archipelagic state and encompasses an estimated 17,508 islands, of which some 6,000 are inhabited. Indonesia extends 5,120 kilometers from east to west and 1,760 kilometers from north to south, straddling the equator and located along major sea lanes from the Indian Ocean to the Pacific Ocean. Indonesia has the most volcanoes of any country in the world and is plagued by a number of natural hazards that include earthquakes, volcanic eruptions, tsunamis, floods, droughts, and forest fires. There are five main islands, two major archipelagos, and 60 smaller archipelagos. The island of Java, where 58 percent of the population lives, is the most densely populated island in the world. Eleven cities have over one million inhabitants. The largest is Jakarta with 9.5 million, with four other cities of over 2 million peoples all located in Java except one in Sumatra.

Indonesia has remarkably more than halved extreme poverty since 1999 to 11.3 percent in 2014, but another 27 percent of the population (65 million people) live between the official poverty line and less than 50 percent more than that poverty line, i.e., they are highly vulnerable to slipping into poverty. Infant (29 per 100,000 live births) and maternal mortality (190 per 100,000) are much higher than in neighboring Malaysia (7 and 29) and Thailand (11, and 26). Indonesia's maternal mortality is comparable to India but lower than Myanmar's (200 per 100,000). Malnutrition rates are high with 37.2 percent of children stunted, 12.3 percent wasted and 18.5 percent underweighted. These rates are as high as in the Philippines, which has only 80 percent of Indonesia's per capita income. Income and geographic disparities in health are huge with for instance under-five mortality in Jakarta, Yogyakarta and Bali almost four times lower than in Papua. Under-five mortality among the bottom 40 percent is two-and-a-half times higher than among the richest quintile of the population.

With adult literacy at almost 95 percent, gross enrollment is 109, 83 and 32 percent in primary, secondary and tertiary education, respectively, with the share of female enrollment exceeding that of males at each level. While equity in access to basic education has increased across socio-economic groups and geographically, large disparities in the quality of education received remain.

Indonesia is the world's third most populous democracy and recently, after competitive elections, a new President took office. Executive power is fairly balanced with a legislature and judiciary, and the press is considered to be free. However, Indonesia ranks poorly at 107 in Transparency International's Corruption Perceptions Index, and is plagued by corruption and patronage practices.

Previously one of the most centralized countries under the Soeharto regime, today Indonesia is one of the most decentralized countries in the world, divided into 34 provinces, 511 districts/cities and some 72,000 villages. With the rapid decentralization process beginning in the early 2000s, districts have been given significant responsibilities for infrastructure and social service delivery. Villages have received some funding for local investments over the years, but recent legislation has increased this significantly.

The Systematic Country Diagnostic (SCD) is a diagnostic exercise designed to identify the most critical binding constraints and opportunities facing a country in furthering its advancement and making sustainable progress toward the World Bank Group's (WBG) twin goals of ending extreme poverty and boosting shared prosperity. The exercise is conducted in close consultation with national authorities and other stakeholders and is based on the current available body of knowledge. A greater analytical understanding of these priority areas will help to inform the preparation of the World Bank Group.

In this SCD for Indonesia, we analyze past trends in growth, poverty and shared prosperity to understand their “deep” drivers, identify the key channels for reducing poverty and increasing the prosperity of the Bottom 40 percent, and highlight the key policies priorities, challenges and opportunities to support these two goals.

II. Trends in Economic Growth

Indonesia rebounded strongly from the Asian financial crisis in 1997 and enjoyed solid growth until 2012. Following a 13 percent contraction in 1998, output growth recovered strongly, grounded on gradually increasing private sector investment and robust domestic consumption. Real GDP growth averaged 4.7 percent in 2000-05, 5.7 percent in 2006-10 and 6.0 percent in 2011-12, demonstrating Indonesia's resilience to the global economic downturn in 2008. The country's GDP almost doubled from USD 580 billion in 2001 to USD 1.1 trillion in 2012, making Indonesia the 15th largest economy in the world and member of the G20.¹⁷ Remarkably, healthy growth has gone hand-in-hand with low fiscal deficits (average 1.4 percent of GDP in 2000-12), a sharp decline in the debt-to-GDP ratio (from over 100 percent in 2000 to just 25 percent in 2012) and external surpluses until mid-2013, when a current account deficit opened for the first time since 1997.

The growth slowdown experienced since 2012 suggests however that growth is strongly influenced by global commodity markets.¹⁸ Indeed, since 2012, weaker global commodity prices and demand, and tighter domestic financing conditions, have reduced growth momentum (5 percent in 2014). Indonesia has been managing the macro-fiscal impacts of the end of the commodities boom to safeguard hard-won gains in poverty reduction and maintain macro-stability. The exchange rate has depreciated by more than 30 percent since mid-2013; monetary policy has tightened; and fuel subsidies, a key source of fiscal risk in the past few years, have been dramatically reduced. This response has achieved its goal of stability but at the cost of adding to the slowdown in domestic demand.

2.1. Growth during the Commodities Boom

The significant rise in commodity prices in 2003-11 led to massive income and wealth effects and a rise in aggregate demand. From 2003 to 2011, the world went through one of the greatest commodities booms of all time. Rapid growth in China, India and other emerging economies translated into rapid increases in demand for many commodities and a sharp rise in prices. Benchmark international prices for coal, crude palm oil, rubber and crude oil—all important export commodities for Indonesia—each rose threefold, in real US dollar terms, between 2000 and 2010. Indonesia, one of the most commodity-abundant countries in the world, benefited substantially from this boom. As summarized by the table below:¹⁹

- **The terms of trade and net exports increased sharply.** Indonesia's terms of trade doubled in 2003-11 leading to a tripling of annual export earnings to USD 203.5 billion in 2011, thanks to a sharp rise in commodity exports. Indonesia's trade surplus then reached record levels (annual average USD 19 billion) and significantly contributed to the surpluses in the current account (0.2 percent of GDP in 2011) and balance of payments (gross reserves jumped to USD 110 billion from USD 34.7 billion in 2005).
- **Investment recovered to its pre-1997 Asian financial crisis level.** The boom filtered into corporate revenues and led to a big increase in investments. After falling dramatically after the 1997/98 crisis, Indonesia's investment-to-GDP ratio recovered strongly a few years into the commodities boom, moving up to 32 percent in 2012 (compared with ratios of 27 percent in

¹⁷ All in constant 2005 USD, PPP.

¹⁸ World Bank, 2014, *Avoiding the Trap*. Development Policy Review 2014.

¹⁹ For more details, see World Bank, 2014, *Avoiding the Trap*. Development Policy Review 2014.

South Korea, 30 percent in India and an extremely high 46 percent in China, for example). While much of this increase has been due to rising investment prices, real investment growth has averaged an annual 8.4 percent over 2008-12 (up from 7.6 percent over 2003-07), and has tracked commodity prices. Econometric analysis shows that terms-of-trade gains contributed around one-third to investment growth over 2005-11.

- **Household incomes increased, boosting private consumption.** The direct rise in the value of resource assets, as well as that of other assets purchased on the back of commodity incomes or commodity wealth, significantly encouraged consumption against these assets. As seen in Section 2, thanks to robust job creation, Indonesia's consumer class grew at 11 percent a year between 2002 and 2014, and now makes up 18 percent of the population (43 million). Real private consumption growth averaged 4.5 percent per year over the period 2003-12, with peaks of 5.3 percent in 2008 and 2012, and private consumption now accounts for 55 percent of nominal GDP (2012).

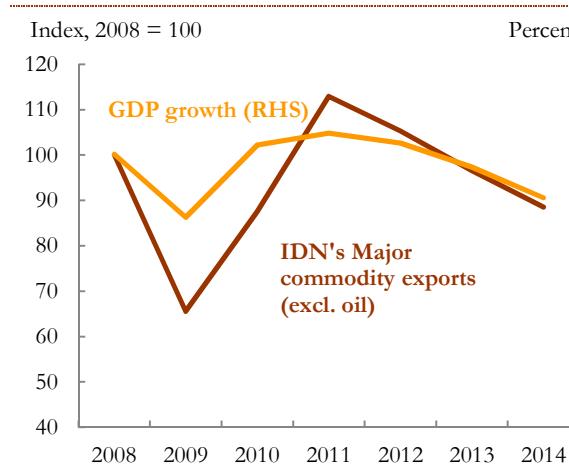
Table 2.1: Terms of trade and growth indicators

| TOT, 2008=100 | Percent, year-on-year growth | | | | Exports |
|-------------------------|------------------------------|-------------|------------|------------|------------|
| | GDP | Consumption | Investment | | |
| 2008 | 100.0 | 6.0 | 5.9 | 11.9 | 9.5 |
| 2009 | 70.7 | 4.6 | 6.2 | 3.3 | -9.7 |
| 2010 | 100.7 | 6.2 | 4.1 | 8.5 | 15.3 |
| 2011 | 126.5 | 6.5 | 4.5 | 8.3 | 13.6 |
| 2012 | 108.3 | 6.3 | 4.8 | 9.7 | 2.0 |
| 2013 | 80.5 | 5.7 | 5.2 | 4.7 | 5.3 |
| 2014 | 72.7 | 5.1 | 5.0 | 4.4 | -1.2 |
| Average: 2008-12 | 101.2 | 5.9 | 5.1 | 8.3 | 6.2 |
| Average: 2013-14 | 76.6 | 5.4 | 5.1 | 4.6 | 2.0 |

The commodities sector directly and indirectly contributed to the strong recovery of GDP growth following the 1997/98 crisis. Commodity-related sectors accounted directly for around one-fifth of real GDP growth between 2002 and 2012 (around one-tenth each from primary and secondary commodities sub-sectors). Given the rise in commodity prices, these sectors' contributions to nominal GDP have been much greater (around two-fifths). Indeed, as Figure 2.2 shows, Indonesia's overall GDP has become highly correlated with growth in the commodities sector. In part, this reflects the second-round effects from commodity-related activity on GDP via demand for other goods and services.²⁰

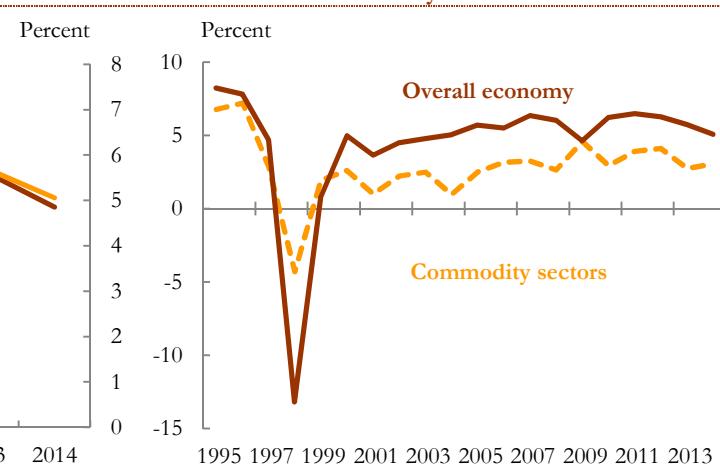
²⁰ These effects are hard to quantify but using the 2008 Input Output table (the most recently publicly available data), a one unit rupiah rise in final demand for the commodity manufacturing sector increases total economic output by 2.14 units (with a direct effect on own commodity manufacturing sector output of 1.37 unit and indirect effect on the output of other sectors of 0.77). The mining sector multiplier is lower at 1.31 (primarily direct effects).

Figure 2.1: Commodity prices and real GDP growth



Source: BPS

Figure 2.2: Real GDP growth: commodity sectors and the overall economy



Source: BPS

A key feature of the commodities boom was the rise in the (largely non-tradable) services sector reflecting in part a sharp appreciation of the real exchange rate (RER). The services sector, broadly defined, contributed an average 3.3 percentage points (pp) to total GDP growth, against 1.8 pp for industry and 0.6 pp for primary sector in 2003-12. The expansion of the services sector was associated with the appreciation of Indonesia's RER, following more than two decades of overall sharp depreciation, during which investments into manufacturing export industries boomed (Figure 2.3). In contrast, the appreciation of the RER in 2002-12 led to a decline of investments flowing into these sectors and a rise of investments in domestically-oriented sectors, chiefly services. There is also evidence that the liberalization of the retail trade in 1998, telecoms from 1999 and air transport in 2004 contributed to the rise of investment and growth in these sectors.²¹ Between 2001 and 2010, the share of transport and communications, financial services and retail trade, hotel and restaurant in total foreign investment flows almost doubled to an average of 63 percent in 2010. A large part of the services sector is composed of micro, small and medium-sized enterprises contributing around 57 percent to GDP and 47 percent of total employment. As shown in Section 3, more than 80 percent of the new jobs created in 2001-11 were in the services sector.²²

In agriculture, exported estate crops expanded in contrast with food crops, which faced significant challenges responding to rising domestic demand. Agriculture grew by an annual average of just 0.6 percentage points in 2003-12, contributing only 10 percent to aggregate growth in that period. This performance reflects the net impact of lackluster growth for most food products, largely offsetting the rise in palm oil and rubber production. The high prices of these products on world markets have supported investment, production and yields. The OECD (2012) finds that diversification away from food staples into palm oil production and other high-valued commodities drove agricultural total factor productivity in the past decade (explaining 60 percent of agriculture growth in that period).²³ This structural transformation within agriculture, combined with rapid

²¹ See, for instance, Dharmawan, Gusti, Ngurah, Irwan, 2012, *The Effect of Air Transport to Economic Development in Indonesia*, Erasmus University of Rotterdam, Erasmus School of Economics.

²² The implications of the expansion of the service sector on poverty and vulnerability are examined in Chapter 2.

²³ OECD, 2012, Agriculture Policy Review Report, p.5-6.

domestic demand for food driven by rising per capita incomes and urbanization, has led to a rapid rise in imports of horticultural products and a movement of labor from agriculture into urban services.

The rise in services and relative decline in agriculture, albeit while both sectors faced high consumer demand, is consistent with “Engel’s Law” effects in consumption. This “law” stipulates that demand for services tends to increase more with income thanks to higher income elasticity of demand of services relative to agricultural products (Chenery, Robinson and Syrquin, 1986).²⁴ In addition, supply of services to customers in urban areas is less constrained than supply of agriculture, explaining a more rapid response of domestic production to rising demand. Indeed, while production and consumption of services often occur simultaneously (investments are often made where the demand is), a key challenge for agriculture and manufacturing is to remain competitive in distant markets (e.g., urban centers), due to high transport and distribution costs in Indonesia.

Figure 2.3: The real exchange rate appreciated over the past decade

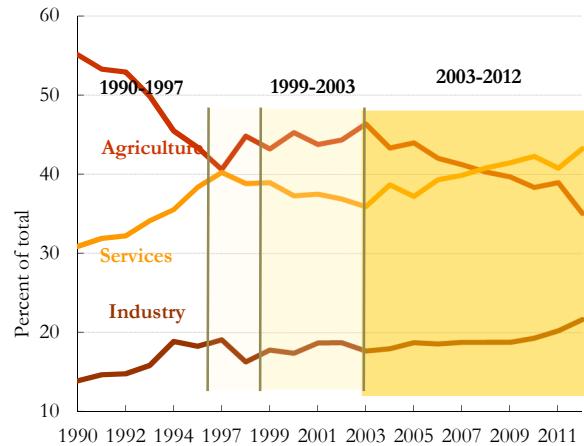
(Index, 2000=100)



Source: CEIC; BIS; World Bank staff calculations

Figure 2.4: Changes in the size of different sectors (structural transformation)

(percent of total employment)



Source: BPS

2.2. Growth after the Commodities Boom

Since 2012, Indonesia has been experiencing the typical macro-fiscal effects of commodity price declines in a resource economy. Key export commodities peaked in 2011 and dropped by about 40 percent by the end of 2014. This sharp decline in commodity export prices, coinciding with a rapid increase in oil imports, sharply reduced Indonesia’s trade surplus and led to the opening of a large current account deficit for the first time in 15 years. From a surplus of 0.2 percent of GDP, the current account turned into a large deficit: 2.7 percent of GDP between 2011 and 2012. On the fiscal side, softer export commodity prices, combined with lower production of oil, reduced oil and gas revenues and increased fiscal pressures through 2014. Government nominal revenues growth dropped from 22.7 to 7.7 percent, in line with the sharp decline in oil and gas revenues growth from 33.6 percent in 2011 to -20.9 percent in 2012 (non-oil and gas revenue growth decreased to 3.2 percent in 2012, from 18 percent in 2011). At the same time, due to high crude oil prices until mid-2014 and a sharp depreciation of the rupiah in the second half of 2013 (see below), energy subsidies increased

²⁴ Engel’s effects refer to the Engel’s Law, introduced by Ernest Engel in 1857, which stipulates that as households’ income increases, the percentage of income spent on food decreases while the proportion spent on other goods and services increases.

significantly. Both external and fiscal pressures mounted sharply as a result of the softening of commodity prices since 2011, forcing the Government to adjust the policy setting and focus on maintaining macroeconomic stability.

Indonesia's macro policies have been significantly adjusted since mid-2013. Bank Indonesia (BI), the country's central bank, tightened monetary policy up until November 2014 (a cumulative increase of 200 basis points), contributing to a halving of credit growth, before easing its key reference interest rate by 25bp to 7.25 percent in February. At the same time, to avoid a decline in foreign reserves, assist the reduction of the current account deficit and absorb external possible shocks following the “taper tantrum”, BI kept the exchange rate flexible. In the second half of 2013, the rupiah depreciated by 26 percent. The rupiah has continued to trend lower against the US dollar by about 8 percent in the year to March 2015. However, US dollar strength has been broad-based and Indonesia's domestic prices have increased at a relatively faster pace, so the rupiah has in fact again strengthened significantly in real trade-weighted terms since mid-2014.

The fiscal sector has also had to adjust to the effect of lower oil and gas revenues and higher energy subsidies to support macro-fiscal stability. Faced with the challenge of slowing revenues and mounting energy subsidies, the Government increased domestic fuel prices by an average 33 percent in June 2013. However, much of the fiscal savings from this reform was lost by the end of 2013 due to the sharp depreciation of the rupiah. The fuel subsidy thus kept increasing: IDR 212 trillion in 2012, IDR 221 trillion in 2013 (despite the fuel subsidy reform) and IDR 246 trillion in 2014. On November 2014, the new Government decisively increased fuel prices by 30 percent. This was followed by the complete removal of the subsidies for gasoline and the capping of subsidies for diesel through a new market-based price determination formula. The year 2015 marks the first year of significantly reduced fiscal risk since 2011.

As a result of the softening of commodity prices and the consequent adjustment of the policy settings, Indonesia's GDP growth has been slowing since 2012. Weaker global commodity prices and demand, and tighter domestic financing conditions, have weighed on the economy, with fixed investment growth roughly halving since 2012 (up 4.1 percent in 2014) and exports contracting slightly (-1 percent in 2014 from 13.6 percent in 2011). Consumption growth also softened in 2014, to 4.8 percent from 5.6 percent in 2013. Consistent with slower output growth since 2012, net job creation has slowed to an annual average of 0.9 percent, only just enough to keep the share of working age Indonesians in employment stable, at 62.6 percent (based on the most recent two labor force surveys, conducted in August 2013 and 2014). Poverty reduction has also been slowing, with the USD 1.25 poverty rate falling by an average of 1.7 percentage points between 2011 and 2013, but slowing to 1.1 percentage points in 2014 and now sitting at 8.6 percent. This trend is consistent with the national poverty rate, which is falling even more slowly as prices for the poor have risen even faster than the CPI. Indonesia's challenge in the years to come is to implement decisive structural reforms in order to revert to a higher growth rate and reduce poverty.

2.3. Growth and Employment

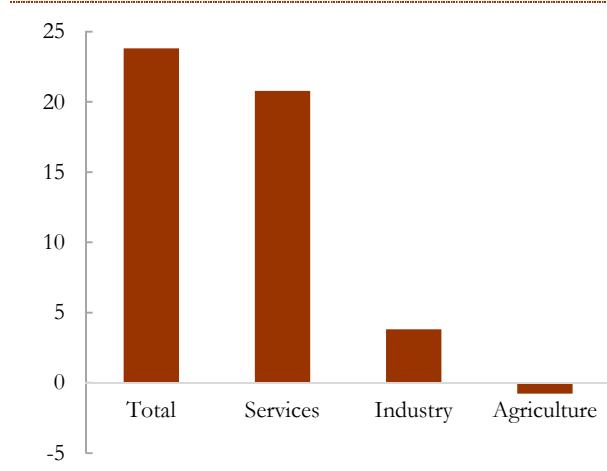
2.3.1. Economic growth led to massive job creation in 2001-12

Consistent with the solid economic growth, job creation was robust in 2001-12, especially in the services sector. Close to 21 million of the 23.8 million new jobs created between 2001 and 2014 were in the services sector. Within this sector, out of the total job growth, 31 percent occurred in community, social and personal services (where 7.4 million new jobs were created), 30 percent in

wholesale, trade and retail (7.3 million new jobs) and 14.5 percent in construction (3.4 million new jobs). Comparatively, agriculture (where 34 percent of total workers are still employed) lost 770,000 jobs as agricultural workers migrated to urban areas, attracted by higher paying but still low-productivity jobs. The industry sector excluding construction (currently 15 percent of total employment) created only 3.8 million new jobs, of which 3.1 million were in manufacturing. Employment in mining, and oil and gas rose fast in line with the commodities boom, but the labor absorption capacity of these sectors is limited.

Figure 2.5: Close to 21 million of all new jobs (23.8 million) between 2001 and 2014 were created in the services sector

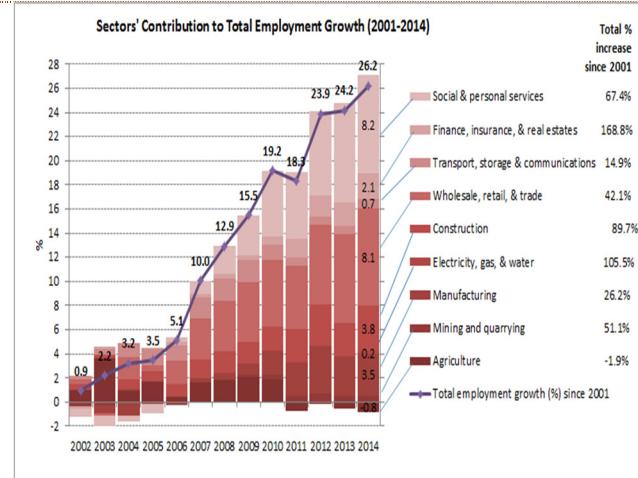
(million)



Source: BPS

Figure 2.6: Most services subsectors created a large number of jobs

(percent)



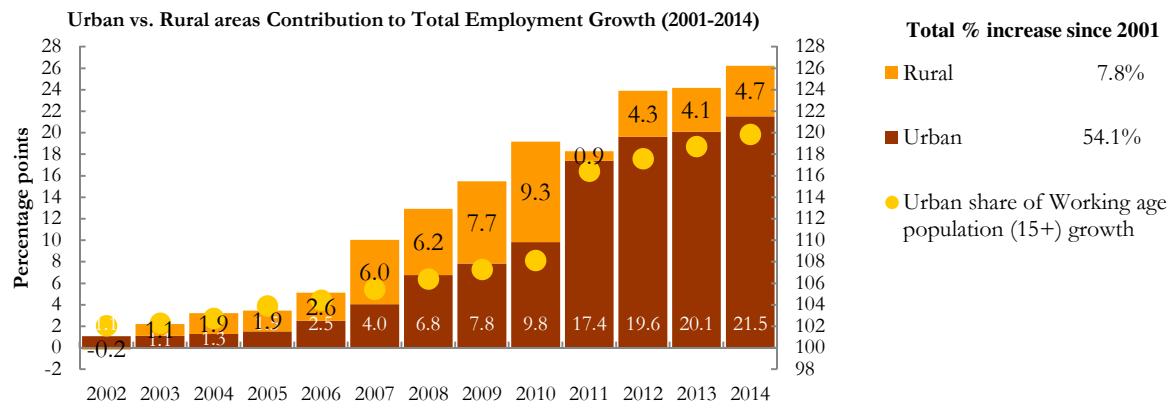
Source: BPS, Sakernas data (employment survey)

The boom in the services sector predominantly occurred in urban areas, leading to an acceleration in urbanization and job creation in urban areas. Total urban employment has grown by a total of 54 percent since 2001 and has gradually overtaken rural employment over the past decade. Furthermore, since 2008 jobs in urban areas have been growing faster than the working age population (Figure 2.7). While the working age population continued to increase between 2005 and 2012, the share of the employed to the working age population rose from 60 to nearly 64 percent, reaching its mid-1990s levels, but has remained stagnant at 62.6 percent in the two following years.²⁵ Rural dwellers have also indirectly benefited from growth and the sharp recovery in urban job markets through outmigration of low productivity workers to urban areas, remittances and spillover effects of growth in proximate urban markets (e.g., on demand for rural goods and services). These factors have helped to reduce rural poverty.²⁶

²⁵ Out of a population of 182 million people aged over 15, Indonesia can count on a total labor force of 121 million, of which 114 million are employed (Sakernas, 2014, August).

²⁶ World Bank, 2014, *Avoiding The Trap*, Development Policy Review 2014.

Figure 2.7: The bulk of employment growth occurred in urban areas, where almost 19.5 million of the 23.8 million new jobs were located

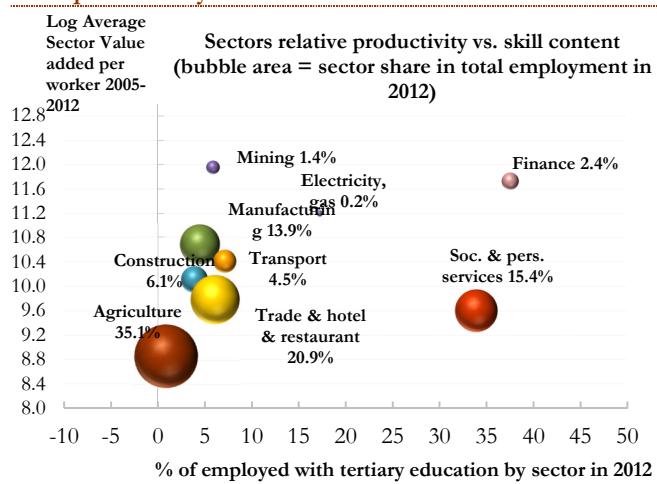


Source: BPS Sakernas data (employment survey)

2.3.2. Most jobs were created in low-productivity sectors

While dynamic labor markets have helped to reduce poverty, they have not reduced vulnerability, because most of the new jobs were created in low productivity sectors.²⁷ The agriculture and ‘wholesale, retail, hotel and restaurant’ (low-end services) sectors, which employ the largest number of vulnerable workers (Table 2.1), have the lowest levels of labor productivity in the economy. Agriculture and wholesale, trade, hotel and restaurant employ 35 and 21 percent of total workers, respectively. They happen to be the two sectors with the lowest productivity and skill-content in the economy (Figure 2.8). Furthermore, less than 10 percent of workers in these sectors have a tertiary level of education and more than 60 percent have no formal contracts. Because of the weight of these sectors in total employment, the overall picture of the economy is one that features a predominance of low value-added, low-skilled, low-productivity sectors, in sharp contrast to Malaysia, for instance (Figure 2.8 and Figure 2.9).

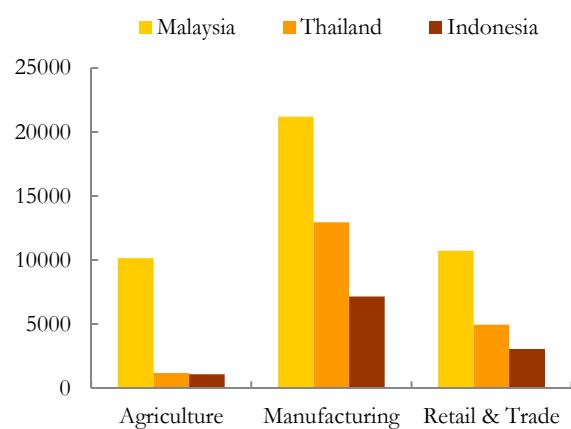
Figure 2.8: Employment in Indonesia is concentrated in low-productivity sectors



Source: BPS and World Bank staff calculations;

Note: *Labor productivity is measured as the value-added (in constant 1990 PPP\$) per person employed.

Figure 2.9: Average sector productivity: Indonesia vs Malaysia and Thailand*

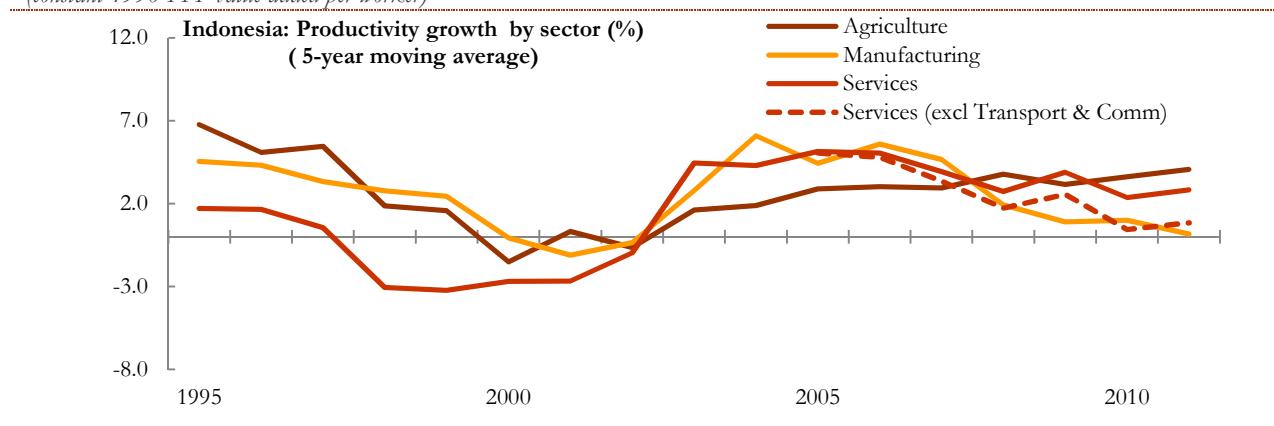


²⁷ As shown in the next paragraphs, productivity in these low-productivity sectors generally did not grow fast, explaining sluggish real wage trends.

Not only are levels of productivity generally low, but sectoral labor productivity growth generally decelerated in the second half of the 2000s. Following the 1997/98 Asian financial crisis during which productivity collapsed in all sectors, productivity growth rebounded uniformly in 2002, but the rebound proved short-lived for most sectors (Figure 2.10). For instance, from a peak 6 percent growth in 2004, average labor productivity growth in manufacturing dropped to only 1 percent in 2010 and close to zero in 2011. The low-end services sub-sectors experienced a similar trend as they absorbed a large number of workers, in contrast to the transport and communications sub-sectors, which held up well in terms of productivity growth, preventing an otherwise sharper decline of productivity dynamics of the overall services sector (Figure 2.10). In the agriculture sector, overall productivity increased as a result of two factors: (i) the release of low-productivity workers, and (ii) investment-driven technology improvements in palm oil, rubber and other estate crops (see Indonesia DPR, 2014). Productivity in agriculture remains, however, much lower than its levels in the mid-1990s.

Figure 2.10: Sectoral labor productivity trends

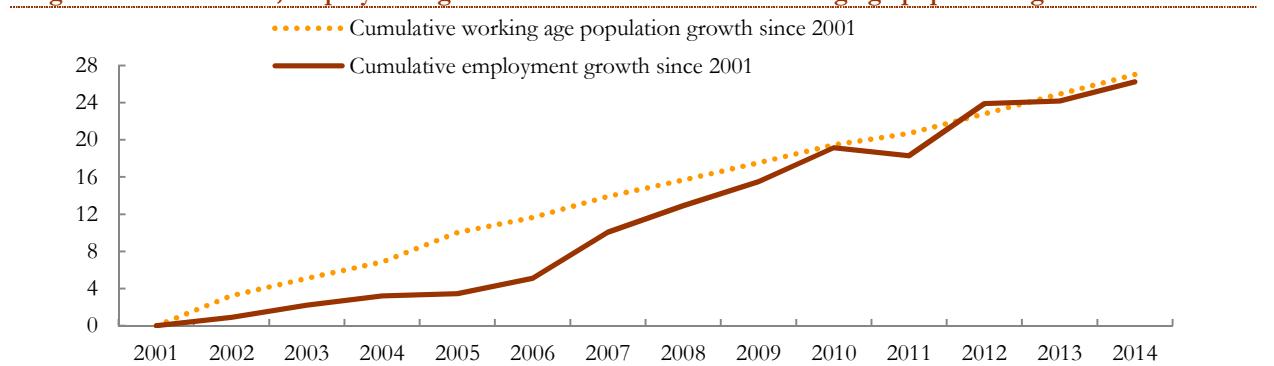
(constant 1990 PPP value-added per worker)



Source: BPS, World Bank staff calculations

Stronger growth will be required in the next few years for employment to catch up with growth of the working age population and avoid raising unemployment. During the commodity boom years, between 2005 and 2012, employment grew by 2.8 percent per year, on average, as opposed to 1.8 percent annual growth of the working-age population, generating an increase in the employment rate. In the two last years, however, due to slower economic growth, employment grew only by 1.2 percent per year, against a 2.1 percent annual increase in the working age population (Figure 2.11).

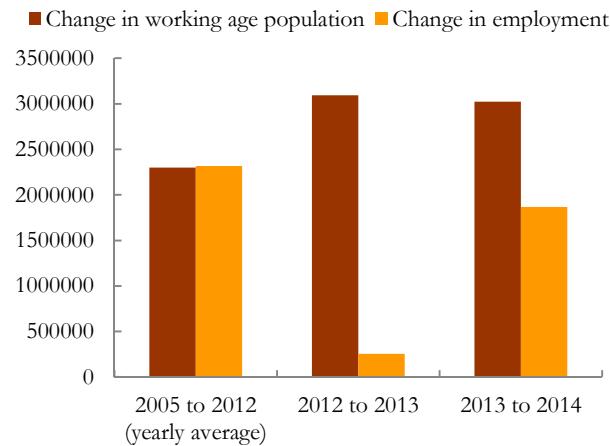
Figure 2.11: Since 2012, employment growth has been lower than working age population growth



Source: BPS and World Bank staff calculations

Slower growth implies that only 2.1 new million jobs have been created since 2012, as opposed to 6.1 million new entrants in the working age population, of whom only around 0.8 million are students. Assuming an annual elasticity of employment to growth of 5 percent, GDP should grow at least an extra 0.45 of a percentage point in 2015 (compared with the 2013-14 average annual growth rate) if the labor market is to absorb all new labor market entrants and avoid a future increase in unemployment or inactivity. Forty percent of women versus 30 percent for men are under-employed.²⁸

Figure 2.12: Out of 6.1 million new entrants in the working age between 2013 and 2014, only 2.1 million have been absorbed by the labor market



Source: BPS and World Bank staff calculations

²⁸ Underemployed are defined as workers employed less than 35 hours per week. Note that the phenomenon is mostly voluntary for both men and women. Only 10 percent of employed men and 8 percent of employed women are underemployed involuntarily.

III. The Contrasting Patterns of Poverty, Vulnerability and Inequality

3.1. Extreme Poverty: Reduced Sharply, but Persists

Remarkably, poverty in Indonesia was more than halved from 23.4 percent in 1999 to 11.3 percent in 2014 (about 27 million people), using the national poverty line. This performance reflects a similar trend in urban and rural areas (Figure 3.1). However, at 8.3 percent in 2014, the urban consumption-poverty rate is much lower than in rural areas where the poverty headcount averages 14.2 percent. Indonesia's poverty performance has been in line with other EAP countries since the Asian financial crisis, but has lagged that of Vietnam and Cambodia after recovery from the crisis (Figure 3.2).

Figure 3.1: Evolution of official poverty rate, 1996-2013

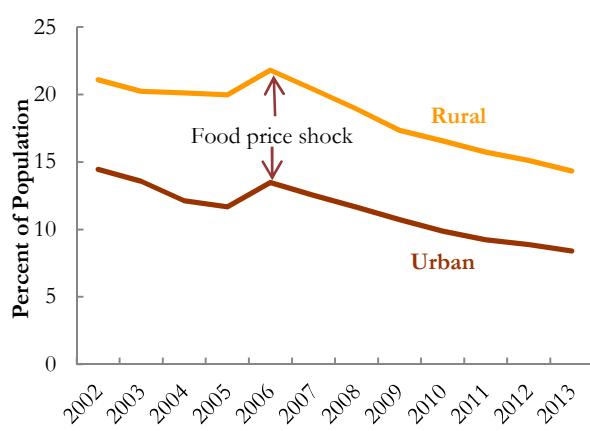
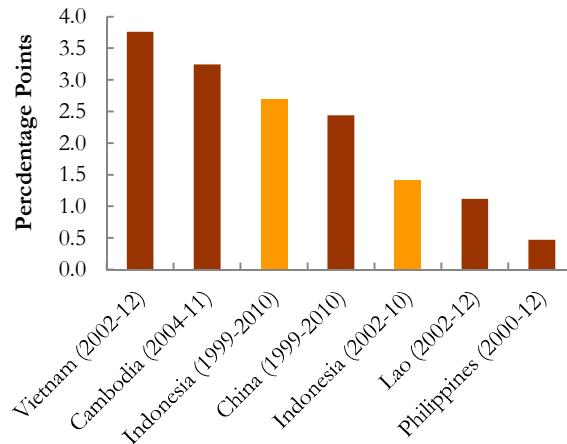


Figure 3.2: Change in poverty rates 2000-12*, Indonesia versus EAP countries (international poverty lines)



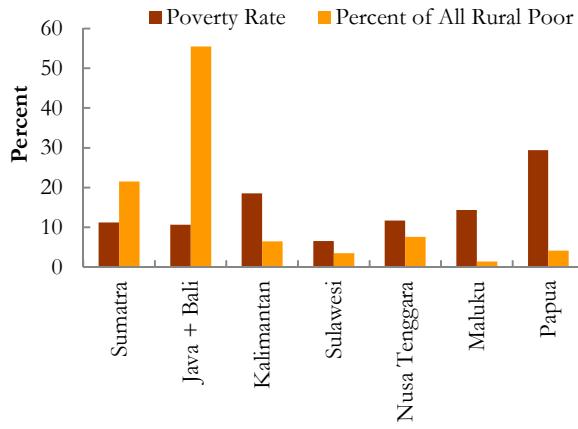
Source: PovCalNet

Note: Thailand and Malaysia are excluded as poverty was less than 5 percent in 2000; International poverty line of USD1.25 PPP per person per day

In terms of geographical distribution, poverty rates are highest in eastern Indonesia (30 percent in Papua) and lowest in Kalimantan, a resource-rich and low-density region (Figure 3.3). Despite enjoying among the lowest poverty rates in the country, the densely populated Java and Bali regions (60 percent of total population) are home to just over half of all Indonesia's poor. This highlights the policy need to focus on all regions of the country when addressing poverty.

Poverty rates are highest for households living in and on the edge of forests and are higher than the national average for people living in coastal areas. This is reflected in the

Figure 3.3: Geographical distribution of national poverty (2014)



Source: Susenas and World Bank calculations

poverty rates of households whose head worked in forestry (29 percent) or fisheries (15 percent) in 2012. In sharp contrast, poverty rates for those whose head worked in industry (9 percent) or services (6 percent) were much lower. Forest areas with the largest number of poor are located in Papua (eastern Indonesia) where poverty rates are highest, Sulawesi (North-East) and Central Kalimantan (North)—see map. Households living in or near forest areas derive the bulk of their incomes from forest ecosystems. It is estimated 20 percent of income of rural population stems from natural resources. In Papua, 50 percent of income is linked to forest activities and other natural resources. Thus lifting the “hard core” poor durably out of poverty is tied to a more sustainable management of natural resources and improving the rural economy broadly, not only agriculture but also non-farm activities.

Figure 3.4: Poverty rates for populations living in and on the edge of forests



3.2. The Bottom 40 Percent: A Highly Vulnerable Group

The relative success in reducing extreme poverty has not been reflected among “vulnerable” households, which are not officially poor but are also far from being safe and secure from poverty. This group accounts for 27 percent of the population (65 million people) that lives between the official poverty line and less than 50 percent more than that poverty line.²⁹ The vulnerability rate has stayed constant since 2002 (Figure 3.5). Together, the poor and the vulnerable amount to about 38 percent of the population (to simplify, the bottom 40 percent). Eighty percent of the vulnerable live in Sumatra/Java/Bali and urban areas (43 percent of the vulnerable versus 37 percent of the poor). Of note, the upward mobility of the poor and the vulnerable is slow.³⁰ Of the poor in 2008, 75 percent failed to exit poverty or vulnerability by 2010. While this was mainly due to lack of productive employment (see Section III), some of it was due to shocks. Fifteen percent of the poor actually left poverty in 2009, but were poor again in 2010 (Susenas data).³¹

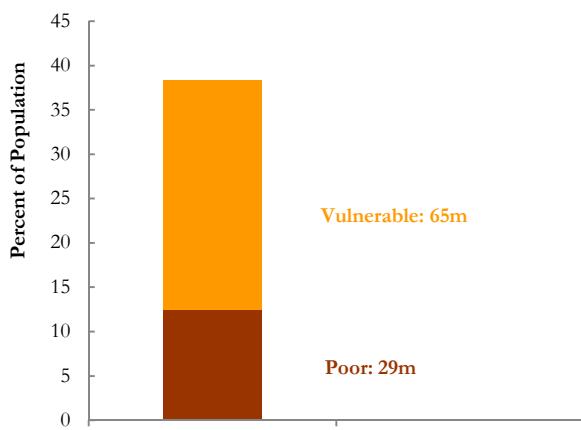
²⁹ The poor are those beneath the official poverty line; the vulnerable are those between the poverty line and 1.5 times that line.

³⁰ As seen below, the upward mobility of individuals in the bottom 40 percent is quite significant over a lifetime horizon.

³¹ The World Bank has recently conducted a study of risk and risk management in Indonesia. Drawing primarily on original qualitative evidence from four rural and peri-urban sites, this study explores in-depth the risks faced and risk management practices adopted at the household and community level in Indonesia. Preliminary findings show

Figure 3.5: Close to 40 percent of the population was poor and vulnerable in 2012

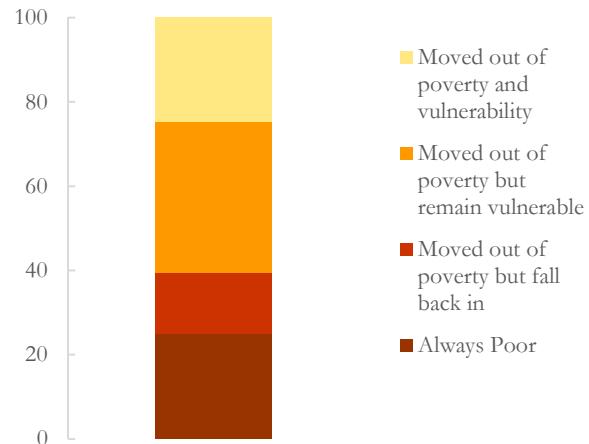
Percent of the population (percent) and number (million)



Source: Susenas data, World Bank staff calculations

Figure 3.6: 75 percent of poor households fail to move out of poverty or vulnerability over a three-year period

Status in 2010 of households who were poor in 2008 (percent)



Source: Susenas data, World Bank staff calculations

The bottom 40 percent of the population are highly vulnerable to food price shocks. Food makes up around 65 percent of total poor household consumption. Consequently, even relatively small increases in food prices tend to have a significant effect on individual welfare, and on the national poverty rate. It is estimated that a 10 percent increase in the overall cost of food would result in a relative increase in poverty of 3.5 percentage points. The food item that has the greatest impact on the poor and near-poor is rice. Rice alone makes up 23 percent of poor households' total expenditure. It is estimated that a 10 percent increase in the price of rice would result in the national poverty rate being 1.3 percentage points higher than it would otherwise be. Rice prices tend to remain high and volatile, due to high logistical costs and trade restrictions. Imports of rice are controlled by the State Logistics Agency (Bulog), the state logistics agency, and are not effective in smoothing rice prices; too little rice is bought too late, due to flaws in design and implementation. The Raskin program—subsidized rice for the poor—is intended to provide food support to 15 million poor and vulnerable households. However, due to much of the rice being lost during distribution from central procurement to the communities, and then further dilution of benefits due to communities informally sharing out what rice was received, the average monthly amount of rice purchased was only around 5-6kg per household, compared with an average monthly consumption of 40kg. This program thus does relatively little to support the poor and those on low incomes or protect them from rice price shocks.

Health-related expenditure shocks are also a key source of vulnerability for the bottom 40 percent.³² The latter benefit from an insurance program financed by the Government but, in reality, a combination of inaccurate targeting and poor implementation has meant that only around half are covered. Out-of-pocket spending is thus high. Overall, it accounts for 40 percent of total health spending in Indonesia. Low insurance coverage combined with generally poor access to good quality health care implies that over 40 million workers are at risk of lost or decreasing productivity and wages due to ill health and prolonged recovery from medical issues. It is estimated that almost 2.3 million

that the rural poor and near-poor face a wide variety of risks and shocks. Among these, food price and health shocks are the most important but they also arise from the high cost of participating in customary lifecycle rituals.

³² The latter has the worse health indicators among income groups: for instance, in 2012, skilled birth attendance was only 72 percent for them versus 97 percent for the richest quintile, while complete immunization rates among 12-23 years old stood at 32.8 percent versus 40.3 percent nationally.

individuals currently fall into poverty annually due to catastrophic health spending. The Government's goal is universal health coverage of all Indonesians by 2019, including workers in both the formal and informal sectors, under the national social security program. As discussed in Section 5 (reforms for inclusive growth), achieving this will require addressing a host of implementation challenges, as well as improving the availability of health care by reducing supply-side deficiencies.³³

In terms of jobs, the bottom 40 percent is heavily concentrated in low-productivity, low-paying activities mainly in the agriculture, and the “wholesale, retail, hotel and restaurant” sectors.

Error! Reference source not found. About 21 million of them are children from poor families; among the 44 million vulnerable adults, about one third (15 million) do not work, 42 percent (18 million) work in agriculture and 10 percent (2.9 million) work in the wholesale, retail, hotel and restaurant sector. The proportion of vulnerable workers within each sector is relatively high in all sectors except communications and banking/finance/business services. For instance, more than a quarter of workers in agriculture, construction and transport can be classified as vulnerable. Agriculture and the wholesale, retail, hotel and restaurant sectors, which employ the largest number of vulnerable workers, also have the lowest levels of labor productivity in the economy. Agriculture and wholesale, trade, hotel and restaurant (dubbed “low-end services”) employ 35 and 21 percent of total workers, respectively. They happen to be the two sectors with the lowest productivity and skill-content in the economy and are largely informal.

As a consequence of the persistence of low productivity jobs and vulnerable forms of work, real wages have been stagnant for the bottom 40 percent of the wage distribution (Figure 3.7). The two lowest deciles have actually experienced negative real wage growth, and for the third and fourth lowest deciles real wage gains have been modest (Figure 3.8). Real wage growth has been higher and more even for medium-high deciles (from the fifth up to the ninth), ranging between 19 and 26 percent, while those in the top decile have enjoyed up to 60 percent real wage increase over the period. Widening wage disparities over time have very likely added to the increase in overall inequality documented in the previous section, undermining the possibility for poorer workers to achieve higher living standards and greater prosperity.

Figure 3.7: Real wages have been stagnant for the lower part of the wage distribution between 2001 and 2014

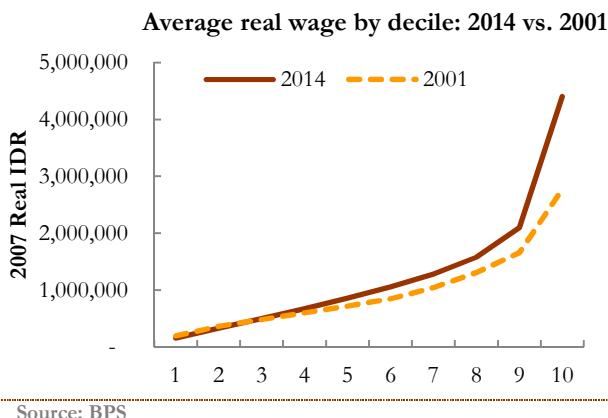


Figure 3.8: Real wage growth has been uneven across the wage distribution between 2001 and 2014

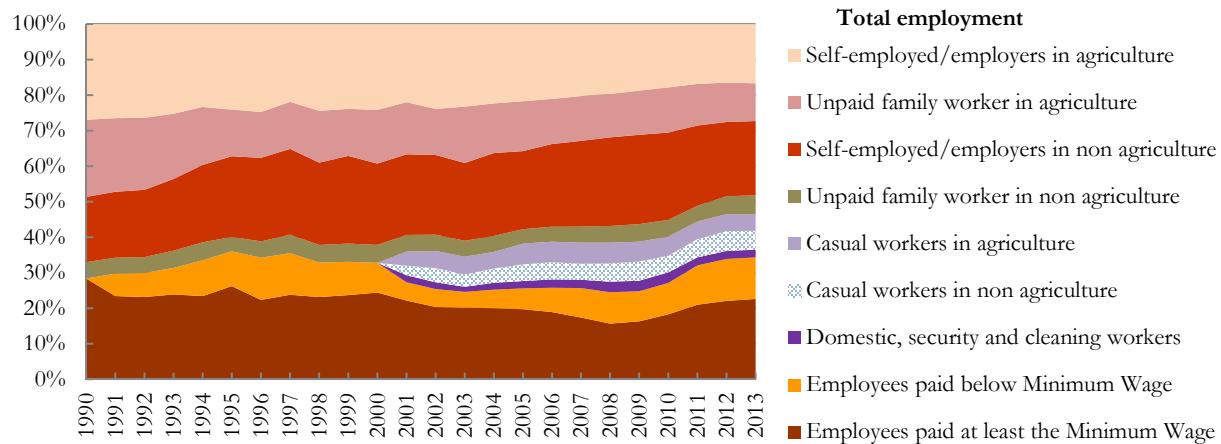


³³ About half the population has access to health insurance, including civil servants, the military, about 25 percent of formal private workers, and the poor and near-poor who are eligible for the Jamkesmas program (which is being merged with other social health insurance programs under the single-payer Jaminan Kesehatan Nasional program in 2014).

Furthermore, most jobs provide little protection to workers and this applies both to the stock of existing jobs and to the flow of newly created jobs. The persistence of low labor incomes and limited workers' protection make many Indonesians vulnerable to shocks and add to rising inequality, undermining recent welfare gains and shared prosperity. The first challenge in addressing workers' protection, however, relates to measurement. The current official Central Bureau of Statistics (BPS) measure of informality, which classifies "informal" workers using a combination of questions on occupation and employment status, is in fact overestimating *de facto* protection. According to the BPS measure, 47 percent of total employment is currently considered "formal", while according to a number of alternative definitions, such as the share of workers with written contracts (only 23 percent of total employment) or the share of workers covered by social security (about 12 percent of total workers before the implementation of SJSN), *de facto* protection is much lower. In addition, all potentially vulnerable forms of work (self-employed, unpaid family workers, casual workers, domestic workers and workers paid below the minimum wages) taken together add up to nearly 80 percent of total employment.

Women tend to be more vulnerable than men due to differences job status.³⁴ Women constitute most of the self-employed and unpaid family workers, making them more susceptible to personal and financial insecurity. The gender wage gap in Indonesia is larger than in other countries in East Asia, with women only earning about 70 percent of what men earn, in part because female workers tend to have less secure terms of employment and are more likely to be self-employed, doing unpaid family work or working in the informal sector.³⁵ Being a woman increases the probability of working in the informal sector by 24 percent.³⁶ Women-owned SMEs are mostly self-employed by necessity. Indonesia's social assistance programs favor female-headed households (FHH), but as typically the sole income earner in the household, FHHs tend to be more vulnerable to shocks and their poverty rates tend to be more volatile. Furthermore, out of the large labor pool of 37 million working-age Indonesians that is inactive, 86 percent of which are women.

Figure 3.9: Vulnerable forms of work may account for 80 percent of total employment



Source: World Bank elaboration on BPS, Sakernas data (Measures of casual and domestic workers were introduced in the Labor Force Surveys only from 2000 onwards).

³⁴ The World Bank's World Development Report (2011) framework for analyzing gender issues emphasizes four dimensions: endowment, opportunities, voice and agency, and cross-cutting dimensions. Gender disparities in endowment (e.g., education and health) have been significantly reduced as shown in the next section.

³⁵ However, in the formal sector, the unexplained gender wage gap is only around 10 percent, which is relatively low by world standards.

³⁶ World Bank Indonesia Jobs Report (2010).

3.3. Inequality: One of the Sharpest Rises in EAP over the Past Decade

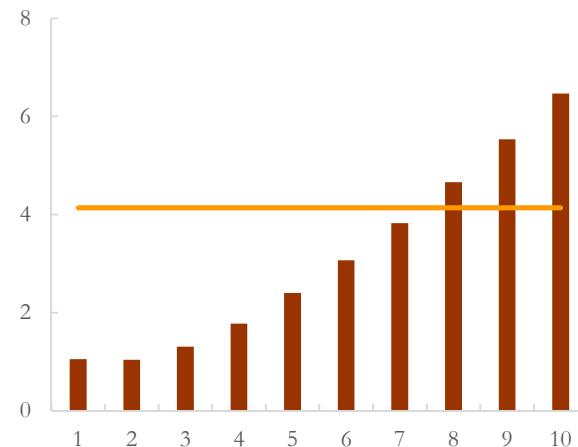
3.3.1. Income inequality

The bottom 40 percent have benefited far less from economic growth than the rest of the Indonesian population. In Indonesia, all households have seen rising real consumption, but it has been highest for the wealthier households, which are pulling away from the rest of the country. Between 2003 and 2010, consumption for the bottom 40 grew at only 1-2 percent per year, while the richest 10 percent enjoyed consumption growth of 6.5 percent and the second-richest quintile of 5.5 percent. Growth in the bottom seven deciles was below that of the national mean. Indonesia's shared prosperity track record is poor compared with other EAP countries, for which comparative data was compiled in Global Database for shared prosperity in 2006-11. The bottom 40 percent in Cambodia, China, Thailand, Lao PDR and the Philippines rates, 9, 7, 4, 1.4 and 1.4 percent, respectively. Compared with countries outside of the region, the bottom 40 percent in Indonesia is achieving prosperity at a rate of less than half that of their counterparts in India, Pakistan, South Africa, Chile and Thailand.

The poorest 40 percent of Indonesians account for only a fifth of consumption and their share has been declining over time. In 2002, the average consumption per person of the richest 10 percent of households was 6.6 times that of the poorest 10 percent; by 2013, this had risen to 10.3 times. As a consequence, the richest 10 percent now account for nearly a third of all household consumption in Indonesia, and the richest 20 percent for nearly half.

The income gap between rich and poor, as measured by the Gini coefficient, increased by almost 12 percentage points between 2000 and 2013. Historically, the Gini coefficient changed little between 1980 and 1996. It fluctuated between 32 and 34 points, rising only to 36 in 1996. This changed in the wake of the Asian financial crisis. Urban and wealthier Indonesians were not only the hardest hit by the crisis but also the slowest to recover. Consequently, inequality fell from 36 points in 1996 to 30 points by 1999. Following the recovery from the crisis, Indonesia experienced a period of strong economic growth, driven in part by the commodities boom and strong domestic consumption. During this period, inequality climbed from 30 in 2000 to 42 by 2013. The true level

Figure 3.10: The richest households have seen much higher growth in consumption than poorer households
(Annualized real consumption growth 2003-10, percent, by household decile)



Source: Susenas and World Bank staff calculations

all experienced higher annual consumption growth rates, 9, 7, 4, 1.4 and 1.4 percent, respectively. Compared with countries outside of the region, the bottom 40 percent in Indonesia is achieving prosperity at a rate of less than half that of their counterparts in India, Pakistan, South Africa, Chile and Thailand.

Table 3.1: The richest 20 percent of households account for nearly half of all consumption
(share of total household consumption, percent)

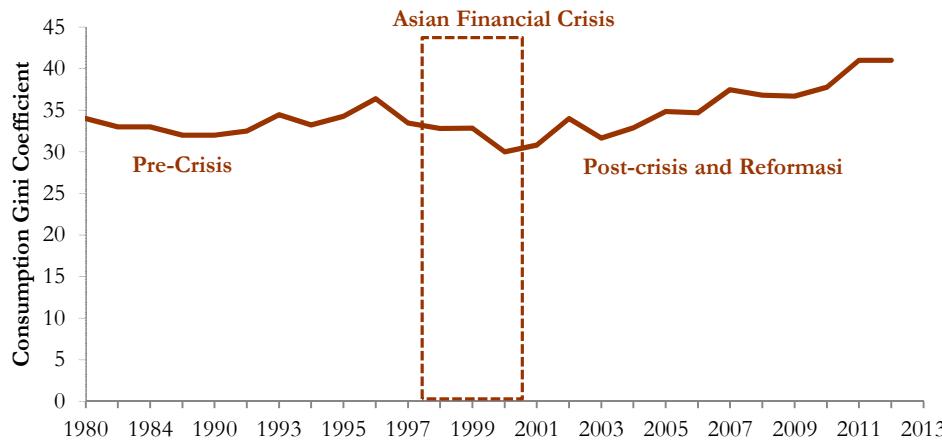
| | 2002 | 2006 | 2010 | 2013 |
|------------------|------|------|------|------|
| Poorest quintile | 10.8 | 10.2 | 9.3 | 8.9 |
| Quintile 2 | 13.7 | 13.2 | 12.5 | 11.8 |
| Quintile 3 | 16.5 | 16.0 | 16.1 | 15 |
| Quintile 4 | 20.4 | 21.4 | 21.6 | 20.6 |
| Richest quintile | 38.5 | 39.1 | 40.6 | 43.7 |
| Richest decile | 25.2 | 24.6 | 26.0 | 28.7 |

Source: Susenas, World Bank staff calculations

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of economic inequality in Indonesia is likely to be even higher than this, as data used to measure it do not adequately represent rich households.³⁷

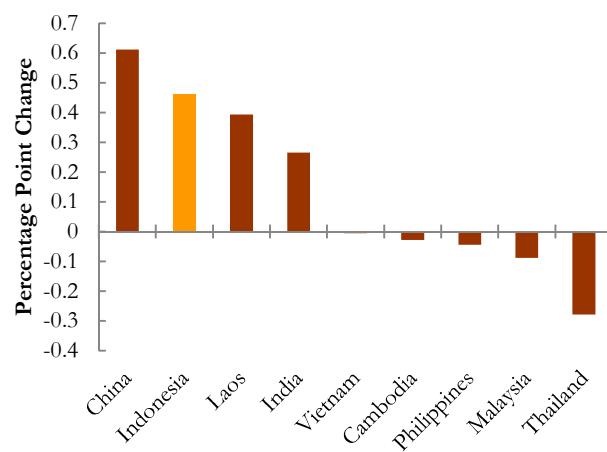
Figure 3.11: Inequality in Indonesia has been steadily rising since 2000
(household per capita consumption Gini coefficient, points)



Source: Susenas, World Bank staff calculations

Over the 1990s and 2000s, only China's Gini coefficient rose faster than Indonesia's. Indonesia has experienced one of the fastest rising rates of inequality in the East Asian region (Figure 3.12), although consistent and reliable international comparisons are difficult.³⁸ The Gini coefficient, which ranges from 0 (perfect equality) to 100 (perfect inequality), increased by an average of 0.5 percentage points per year over this period. However, most of this increase took place after 2000, at an annual rate closer to 1 percentage point per year. At the same time, other fast growing countries in the region, such as Malaysia, Thailand and Vietnam, saw flat or declining inequality.

Figure 3.12: Gini coefficients in East Asia, 1990s and 2000s



Source: Kanbur, Rhee and Zhuang (2014) *Inequality in Asia and the Pacific*, from PovCalNet; World Bank staff calculations

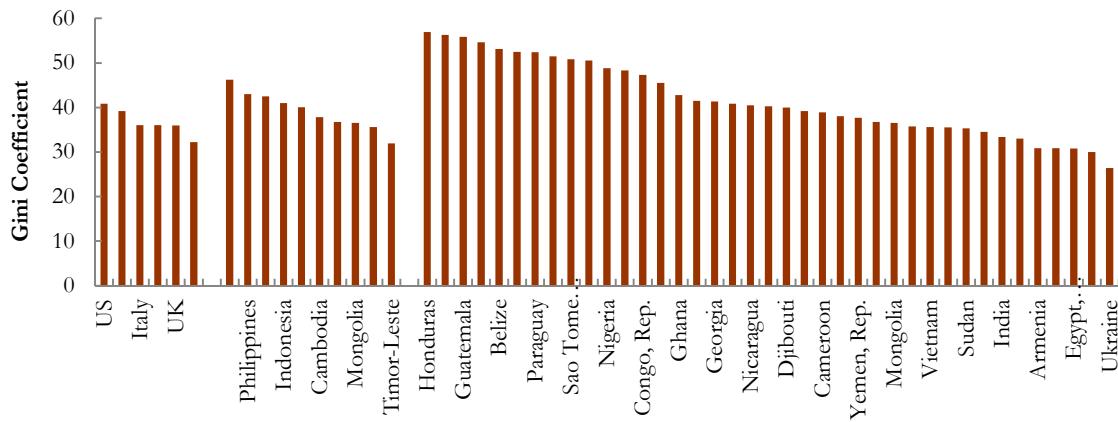
Note: Consumption Ginis for all countries except Malaysia, which uses income. The periods for each country are: Indonesia 1990-2011; Malaysia 1992-2009; Lao PDR 1992-2008; China 1990-2008; Vietnam 1992-2008; Thailand 1990-2009; the Philippines 1991-2009; and Cambodia 1994-2008.

³⁷ Inequality in Indonesia is more fully detailed in *Hard Choices*, Indonesia Economic Quarterly, World Bank, July 2014.

³⁸ Comparing Gini coefficients across time and countries is difficult, due to different welfare measures (income or consumptions), different welfare aggregates (e.g., whether housing, durables and self-production are included in the consumption aggregate, and in what manner), and different within-country purchasing power adjustments (spatial cost of living). These differences can affect both levels and changes in levels. Moreover, the choice of start and end points also affects trends over time. Work has begun on an East Asian data portal which will facilitate more consistent comparisons.

Indonesian inequality is relatively high for the region, albeit average for middle income countries. The Indonesian Gini is now over 40, behind only Malaysia, the Philippines and China in EAP. However, it remains lower than many LAC countries (although LAC Gini coefficients are income-based).

Figure 3.13: Gini coefficients for selected countries

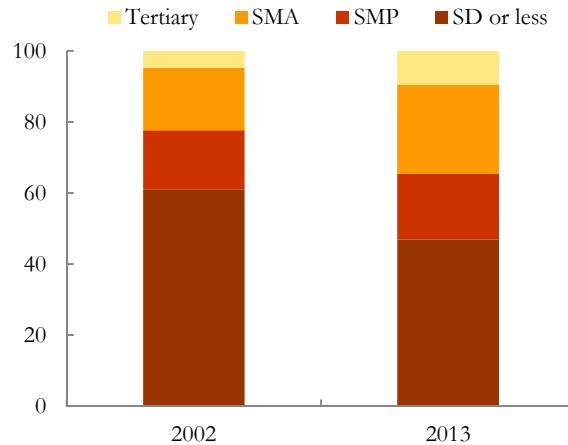


Note: Latest year available, ranging from 2000 to 2012. Some coefficients are for income, some for consumption. The consumption Gini for a country is always lower than its income Gini.

In fact, the true level of Indonesia's inequality is most likely even higher. Accurately measuring inequality requires collecting data from a representative sample of all households, from the poorest to the richest. In Indonesia, however, it appears that the richest households are under-reporting consumption or missing from the data altogether. According to the National Socio-economic Survey (Susenas), which is used to estimate inequality, only 5 million people (or 2 percent of the population) consumed more than IDR 2 million per month during 2012, and 1.3 million (0.5 percent) more than IDR 4 million per month. Meanwhile, only around half of the owners of private passenger cars registered with the police are found in Susenas. If half are missing, then the true Gini is likely to be significantly higher.

Education is a key factor in explaining inequality in Indonesia. Greater demand for more educated workers has meant that they enjoy higher wages. Compared with workers with a primary education or less, those with junior secondary education now enjoy a 20 percent premium, those with senior secondary a 40 percent premium, and those with tertiary earn double. This premium has been increasing over the past decade. This gap in wages between the more and the less educated influences consumption inequality. Households whose head has more education have higher consumption, and this gap with poorly educated households has also been increasing over time. Because jobs increasingly require more education, since 2013 workers with primary education have fallen from a majority to a minority. As a consequence, declining demand for less educated workers puts downward pressure on their wages relative to those for more educated workers.

Figure 3.14: Jobs increasingly require more education
(workers by education level, percent of total)



Source: World Bank staff calculations based on Sakernas and Susenas data

Note: Worker wage premium represents how much higher wages workers at each level of education receive compared with workers with primary or less education, controlling for experience, gender, work status, location and other factors. Household consumption premium represents the same, for per capita consumption and head of household's education.

The distribution of capital asset ownership across the population makes a difference too. Since the beginning of 2002 until the end of 2013, the Indonesia Stock Exchange (IDX) Composite Index (a measure of all stocks) increased in nominal value by nearly 11 times, averaging compounded returns of 22 percent per year. The corresponding property index increased in value by 12.5 times, averaging 23 percent in annual compounded gains. Only wealthier Indonesians have benefited from strong capital returns. However, the extent of rich households' income rise is not adequately captured in household surveys. Indeed, many of the rich are not included in survey data, so income in the form of capital gains in stocks and housing is under-represented.

Finally, the increasing share of capital income in national income exacerbates inequality. Not only are many Indonesians excluded from rising capital and asset markets, the wages and salaries upon which they rely have seen a declining share of national income. For example, the labor share of income in industry fell by 3-4 percentage points between the early 2000s and mid-2000s, reflecting a broader Asian pattern. As the poor do not own capital, an increasing capital income share goes to richer households, further exacerbating inequality. Inequality is thus increasing as labor's share of national income is falling.

Figure 3.15: Workers with more education receive higher wages, and live in households with higher consumption
(wage and consumption premiums to higher than primary education, incremental percent over primary education)

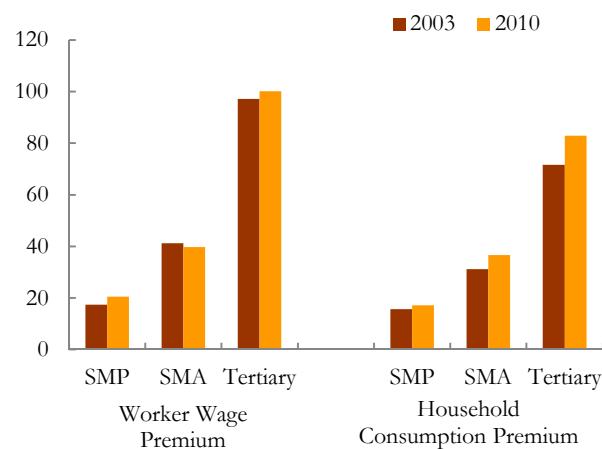
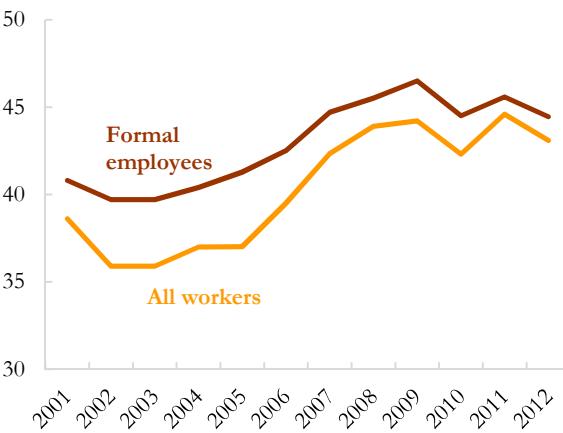


Figure 3.16: Increasing consumption inequality is being driven partly by increasing inequality in labor incomes
(Labor income Gini coefficient, 2001-12, points)



Source: World Bank staff calculations based on Sakernas data

3.3.2. Long-term income mobility

The rich in Indonesia tend to stay rich over time but the poor have a reasonable chance of moving into higher income levels within their lifetimes. Of the individuals with total personal income in the top 20 percent of Indonesians aged between 25 and 34 years old in 1993, nearly two-thirds remained in the top 20 percent 14 years later. Conversely, individuals in all of the other quintiles experienced much greater relative movement over the period,

both upwards and downwards, with no more than one third of the first four quintiles remaining in the same place. Of those in the poorest income quintile in 1993, 65 percent had reached a higher income quintile by 2007, with 19 percent reaching the top two quintiles. Thus, the poor have a reasonable chance of moving into higher income levels within their lifetimes—people who start out at the bottom of the income distribution can get to the top if they work hard, have the right skills and enjoy a measure of good luck, while people who start out towards the top can lose their place. However, investments to reduce inequality of opportunities are needed to reduce inequality in the long term.

Table 3.2: The composition of the richest quintile of income earners is relatively sticky; more mobility in other quintiles
(Percent of 1993 income quintiles in 2007 quintiles)

| | 07 Q1 | 07 Q2 | 07 Q3 | 07 Q4 | 07 Q5 |
|-------|-------|-------|-------|-------|-------|
| 93 Q1 | 35 | 32 | 15 | 15 | 4 |
| 93 Q2 | 34 | 25 | 27 | 9 | 4 |
| 93 Q3 | 23 | 25 | 34 | 14 | 3 |
| 93 Q4 | 14 | 15 | 24 | 26 | 21 |
| 93 Q5 | 6 | 4 | 8 | 19 | 64 |

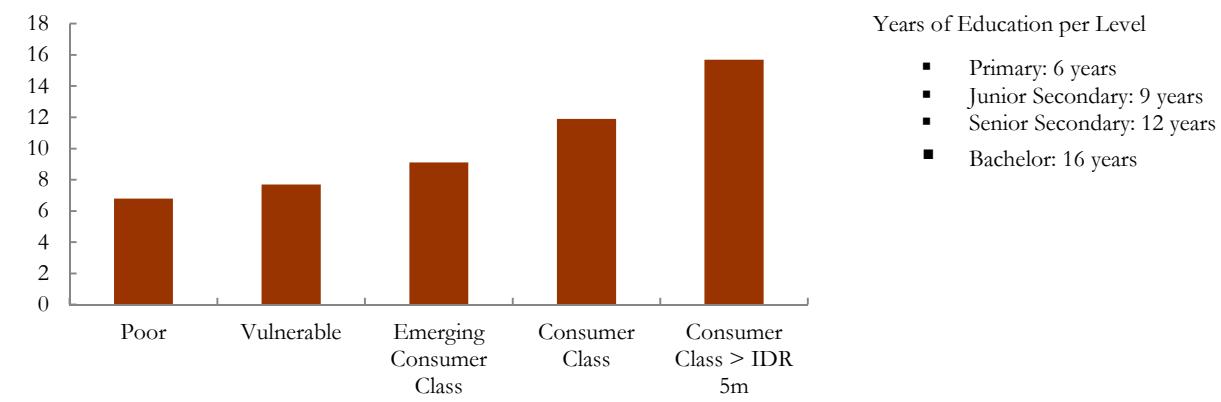
Source: IFLS World Bank staff calculations

Note: Total income quintiles for individuals aged 25-34 in 1993, excluding those with zero income.

The most important factor enabling upward mobility into the consumer class is quality education. Indonesia's consumer class grew at 11 percent a year between 2002 and 2014, and now makes up 18 percent of the population.³⁹ The main pathway into the consumer class has been through better jobs and higher wages. The majority is formal employees (58 percent) or are business owners with paid workers (17 percent), (Figure 3.17). Very few work in agriculture; most work in manufacturing or services. Better employment, in turn, is accessed through higher education. The consumer class, roughly equal to the two top quintiles, differs from the rest of the population in having, on average, high school education, while the wealthiest members of the consumer class hold a bachelor's degree on average (Figure 3.17). While near-universal access to primary education has been achieved in Indonesia, new policies are needed to ensure that the bottom 40 percent continue on to high school and further. For example, in 2012 students from the bottom 40 percent of households in terms of income represented only 10 percent of tertiary enrolment. The needed improvements in overall education quality will also require a strong focus on reducing learning disparities.

³⁹ See World Bank (forthcoming) *Indonesia's Middle Class*.

Figure 3.17: The consumer class is tertiary-educated, on average
(average years of schooling by class)



Source: Susenas 2013 and World Bank staff calculations.

In sum, members of rich Indonesian households have access to assets such as real estate and stocks that have allowed their wealth to grow rapidly. At the same time, with better education, they are able to find better jobs to boost their incomes. Those from poorer households, however, lack financial assets and can only improve their income through work. Most of the jobs created in Indonesia since 2001, and indeed most current jobs, are in low productivity sectors, resulting in low real labor incomes, particularly for the poor and the vulnerable. In addition, these workers have limited access to formal worker protection. Limited access to good job opportunities also undermines Indonesia's economic growth, since Indonesia is not maximizing its current labor force in terms of its productive potential, exactly at the time when the demographic dividend is peaking.

3.3.3. Inequality of opportunity⁴⁰

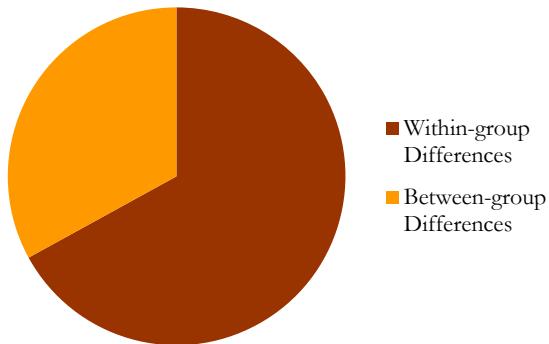
Around one-third of total inequality is due to circumstances that children are born into, or develop soon after. Some inequality is due to circumstances that are beyond the control of an individual, such as gender, ethnicity, birthplace or family background. This type of inequality prevents individuals from achieving their potential, which is not only unfair to them but also lowers Indonesia's human capital overall, reducing growth and productivity. Equality of opportunity, therefore, aims to level the playing field so that these circumstances do not unduly influence a person's chance to succeed. In Indonesia, just three of these factors—the gender of the head of the household, their parents' education, and where they were born (urban or rural, which region of Indonesia)—were associated with 33 percent of total consumption inequality in 2012 (Figure 3.18). Thus education, women's empowerment and access to good quality services in rural areas will be crucial in reducing inequality of opportunity and future income inequality.

Moreover, while inequality of opportunity declined in earlier periods, it is now rising once again. For heads of households born in 1948-57, 39 percent of the inequality in their present day consumption can be explained by these selected birth circumstances (Figure 3.19). For those born a decade later, when Indonesia first began its economic expansion, this fell to 37 percent. For those born a decade later again, who would be the first to benefit from Indonesia's massive primary school expansion of the 1970s, it fell to 34 percent. However, for those born in the late 1970s, the percentage of current inequality due to these birth circumstances is rising once again.

⁴⁰ Concept and measurement. Roemer 1993, Van Der Gaer 1993. HOI by the World Bank (Barros and others 2010).

Figure 3.18: A third of adult inequality is due to selected birth circumstances

(share of consumption inequality due to differences between groups of different gender, parents' education and birth location, and to differences within these groups)



Source: Susenas 2011-13

Note: Decomposition of Theil L (GE (0)) Index (all individuals) into within and between group differences. Birth circumstances are head of household gender, parents' education*, province of birth and whether the birth location was fully urban (whether *kotamadya* or *kabupaten*). *Adults' own education is taken as a proxy for their parents' education, which are not in the data. However, analysis of IFLS data shows that parents' education and income are important determinants of children's educational outcomes, as are availability of schools, all of which are themselves birth circumstances. Non-birth circumstances include children's effort.

The differences between the lives of children of different family backgrounds in Indonesia can be very stark. Inequalities of opportunity can be seen by comparing a child born in Jakarta to non-poor parents who have at least high school education with a child born in a rural area of Papua or Maluku to a poor family with little education. The former has only a 6 percent chance of lacking proper sanitation, compared with 98 percent for the latter child. These differences extend across all other indicators of opportunity, such as access to clean water, having non-dirt floors in the house, primary school enrolment, birth by skilled attendant and immunization coverage. This is true not only when comparing Jakarta with Papua. Children from poor households in rural areas consistently lag behind children from rich households in urban areas on almost every indicator.

When inequality of opportunity is experienced on multiple dimensions by the same children, the effect on later outcomes is likely to be considerably worse. Children in rural areas are more likely to lack proper access to education, health and transportation services than urban children. However, children in rural areas are also more likely to experience a lack of all these opportunities at the same time. Of the 35 percent of all urban children who lack access to at least one of these dimensions, 20 percent lack access on two, where this is represented by areas within two overlapping circles) and only around 3 percent lack access on all three (the area within three overlapping circles). In contrast, 58 percent

Figure 3.19: The degree of inequality due to selected birth circumstances had been falling, but is now rising again

(share of consumption inequality due to differences between groups of different gender, parents' education and birth location, by birth cohort)

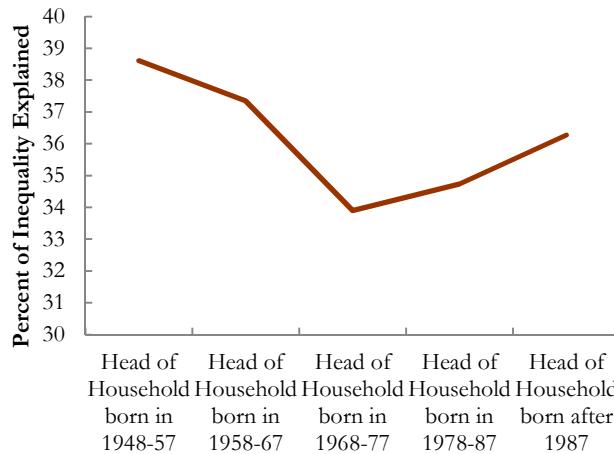
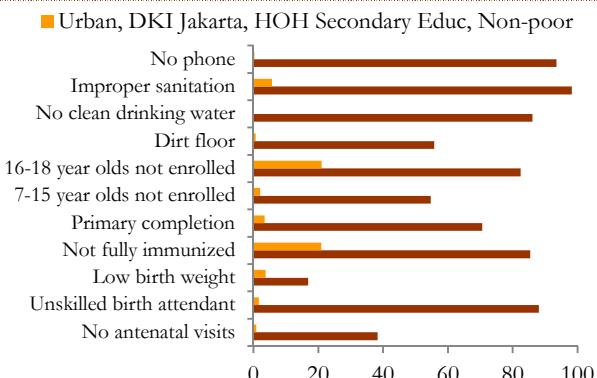


Figure 3.20: Differences in access to opportunities in life for children in Indonesia

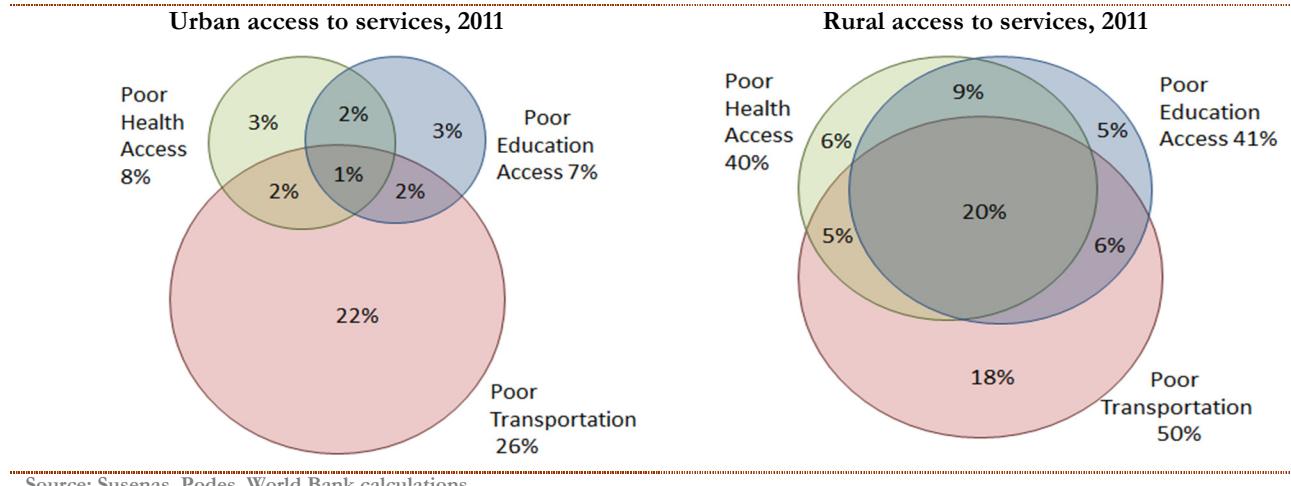
(lack of access, percent)



Source: Susenas 2012, DHS 2007 and World Bank staff calculations

of children in rural areas lack access to at least one dimension, but furthermore, a third of them lack access on two dimensions and another third lack access on all three dimensions.

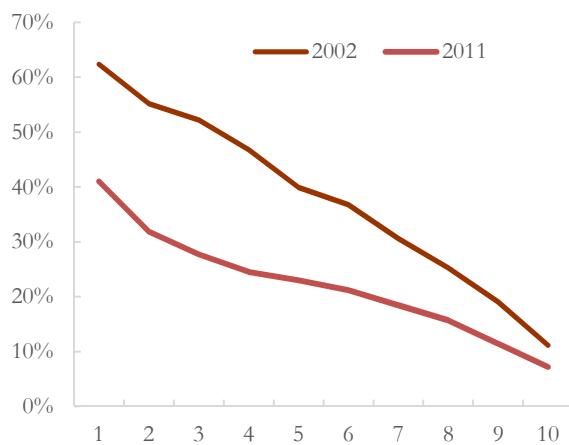
Figure 3.21: Most rural children without access to health, education and transportation services are deprived on more than one dimension



Source: Susenas, Podes, World Bank calculations

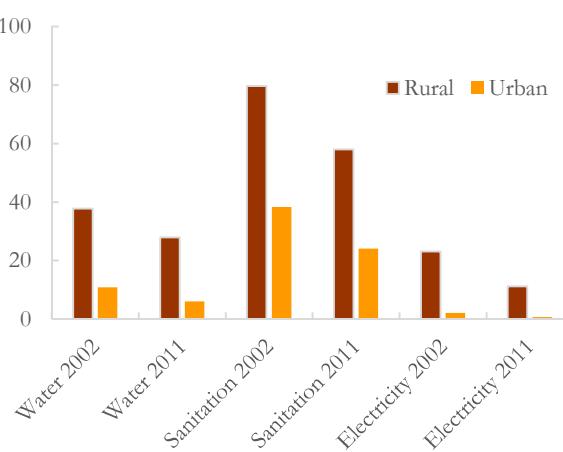
In some dimensions the gap between children from rich and poor families fell between 2002 and 2011, including for most health, education and housing outcomes and opportunities. For example, 63 percent of children in the poorest consumption decile were delivered by an unskilled attendant in 2002, compared with just 11 percent for the richest decile, a 52 percentage-point gap. By 2011, this gap had closed to 34 percentage points. Similar the gap between rich and poor children, the rural-urban gap is also closing on many dimensions, such as access to clean drinking water, improved sanitation and electrification. However, the rural-urban gap is closing at a slower rate.

Figure 3.22: Children from poorer households start further behind in life, but the gap is closing
(not delivered by a skilled birth attendant by household per capita consumption decile, percent)



Source: Hadiwidjaja, Paladines and Wai-Poi (2013) from Susenas

Figure 3.23: Opportunity gaps between urban and rural households are closing, but at a slower pace
(lack of access by decile, percent)



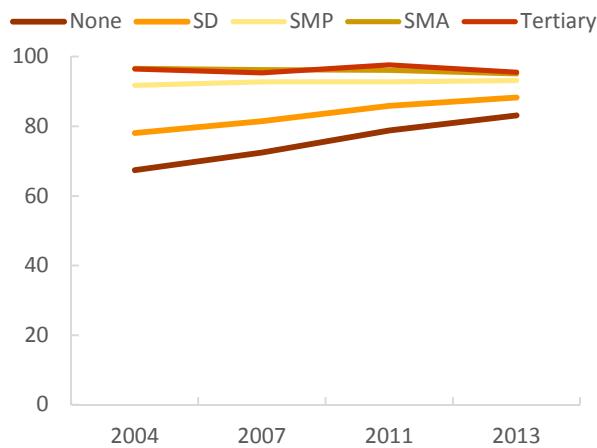
Substantial and sustained efforts by the Government to expand educational access to all over the past 40 years are contributing to closing gaps in education opportunities. Enrolment rates

among 13-15 year olds whose parents had a primary school level of education or less have increased in the past decade. They are converging with children of parents who have a junior secondary level of education or higher, who already had high enrolment rates. Closing the school enrolment gap has provided poor children with opportunities to improve their education outcomes for many years now. Adults whose parents had little education are increasingly likely to achieve a higher level of schooling themselves. For example, nearly 60 percent of people born between 1952 and 1961 into a household where the parents had no education also received no education themselves. For those born in 1962-71, this rate dropped to 45 percent, and to just 21 percent for those born in 1972-81.

With educational mobility having increased over the past 30 to 40 years in Indonesia, children from poorer or less educated families now have a greater chance of achieving higher educational attainment themselves. However, the stakes are now higher, with the premium for more education increasing over the past decade. This means that those children who do not break the inter-generational transmission of disadvantage are falling increasingly further behind their peers. Furthermore, measures of access and opportunity, especially in health and education, do not reflect the quality of services received. Children in poorer or more remote areas not only participate less in these services, but when they do, the quality is often lower.

Figure 3.24: Enrolment rates of children with less educated parents are converging...

(enrolment rate of children aged 13-15, by parents' final education, percent)

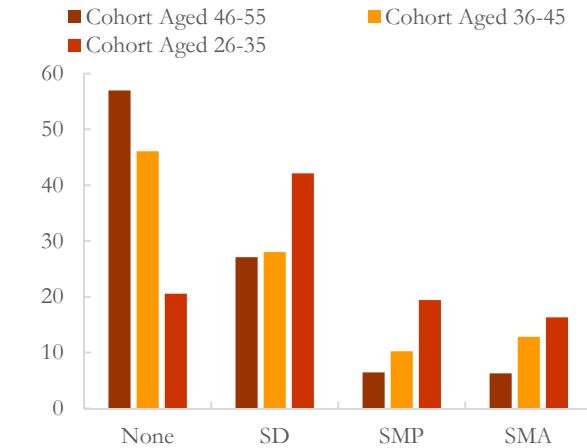


Source: Susenas and World Bank staff calculations

Note: Enrolment rates over time, by final educational attainment of parents.

Figure 3.25: ...and children born to parents with no education are achieving greater educational attainment

(final educational attainment for children whose parents have no education, percent)



Source: IFLS 2007

Note: Final educational attainment in 2007 by age cohort.

In sum, while income inequality due to circumstances beyond the control of an individual is rising, Indonesia's major progress in education in an environment of rising return to education augurs well for the future path of inequality. That said, education is only one of the factors explaining inequality of opportunity. Other important dimensions, such as access to rural services (health, sanitation, electricity, etc.), as well as greater empowerment of women, will need to be addressed.

IV. Pathways for Poverty Reduction and Boosting Shared Prosperity

4.1. The Analytical Framework: The Three Pathways

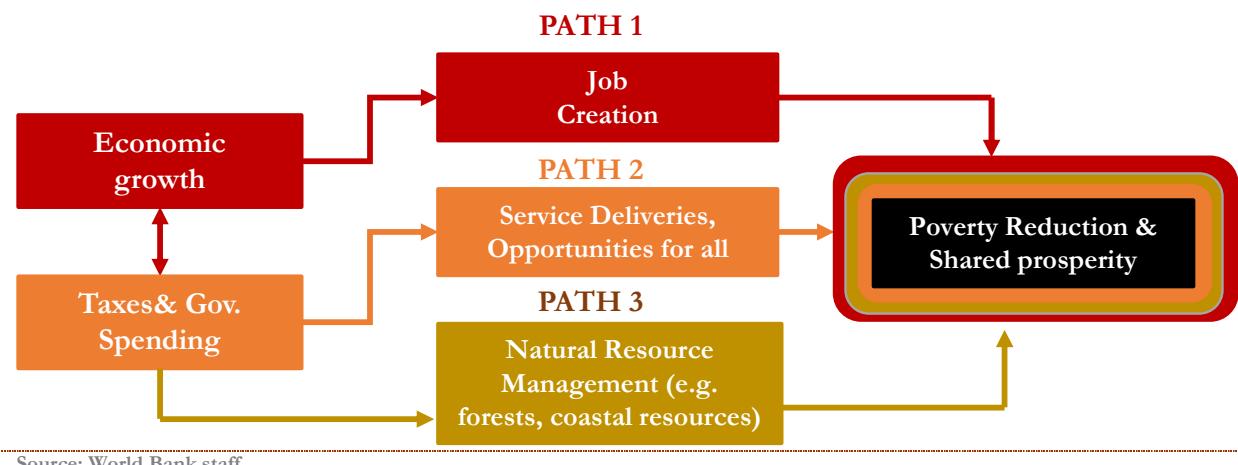
The analytical framework used here posits that reducing poverty and increasing shared prosperity in Indonesia rests on three pillars: economic growth, access to services for all, and the quality of natural resource governance and management. This framework is based on a thorough analysis of the drivers of poverty in Indonesia and lessons from international experience.⁴¹ As the diagram below illustrates, a growth strategy that generates jobs is fundamental. For the first pillar, while the private sector is the main engine of economic growth, the Government nonetheless plays a critical role by devising and implementing policies and regulations that encourage private sector participation and economic growth. For the second pillar, spending public money in the right areas, and doing so efficiently and effectively, is crucial to improving opportunities for all citizens through universal access to health, nutrition, education and basic infrastructure.

The special nature of poverty in forest and coastal areas in Indonesia suggests that pathways 1 and 2 based on the first two pillars will not by themselves be sufficient and therefore need be supplemented by natural resource management policies, to reduce poverty in these areas. Given the very large number of people living in these areas in Indonesia, and their high levels of extreme poverty, a third pathway, working through the management of natural resources, is needed. Indeed, remoteness, low population density and dispersed community locations imply that (i) connection with, and externalities from, growth in non-resource sectors are weak; (ii) access to markets and high quality services such as education and health is difficult; and (iii) the cost of providing high-quality services and infrastructure (e.g., roads) is high. The fate of people living in these areas is intimately tied to natural resource activities and man-made and natural changes in the related ecosystems, such as deforestation, overexploitation of resources, floods and landslides.

The severity of natural resource degradation and air pollution in Indonesia warrants that environmental sustainability needs to be addressed in its own right. Indonesia ranks among the top greenhouse gas (GHG) emitting countries of the world. Roughly one-third of Indonesia's GHG emissions originate from land-use changes and forest degradation, 26 percent from peat fires and 22 percent from fossil-fuel emissions, which are also rising steeply. Overall, outdoor and indoor (cooking) air pollution is high and generates negative health impacts that cost billions of US dollars. The increase in Indonesia's GHG emissions can be attributed partly to rising commodity production (e.g., palm oil) and poor governance regarding land use and resource extraction. This is exacerbated by rapid population growth (2.9 million additional people per year), rapid urbanization (with a 65 percent urbanization rate projected by 2050), and rapid growth of the domestic "middle class" and aggregate consumption (and with it rapid energy demand growth).

⁴¹ See Amber et al. (2013) for a similar framework that attempts to capture the pathways for most development countries.

Figure 4.1: Pathways of poverty reduction in Indonesia



Source: World Bank staff

4.2. Pathway I: Binding Constraints to Growth and Job Creation and Reform Options

Rapid and stable economic growth is essential, in light of its impact on poverty reduction, but it is not sufficient as the quality of growth and jobs matters tremendously for reducing vulnerability and increasing shared prosperity. Looking ahead, Indonesia will not be able to count on favorable commodity prices and it will take structural reforms to boost inclusive growth. The end of the commodities boom has exposed Indonesia's deep structural weaknesses, which will need to be addressed if the economy is to revert to high levels of growth in an inclusive and sustainable fashion.

The structural weaknesses include: (i) infrastructure bottlenecks; (ii) a poor business environment; (iii) labor, land and capital markets that are unsupportive to inclusive and sustainable growth; and (iv) skills shortages and mismatches.

4.2.1 Infrastructure bottlenecks

4.2.1.1. Constraints and costs to the economy

Over the past decade, slow growth in the infrastructure capital stock, in a context of high economic and vehicle fleet growth, has contributed to serious congestion problems and poor logistics performance, seriously undermining productivity growth, competitiveness and poverty reduction efforts. Problems with transportation are among the worst business constraints for manufacturing firms: about 25 percent of Indonesians have no access to reliable power and only 16 percent of urban dwellers have access to piped water. Indonesia spends over 24 percent of its GDP on logistics—moving goods into, out of, and around the country. If Indonesia was only as efficient as Thailand, the economy would save USD 80 billion annually in reduced logistics cost.

The under-investment in infrastructure has been massive as energy subsidies have crowded out public spending in infrastructure. Total infrastructure investment—that is, investment by the central government, sub-national governments, state-owned enterprises and the private sector—has remained at only 3 to 4 percent of GDP over the past decade. This is far below the rates of above 7 percent of GDP before the 1997 Asian financial crisis, and the 10 percent and 7.5 percent spent by China and India, respectively. In 2012, spending on energy subsidies claimed more than one-fifth of the central government's budget, more than three times the allocation for infrastructure such as roads, water, electricity and irrigation networks, and three times government-wide spending on health.

Past efforts to increase infrastructure spending have been hampered by regulatory bottlenecks and governance issues. For the past 10 years, the outcomes on infrastructure investment have been unrelated to the amount invested. In roads, for example, a six-fold increase in spending resulted in only 20 percent more kilometers of roadway (see Section III, 3.2 for more examples). A maze of poor regulations, coupled with the use of public policy for personal gain, has made it extraordinarily difficult to deliver on large-scale infrastructure. It takes 930 days for even the state-owned power utility (PLN) to obtain the permits needed to begin construction of a power station. Finally, realizing return on investment will depend on how projects are implemented with efficient and cleaner procurement, attention to planning and project management, and tackling chronic issues of corruption.

4.2.2. Poor business environment

4.2.2.1. Constraints and costs to the economy

High cost of doing business and regulatory uncertainty

Investment in Indonesia is constrained by the fact that the processes for firms, both large and small, to register their operations and obtain the necessary licenses are complicated, expensive and time-consuming.⁴² It takes 52.5 days to start a business in Indonesia compared with only 5.5 and 2.5 days in Malaysia and Singapore, respectively. For example, obtaining the licenses necessary to start a new business in manufacturing takes 794 days by law, although actual implementation can be slower still. Within the energy sector, investors report that obtaining the various permits and licenses needed to establish a power plant can take over 4 years. Construction permits, paying taxes, and enforcing contracts are among the bottom 40 percent's most cumbersome procedures in the world. Obtaining permits and licenses to operate in certain sectors can take years (e.g., more than 3 years to obtain all the licenses needed for an independent power producer).

The weak business environment is reflected, for example, in the World Bank Group's Doing Business rankings. Indonesia is currently at 114th place (out of 189 economies). This performance is below the regional average and its peer countries' performance: the Philippines, China, Thailand, and Malaysia ranked 95th, 90th, 26th, and 18th, respectively. Indonesia's overall performance is only slightly better than India and Cambodia.

Finally, regulations governing investment and trade are restrictive, inconsistent and fluctuant. It is hard to imagine how private investment and growth can reach 6 percent if these issues are not addressed.

Capital markets

There is ample evidence that enterprises in Indonesia are severely credit constrained. The MSME financing gap is estimated at USD 330 billion, out of which USD 240 billion is in the agricultural sector. Firms tend to rely more on retained earnings than on bank credit for the expansion of their activities, which in turn means that current cash flow becomes the major factor in investment decisions. This constrains private sector investment considerably across the economy, and most damagingly in innovative firms that would be introducing productivity-raising trends, but usually have

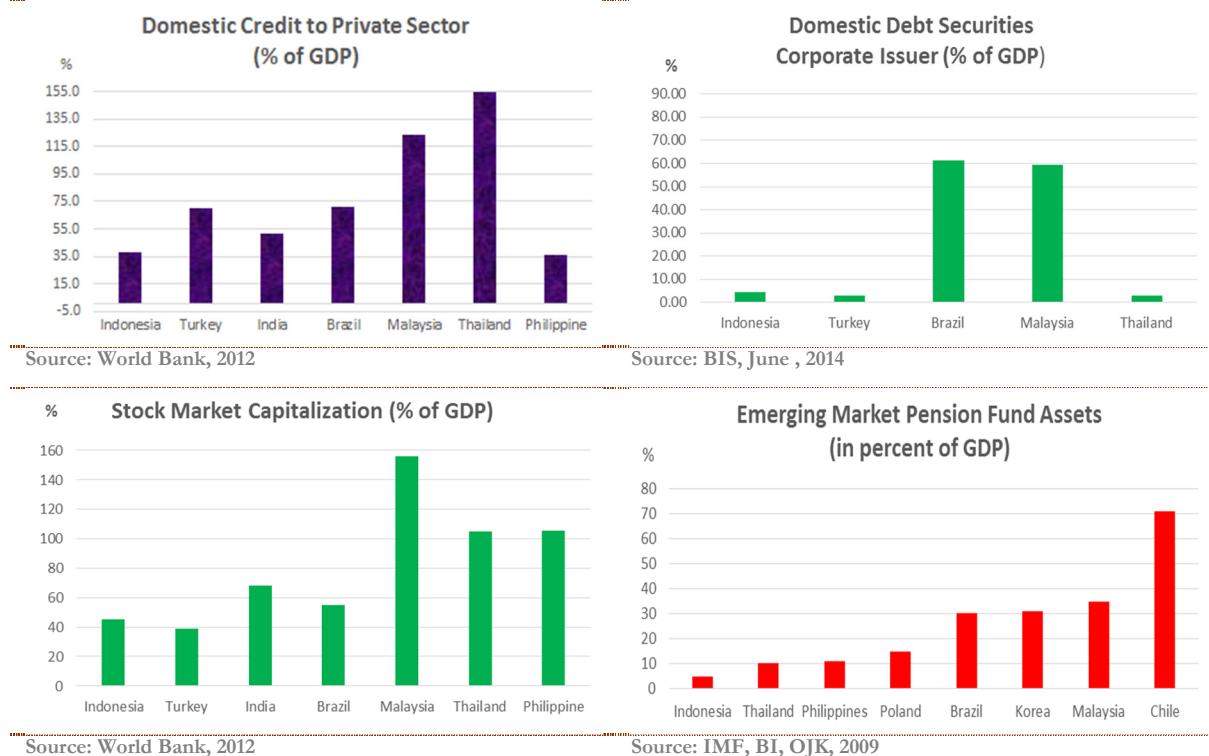
⁴² For analysis on business licensing and OSS issues in Indonesia see Asia Foundation, 2007, "Making Sense of Business Licensing in Indonesia: a Review of Business Licensing Policy and Survey of One Stop Shop Service Centers", KPOB and the Asia Foundation, 2008, "Local Economic Governance in Indonesia: A Survey of Businesses in 243 Regencies/Cities in Indonesia.", and Nurridzki, N., 2010, "Pilot Study: Mapping and Streamlining Business Licenses at the National Level", Report for the Multi Donor Facility for Trade and Investment Climate, World Bank.

negative cash flow in the early stages of operation. In addition to the growth and productivity implications of credit constraints, there is a poverty and shared prosperity implication of constraining available funding to profitable and innovative micro-entrepreneurs, as well.

This state of affairs reflects Indonesia's very under-developed financial market. In total, there are about 120 commercial banks and more than 1,600 rural banks, which accounted for 78.6 percent of financial system assets in 2014, with significant concentration of banking sector assets and the deposit base in the top 20 banks and specifically in the three (state-owned) banks. Despite its size, the Indonesian banking sector claims on the private sector stand at only one third compared with close to 100 percent on average in Malaysia, Thailand and the Philippines.

Past strong growth of bank loans and an increased loan-to-deposit ratio have not been sustained for long enough to lift the ratio of bank loans to GDP from a relative low at around 45 percent. In the next few years unless growth of deposits picks up significantly, bank loan growth will remain soft, spelling credit constraints for the business sector going forward. Moreover, bank loans have been largely provided to large enterprises and not to MSMEs, which are the source of 97 percent of employment and 57 percent of value-added in the economy. The share of loans to MSMEs over total bank loans was around 20 percent at 2014, up from 16 percent in 2013 but still low.

Figure 4.2: Key financial market indicators



Indonesia also faces low levels of financial inclusion, which can undermine poverty alleviation and affect the near-poor as well. The World Bank's Global Findex survey found that in 2011 only about 20 percent of Indonesian adults held an account at a formal institution. This number is only 16 percent in rural areas, and even less for the poorest 40 percent of the adult population. Exclusion from the formal financial sector has been shown broadly to intensify income inequality, as the "unbanked" pay higher costs for financial services or are unable to invest, consume or plan adequately for lifecycle risks. A further feedback effect takes the financially excluded to traditional, lower

productivity sectors, as moving in search of a productivity-improving innovation entails risks that a poor or near-poor household can ill afford to incur.

Geography and low levels of financial literacy are particular challenges for financial inclusion in Indonesia. Access to financial services in regional and remote areas is poor. According to Bank Indonesia, one bank office serves 15,992 people compared with an average of 3,745 adults per branch in high income countries and an average of 12,000 adults per branch in the EAP region. According to an OJK 2013 survey, only 21 percent of Indonesians have the knowledge, skills and confidence to say they understand their financial products and services in full. But studies also found that financial inclusion in Indonesia is a multidimensional problem, also involving a lack of physical access, transaction costs, income level, education, lack of identification documents, and socio-economic factors.

**Table 4.1: Selected financial inclusion indicators
(percent)**

| Account at a formal financial institution | Indonesia | East Asia & Pacific | Lower middle income |
|--|-----------|---------------------|---------------------|
| All adults (age 15+) | 19.6 | 54.9 | 28.4 |
| Female adults (age 15+) | 19.2 | 52.3 | 22.9 |
| Male adults (age 15+) | 20.0 | 57.6 | 33.9 |
| Income, bottom 40% (age 15+) | 10.3 | 39.8 | 19.7 |
| Income, top 60% (age 15+) | 26.4 | 65.6 | 36.3 |
| Young adults (ages 15-24) | 12.8 | 52.1 | 21.5 |
| Older adults (age 25+) | 21.6 | 54.9 | 31.2 |
| Mobile financial services | | | |
| Mobile phone used to pay bills (age 15+) | 0.2 | 1.3 | 2.0 |
| Mobile phone used to receive money (age 15+) | 0.6 | 1.2 | 3.8 |
| Mobile phone used to send money (age 15+) | 0.6 | 1.0 | 2.4 |

Source: World Bank Findex 2012, data as of 2011 (updated data available May 2015)

There is significant potential to expand financial access through digitizing social transfers, remittances and supply chain payments, given Indonesia's high level (80 percent or 143 million) of unbanked population. Both volume and value of annual transactions of e-money more than doubled in 2012 and increased by over half in the following year. In 2014, the introduction of revised e-money and branchless banking regulations created new service delivery opportunities through agent networks, with initial data showing very promising increases by clienteles of individual banks (an update of the national figures would only be available in May 2015). Basic uniform micro-insurance products developed and jointly offered by groups of micro-insurance providers have also exhibited rapid penetration rates.

Labor markets

While there are many important labor market issues that interfere with the objective of achieving shared prosperity, there is one that imposes high costs to firms and impedes formal employment and productivity growth: the severance pay provisions. In 2003, the Government introduced a Labor Law that significantly improved workers' rights and made hiring more flexible. However, the law made it more costly to fire workers. In particular, the provision mandating that

severance pay should be at least 100 weeks of wages is considered an example of the unintended distortions in the labor market that can be caused by well-intentioned regulation. The majority of companies adjust to the high severance pay provision by either not formally signing a contract for workers (only 23 percent of all firms do) or resorting to short-term contracts that by law are capped at 3 years. Hiring formal workers is discouraged. At the same time, when a worker decides to voluntarily quit a company, only a part of the severance pay is paid. The system creates an incentive for employers to go informal and for workers to be fired: a “lose-lose” equilibrium.

The minimum wage setting process is another critical labor market issue. Indonesia followed a prudent minimum wage setting policy for most of the past decade or so but, since 2010, there has been a significant departure from the moderate pace in minimum wage increases (as seen in Chapter 1). In 2013, 25 provinces increased their minimum wage by an average 30 percent and Jakarta increased its minimum wage by 44 percent. This increase certainly significantly reduced Indonesia’s nominal wage advantage vis-à-vis China, as China’s average labor productivity is indeed much higher than Indonesia’s. Indonesian formal labor-intensive firms in manufacturing and services seem however more concerned about the uncertainty surrounding the minimum wage setting process and the threat of future high increases.

However, in practice, the percentage of workers to which the minimum wage legislation applies is very small. This reflects three inter-related factors: (i) many workers are self-employed, with 61 percent of workers declaring themselves self-employed in 2011; (ii) about 54 percent of workers operate in the informal sector and over 80 percent of workers (including formal) do not have a contract; and (iii) government capacity to enforce compliance with minimum wage legislation is limited. Compliance enforcement requires coordination at the central level, between the Ministry of Manpower and relevant ministries, as well as between central and local governments and relevant actors (district heads and wage councils).

Although the labor legislation provisions such as severance pay and the minimum wage do not affect the majority of workers in Indonesia, they can impede productivity growth and the structural transformation through various mechanisms. For instance, workers’ movement into formal sectors is constrained as: (i) workers who want to move are not compensated fully for severance by employers if they leave voluntarily; and (ii) employers in the formal sectors account for the high potential cost of dismissal and the uncertainty around minimum wage increases when making hiring decision. As result, movement of workers occurs mostly between informal and semi-formal companies. This may explain why agriculture still employs 35 percent of workers, while the contribution of this sector to GDP has declined to 11 percent. It also explains why the overwhelming majority of workers in services sector are in low-end, low-productivity, informal activities. In addition to undermining movement of workers to formal sectors, uncertainties around the trajectory minimum wage are a deterrent to investment in formal sectors, in particular in manufacturing.

4.2.3. Skills shortages and mismatches

4.2.3.1. Constraints and costs to the economy

Despite a major increase in public investment in education and greater coverage, the skills gap for meeting the needs of the private sector and to enhance job opportunities to increase incomes remains large in Indonesia. Indonesia compares unfavorably with other middle-income economies and East Asian neighbors in learning assessments such as PISA. For instance, 15-year-old students in Indonesia have learning levels far below their peers in Vietnam, even though per-capita

income is higher. Two-thirds of firms complain that finding suitable employees for professional and managerial positions is either “difficult” or “very difficult”; and almost 70 percent of employers in manufacturing report finding it “very difficult” to fill skilled professional-level positions (i.e., engineers). In order to expand workers’ entry into manufacturing and high-end services (e.g., finance, business services, communications, etc.)—once again crucial for productivity growth—these issues need to be addressed.

The growth payoff of skills development is large, if difficult to quantify. Because more than 60 percent of Indonesian firms report that skills are a constraint, relaxing this constraint can help them expand and become more competitive. Today, the majority of tertiary graduates work in the public sector. Going forward, skills development is likely to increase the flow of graduates employable in the private sector where the focus is arguably more on specific skills than diplomas (contrary to the public sector). This could thus increase aggregate productivity and growth through “within sector” productivity growth (e.g., new workers in manufacturing and high-end services equipped with more skills) and/or labor movement from low-end services to manufacturing (e.g., workers from low-end services moving to manufacturing thanks to adequate training). Developing skills should also help Indonesia leverage the opportunities to increase middle-class demand and withstand competition from ASEAN partners. Without the right skill sets among those entering the workforce, imports may remain more competitive than domestic production in satisfying the demand for higher quality products and services from Indonesia’s growing middle-class.

4.2.4. The constraints imposed by agricultural policies

The above constraints have severely constrained all productive sectors. In agriculture, their effects have been exacerbated by particular weaknesses in agricultural policies. With rising incomes and urbanization food consumption and expenditure patterns are shifting to higher value and processed foods, posing both challenges and opportunities. Between 1998 and 2013, animal product consumption more than doubled while the consumption of cereals declined. Over the same period, the share of processed foods in urban food expenditures rose from 15 percent to more than 30 percent. By 2030, the value of domestic demand for fish, milk, meat and fruits (USD 47 billion) is expected to be nearly twice the aggregate value for cereals and rice (USD 25 billion). This changing diet poses challenges related to bio-security and logistics, yet also offers major opportunities for Indonesian farmers, manufacturers, and service companies.

Current agricultural policies continue to focus on achieving self-sufficiency in rice, maize, and sugar based upon fertilizer and other subsidies, a narrow focus on the country’s irrigation infrastructure, and restricted trade. While Indonesia’s rice and maize imports have been held in check, the wider results of this ‘food sovereignty’ policy have not been encouraging. From 2009 to 2014, Indonesian’s average rice consumer prices (USD 0.67/kg) were 30-50 percent higher than in some regional countries (wholesale prices: USD 0.47/kg in Thailand, and USD 0.40/kg in Vietnam). During this period, overall consumer food price inflation was considerably higher than that in the region’s other middle-income countries. Fertilizer subsidies (accounting for one-third of central government agricultural spending in 2008-12) have contributed modestly to cereal crop productivity, but have had little impact on smallholder profitability and competitiveness. In 2013, profits of an average rice farm (0.3 ha) in West Java were 13 times smaller than in an average farm (2.5 ha) in Suphan Buri (Thailand), while production costs were 14 percent higher. And, increased cereal self-sufficiency has not translated into improved nutritional outcomes. Indonesia faces the ‘double burden of malnutrition’ with comparatively high rates of child stunting and child obesity, and with little progress observed in nutrition indicators since the mid-2000s. Imports of processed and higher-value

foods have increased rapidly and, in 2013, at USD 8.9 billion, accounted for 70 percent of Indonesia's food imports.

4.3. Pathway II: Binding Constraints to Service Delivery to All

While access to good jobs is the key pathway out of poverty and vulnerability, it is not sufficient to ensure shared prosperity. In Indonesia, a large number of households classified as non-poor are poor in many “non-income” dimensions, including access to decent housing, transportation, water, sanitation, health and education. Clearly, greater income and prosperity do not translate fully into enhanced living standards as long as access to key services is not improved. This sub-section discusses the key issues around quality of public spending in Indonesia, starting with fiscal choices and access to key services in urban and rural areas, and then going on to look at the fiscal incidence of government expenditure and taxes at the household level.

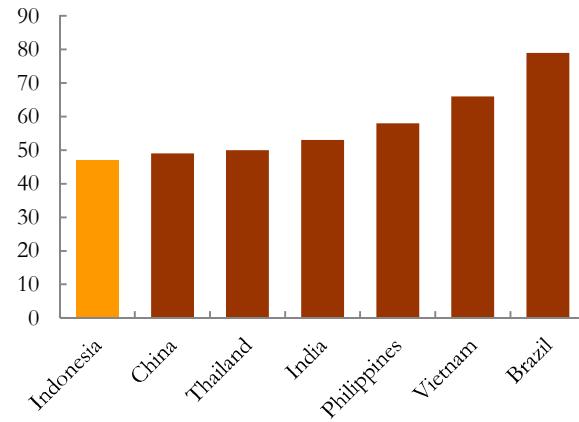
4.3.1. Constraints from the overall fiscal picture and composition of public spending

Prudent fiscal management has helped Indonesia maintain macro stability. Over the past decade, stable growth has gone hand-in-hand with low fiscal deficits (1.4 percent of GDP, on average, during 2001-14) and rapidly declining public debt (from 100 percent of GDP in 1999 to 24.9 percent in 2014). By law, the fiscal deficit for general government has been capped at 3 percent of GDP since 2003. Prudent fiscal management, in conjunction with coherent monetary and exchange rate policies, has allowed Indonesia to weather a range of external shocks, including the 2008 global financial crisis, and maintain relatively high and stable growth over the past decade.

However, fiscal policy has faced important challenges in its revenue mobilization and allocation functions, leading to inadequate provision of key public goods. Although total revenues doubled between 2001 and 2014 in real terms, they have remained stagnant as a share of GDP. Indonesia's revenue-to-GDP (15.2 percent) and tax-to-GDP (11.3 percent in 2014) ratios are very low relative to the country's own potential and by international standards (Figure 4.3). Revenue growth over the past 2 years has been particularly weak, reflecting unfavorable macro conditions (weak commodity prices and slowing growth) and long-standing compliance issues. With the sharp decline in crude oil prices, revenues from oil and gas production, which accounted for 20

percent of the total (3 percent of GDP) revenue in 2014, are projected to decline sharply, imposing further challenges to fiscal policy. In short, with revenue collection way below its potential and the rule limiting fiscal deficits to 3 percent of GDP, Indonesia's fiscal sector has remained smaller than it should have done, implying sub-optimal levels of public expenditure (basically with a revenue-to-GDP ratio of 15.2 percent, public spending is capped at 18 percent of GDP). As discussed in Section VI, there is a pressing need to devise a sound medium-term strategy to collect more revenues to finance the new Government's ambitious development targets.

Figure 4.3: Actual tax revenues as a share of potential tax revenues, percent



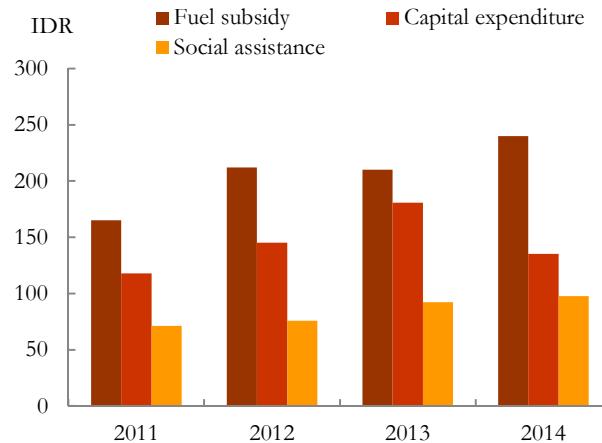
Source: Fenochietto, R. and Pessino, C., 2013, “Understanding Countries' Tax Effort”, IMF Working Paper WP/13/244.

Large energy subsidies have crowded out public spending on infrastructure and social programs, constraining shared prosperity. In 2012, spending on energy subsidies accounted for more than one-fifth of the central government's budget, more than three times the allocation for infrastructure such as roads, water, electricity and irrigation networks, and three times government-wide spending on health. The recent energy subsidy reforms have opened space for larger spending in these long-neglected areas. With the new subsidy scheme the cost of fuel subsidies is projected to fall sharply from 2.4 percent of GDP in 2014 to 0.6 percent of GDP in 2015. The projected fiscal savings of nearly IDR 200 trillion, or about USD 16 billion, open the door to more productive spending on infrastructure and health, particularly over the longer-term when rising fuel subsidy costs would otherwise have crowded out such spending. (In the near term, the downward pressure on oil-related revenues due to the fall in global oil space limits the increase in fiscal space.)

Significant under-spending in infrastructure and health have undermined the transformation of natural resource wealth into strong physical and human capital. In natural resource-rich settings such as in Indonesia, desirable outcomes from public spending should include the accumulation of physical and human capital in order to compensate for the depletion of natural resources capital over time. This requires adequate spending on infrastructure, education and health, and ensuring that public spending leads to improved outcomes in those areas. In Indonesia, despite major efforts, the agenda of building a strong physical and human capital remains largely unfinished. As regards physical infrastructure, total investment—that is, investment by the central government, sub-national governments, state-owned enterprises and the private sector—has remained at only 3 to 4 percent of GDP over the past decade. This is far below the rates of above 7 percent of GDP before the 1997/98 Asian financial crisis and the 10 percent and 7.5 percent spent by China and India, respectively. Indonesia's huge infrastructure gap translates into massive congestion on the country's roads, ports, the telecom networks, etc., clearly constraining growth and shared prosperity.

The accumulation of human capital would have been stronger if Indonesia's bold constitutional decision to allocate 20 percent of the budget to education had been accompanied by adequate funding for health. As seen above, while this commitment is paying off in terms of enrollment and numbers of graduates, it has not yet turned around the quality of education.⁴³ In particular, there are significant disparities in educational opportunity in post basic education where the labor market returns are higher and most of the recent growth in jobs has been concentrated. The building of strong human capital is, however, more constrained by under-spending in health and inadequate health indicators. In 2012, total government outlays for health were only 1.0 percent of GDP. This is the fifth-lowest health spending-to-GDP ratio out of the 188 countries for which data are available: only South Sudan, Pakistan, Chad and Myanmar had lower ratios. While

Figure 4.4: Central government spending on fuel subsidies, capital expenditure and social assistance (2011-14)

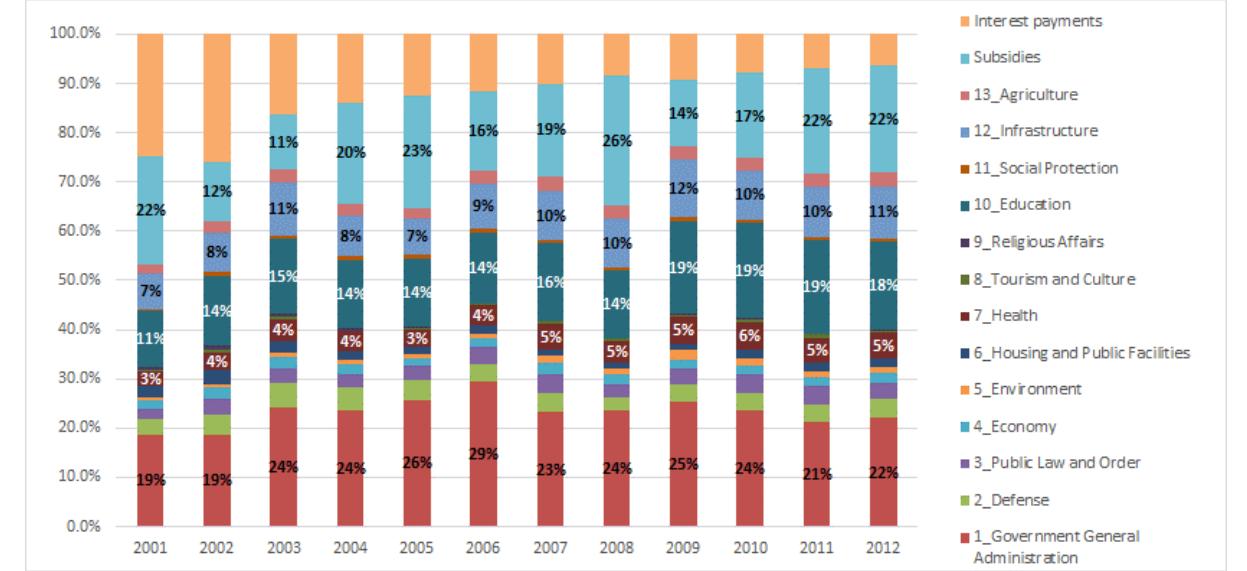


Source: Ministry of Finance, Indonesia

⁴³ World Bank, 2012. "Indonesia Education Public Expenditure Review: Spending Better".

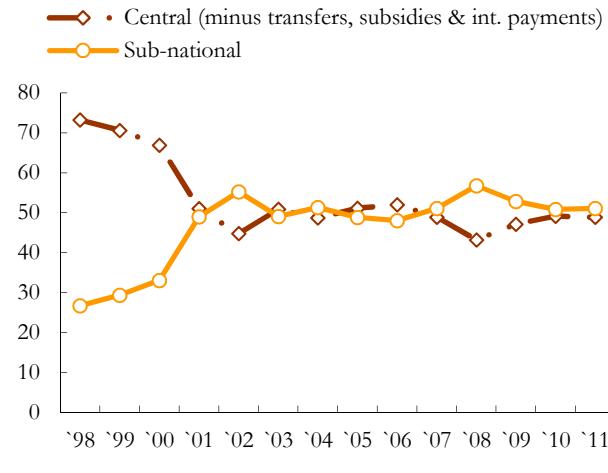
performance in health is not all about money, it is likely to largely explain Indonesia's poor health indicators in many areas. As mentioned earlier, despite significant progress in infant and child mortality, 37 percent of children are stunted and Indonesia has one of the highest maternal mortality rates in the Asia region (190 per 100,000 live births in 2013).

Figure 4.5: Inter-sectoral allocation of total (central and sub-national) public spending



The recent bold energy subsidy reforms have created fiscal space to spend more on key development priorities. Improving sub-national government expenditure choices and execution for local service delivery will be the next big step in improving the quality of spending. With the decentralization launched in 2001, transfers to sub-national governments rose significantly, and now make up about half of the state budget, net of subsidies and interest payments (about 5.5 to 6 percent of GDP).⁴⁴ Over 80 percent of this amount accrues to sub-national governments at the lowest level, the district/city level, which have primary responsibilities in the provision of local public services, including infrastructure, health, and education.

Figure 4.6: Central and subnational spending as a percentage of total spending



Source: Ministry of Finance, Indonesia

To date, sub-national government spending has been excessively dominated by spending on administration over productive sectors and on personnel over maintenance and capital spending. Improving the “allocative” efficiency of local government budgets by reallocating more resources to front-line service delivery will be an important step in improving the rural population’s access to basic services (see Section V, 2.2).⁴⁵

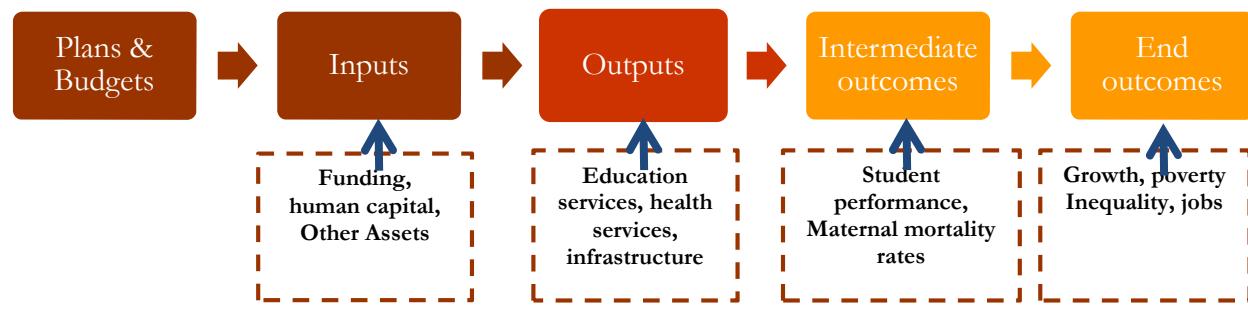
⁴⁴ Sub-national governments receive about 90 percent of their budgets from the central government (fiscal transfers).

⁴⁵ See for instance, World Bank (2012). Indonesia Subnational Public Expenditure Review: Optimizing Subnational Performance for Better Services and Faster Growth.

4.3.2. Constraints from budget execution and service delivery

Ensuring good quality in public spending also requires ensuring that public spending inputs (e.g., public spending on health) efficiently lead to good outputs (e.g., health clinics, nurses and equipment) and effectively yield desirable outcomes (e.g., access to health care, low maternal mortality rates, etc.). To achieve shared prosperity, public money should be allocated to the right areas (e.g., roads versus energy subsidies) and effectively deployed to benefit people, which requires an effective, non-corrupt bureaucracy. Ineffective delivery of services reduces the amount of in-kind services received and tends to increase out-of-pocket spending, with possible impacts on poverty levels.

Figure 4.7: From spending allocations to outcomes



Source: World Bank staff

A suite of public expenditure reviews (PERs) published by the World Bank in recent years reveals a general picture of poor quality of spending in Indonesia.⁴⁶ Overall, where spending has been increased, improvements in outputs and intermediate outcomes have been disappointing. The following provide a few examples:

- In the roads sector (40 percent of infrastructure spending), public spending has returned to the pre-crisis level, driven by investments by sub-national governments. Despite this, access to transport services and the quality of road networks in Indonesia remain inadequate and lag neighboring countries. According to household surveys, 26 percent of urban residents have poor access to transport services and many cities in Indonesia fail to invest enough in infrastructure to keep pace with the increasing demands of rapidly growing cities.⁴⁷
- In education, a tripling of spending over the past decade has mostly gone to teacher salaries due to acceleration in teacher hiring (now Indonesia has one of the lowest student-teacher ratios in the world) and teacher certification (salaries doubled for certified teachers). However, this has not led to better educational outcomes as measured by student performance indicators such as PISA. More than half of teachers do not meet minimum competency levels and Indonesia's student learning outcomes in reading, math and science remain low compared with other countries and have seen no improvement over the past decade. Forty percent of 15-year-olds are below the lowest competency level in math. Examples of where local

⁴⁶ Public expenditure reviews were undertaken for the education sector, the road sector, social assistance, agriculture and sub-national spending.

⁴⁷ “Urbanization and Economic growth in Indonesia: Good news, bad news and (Possible) Local Government Mitigation”, Regional Studies, Vol. 41.

governments should invest more or invest more wisely include non-salary spending (e.g., through greater support to teacher professional development and school grants).

- In agriculture, public spending on agriculture has increased substantially in recent years, but had gone to private input subsidies (e.g., fertilizer, seeds, credit) rather than public goods (e.g., irrigation schemes, research and extension). Furthermore, fertilizer subsidies are regressive, with 60 percent of the subsidies benefiting the 40 percent largest farmer. These larger/wealthier rice farmers that use more urea therefore capture a larger share of the subsidies. The bottom 40 percent of farmers receive only 21 percent of the subsidy envelop.

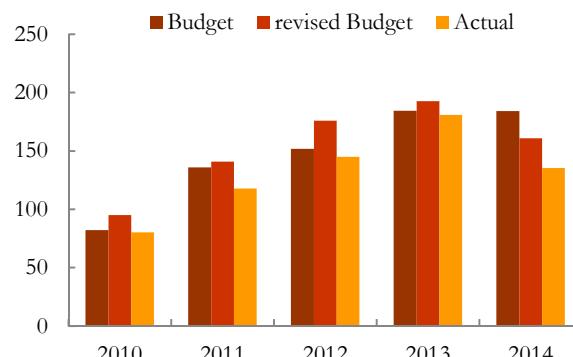
The examples above show that intra-sectoral allocation and local service delivery issues (i.e., how well spending is translated into outputs and desirable outcomes in a sustainable manner) are as important as “money” in supporting the twin goals. With the advent of decentralization in 2001, the effectiveness and efficiency of the delivery of services has become highly constrained by complex coordination issues, and weak management capacities and accountability frameworks linked with the production of public services. For instance, provincial and district roads now account for over 80 percent of Indonesia’s total road network. Thus any project cutting across district boundaries requires lengthy consultations, discussions and coordination. For instance, in water and sanitation, the central government’s increased spending in water resources management and water treatment plants has not been well synchronized with local water utility companies’ investments to connect households to the piped-water systems.

Budget planning and execution

Overcoming planning and budget execution challenges, particularly in the infrastructure sector, will be key in realizing the benefits implied by recent energy subsidy reforms and the Government’s ambitious development plans. The significant redirection of spending away from fuel subsidies and towards development priorities, especially infrastructure, is a major positive policy change toward improving the quality of spending. However, the extent to which these policy intentions will materialize depends on overcoming long-standing implementation problems, particularly land acquisition for new infrastructure projects.

Execution problems constrain actual spending and in turn the achievement of development objectives for improving the supply and quality of infrastructure services. In recent years, the execution rates of capital expenditure, most of which is for infrastructure, have been well below budgeted levels, averaging 90 percent of the Budget, or 86 percent of the revised Budget between 2010 and 2014. In 2014, capital spending fell far short of the budgeted amounts, disbursing only 73 percent of the Budget and 84 percent of the revised Budget, with spending contracting sharply in nominal terms from 2013, by 26 percent.

Figure 4.8: Execution of capital expenditure fell short of the budgeted levels (Budget, revised Budget, actual of capital expenditure, IDR trillion)



Source: Ministry of Finance, Indonesia

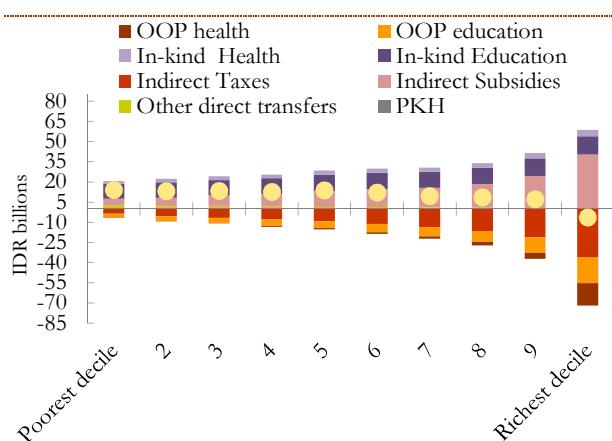
These weaknesses in inter-governmental coordination, combined with regulatory bottlenecks and land acquisition challenges, have also strongly discouraged private sector participation to local service delivery.

- For instance, in the education sector, one of the biggest challenges is that regulations require a foundation type of legal ownership structure for educational institutions, precluding for-profit investors from entering the market to deliver education services.
- In the health sector, foreign investment is not allowed for hospitals below 200 beds. At the same time, the deployment of private investments to build hospitals above 200 beds is severely constrained by a limited availability of trained domestic doctors and nurses as foreign doctors and medical staff are not allowed to provide services in Indonesia.
- In the transport and water sectors, in 2009, the Government identified 58 projects spanning 11 different areas including toll roads, maritime transportation and water resources, to be implemented in 2010-15 through PPP schemes. The estimated total value of these projects was USD 51.2 billion (PPP source book 2012). However, by 2012, only three projects were considered “ready for offer”, whereas 26 projects were categorized as “priority” and 29 as “potential PPP projects”.

4.3.3. Effectiveness of fiscal policies in reducing poverty

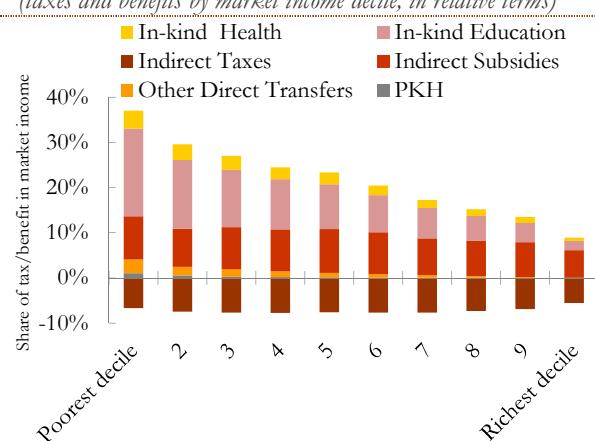
In Indonesia, the bottom 40 percent receives far less from government spending than the rich in absolute terms, although the little they do receive represents a large share of their (low) incomes. In Indonesia in 2012, the rich received far more government spending than the poor and bottom 40 percent, although they also paid more taxes and user fees associated with health and education (Figure 4.9). However, while the poor and bottom 40 percent received far fewer benefits in absolute terms, the benefits they do receive represent a far greater share of their market income (around 30 percent on average), because their incomes are so low (Figure 4.10). These findings are a reminder that disparities in the quantity and quality of services delivered across geographical areas affect out-of-pocket spending patterns, which in turn affect poverty levels. More and better in-kind services (health, education, etc.) received by the poor would help them to direct more spending toward food to improve their nutritional status, or to other areas that improve their welfare.

**Figure 4.9: The rich benefited from more government spending than the poor in 2012...
(taxes and benefits by market income decile, in absolute terms)**



Source: Afkar, Inchauste, Jellema, Lustig and Wai-Poi (2015) The Distributional Impact of Fiscal Policy in Indonesia.

**Figure 4.10: ...but because poor incomes are so low, the benefits they do receive represent a much greater proportional benefit
(taxes and benefits by market income decile, in relative terms)**

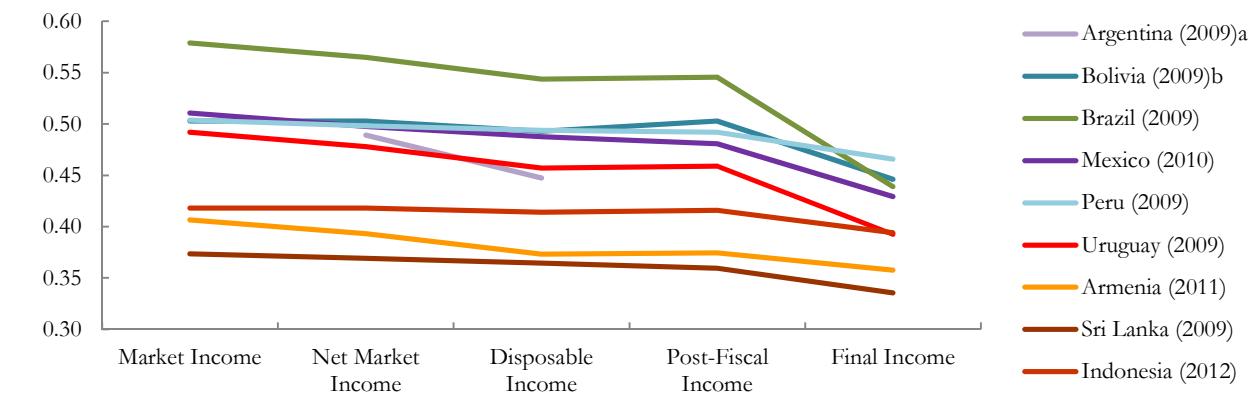


Source: Afkar, Inchauste, Jellema, Lustig and Wai-Poi (2015) The Distributional Impact of Fiscal Policy in Indonesia.

Despite significant transfers to the bottom 40 percent through education and, to a lesser extent, subsidies, Indonesia's fiscal policy does little to reduce poverty. The (few) benefits that the poor receive from energy subsidies are offset by the indirect taxes they pay on consumption, such as VAT and tobacco excise. Direct transfers (social assistance) do reduce the poverty rate, but only by 1.3 percentage points.⁴⁸ Nor does fiscal policy do much to reduce inequality. The consumption of health and education spending does reduce the Gini coefficient by around 2.5 points, but this is minor compared with countries in Latin America (Figure 4.11), which also reduce inequality significantly through progressive income taxation, and wider and larger cash transfers.⁴⁹

Figure 4.11: Several Latin America countries are far more progressive than Indonesia in reducing inequality

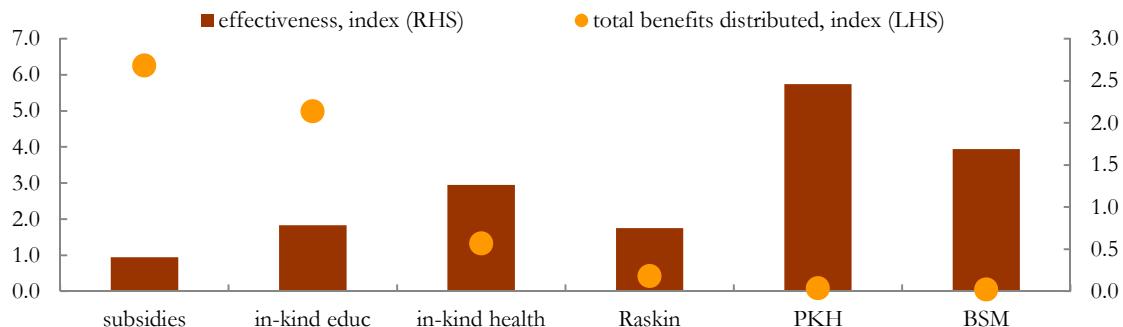
They reduce the Gini by 10-15 points between the market income distribution before any government taxes or transfers, and the final income distribution after all taxes, transfers and indirect subsidies and spending (Income Gini at different income definitions)



One of the reasons why Indonesia is less effective at using fiscal policy to reduce poverty and boost shared prosperity is that it spends least on the programs that would be most effective in reducing poverty and inequality. The programs that reduce the Gini coefficient by the most per rupiah spent are conditional cash transfers for human capital (PKH) and school scholarship (BSM) programs. However, these programs receive the least spending (Figure 4.12). At the same time, by far the largest amount of spending—historically—has been on subsidies and education, which do little to reduce inequality for the amount of money spent. That said, as seen in Section III, spending in education is a key driver of lifetime mobility and a key way of reducing inequality in the long term.

Figure 4.12: The programs that are most effective in reducing inequality receive the least spending

(Effectiveness at reducing the Gini relative to program cost (LHS) and program cost (RHS))



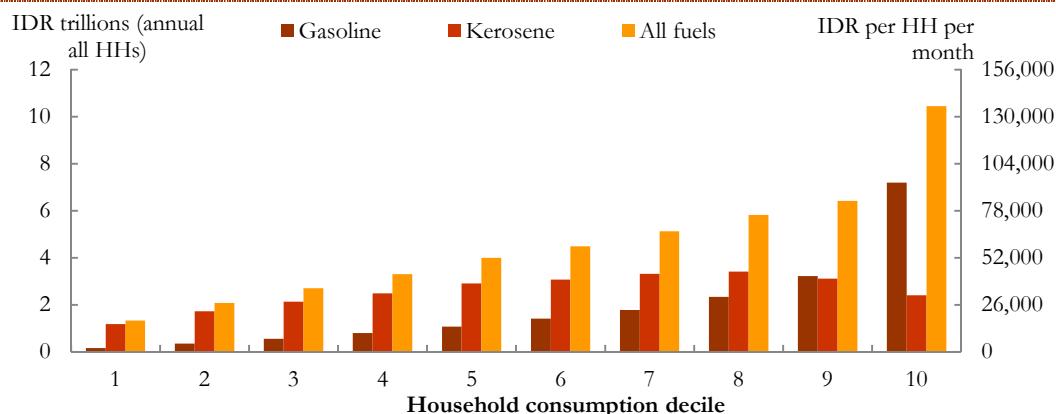
Source: Ministry of Finance, Susenas and World Bank staff calculations

⁴⁸ Afkar, Inchauste, Jellema, Lustig and Wai-Poi (2015) The Distributional Impact of Fiscal Policy in Indonesia

⁴⁹ The impact of Indonesia's progressive income tax—which covers relatively few households—is difficult to assess, as most of the higher income households that pay income tax are missing from the household survey data.

Fuel subsidies consumed a significant share of public resources, but mainly benefited higher income groups. Spending on fuel subsidies disproportionately benefits households at the top of the income distribution: 84 percent of all benefits go to the top half of households by consumption, and only 16 percent to the bottom half, while 40 percent of benefits go to the richest 10 percent of households, and less than 1 percent to the poorest 10 percent. Moreover, around two-thirds of poor and near-poor households do not consume any gasoline whatsoever, although the likelihood of them consuming gasoline and the actual quantity consumed would rise if their income increased. In addition, not only do the poor receive fewer benefits from fuel subsidies, they also are likely to suffer more from the poor provision of infrastructure that is an indirect consequence of large energy subsidies: they live in the areas that are most flood-prone and often have the greatest difficulty in accessing key basic services.

Figure 4.13: Distributional impact of fuel subsidies



Source: Ministry of Finance, Susenas and World Bank staff calculations

4.3.4.2. Social assistance and protection

Greater social protection is needed to shield the vulnerable from shocks that push them into poverty, while helping those beneath the poverty line to climb above it. This entails strengthening social assistance programs and making the ongoing social security reforms effective and sustainable.

Social assistance

Since the Asian financial crisis in 1997/98, Indonesia has launched a series of safety net programs that address a variety of risks that poor families face. Key programs include: (i) a rice for the poor program (Raskin, see Section II, 2); (ii) a conditional cash transfer program to enhance human capital (PKH); and (iii) a conditional cash transfer program providing scholarship to the poor (BSM). Indonesia has a new targeting system in place to identify the poor and ensure that they receive these benefits through a Unified Data Base (UDB), which includes both poor households and those at the greatest risk of falling into poverty. All major programs are now using the UDB, although continuous improvements in targeting are required. Household information needs to be appropriately updated and validated, and a grievance and complaints system is an important next step. Still, Indonesia lacks a formal crisis monitoring and response system with an automatic safety net that kicks in to protect households when significant shocks arise.

To enhance the impact Indonesia's social assistance system, it is important to reform the current system by spending more on the programs that work well, revisit the adequacy of

benefit levels and fill in gaps in the net. Improving the system will likely require far more resources than are currently spent by the Government, at roughly 0.5 percent of GDP on social assistance. Other large middle-income countries spend, on average, three times as much on these programs. Central government social spending is currently distributed among roughly 12 ministries, 22 programs, and 87 activities, such that oversight and coordination plays a crucial role in devising the poverty assistance strategy, integrating poverty programs and coordinating implementation with various ministries.

Proven programs should also be expanded. The human capital conditional cash transfer program (PKH), for instance, was introduced to 810,000 households in 2007 and has since been expanded to cover 2.4 million households across 33 provinces. Although plans are in place to roll the program out to 3.2 million households, PKH will only cover 5 percent of Indonesian households. Conditional cash transfers like PKH have proven effective in reducing poverty and inequality in Mexico (Progresa/Oportunidades) and Brazil (Bolsa Familia), but these programs cover around a quarter of the population.

Program benefit levels need to adequately address the risks they are targeting. There is already evidence that benefit levels for some programs are not adequate. For instance, the benefits of the education conditional cash transfer (BSM) typically do not address many important ancillary costs (e.g., the cost of transport or books) that are incurred by a household choosing to send children to primary or secondary school. The Government took positive steps by increasing benefits for BSM and PKH in 2013 as part of the compensation package tied to the fuel subsidy reform. These benefit levels need to increase in the future in line with rising education and health costs. Assistance also needs to be received by poor and vulnerable households at the right time. Again, consider the BSM program as an example. Although the program gives cash assistance to the poor to help them pay for supplemental fees and other costs associated with educating children, the cash is sometimes received after the school year has begun. This means that the poor still have to find ways to help cover school costs that are incurred before the benefits are received. A good way to reform BSM and other programs is to ensure that funds are provided to families at times that make sense.

Programs such as BSM and PKH cover many vulnerable households, but do not yet adequately cover especially vulnerable groups. The elderly population is also at risk, especially at a time when their ability to generate income is low. Similarly, people with disabilities often require special support to enable them to attend schools, seek appropriate health care, and become an active part of the workforce. Building a comprehensive social assistance system will require extending cash assistance and in-kind assistance programs to serve these vulnerable groups.

Some risks facing Indonesia's poor are not yet covered, leaving families exposed and vulnerable. Indonesia does not provide adequate coverage for cognitive, nutrition and psychosocial support for early childhood. An early childhood education and development program should be piloted to address this critical gap in coverage at the earliest stage of the lifecycle. Also, the Government currently lacks a program to protect families from temporary or longer-term unemployment. Workfare programs could provide temporary employment opportunities to boost household incomes, especially during crises for urban workers and between agricultural seasons for rural workers.

For the Raskin program (rice distributed to the poor), moving to e-money for food purchases by the poor could be considered as it eliminates all financial costs of tying up food stocks, the "leakage" issues common in public food distribution, etc. International experience shows that ensuring that the e-money is usable in private stores (and not only in public distribution sites) is

important. One advantage of the e-money system is to allow recipients to use the money or vouchers to purchase fruits, vegetables and dairy products (not only rice), which all would be beneficial to nutritional balance. For many of the poor the nutritional problem may not be a calorie one. Simply adding more rice to the diet may not be the appropriate solution.

Social security

Because only 41 percent of the Bottom 40 percent are covered, Indonesia is committed to and putting significant effort into attaining universal health coverage (UHC) by 2019. The country launched a National Health Insurance Program in 2014 (JKN) and is making health insurance free for the poorest 40 percent of the population—a key policy of the administration of President Joko Widodo (“Jokowi”).⁵⁰ UHC could be instrumental to boosting shared prosperity and reducing poverty in Indonesia, where 93 million Indonesians (40 percent of the population) live under USD 2 per day and where inequality is also rising.

Lack of supply-side readiness is key challenge to attaining UHC, which could ultimately make the UHC an empty promise. Health facilities are generally ill-equipped with the physical and human resources necessary to provide the basic services required by law. In fact, there is not one primary health facility in Indonesia (*Puskesmas*) that has all the required general service readiness items. There is substantial variation in service readiness across regions with acute deficits in medicines and diagnostics in most locations. Achieving UHC thus requires spending more in health, particularly on supply-side readiness, and spending better by improving local service delivery. The Government only spends 1.2 percent of GDP in health, the fifth lowest ratio in the world. This low level of spending remains after health spending has tripled in the past decade. Results are limited and there is no correlation between the adequacy of health services and health spending per capita across regions. Local governments have poor capacity to deliver services and are weakly accountable to central government and their citizens.

To be effective and sustainable, the UHC program will require appropriate benefit levels, sound fiscal risk management, sound institutional development and management, and non-contributory coverage of the poor and vulnerable, while at the same time collecting contributions from those who can afford to pay. Strong leadership is required for implementation due to the large number of stakeholders with diverging interests, the significant impact of these programs to the social structure of the country, and the significant potential impact on the state budget, the labor market and the macro economy. It is crucial to develop a roadmap outlining activities, roles and responsibilities to ensure smooth, effective transformation, and to monitor the progress of the implementation.

The Social Security Organizing Agency (BPJS) Law improves the legal, governance and financial structure of the social insurance system by legally separating the assets of the administrators from the assets of the social security funds that they manage. The separation of assets into different legal entities and the use of a custodian to hold fund assets are important safeguards for fund members and are consistent with international best practice. However, it will be a significant challenge to ensure that the legal structure is properly implemented and the system operates as intended. To ensure assets are managed correctly, the Government will need to issue investment and risk management regulations defining the financial framework and governance

⁵⁰ The other components of the social security reforms comprise universal employment insurance coverage by July 2015 and an important institutional overhaul to reduce the fragmentation of the social security system.

structure of the new system. It should be noted that different investment policies and fee structures are appropriate for different funds, and it will be necessary to ensure the integration of reserves, investment policy and asset-liability management for each fund.

It is important for the Government to formulate and implement policies and procedures to ensure the fiscal sustainability of the National Social Security System (SJSN) social insurance funds and to ensure that the financial risks of the SJSN are properly managed. If the contribution rates are set too low relative to promised benefits, or if the contributions and/or benefits are not periodically adjusted, or if program funds are mismanaged, the social security funds could become insolvent and require significant budget transfers. Above all, integrated systems and operations for the BPJS are a must to avoid the inefficiencies of having separate ID numbers and contributions collection processes for the same participants.

SJSN implementation creates a potentially large contingent liability for the state budget, which is the ultimate guarantor of fund solvency. Consequently, the Government has a strong incentive to ensure that the programs are properly managed. This will require the creation of risk management capability within the Government and strong supervision and control of BPJS operations to protect the rights of participants, prevent fraud and corruption, ensure proper financial management, and control operational expenses. Good governance and oversight of the system is critical given the huge amounts of money that will flow into the five funds and the critical role that these programs will play in the country's social protection system, and greater clarity in the respective roles and functions of the various institutions is critical. The collection of contributions raises another set of concerns. While contribution collection mechanisms for salaried workers are already available, there is no such mechanism available for non-salaried workers. Effective collection from non-salaried workers is needed to ensure high levels of participation from that sector, and to avoid the significant anti-selection that will occur if only those with high risk choose to join the SJSN programs. The Government will need to study a wide range of possible collection mechanisms, examine other countries' experience and pilot test possible options for collecting contributions from non-salaried workers. Finally as noted above, the effectiveness of the universal health insurance element of the system will require substantial upgrading of the health system to ensure supply, particularly to the poor and vulnerable.

4.4. Pathway III: Binding Constraints to Better Management of Natural Resources

Poverty reduction in forest and coastal areas cannot be addressed solely by the first two pathways and requires, in addition, improved governance and management of natural resources in Indonesia. Indeed, natural resource activities directly affect local communities, through employment generation, access to the resources and the environmental impact of operations. Over the past few decades, the overexploitation and poor governance of Indonesia's forests, marine and other natural resources have had high social and environment costs. People living in forest and coastal areas, who depend on climate-sensitive livelihoods, and live and work in areas susceptible to drought, flooding and landslides, bore much of these costs. The high level of poverty in these areas is linked to the poor governance of Indonesia's natural resource sectors in past decades.

4.4.1. The poverty cost of poor forest resource management

Indonesia's forest capital wealth is one of the most valuable in the world and yet, as seen in Section 1, the population living in and on the edge of forests is the poorest in Indonesia. Indonesia's natural and planted forest area is estimated at 94 million hectares, i.e., over a half of the

country's land cover. Thirty two million people live in forest areas. Of these, 6.3 million are poor. That is, the poverty rate in these areas is 19.6 percent, the highest in the country and way above the national average poverty rate of 11.3 percent. Populations in forest area account for one-fifth of all the poor in Indonesia. Village surveys (PODES) show that in 2012, only 12 percent of forest villages had maternity facilities and midwives, 38 percent of them had a primary school within 6km, and only 8 percent of them had a secondary school.

The high level of poverty in forest areas reflects many factors, including rapid degradation of natural resources, lack of access rights to land for local communities and poor access to health and education services. Indonesia's strategy to manage forests through concessions and through centralized management structures without local monitoring and ownership has resulted in overexploitation of forest assets and uses of the resource that neither benefit the poor, nor create economic value. Indeed, local communities' land access rights are limited and community forestry license programs have not achieved their targets. Traditional customary communities (*adat*), which occupy more than 30 million ha of forest lands, have no formal land rights, which might now change due to favorable constitutional counter-decisions. At the same time, the allocation of concessions for timber, pulp and paper production and, increasingly, oil palm plantations, is opaque while the enforcement of spatial and environmental planning is ineffective. As a result, the deforestation rate is rapid, and is a key source of loss of livelihoods for local communities as a large part of their income depends on forest resources. The FAO estimates that 25 percent of the forest cover was lost between 1990 and 2010, primarily in biodiversity-rich primary forests. Consistent with the FAO number, the UNFCCC estimates that annual deforestation and degradation are 670,000 ha/year and 425,000 ha/year, respectively (UNFCCC, 2014). Deforestation results from many factors, including significant growth in oil palm plantations, mining production and urbanization), as well as substantial governance issues in land-use licensing and law enforcement processes. Almost 42 million ha of forest dedicated to production are no longer under concession.

Deforestation over the past decade has also been accompanied by widespread forest and peat land fires, with high economic, social and environment costs. Indonesia has experienced annual large-scale forest and land fires since 1982, but with increasing scale and regularity in recent years. These fires are triggered by land preparation for agriculture, illegal logging, insecure land tenure of the community, and land speculation. Such forest fires impose significant economic and social, as well as environmental, costs. The total damage and losses caused by these fires in the period between February and April, 2014, was USD 935 million in the province of Riau.⁵¹

4.4.2. The poverty cost of poor management of marine and coastal resources

Indonesia's marine resource wealth is one of richest in the world. Indonesia is home to the largest mangrove and sea-grass ecosystems in the world. The country's coral reefs span more than 5.1 million ha, representing 18 percent of the world's coral reefs.¹⁵ Nearly a quarter of the world's mangrove forests (22.6 percent of global mangroves) are in Indonesia. The country totals about 3.3 million ha of sea-grass, the largest in the world. Yet, as seen in Section II, the average poverty level of people living in coastal areas is the second highest in Indonesia even if the country's rich coastal and marine resources have provided local inhabitants with food and income for centuries.

The high level of poverty of individuals living in coastal areas is, to a large extent, due to poor management of coastal and marine resources. Coastal communities depend on healthy marine

⁵¹ World Bank, 2014. *Hard Choices*, Indonesia Economic Quarterly, World Bank, July 2014.

and coastal ecosystems for essential goods such as food, fuel wood, shelter and clean water, and their fate is tied to the management of these resources. However, marine and coastal ecosystems are deteriorating rapidly across Indonesia. Coastal deforestation, water pollution and overfishing have reached a level that threatens the sustainable capacity of coastal and marine ecosystems to support the future economic development of Indonesia. According to recent estimates by the Ministry of Maritime Affairs and Fisheries' (MMAF) Directorate of Fisheries Resources, the majority of fisheries in 7 of Indonesia's 11 fisheries management areas are already fully exploited. Furthermore, close to 65 percent of Indonesia's coral reefs are considered threatened from overfishing, and almost half are considered threatened specifically from destructive fishing practices. Finally, more than 40 percent of Indonesia's mangroves have already been lost. As a result of these degradations about 58 percent of the population in Java lives in water insecure areas, as water and soil pollution levels (mercury and lead) are among the highest in the world. These problems have been aggravated by many natural disasters, including tsunamis, hurricanes, global warming and their concomitant effects.

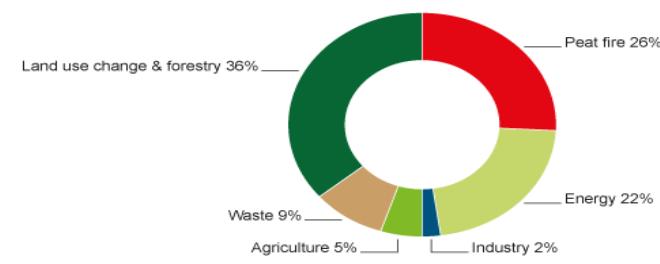
Illegal, unreported, and unregulated (IUU) fishing results in massive losses of revenues and affects indirectly poverty levels of communities living in coastal areas. The Government estimates that as much as USD 20 billion worth of maritime resources per year are stolen by dubious foreign and local fishing companies, who pay bribes to relevant law enforcers to look the other way. Compared with last year's revenues of under USD 4 billion from vessels with a license to fish, the magnitude of this revenue loss is huge. An estimated 4,800 foreign boats fish illegally in Indonesian waters each year. The new Government has indicated a strong commitment to fight illegal fishing through more effective law enforcement. Reduction in illegal fishing can in principle lead to significant increases in domestic supply of fish, as well as increased prices, which bodes well for increasing local fishermen's incomes.

4.4.3. Costs and risks due with environment degradation and climate change

Indonesia ranks among the top GHG emitting countries of the world. The greenhouse gas (GHG) emission intensity of Indonesia's GDP remains relatively high compared with regional peers, reflecting not only the structure of the economy but also the composition of the energy sources available. Estimates suggest that roughly two thirds of Indonesia's GHG emissions originate from land use changes and peat degradation, although fossil-fuel emissions are also rising steeply. The expansion of oil palm is responsible for GHG emissions where new plantations replace natural and/or forest habitats, including primary forests, and are planted on deep peat which, once drained for agricultural purposes, dries up and becomes vulnerable to fires. Eventually, those areas subside, become flooded and lead to productivity losses. Overall, outdoor and indoor (cooking) air pollution generates negative health impacts that cost an estimated at USD 4.6 billion per year, or about 1.6 percent of the country's gross national income in 2008.

The increasing trend in Indonesia's GHG emissions, driven by commodity expansion and poor governance, may be exacerbated by major demographic changes currently underway and expected to continue for the next decades: (i) population growth, with 2.9 million additional people added to the population every year; (ii) rapid urbanization, with 65 percent of the population projected to live

Figure 4.14: Sources of CO₂ emissions



Source: World Bank (2009) Country Environment Assessment.

in urban areas by 2050; and (iii) changing socioeconomic composition, with the middle class rising in size and influence.

As an equatorial and archipelagic country, Indonesia is expected to begin experiencing significant impacts from climate change over the next 20 years. However, little has been done to date to put together a systematic approach aimed at adaptation (Box 4.1).

Box 4.1: Estimated impacts of climate change on SEA, including Indonesia

Heat extremes: Unprecedented heat extremes are expected to 30-40 percent of land area during boreal summer by 2040s. Strongest increase is expected in Indonesia and the southern Philippines, with roughly half of summer months experiencing unprecedented heat.

Sea-level rise: For Southeast Asian coastlines, projections of sea-level rise by the end of the 21st century relative to 1986-2005 are generally 10-15 percent higher than the global mean. The analysis for Manila, Jakarta, Ho Chi Minh City, and Bangkok indicates that regional sea-level rise is likely to exceed 50 cm above current levels by about 2060.

Coral reef loss and degradation: Severe impacts for marine fisheries and tourism. Increasing sea surface temperatures have already led to major, damaging coral bleaching events in the last few decades. Under 1.5°C warming and increasing ocean acidification, there is a high risk (50 percent probability) of annual bleaching events occurring as early as 2030 in the region.

“Turn Down the Heat: Climate Extremes, Regional Impacts, and the Case for Resilience”, June 2013, a report for the World Bank by the Potsdam Institute for Climate Impact Research and Climate Analytics

The changing climate will hurt the poor, especially those who live at flood threatened degraded coastal zones, as well as potentially high-productivity sectors that create employment, such as tourism. Coral reefs are under threat because of rising sea temperatures, while subsiding peat domes and the destruction of mangrove forest will not only have negative impacts on vulnerability of coastal zones to disasters, but have also impacts on livelihood of the poor. The Asian Development Bank (ADB, 2009) projects that by the end of the century climate change will cost Indonesia between 2.5 and 7 percent of GDP.

4.4.4. Management of disaster risks and building resilience

Finally, with high levels of vulnerability, Indonesia’s hard fought efforts to reduce poverty are constantly under threat from shocks. Enhanced social protection can reduce the likelihood of sliding back into poverty for the bottom 40 percent and strengthened disaster management can help to mitigate shocks from natural disasters such as earthquakes, tsunamis, volcanic eruptions, floods, landslides and forest fires.

Given the experiences in Aceh and more recently Yogyakarta, there is broad public support for improving preparation and response to natural disaster. Safeguarding hard-fought poverty reduction in Indonesia calls for continuously enhancing the management of disaster risks and further building resilience. Indonesia is indeed situated in one of the world’s most active disaster hot spots, where several types of disaster, such as earthquakes, tsunamis, volcanic eruptions, floods, landslides, droughts and forest fires, frequently occur. According to a global risk analysis by the World Bank, Indonesia is among the top 35 countries that have high mortality risks from multiple hazards. About 40 percent of the population is at risk, that is, more than 90 million lives. Going forward, the increase in population and assets exposed to natural disasters, combined with the rise in the number and intensity of hydro-meteorological events resulting from climate change, may further increase the economic and human impact of natural disasters.

Indonesia's cities' resilience to natural disasters has weakened due to the rapid construction of physical assets in urban areas and weak enforcement of building codes and zoning regulations. Indonesia's rapid and not always well-planned build-up of physical assets (buildings, houses, etc.) in urban areas poses specific challenges to sustainability. Indonesian cities have seen a rapid demand for urban housing and commercial space over the past decade. The private sector (real estate and construction) has responded rapidly but rapid physical construction has often meant that many new buildings have been built with less than ideal consideration to building codes. In addition, in densely populated neighborhoods, site plans are typically constrained by a lack of available space to maintain the proper functioning of urban ecosystems, such as drainage and open public spaces. Indonesia's capital, Jakarta, is particularly exposed, with urbanization-induced land subsidence posing a bigger threat to the metropolitan area than climate change associated with rising sea levels.

Disaster impact on housing is a useful proxy for the degree of vulnerability. In the past 5 years, the Government has spent between 20 and 50 percent of its reconstruction budget on housing. This indicates not only the rise in the proportion of disaster impacts on urban assets, but also the actual public investment for repairing assets, ideally with more stringent standards. Looking at the proportion of the Government's post-disaster spending between more urbanized and non-urban provinces, there is also a tendency to spend more on more urbanized provinces. This is also an indication of the disproportionate impact of disasters on urban versus non-urban assets (i.e., between permanent and non-permanent structures).

While relatively low compared with the size of the national economy, the average annual cost of natural disasters is significant at the sub-national level. Over the past 10 years, the annual average cost of natural disasters in Indonesia is estimated at 0.3 percent of national GDP or USD 1.5 billion. The economic impact of the 2004 earthquake in the province of Aceh was estimated at USD4.5 billion i.e., 1 percent of national GDP, but that represented 54 percent of the provincial GDP. Likewise, the 2006 earthquake in the province of Yogyakarta caused losses estimated at 30 percent of provincial GDP. As Table 9.1 shows, the economic impact of recent disasters has been substantial at the provincial level.

Preliminary fiscal disaster risk analysis suggests that the annual fiscal disaster losses are in the range of USD 420-500 million and that once every 100 years these losses are close to USD 1.5-1.6 billion. Using public spending data of past events, as estimated from the number of buildings destroyed and damaged, to simulate possible future spending needs (or fiscal losses) related to natural disasters, it can be estimated that in an average year the fiscal losses are estimated in the range of USD 420-USD550. In every 10 years they could exceed USD 800-950 million, while every 100 years losses could be in excess of USD 1.5-1.6 billion. These estimates provide indicative sizes of financial liability that the Government may have to face should such events occur.

The rapid expansion in the physical assets of cities requires both a credible regulatory framework and a healthy market that can translate this growth potential into preventive and risk-management investments. Several concrete policy options can be considered to enable Indonesia to reap the full benefits from urbanization, while leveraging growth to build more resilience. A national program on hazardous micro-zoning providing detailed instruments for incorporating resilience into site design and construction standards; financing framework for both urban, housing and property development that incentivizes investment with built-in resilience linked to disaster insurance; and national program on urban upgrading and ecosystem rehabilitation to increase the resilience of existing settlement and urban infrastructure as part of the greening of Indonesia's future growth.

V. Reform Priorities and Cross-Cutting Pre-requisites

The three pathways discussed above accompanied by two “pre-requisites” provide a useful framework to consider priority reform areas. Reforms under growth-jobs, service delivery-opportunity for all and natural resource management pathways are complementary and mutually supportive. For instance, reforms to boost non-commodity sector growth can indirectly help service delivery through greater government revenues and may reduce pressure on natural resources. This complementarity among the different pathways suggests that shared prosperity should be addressed using a comprehensive but coherent reform agenda. Reforms under the three pathways should be supported by two important underlying, cross-cutting pre-requisites: domestic revenue mobilization (“collecting more”) and “governance” reforms to improve policy coordination, project implementation and transparency.

5.1. Prioritization Criteria

In this SCD, we attempt to prioritize reforms based on impact (evidence-based), complementarity/synergy, sequencing and feasibility:

- *Evidence on the salience of a constraint for achieving the twin goals.* The degree to which constraints to achieving shared prosperity through the three identified pathways are binding, based on existing empirical evidence;
- *Reform complementarities and synergies.* The extent to which reforms addressing the most binding constraints have significant impacts on, and relevance for more than one pathway; such reforms are considered “high priority” or “transformational”; and
- *Reform sequencing and feasibility.* Some reforms may not be feasible before the full implementation of higher order reforms while other reforms may be pertinent but lack the minimum political support needed to implement them.

5.2. Reform Priorities

5.2.1. Economic growth and jobs

Enhancing prosperity for the Bottom 40 percent rests in large part on the implementation of structural reforms to shift the economy to a productivity-based growth path. The structural reform agenda ultimately aims to increase the productivity in agriculture by increasing cereal yields, reducing post-harvest waste and shifting to higher value crops, and accelerate investments in manufacturing and services, including tourism, thereby reducing dependence on mineral commodities for exports. Urgent actions to support this shift include reforms that can be expected to generate “quick wins”, while recognizing that the full benefits of such a shift will accrue only over the longer term.

Infrastructure

Large investments in infrastructure (*roads, seaports, railways, irrigation and drainage*) to better connect the economy domestically, reduce logistics costs, support productive activities and improve access to services are clear priorities.⁵² Investment in infrastructure is “transformative” in Indonesia in that it supports growth and competitiveness, is crucial to providing key services to the population and is

⁵² For a summary of the evidence on this, see World Bank, 2014. *Avoiding the Trap.*). Development Policy Review 2014.

supportive of human capital development and social inclusion. Indonesian cities are growing fast and a key challenge for sub-national governments is to rapidly put in place the *infrastructure to support economic activities, ease urban mobility and provide water, sanitation and other services* to a growing population. Infrastructure gaps in rural areas are also large. Priority infrastructure there includes *community-level production-supporting infrastructure, irrigation investment*, with complementary R&D and extension services, and enhancing governance to increase user participation and sustainability of investments.

A special focus on *energy* is warranted. Demand for energy is growing by 7-8 percent annually, requiring a rapid supply response to avoid an energy crisis in the years to come. About 35 million Indonesians lack access to electricity. It is estimated that meeting the energy needs of the economy and closing the access gap would require 66.8 GW of incremental generation capacity and 477 TWh power supply capacity for a total investment over USD 200 billion. If the objective were to close the gap in the next 10 years, that would mean an investment of USD 20 billion per year. Furthermore, with energy contributing almost a quarter of total CO₂ emissions, reducing the heavy reliance on fossil-fuel sources to meet rising demand would help Indonesia contribute to the global climate change agenda. To improve the efficiency and sustainability of the energy sector, a reduction of the large electricity subsidy bill (USD 10 billion in 2014) is needed to boost investments in the sector, while policy and regulatory bottlenecks to investments by all players would need to be overcome.

Public sector financing. Total resources needed to close Indonesia's infrastructure gap are estimated at about USD 500 billion by the new administration (USD 100 billion a year). Of this, the State Budget is expected to finance about one-third, made possible by a significant reduction of fuel subsidies. The rise in infrastructure spending in the medium term is, however, contingent on reforms to increase revenue collection and tax compliance, which are among the lowest in Asia and middle-income countries (see Section IV). The remaining two-thirds of the financing need are expected to come primarily from the private sector and, to a lesser extent, SOEs. To support the latter, the 2015 Budget included a capital injection of about USD 5.3 billion (IDR 70.4 trillion) into SOEs. Most SOEs in Indonesia have weak financial capacity, in part attributable to subsidies, and are heavily constrained in terms of investment.

The private sector participation. The scale of investment needs in national, urban and rural infrastructure is huge (estimated at about USD 500 billion for the next 5 years). *The private sector should thus play a crucial role* since the national budget will be insufficient to finance it. With the recent establishment of a PPP unit at the Ministry of Finance, the new Government is trying to address these bottlenecks more effectively than in the past.⁵³ The legal framework for PPPs has also been amended to allow the private sector to invest in the development and operation of financially viable infrastructure projects without being obliged to enter into a joint-venture with an SOE. Various incentive mechanisms have been established, including the Indonesia Infrastructure Guarantee Fund (IGF), Indonesia Infrastructure Finance Fund (IIFF) and SMI, the Viability Gap Financing (VGF) program. The challenge now is to make these institutional mechanisms operational and well-coordinated.

Removing regulatory bottlenecks. Better implementation of both public and PPP operations will require complementary regulatory reforms in many sectors to remove bottlenecks (see Box 4.1 on the energy sector) and an effective implementation of the new land law, which will require good

⁵³ Toll roads particularly have been targeted for PPP financing: the three “ready for offer” projects totaling USD764 million include a toll road project accounting for 83 percent of the total (USD628 million), while the 26 Priority PPP projects include 13 toll roads totaling USD32.5 billion or 85 percent of the total value of the 26 projects.

implementing regulations. Better implementation for both public and PPP operations would benefit greatly from effective implementation of the 2012 Land Law and relevant regulations. Without faster and less conflict-ridden acquisition of land, implementation of infrastructure projects will remain uncertain and costly. Finally, it is not clear whether the private sector will be willing or able to participate in investment in some sectors. For instance, in ports, a constraint is that SOEs need to own at least 51 percent shares for projects, which results in the playing field being weighted in favor of SOE entities

Building “better” ex-ante. Major investment in new infrastructure presents an opportunity to drive an overall decrease in disaster risk through growth. The flip side to this is that under-investing in resilient infrastructure would by default result in increased risk. Indonesia faces medium to high risk across the whole country from multiple natural hazards. Therefore, *risk-sensitive planning and design standards are essential to protect growth that depends on critical infrastructure assets*. Indonesia has good examples of “building back better” after major disasters. As a result, this is the chance to be a *global leader among MICs in “building better” ex-ante*. Key approaches include risk-sensitive land-use planning, adequate budgeting to provide sustainable operations and maintenance, and insurance options for public assets.

Box 5.2: The energy sector

Demand for energy is growing by about 8 percent annually requiring a rapid supply response to avoid an energy crisis in the years to come. It is estimated that meeting the needs of the economy and closing the access gap would require 66.8 GW of incremental generation capacity and 477 TWh power supply capacity for a total investment over USD 200 billion. If the objective were to close the gap in the next 10 years, that would mean an investment of USD 20 billion per year. The new Government’s goal is to increase generation capacity by 35 GW by 2019, an ambitious goal. Of the 35 GW capacity being targeted, 20-25 GW is expected to come from IPPs.

Meeting these goals requires massive financing mobilization and significant reforms to improve investment climate (e.g., permitting and licensing) and the capacity of PLN, the state utility company, to invest (e.g., heavy subsidy of electricity to residences). Lack of transparent and clear guidelines regarding the tendering process,⁵⁴ for instance, and payments to support or block certain bills or actions are processes that facilitate corruption schemes.⁵⁵ An additional challenge is heavy reliance of most power generation on conventional fossil fuel sources, such as oil, natural gas and coal. To date, less than 20 percent of power generation comes from hydroelectric, geothermal and other renewable sources. The recently enacted Energy Law and Electricity Law provide a renewed legal framework for the energy sector, with an emphasis on economic sustainability, energy security, and environmental conservation. One constraint for the geothermal sector and increased private sector investment is the difficulty of sharing early stage exploration risk, and the stringent conditions for the existing USD 300 million fund put up by the state for that purpose. The development of hydro and other renewable energy sectors is also impeded by lack of standard purchasing power templates from PLN (except for micro hydro), lack of any private sector incentive to develop off-grid solutions and less than attractive size bidding by the government in the recent solar auctions.

As of 2013, hydroelectricity accounted for only 8.78 percent of the current forty-six thousand megawatt capacity.⁵⁶ Indonesia is also the third highest producer of geothermal energy in the world but has only tapped about four percent of its potential.⁵⁷ Until August 2014, geothermal activities were lawfully defined as a mining activity under Indonesian regulation, and thereby prohibited from protected forest and conservation areas (UU No. 27/2003). However, 80 percent of geothermal reserves are located in such areas. Law No. 21/2014 now separates geothermal activities from other mining areas, but coordination with other policies and drafting of operation regulations will take time. As mentioned above, companies must bear the cost of geothermal exploration—drilling wells at several billion dollars in initial outlays without certainty that the well will be useable. In 2013 for example, one major foreign geothermal company had to drill eight wells before finding a sufficiently productive one.⁵⁸

⁵⁴ International Energy Agency. Energy Policy Review of Indonesia. 2008. (p 60)

⁵⁵ Warburton, Eve. *The Business of Politics in Indonesia*. Inside Indonesia. Edition 117: Jul-Sep 2014.

⁵⁶ “Indonesia to Build more Hydropower Plants to Boost Alternative Energy.” The Jakarta Globe. 27 February 2014.

⁵⁷ “Geothermal Energy.” Indonesia Investments. Accessed 25 February 2015.

⁵⁸ Personal interview with energy company owner.

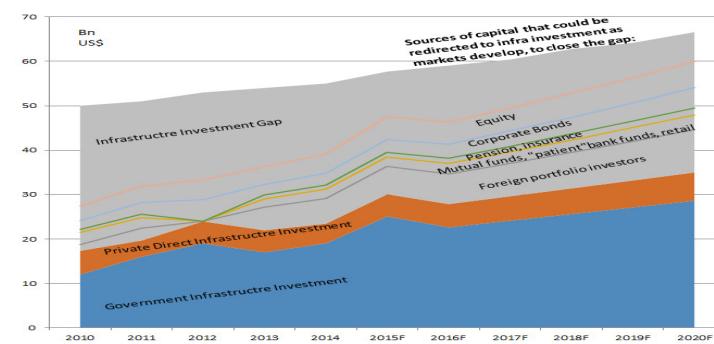
Incentive and accountability of local governments. With decentralization, local governments have crucial infrastructure responsibilities and sub-national governments actually now do spend more than the central government on infrastructure (1.5 percent of GDP versus 1 percent of GDP). But they could spend much more to improve roads, water and sanitation and health infrastructure (both in terms of new investments and maintenance) if their budgets were not tied up by excessive spending on personnel and if they could raise more revenues themselves. Over 40 percent of sub-national government spending is on personnel and about 90 percent of their budgets come from the central government (fiscal transfers). Major changes to fiscal federalism that would promote greater investment are unlikely to garner much political support in the short run, but incentives can be improved on the margin by increasing performance-based transfers tied to spending on sectors/areas of national priorities

Deepening the financial market. Financing sources with long-term maturities of up to 30 years, as required to fund infrastructure projects, remain below Indonesia's financial market current capacity. Indonesia's financial markets are too thin to support infrastructure investment without important reforms. The capital market capitalization is low at 66 percent of GDP. Corporate debt markets are thin accounting for 2.2 percent of GDP, compared with 6 percent for the Philippines, 19 percent for Thailand and 43 percent for Malaysia. Non-Bank Financing Institutions (NBFIs) as a whole account for slightly more than 20 percent of financial systems assets, with no significant change in this percentage over the past decade. While a number of sectors such as insurance, mutual funds, and pension funds are growing rapidly, they have started from a low base (compare pension fund assets at 5 percent of GDP versus 10-15 percent in the Philippines and Thailand, and 40 percent in Malaysia).

In order to enhance market depth and liquidity, regulations should be put in place to regulate the creation of special investment vehicles and to allow the conduct and standardized practice of securities repurchase agreements. Public policy can further nudge the system toward greater financial depth by supporting corporate bond market development, which is particularly constrained by strict investment requirements, high underwriting costs and weaknesses in the execution regime including a credible legal system that allows for the effective enforcement of contracts and property rights. Investor protection would provide investors with a modicum of certainty when making long-term financing decisions.

The ongoing reform of the social security regime further presents an opportunity to deepen financial markets. The newly created Social Security Organizing Agency (BPJS), which replaces Jamsostek, will be expected to cover ten times the number of workers it does now (from 12 to 110 million, at least), which will multiply by a significant factor the amount of assets under management. A substantial portion of Jamsostek funds was invested in government bonds and bank deposits. Given that BPJS is set to become the largest institutional investor in the market, this presents an opportunity to widen the choice of eligible investments, accompanied by greater transparency and accountability

Figure 5.1: Funding sources to fill in the existing infrastructure investment gap



Source: Bank Indonesia 2014, WDI 2014, DJPU 2014, MOF 2014, OJK 2014.

requirements. In addition, private sector institutional investors, such as insurance companies and private pension and mutual funds, might be encouraged to similarly widen their spectrum of investment opportunities, including in the infrastructure bonds market. Regulatory and supervisory frameworks for these institutions should be enhanced to improve their asset-liability management practices, driving them toward making long-term investments to match with their liabilities instead of only focusing on short-term returns. Figure 4.2 shows, as one possible scenario, that an increase or redirection of by 50 percent of existing bond funding and 10 percent of equity investment to infrastructure finance will close the existing funding gap for the foreseeable future.

Coordination issues. The availability of more resources would need to be accompanied by efforts to overcome weak coordination and institutional capacity, which have led to under-spending of already low budgeted capital investment. Planning has been plagued by poor selection and preparation. To begin with, various ministries and SOEs have different project criteria and lists. The authorities might want to consider empowering one dedicated agency/ministry to undertake project selection. This can help ensure that selected projects respond to value-for-money and viability/feasibility rather than just political imperatives. In addition, attention needs to be paid to cherry-picking by the ministries, which are content to leave the more complex and less viable investments to the private sector, when the opposite might be a more effective approach. For SOEs, strengthening financial standing would be important for facilitating greater investment, but their planning, budgeting and procuring would also need to be strengthened to enhance efficiency in their investments and create space for leveraging private sector financing and investment.

Business environment

Improving the business environment is another “transformative” reform that is crucial for growth and job creation, access to key services and better management of natural resources. The key priority reforms in this area are as follows:

Regulatory uncertainty and inconsistency. A number of sector-specific laws and measures announced recently significantly worsen the investment climate by placing additional restrictions on businesses and investors. In addition, many of the sector-specific laws and measures are either inconsistent or misaligned with existing laws and regulations, thus further increasing uncertainty. Well-meaning attempts by the executive to support the economy in moving up the value chain can fall prey to special interests and result in protecting uncompetitive local production. Improving business processes can be stymied by bureaucracies seeking to hold on to opportunities for corruption. Efforts to enhance local participation can create uncertainties in existing and future foreign investment. Indonesia needs to strengthen the quality of the policy formation process for economic policies and regulations. Some countries have done this by empowering one ministry or government agency to play the function of “policy integrator” (i.e., create a so-called “Center of Government”, or CoG). A strengthened policy formation process should help address genuine concerns of Indonesians that the public interest be protected, and should enable the Government to push back against more narrow rent-seeking activities and self-centered business interests.

Investment licenses and permits⁵⁹. The importance of streamlining business licensing is recognized by the government to be a major policy priority. In his first impromptu visit (*blusukan*) after being inaugurated, the President visited the Investment Coordinating Board (BKPM) in October 2014, and instructed BKPM and relevant ministers to implement a central one-stop services (OSS) within three

⁵⁹ See World Bank, March 2015, Indonesia Economic Quarterly.

months (i.e., by January 2015). He also emphasized that investors should need to visit only BKPM to apply for licenses at the national level. At the time of the President's visit, investors still needed to apply for licenses from various ministries and agencies outside BKPM at the national level, as well as for sub-national licenses, while BKPM itself only processed 14 licenses, including the principle license at the start of the licensing process and the operational license at the very end of it. Once fully implemented, a central OSS will mean the integration of all licensing processes at the national level under one roof, simplifying the currently complex web of business licensing across the different national and sub-national agencies. The intended result is a quick, simple, transparent and integrated licensing service. The reform at the BKPM level should however be complemented by the implementation of effective sub-national one stop services.

“Doing business”. Indonesia currently ranks 114th out of 189 countries in the ease of doing business, as measured by the World Bank Group.⁶⁰ Along with construction permits, paying taxes and enforcing contracts are among the bottom 40 percent's most cumbersome procedures in the world. This performance is below the regional (East Asia and Pacific) average and its peer countries' performance: the Philippines, China, Thailand, and Malaysia ranked 95th, 90th, 26th, and 18th, respectively. The Government has begun to take note, however, and is implementing an action plan that consists of seventeen actions across eight “Doing Business” areas (aligned to eight of the ten indicators in the WBG's “Doing Business” country rankings). In 2014, the Government followed up with actual implementation improvements in the areas of starting a business, paying taxes, and getting electricity (reducing the time required for the latter by 11 days).

Better functioning capital, labor and land markets. For capital markets, the need to mobilize more domestic capital for infrastructure investment is well-recognized, but will require sustained efforts to strengthen the role of the segmented banking sector and deepen non-bank lending, including over the long term by reducing the aversion to long-term local currency lending and the psychological impacts of the 1997/98 crisis. Labor market reforms could have relatively immediate benefits, but negotiating the “grand bargain” necessary will be at least a medium-term effort. Moving to formulae-based for minimum wage determination will be crucial to provide a more certain, simple and fair minimum wage setting process. The aim is to make employers, workers and job seekers better off by promoting a more evidence-based and less politicized wage-setting process. This is expected to lead to more predictable annual increases, and, by introducing improvements in the governance structure, reduce the scope for discretionary decision making. Land, and its ownership and management, is perhaps the area in which implementation would be most arduous, requiring major institutional and governance reforms. The benefits, however, can be cross-cutting for infrastructure development, agriculture, urban development and environmental sustainability

Skills

Closing Indonesia's skills gap requires a three-pronged reform strategy. First, there is a clear need to improve access to and quality of early childhood and basic education to build a strong base of cognitive, social and behavioral skills necessary to acquire the higher-level skills needed in the labor market. However, even if the educational system could be perfected instantly, the first graduates would only join the workforce in about 10-20 years' time. It is therefore essential to find short- and medium-term solutions for the current skills constraints: the second and third prongs of the strategy are thus

⁶⁰ World Bank, 2014, “Doing Business 2015: Going Beyond Efficiency”.

improving the relevance of feeders into the labor market (technical and vocational education, and tertiary education) and upgrading the skills of the existing workforce (reform of the training system).

Primary and secondary education. After achieving near universal access to 9 years of education, the Government is focused on expanding access to 12 years of education (including senior secondary) partly in response to a growing demand for higher skills in the labor market. Expanding access to 12 years of good quality education for all Indonesians will also require: (i) improvements in the efficiency of public education spending. Increased teacher hiring and the introduction of professional allowances have absorbed a significant amount of recent increases in public education spending. However, the size of the existing teacher force, measured by the student-teacher ratio, is large when compared with international benchmarks associated with good education quality. Making better use of teachers through more efficient school and staffing standards and improving teacher distribution have the potential to realize significant savings. In turn, these savings can support the expansion of good quality learning opportunities that the Government has committed to. Without these savings the system may not be able to afford to expand services while improving education quality; (ii) raising levels of teacher competency will be central to the success of efforts to increase levels of educational attainment in Indonesia. Recent improvements in pay brought about through the teacher certification program have so far not led to improvements in levels of teacher competency or student learning.⁶¹ Greater attention is needed to improve teacher accountability and strengthen the systems that deliver professional development opportunities to existing teachers to raise teacher content knowledge, teaching skills and motivation.

Technical, vocational and tertiary education. In expanding access to senior secondary education, it is vital that both general (SMA) and vocational (SMK) tracks provide graduates with a strong set of general skills demanded in the labor market. Vocational secondary schools might provide a fast route for training mid-level skilled workers for the immediate needs of the labor market, but they may not provide graduates with a sufficient foundation of general skills that makes them adaptable to changes in the needs of the labor market. On the other hand, graduates from the general track who do not enter tertiary education likely lack sufficient job-relevant skills. It is important that as senior secondary schooling is expanded both tracks provide the right skills mix and that there is enough permeability between tracks to ensure graduates have a range of paths open to them for continuing their skills acquisition (e.g., community colleges and non-university degrees).

Making vocational education and tertiary responsive to employer needs is a priority. In the absence of the right policies, education institutions tend to be isolated from the labor market. They tend to naturally respond to their ‘clients’, comprising of potential and current students, as well as their owners or regulators. As a result, if students’ demands are not in line with the labor market (because of lack of information, for example) or the regulatory framework prevents institutions from responding to the demands of their ‘clients’ then these institutions will not respond to the demands in the labor market.

Improving information flows and strengthening incentives improve the responsiveness of tertiary education. Without information about labor-market trends and the quality of tertiary institutions the choices of potential students will not be aligned with those of the labor market and institutions will have little incentive to align their offerings to the demands of employers. But information is not enough. Even if the right information is on hand, it is still important to provide the right incentives.

⁶¹ See “Teacher Reform in Indonesia: The Role of Politics and Evidence-Based Policymaking”, World Bank, November, 2014.

This requires autonomy and accountability, incentives for performance (especially in public institutions) and opportunities for direct links between institutions and employers (for example apprenticeships, staff exchanges, research collaboration).

Skills upgrading in the workforce. There is a need to address the skills shortages of those already in the labor market. Coverage of the existing training system is very low, with only about 5 percent of the labor force reporting having received any formal training. On-the-job training is rare, with firms in Indonesia much less likely to report offering opportunities for training to their employees than in other countries in the region. While the institutional set-up for the training sector is largely established, the training system needs to be expanded and greater employer participation needs to be fostered.

More resources are needed for training but they should not all come from the public sector. Skills upgrading is not only the responsibility of the public sector since firms and individuals also benefit from upgrading efforts. As many other countries have done, resources should come from both public and private sources with public funds used strategically to incentivize private spending from employers. The quality of training offered also needs to improve by using a competency-based training approach and to incentivizing quality improvement from training providers. Accreditation is largely voluntary at the moment and competency-based methodologies are rarely used in training. Public funding could be used more strategically to incentivize training providers to adopt competency-based training and ensure that training institutions are accredited. There is also a need to accelerate the expansion of good quality training opportunities in higher value-added skills in strategic sectors. The current supply of training providers is concentrated on low-skilled occupations, while there is an undersupply of training providers in strategic sectors of the economy that require larger fixed investments to be established (food products, manufacturing). Expanding this supply will be critical to ensure skills upgrading happens in the right sectors.

Providing demand-side subsidies to hard-to-employ groups will be crucial to ensure that training can be accessed by all. Small and medium-size enterprises (SMAs) tend to under-invest in their workers because of logistical constraints, since the cost of sending one worker to training means stopping production. Hard-to-employ populations most in need of retraining may face financial constraints to access training, even if that training is relevant and of good quality. Strategic industries may also face short-term constraints in developing training providers. Public investment has a strong role to play in targeting these populations on equity and productivity grounds.

Agriculture policies

The above reforms are likely to help improve the productive environment of all sectors. For the agriculture, complementary policies are needed to modernize the sector. With rising incomes and urbanization, food consumption and expenditure patterns are shifting to higher value and processed foods. Indeed, there is a need to better align agricultural policies with Indonesia's transition as a middle-income country. Current policies have inhibited rather than facilitated the structural transformation within agriculture and the broader agro-food system. This entails broadening policy goals (competitiveness, nutritional balance, and environmental protection); embracing regulatory and facilitative roles (especially related to food safety and plant and animal health); and carrying out supply-side reforms and tackling supply bottlenecks (land, irrigation infrastructure, and agricultural innovation systems). Enabling these growth-critical investments requires the phasing down of sector subsidies and complementary (non-agricultural) policies to improve the competitiveness of high value perishables subsectors and promote investments in food processing, cold chain logistics, etc. The

provision of public goods is also critical for improving the productivity and sustainable livelihoods of the 5 million households involved in the production of oil palm, coffee, cocoa, and tea.

5.2.2. Access to key services and opportunities for all

Local service delivery

Improving local service delivery will require building the capacities of local government to deliver services, moving toward a more performance-based transfer system, providing the tools for citizens to monitor local service delivery, as well as differentiated approaches adapted to different types of regions. It also requires combining the current top-down approach to reform, whereby local governments implement national policies, with a more frontline approach, which uses the frontline service as the entry point to develop solutions, working out from there to identify and align supporting interventions at each levels of government. Ultimately, improving local service delivery is about enhancing the way in which central, provincial, district, and village governments work together to deliver results on the ground.

Transfers to sub-national governments have increased substantially over the past decade and now make up one-half of the state budget, net of subsidies and interest payments (about 7 percent of GDP). The sub-national transfer system is composed of four “buckets”: (i) a “block grant” component (*Dana Alokasi Umum*, or DAU); (ii) a specific purpose grant (*Dana Alokasi Khusus*, or DAK), allocated to certain regions with the aim of funding special activities of the region in accordance with national priorities; (iii) a revenue-sharing (DBH) component aimed at sharing tax and non-tax natural resource revenues with all districts with a larger proportion of revenues going to resource-rich districts where the revenues originated; (iv) the special autonomy fund (*Dana Otsu*) for Aceh, Papua and West Papua provinces; and (v) a number of small adjustment funds (*Dana Penyesuaian*) such as additional allowances for teachers, professional benefits for teachers, School Operational Assistance program (*Bantuan Operasional Sekolah*, or BOS), local incentive grants (*Dana Insentif Daerah*, or DID) and various infrastructure support funds. In 2012, DAU accounted for 60 percent of total transferred revenues, DBH 19 percent, special autonomy fund s and adjustment funds 16 percent, and DAK 6 percent.

Addressing the poor performance of local service provision documented in Section III will require measures to increase incentive, capacity and accountability of LGs. On the supply-side, an overhaul of the fiscal transfer system to provide the right incentives and measures to enhance delivery capacity (tools, own-resource mobilization and accountability framework focused on results) are needed. On the demand-side, enhancing the capacity of the population to hold local leaders accountable for results is crucial.

A “second generation” fiscal transfers system is needed to:

- **Incentivize performance of LGs.** Local governments receive about 90 percent of their budgets from the central government, but the central government has no effective mechanism to significantly influence the composition of local governments’ spending. The DAK, allocated to certain regions with the aim of funding special activities of the region in accordance with national priorities, only covers 6 percent of these transfers. While claiming a small share of the total transfer, the DAK is overly fragmented, scattered across too many sectors and districts, and thus unable to significantly increase the capacity to delivery services. Going forward, increasing the share of the DAK in the total allocation and refocusing the DAK’s targeted sectors to a few critical ones (e.g., water supply, sanitation, transport and health) could greatly support service delivery.

- ***Tailor transfers to challenges in different ‘clusters’***. There is today a one-size fits all approach in the intergovernmental finance system, despite the diversity of issues faced by regions in Indonesia. The uniform treatment of heterogeneous sub-national units in policy design and implementation is a problem for the proper resourcing of provinces and districts. Large municipalities, small- and medium-sized cities, and rural districts are all treated more or less equivalently from a fiscal point of view. Yet, some districts have significant gaps in access whereas others have simply a quality of service problem as access is not a problem. Ideally budget allocations and program focus should be tailored to each different situation. Also, from a fiscal point of view, there are strong arguments in favor of treating large municipalities differently from smaller ones and rural districts.
- ***Eliminate perverse incentives in the grant allocation system***. Perverse incentives in the grant allocation system have encouraged spending on salaries and administration at the expense of a more balanced use of resources that promotes service delivery outcomes. Furthermore, central government line agencies spend their own budgets on local functions, which reinforces LGs’ focus on salaries and administration as funds that could have been allocated on capital were either saved or spent on less important activities. Furthermore, unclear assignment of responsibilities limits the empowerment of local authorities and the potential involvement of civil society.

To complement monetary incentives, non-monetary forms of incentives can be crucial. For instance, dissemination of public information on LG performance (as done in most OECD countries) or temporary central governments’ ‘take-over’ of services (e.g., Colombia, US, UK) to restore performance before handing the service delivery facility back to the local entity. Non-monetary incentives include refocusing the bureaucracy to be accountable for results and not only for compliance. The bureaucracy (both central and local) is highly geared towards input controls, which focus on compliance. An accountability framework focused on compliance undermines the focus on results and service delivery performance. The central government does monitor service delivery and regional growth performance, but provides limited incentives to encourage or require sub-national spending performance against those outcomes. A culture of rewarding local governments for achieving good results can enhance competition between local governments and encourage improved service delivery. The paradigm shift in resource management towards greater focus on results should also happen at the central government level, which also heavily focuses on input controls and compliance.

In addition to appropriate incentives, tools for identifying key service delivery gaps and monitoring district performance in closing those gaps (building on KPI) are needed. These comprise:

- A system to ensure alignment of investments across different levels of government
- Tools to identify needs and build LG capacity
- Social accountability tools for different clusters
- Tools for easy reporting and monitoring of expenditures
- Tools to document and demonstrate good local practices.

Furthermore, developing LGs-led financing instruments, such as PPPs, municipal bonds, and intermediary financing, could greatly enhance the capacity of municipalities to finance infrastructure. Indeed, even with improved targeting of transfers and efforts to increase fiscal capacity an own

resource mobilization at the local level, financing of infrastructure needs through the budget are likely to be insufficient. A regulation for municipal finance has been issued in 2012 by the Ministry of Finance to enable provincial governments to tap capital markets for funding local infrastructure. However, to date no issuances have taken place due to challenges related to institutional issues such as audit, ratings and support of the regional parliaments.

Delivery at the village level. Beyond LGs, the new Village Law provides an opportunity to strengthen service delivery at the village level, particularly if investments are complementary. However, capacity and incentives may also be difficult to address.⁶² Indonesia has a long experience in service delivery at the community level by communities themselves. For instance, PNPM-Mandiri Rural, the largest of Indonesia's community-driven development initiatives, provided small-scale public infrastructure in local communities utilizing a community-based approach in which communities plan, prioritize and decide their own needs; implement the projects; manage and account for funds; and maintain the assets built. The program has financed the construction of more than 100,000 km of rural roads; 17,000 small bridges; 28,000 clean water systems; and the rehabilitation or construction of over 50,000 schools and health facilities. It has also supported more than 301,000 business activities conducted by women since its inception with a total commitment of USD 3.6 billion (IDR 33 trillion) over the period 1998-2015. The PNPM platform has also been used as a means for reaching the marginal populations and in delivery of programs such as efforts to reduce malnutrition and stunting. The new Village Law aims to use key PNPM institutions to continue to support village development and improve village-level service delivery.

Box 5.3: The new Village Law and basic service delivery

After several years of deliberations, a Village Law was approved by the House of Representatives (DRP) in December 2013. The law was initiated by the Government as a means to address existing weak governance arrangements in villages and empower communities to meet their own development needs, including provision of basic infrastructure and oversee public spending. One of the main notions behind the law is to institutionalize PNPM Mandiri (the Bank-supported National Program for Community Empowerment) by enshrining community-driven development principles into the legal framework. As part of that, and once the law is fully implemented in 2018, villages will receive significant increased financial transfers: on average about IDR 1.4 billion (USD 120,000) per village. These will support the execution of village medium-term development plans that have been developed in a participatory manner by community members. This can include territory infrastructure and village-scale facilities for job creation. The law also provides for greater accountability of the village government to villagers, through a democratically elected Village Council and through annual Village Assemblies that might improve the quality of village spending. However, the law does not include provisions that would strengthen the accountability of district governments or front line facilities to village governments and communities. This needs to be addressed in the implementing regulations of Law No. 23/2014 on Regional Administration, which replaces Law No. 32/2004 on Regional Governance.

Stronger demand-side pressure for service delivery. Improved access to information, increased public-private sector dialogue and engagement in local political processes are improving local economic governance and development. Although there is no clear-cut solution to organizing the demand-side pressure for better service delivery, there exist some local success stories where mobilizing the demand-side has helped to improve the service delivery of public goods and service delivery. This has taken for instance the form of pressuring local leaders into passing new local policies or implementing already existing policies. A variety of approaches can be helpful for improving citizen engagement. These include sharing information about public service quality with local citizens (open

⁶² In general, incentive and capacity problems are more difficult to tackle at the village level in part because there are more of them, but in some ways it is easier because social accountability mechanisms are likely to be more effective at the village level.

data), including comparative studies of one locality with other similar ones. In the context of Indonesia, strengthening of community-driven programs, which have a strong demand-side accountability component, can help.

Social protection and social security

To achieve the twin goals in Indonesia, greater social protection is needed to shield the vulnerable from shocks that push them into poverty, while helping those beneath the poverty line to climb above it. This entails *strengthening social assistance programs and making the ongoing social security reforms effective and sustainable*. Improving social assistance will likely require far more resources than are currently spent by the Government, at roughly 0.5 percent of GDP. Other large middle-income countries spend, on average, three times as much on these programs. At only 1 percent of GDP in 2012, total government outlays on health were the fifth-lowest out of the 188 countries for which data are available: only South Sudan, Pakistan, Chad and Myanmar had lower ratios. Because only 41 percent of the Bottom 40 are covered, Indonesia is committed to and putting significant effort into attaining universal health coverage (UHC) by 2019. The country launched a National Health Insurance Program in 2014 (JKN) and is making health insurance free for the poorest 40 percent of the population—a key policy of the administration of President Joko Widodo (“Jokowi”).⁶³ UHC could be instrumental to boosting shared prosperity and reducing poverty in Indonesia, where 93 million Indonesians (40 percent of the population) live under USD 2 per day and where inequality is also rising.

5.2.3. Natural resources management and environment sustainability

Removing constraints to shared prosperity include beginning the difficult task of improving natural resources management and environment sustainability. A key priority in improving natural resources management and environmental sustainability in Indonesia is a *reform of the governance of land allocation, land rights access and spatial planning*. Good management of these is a pre-requisite for improving the livelihoods of local communities but will also influence food production, urban and infrastructure development, and mining and forestry resource management, environment degradation and pollution, as well as the prevalence of social conflicts.

Unified land legislation and management. Sound and well-enforced land allocation through unified land legislation is necessary that included clarification regarding customary land on forestry land, recognition and a conflict resolution system. This requires:

- A unification of land management and titling and an acceleration of land registry;
- For forest management, introducing effective fiscal incentives and licensing and enforcement to reduce the rate of deforestation and land degradation. This includes positive incentives for environmental services where REDD+ could be effective, and acceleration of the implementation of the Forest Management Unit program.
- Granting land rights granted to local communities.
- More coherent spatial planning (only seven of the 34 provinces have a legally binding plan), including down to the village level will be essential to provide the framework for land classification and enforceability of violations. The OneMap concept will be important to unify mapping and information standards, but it needs revisions and urgent approval.
- Revision of permitting processes for timber concessions, oil palm and mining to make them more participatory, transparent and aligned with the spatial plans.

⁶³ The other components of the social security reforms comprise universal employment insurance coverage by July 2015 and an important institutional overhaul to reduce the fragmentation of the social security system.

- Upgrading of strategic environment assessments and Amdal (environmental assessment) to inform permitting process and spatial plans.
- Creating and strengthening technical institutions and management structures at the sub-national level in order to support participatory planning and monitoring at the village, district and provincial level.

A more integrated approach to planning for agriculture, energy and water management.

Almost 60 percent of geothermal production is in conservation forests, similar to the hydro potential. Sedimentation undermines current investments in water reservoirs. At the same time coal mining and agrochemicals are responsible for watershed pollution. Close to 75 percent of main rivers and 15 main lake systems are heavily polluted. Planning and management at watershed level and coastal lowland level needs to be strengthened. Coordination between Ministries will be essential to avoid sector solutions with high costs to other sectors.

Implementing REDD+ and disaster risk management. For this policy priority, accelerating programs such as land registry and implementing REDD+ would be a good start. With land use changes, forestry and peat fires, generating more than 70 percent of CO₂ emissions, efforts in this area could decisively increase Indonesia's contribution to global climate change initiatives, while supporting resilience to natural disasters, which disproportionately impact the poor. Building greater resilience to natural hazards could be supported by the establishment of a national program on hazardous micro-zoning providing detailed instruments for incorporating resilience into site design and construction standards; providing a financing framework for both urban, housing and property development that incentivizes investment with built-in resilience linked to disaster insurance; and a national program on urban upgrading and ecosystem rehabilitation to increase the resilience of existing settlement and urban infrastructure as part of the greening of Indonesia's future growth.

Priorities for marine and fisheries resource management. For marine and fisheries resources, priorities include (i) *implementing control and surveillance over sovereign marine and fisheries resources to support the eradication of illegal overfishing (IUU);* (ii) *improving marine natural resources and fisheries management to improve the sustainability of the natural capital while accommodating an expansion of commercial wild capture fisheries, and sustainable aquaculture production and tourism;* (iii) *improving the investment climate and support PPP for sustainable capture fisheries and aquaculture to increase production and the sector's contribution to GDP, reduce poverty among fisher and coastal communities as well as improve national food sovereignty and food security and, finally;* (iv) *investing in complementary electrification for commercial fisheries cold storage and processing plants* to increase overall economic value of fisheries sector, increase exports and diversify and create jobs, particularly in eastern Indonesia.

5.3. Cross-cutting pre-requisite 1: collecting more and spending better

There is a strong political consensus that boosting reforms and investment in infrastructure, energy, health and social protection is the right course but this needs to translate into sustained fiscal reforms in the medium term. Indeed, even if there is no policy reversal of the fuel subsidy reforms and that the fiscal savings will be reallocated to development priorities, additional fiscal space is needed to fund a sustained increase in the above priority areas. Given the large infrastructure deficit, the Government should aim to increase total government infrastructure spending (reflected as increased capital spending) from 2.3 percent of GDP in 2013-14 to 3.8 percent

by 2019.⁶⁴ The investment required on the supply-side to implement fully the Universal Healthcare Coverage (UHC) program by 2019 requires public health spending excluding National Social Security System (SJSN) spending, to increase to around 1.4 percent of GDP per year (from 1.0 percent of GDP in 2014); this will be reflected by higher material spending. On top of the health-related increase in social assistance spending, social assistance spending on the poor and vulnerable should double, equivalent to an increase of 0.5 percent of GDP, by 2019 to enable expansion of programs for the poor and vulnerable. Simulations using a medium-term fiscal framework show total expenditure will need to increase from 17.3 percent of GDP in 2014 to 20.0 percent by 2019.⁶⁵ This places **reforms to collect more revenue** in intense focus. Indeed, assuming a “business-as-usual” situation with no significant reforms on revenue policy or administration, baseline revenue for 2015-19 is projected to stay level at between 13.3 and 13.4 percent of GDP due to expected continued moderation in commodity prices reducing non-tax revenues from oil and gas. In other words, Indonesia is forced to mobilize more government revenues in order to adequately finance priority development areas within the legal fiscal limit of 3 percent of GDP.

5.4. Cross-cutting Pre-requisite 2: Governance (Implementation, Coordination and Transparency)

Getting the reform priorities right is a first step. Effectively implementing them to efficiently achieve shared prosperity is a key challenge in Indonesia. Some of the systems and practices within the public administration that have been part of Indonesia’s development process over the past decades may not serve its future needs and could undermine future growth. Despite the substantial changes in the roles and responsibilities of the public institutions since 1998, many of the core elements of the pre-1998 era remain. While there are now multiple stakeholders formulating and implementing policy at both the national and sub-national levels, there are, so far, no effective coordination mechanisms across government. The outcome has been poor delivery of services by government institutions, inconsistent policy settings across sectors, and a lack of responsiveness of the administration to the priorities of the Government and citizens. The failure to adapt old institutional arrangements and policies to reflect the new environment is an impediment to the effectiveness of the public administration, and poses a threat to Indonesia’s future ambitions.

To support a rapidly developing economy attention needs to be given to refocusing the public administration to establish: (i) a stronger Center of Government (CoG) to manage the policy process and resolve policy conflicts; (ii) an enhanced selection process (including allocation between private/public sectors) and management of major capital projects to remove obstacles to their implementation; and (iii) a streamlined bureaucracy for enhanced accountability among other goals. These reforms are notoriously difficult to implement. However, given the costs of not acting to the economy, to citizens and to the country’s ambitions, Indonesia cannot afford not to consider implementing some of these reforms in the short term. Perhaps the most urgent reform is the need for a stronger Center of Government. In 2004, OECD/Sigma provided an outline of some of the core functions one would expect to be effective. These functions include: (i) policy document review, quality assurance and inter-ministry mediation; (ii) monitoring government performance; (iii) coordination of horizontal policies/priorities; (iv) legal conformity of draft laws; (v) communication with media and the public; and (vi) coordinating with other branches of the state.

⁶⁴ Estimate based on scenario of getting above 6 percent growth through an infrastructure big push and assuming two-thirds of the increase in infrastructure spending is publicly financed.

⁶⁵ Even assuming that fuel subsidy reforms are not reversed.

In Indonesia several different institutions play some role in the coordination of policies including the Coordinating Ministries, the Vice-President's office, the delivery units (UKP4 and TPN2K) and others. However, this fragmentation of CoG roles and functions has not, so far served Indonesia well. On the contrary, ministries have been able to implement new policies and regulations that conflict with other regulations. Policy management is also more difficult because of the challenges to coordinate separate planning and budgeting processes for different parts of the budget. In the future, Indonesian authorities may want to consider how to refine the mandates and functions of the various institutions that support the CoG, and to empower the President's office (or its designate), or another institution to play a stronger role in managing the policy process.

Hand-in-hand with high quality of spending is the effort to improve transparency and accountability so as to maximize funding flows to the most vulnerable and the areas of most pressing need. Indonesian public policy faces governance problems that weaken its effectiveness and delay the impact of public spending. Corruption detection and enforcement have received relatively more attention than corruption prevention in the public sector space. The Indonesian Corruption Eradication Commission (KPK) has been engaged in investigating, prosecuting, supervising, preventing and coordinating efforts to combat corruption, with some palpable high-profile results. Strengthening the KPK as a well-funded independent body is critical. Weaknesses remain in the judiciary for establishing a viable legal system to enforce contracts and increase investment security. In addition, more attention should be given to corporate governance, also important for improving the overall investment climate, with issues in the enforcement capabilities of regulators, weak boards and corporate governance culture, and little participation of institutional investors.

The table below summarizes some of the key governance challenges around some of the key reforms needed to achieve the twin goals.

Table 5.1: Governance challenges around key priority reform areas

| Key area | Policy orientation/ drive | Key governance challenge to address |
|--------------------------------|--|---|
| Closing the infrastructure gap | <ul style="list-style-type: none"> - More public resources to infrastructure - Address project selection and coordination issues - Attract private investment in infrastructure - Strengthen PPP frameworks - Strengthen decentralization framework | <ul style="list-style-type: none"> - Budgeted revenues are not realistic, and under collection relative to budget means that discretionary spending items get slashed; infrastructure resources are cut back during the year; execution is much less than allocation. - A lack of pre-identified, independently appraised projects means lead times to increase actual spending are very long, and project quality is compromised. - Feasibility studies are used for compliance not for improvement, no system for trading-off projects across governments - Project targets too simple with no clear accountability for outcomes - Excessive discretion among policy makers and regulators means that too much risk sits with the private sector, relative to likely return, so PPP projects do not get off the ground. - Procurement insufficiently focused on value-for-money, and excessively focused on compliance thus creating risk shirking environment, and sclerosis. - Dominance of SOEs in infrastructure sectors crowds out genuine private sector. Mispricing of SOE products means insufficient net income is generated. Some evidence of distorted SOE decision making. - Decentralization framework too biased to operational spending, and insufficiently focused on results. Community input lower than desired. - Musrenbang routines do not provide realistic or effective planning inputs at national or sub-national levels. |

| | | |
|--|---|--|
| | | <ul style="list-style-type: none"> - Parliamentary discretion at detailed project level encourages inappropriate and excessive Parliamentary interventions, with risk of corruption. - Insufficient regard paid to ex-post review, and to asset management once infrastructure is in place. |
| Improve business environment | <ul style="list-style-type: none"> - Investment licenses and permits - Reduce regulatory uncertainty and inconsistency - Reduce the cost of doing business (red tape and corruption) | <ul style="list-style-type: none"> - Inconsistency and lack of clarity in the tax code and its enforcement. - Excessive discretion by regulators increases uncertainty in business environment. - Insufficient transparency, with limited regard to appropriate due process. - Poorly defined rules on conflict of interest. - Poorly defined and non-mutually recognized allocation of functions between government agencies means overlapping and excessive total burden of regulation. Center of government is ineffective as arbitrator of bureaucratic overlaps. - Oversight of banking system insufficient to limit adequately money laundering. - Heavy SOE sector crowds out competition in some sectors. - The quality of justice system is compromised, casting doubt on enforceability of regulations. |
| Improving local service delivery (urban & rural) | <ul style="list-style-type: none"> - Address supply-side issues (spend better agenda) - Demand-side governance and accountability | <ul style="list-style-type: none"> - Neither sufficient transparency nor accountability about resource flows. - Fragmented decision-making across levels of government. - Inadequate mechanisms for citizen participation in resource allocation and in making clear demand. - Uneven administrative quality. - Minimum service standards not adequately enforced. - Conflict of interest and other laws are not effective at limiting personal enrichment. |
| Management of natural resources | <ul style="list-style-type: none"> - Sustainable management of forest resources - Sustainable management of marine resources - Sustainable management of mining resources | <ul style="list-style-type: none"> - Plethora of over-lapping regulations (from within and between jurisdictions) makes cost of entry to exploration unduly high. - Mineral export ban encourages illegal or informal exports from mining. Shifts profitability to other countries. - Lack of clarity underpinning the legal foundation to production sharing contracts in oil and gas. - Underinvestment in enforcement capacity. - Opaque policy processes including in designing and implementing fiscal regime. - Lack of consistency and transparency in awarding of licenses across subnational governments. - Inconsistent maps used across and by land use regulators, including central ministries and local bodies. |

The next decade represents the most favorable window for eradicating extreme poverty and increasing the prosperity of the Bottom 40 percent in Indonesia. The country's ongoing "demographic dividend" will end by around 2030, when the population above 65 years of age will start increasing faster than the population of working age. When Indonesia reaches that point, potential growth is expected to decline as a result of reduced labor supply, lower savings rates and perhaps less entrepreneurial innovation. Thus reforms and growth levels in the next decade or so will determine whether Indonesia will climb the income ladder and become "rich" before starting to get "old". That is, whether Indonesia will be able to mimic the experience of Japan, Hong Kong SAR, China, Singapore and South Korea, all of which became "rich" before becoming "old". World Bank calculations show that reaching high-income status by 2030—i.e., a per-capita income of

USD12,000—requires growing by 9 percent annually over the next 16 years.⁶⁶ Short of this exceptionally high rate of growth, growing at least above the current 5 percent “trend” growth rate would be required to position the country well to move onto the next level.

With China shifting away from commodity-intensive investment, the commodity tailwinds that have supported Indonesia’s growth are morphing into headwinds and the authorities’ focus is both on the short-term and the long-term agendas. While implementing structural reforms for shared prosperity, Indonesia has been managing the macro-fiscal impacts of the end of the commodities boom to safeguard hard-won gains in poverty reduction and maintain macro-stability. The exchange rate has depreciated by more than 30 percent since mid-2013; monetary policy has tightened; fuel subsidies, a key source of fiscal risk over the past few years, have been dramatically reduced. This response has achieved the goal of maintaining stability at the cost of adding to the slowdown in domestic demand. This brings to the fore the two cross-cutting pre-requisites discussed above. Policy measures to strengthen tax and non-tax compliance and the removal of expenditure execution constraints are both crucial if growth is to rebound in the near term and the proceeds are to be focused on the shared prosperity agenda in a less supportive global environment. The country can do it as its impressive long-term growth and poverty reduction trajectory attests. But the clock is ticking.

⁶⁶ Using constant 2013 US dollars.

Table 5.2: Indonesia SCD Priorities

| Pathway | Key Area | Indonesia SCD Priorities |
|---|--|--|
| Pathway 1 - Job Creation | Infrastructure and Energy | <ul style="list-style-type: none"> • Increase investment in both urban and rural infrastructure, given rapid urbanization and significant infrastructure gaps in rural areas. • Increase investments in the energy sector given the need for a rapid supply response to growing energy demand, while also focusing on enhancing the efficiency and sustainability of the sector. • Increase mobilization of private investments for infrastructure, given that public financing will be insufficient to address the significant investment needs. • Mainstream disaster risk resilience in infrastructure investments. |
| | Business Environment | <ul style="list-style-type: none"> • Enhance the openness and consistency of trade and investment regulations. • Improve the business climate, particularly by streamlining business licensing. • Deepen financial markets, given severe credit constraints. • Ensure flexible labor markets, by addressing potential constraints in severance payments and moving to a formula-based minimum wage setting. • Close the country's skills gap, by strengthening early childhood and basic education and technical and vocational training. • Modernize agricultural policies, away from the current narrow focus on 'food sovereignty' in rice to higher value-crops and processing. |
| Pathway 2 - Service Delivery and Opportunities for All | Service Delivery and Opportunity for All | <ul style="list-style-type: none"> • Collect more fiscal revenues (see "pre-requisites" below) • Incentivize performance of LGs increasing the share of the DAK in the total allocation and refocusing the DAK's targeted sectors to a few critical ones (e.g., water supply, sanitation, transport and health) • Tailor fiscal policy (e.g. transfers) towards sub-national governments to the challenges faced by different "clusters", namely large municipalities, small- and medium-sized cities, and rural districts • Eliminate perverse incentives in the grant allocation system to spend more on local services and infrastructure and less on personal and administration • Build capacity and enhance the performance of local governments; and adopt a more bottoms-up approach to management and reforms of local services. • Expand social assistance, given that social assistance spending is about a third of comparable countries, while ensuring fiscal sustainability of the programs and |

| | | |
|---|-----------------------------|--|
| | | focusing on programs which have been most effective in reducing poverty and inequality. |
| Pathway 3 - Natural Resources and Environment | Natural Resource Management | <ul style="list-style-type: none"> Reform the governance of land allocation, land rights access and spatial planning, including by accelerating programs on land registry and REDD+. Adopt a more integrated approach to agriculture, energy and water management, given their linkages. Strengthen the sustainable management of marine and fishery resources, in order to increase the overall economic value of the resources and diversify and create jobs, particularly in Eastern Indonesia. |
| Cross Cutting Prerequisite 1 – Collect More and Spend Better | | <ul style="list-style-type: none"> Implement sustained fiscal reforms, in particular reforms to collect more revenues given the large spending needs envisioned for infrastructure and social assistance programs. |
| Cross Cutting Prerequisite 2 – Governance | | <ul style="list-style-type: none"> Update and modernize public sector institutions, particularly in order to strengthen coordination across different stakeholders and levels of the government. Strengthen the Center of Government, especially in regard to the management of major capital projects. Streamline the bureaucracy in order to address fragmentation of roles and functions and enhance accountability. Expand anti-corruption efforts, including by strengthening the Indonesian Corruption Eradication Commission (KPK), the judiciary and corporate governance. |

Appendix 1: Indonesia's Development Indicators at a Glance

| | 1995 | 2000 | 2005 | 2010 | 2011 | 2012 | 2013 | 2014 |
|---|------|------|------|------|------|------|------|------|
| Demographics¹ | | | | | | | | |
| Population (million) | 199 | 213 | 227 | 241 | 244 | 247 | 250 | .. |
| Population growth rate (%) | 1.5 | 1.3 | 1.2 | 1.3 | 1.3 | 1.2 | 1.2 | .. |
| Urban population (% of total) | 36 | 42 | 46 | 50 | 51 | 51 | 52 | .. |
| Dependency ratio (% of working-age population) | 61 | 55 | 54 | 53 | 53 | 52 | 52 | .. |
| Labor Force² | | | | | | | | |
| Labor force, total (million) | 84 | 98 | 106 | 117 | 117 | 120 | 120 | 126 |
| Male | 54 | 60 | 68 | 72 | 73 | 75 | 75 | 77 |
| Female | 31 | 38 | 38 | 45 | 44 | 46 | 45 | 49 |
| Agriculture share of employment (%) | 43 | 45 | 44 | 38 | 36 | 35 | 35 | 35 |
| Industry share of employment (%) | 19 | 17 | 19 | 19 | 21 | 22 | 20 | 21 |
| Services share of employment (%) | 38 | 37 | 37 | 42 | 43 | 43 | 45 | 44 |
| Unemployment, total (% of labor force) | 7.0 | 8.1 | 11.2 | 7.1 | 7.4 | 6.1 | 6.2 | 5.7 |
| Poverty and Income Distribution³ | | | | | | | | |
| Median household consumption (IDR 000 per month) | .. | 104 | 211 | 374 | 421 | 446 | 487 | 548 |
| National poverty line (IDR 000 per month) | .. | 73 | 129 | 212 | 234 | 249 | 272 | 303 |
| Population below national poverty line (million) | .. | 38 | 35 | 31 | 30 | 29 | 28 | 28 |
| Poverty (% of population below national poverty line) | .. | 19.1 | 16.0 | 13.3 | 12.5 | 12.0 | 11.4 | 11.3 |
| Urban (% of population below urban poverty line) | .. | 14.6 | 11.7 | 9.9 | 9.2 | 8.8 | 8.4 | 8.3 |
| Rural (% of population below rural poverty line) | .. | 22.4 | 20.0 | 16.6 | 15.7 | 15.1 | 14.3 | 14.2 |
| Male-headed households | .. | 15.5 | 13.3 | 11.0 | 10.2 | 9.5 | 9.2 | 11.2 |
| Female-headed households | .. | 12.6 | 12.8 | 9.5 | 9.7 | 8.8 | 8.6 | 11.9 |
| Gini index | .. | 0.3 | 0.4 | 0.4 | 0.4 | 0.4 | 0.4 | 0.4 |
| Percentage share of consumption: lowest 20% | .. | 9.6 | 8.7 | 7.9 | 7.4 | 7.5 | 7.4 | 7.5 |
| Percentage share of consumption: highest 20% | .. | 38.6 | 41.4 | 40.6 | 46.5 | 46.7 | 47.3 | 46.8 |
| Public expenditure on social security & welfare (% of GDP) ⁴ | .. | .. | 0.4 | 0.4 | 0.4 | 0.4 | 0.6 | 0.5 |
| Health and Nutrition¹ | | | | | | | | |
| Physicians (per 1,000 people) | 0.16 | 0.16 | 0.13 | 0.29 | .. | 0.20 | .. | .. |
| Under five mortality rate (per 1000 children under 5 years) | 67 | 52 | 42 | 33 | 32 | 31 | 29 | .. |
| Neonatal mortality rate (per 1000 live births) | 26 | 22 | 19 | 16 | 15 | 15 | 14 | .. |
| Infant mortality (per 1000 live births) | 51 | 41 | 34 | 27 | 26 | 25 | 25 | .. |
| Maternal mortality ratio (estimate, per 100,000 live births) | 420 | 340 | 270 | 210 | .. | .. | 190 | .. |
| Measles vaccination (% of children under 2 years) | 63 | 74 | 77 | 78 | 80 | 85 | 84 | .. |
| Total health expenditure (% of GDP) | 1.8 | 2.0 | 2.8 | 2.9 | 2.9 | 3.0 | .. | .. |
| Public health expenditure (% of GDP) | 0.7 | 0.7 | 0.9 | 1.1 | 1.1 | 1.2 | .. | .. |
| Education³ | | | | | | | | |
| Primary net enrollment rate (%) | .. | .. | 92 | 92 | 92 | 93 | 92 | 93 |
| Female (% of total net enrollment) | .. | .. | 48 | 48 | 49 | 49 | 50 | 48 |
| Secondary net enrollment rate (%) | .. | .. | 52 | 61 | 60 | 60 | 61 | 65 |
| Female (% of total net enrollment) | .. | .. | 50 | 50 | 50 | 49 | 50 | 50 |
| Tertiary net enrollment rate (%) | .. | .. | 9 | 16 | 14 | 15 | 16 | 18 |
| Female (% of total net enrollment) | .. | .. | 55 | 53 | 50 | 54 | 54 | 55 |
| Adult literacy rate (%) | .. | .. | 91 | 91 | 91 | 92 | 93 | 93 |
| Public spending on education (% of GDP) ⁵ | .. | .. | 2.7 | 3.5 | 3.6 | 3.8 | 3.8 | 3.6 |
| Public spending on education (% of spending) ⁵ | .. | .. | 14.5 | 20.0 | 20.2 | 20.1 | 20.0 | 19.9 |
| Water and Sanitation¹ | | | | | | | | |
| Access to an improved water source (% of population) | 74 | 78 | 81 | 84 | 84 | 85 | .. | .. |
| Urban (% of urban population) | 91 | 91 | 92 | 93 | 93 | 93 | .. | .. |
| Rural (% of rural population) | 65 | 68 | 71 | 75 | 76 | 76 | .. | .. |
| Access to improved sanitation facilities (% of population) | 38 | 44 | 53 | 57 | 59 | 59 | .. | .. |
| Urban (% of urban population) | 60 | 64 | 70 | 70 | 73 | 71 | .. | .. |
| Rural (% of rural population) | 26 | 30 | 38 | 44 | 44 | 46 | .. | .. |
| Others¹ | | | | | | | | |
| Disaster risk reduction progress score (1-5 scale; 5=best) | .. | .. | .. | .. | 3.3 | .. | .. | .. |
| Proportion of seats held by women in national parliament (%) ⁶ | .. | 8 | 11 | 18 | 18 | 19 | 19 | 17 |

Source: ¹ World Development Indicators; ² BPS (Sakernas); ³ BPS (Susenas) and World Bank; ⁴ MoF, Bappenas and World Bank staff calculation, only includes spending on Raskin, Jamkesmas, BLT, BSM, PKH and actuals; ⁵ MoF; ⁶ Inter-Parliamentary Union

Appendix 2: Indonesia's Historical Macroeconomic Indicators at a Glance

| | 1995 | 2000 | 2005 | 2010 | 2011 | 2012 | 2013 | 2014 |
|--|-------|-------|-------|-------|-------|-------|--------|--------|
| National Accounts (% change)¹ | | | | | | | | |
| Real GDP | 8.4 | 4.9 | 5.7 | 6.4 | 6.2 | 6.0 | 5.6 | 5.0 |
| Real investment | 22.6 | 11.4 | 10.9 | 6.7 | 8.9 | 9.1 | 5.3 | 4.1 |
| Real consumption | 21.7 | 4.6 | 64.4 | 4.1 | 5.1 | 5.4 | 5.6 | 4.8 |
| Private | 22.7 | 3.7 | 0.9 | 4.1 | 5.1 | 5.5 | 5.4 | 5.3 |
| Government | 14.7 | 14.2 | 6.6 | 4.0 | 5.5 | 4.5 | 6.9 | 2.0 |
| Real exports, GNFS | 18.0 | 30.6 | 16.6 | 15.3 | 14.8 | 1.6 | 4.2 | 1.0 |
| Real imports, GNFS | 29.6 | 26.6 | 17.8 | 16.6 | 15.0 | 8.0 | 1.9 | 2.2 |
| Investment (% GDP) | 28 | 20 | 24 | 31 | 31 | 33 | 32 | 33 |
| Nominal GDP (USD billion) | 202 | 165 | 286 | 755 | 893 | 918 | 910 | 889 |
| GDP per capita (USD) | 1229 | 948 | 1,560 | 3,233 | 3,663 | 3,718 | 3,644 | 3,524 |
| Central Government Budget (% GDP)² | | | | | | | | |
| Revenue and grants | 15.2 | 20.8 | 17.9 | 14.5 | 15.5 | 15.5 | 15.1 | 14.6 |
| Non-tax revenue | 4.8 | 9.0 | 5.3 | 3.9 | 4.2 | 4.1 | 3.7 | 3.7 |
| Tax revenue | 10.3 | 11.7 | 12.5 | 10.5 | 11.2 | 11.4 | 11.3 | 10.8 |
| Expenditure | 13.9 | 22.4 | 18.4 | 15.2 | 16.5 | 17.3 | 17.3 | 16.7 |
| Consumption | 3.9 | 4.0 | 3.0 | 3.6 | 3.8 | 3.9 | 4.1 | 4.0 |
| Capital | 4.6 | 2.6 | 1.2 | 1.2 | 1.5 | 1.7 | 1.9 | 1.3 |
| Interest | 1.4 | 5.1 | 2.4 | 1.3 | 1.2 | 1.2 | 1.2 | 1.3 |
| Subsidies | .. | 6.3 | 4.4 | 2.8 | 3.8 | 4.0 | 3.7 | 3.7 |
| Budget balance | 1.3 | -1.6 | -0.6 | -0.7 | -1.1 | -1.8 | -2.2 | -2.2 |
| Government debt | 32.3 | 97.9 | 47.2 | 24.3 | 22.8 | 22.6 | 24.1 | 23.9 |
| o/w external government debt | 32.3 | 51.4 | 23.4 | 11.1 | 10.2 | 9.9 | 11.2 | 10.2 |
| Total external debt (including private sector) | 61.5 | 87.1 | 47.1 | 26.8 | 25.2 | 27.5 | 29.2 | 32.9 |
| Balance of Payments (% GDP)³ | | | | | | | | |
| Overall balance of payments | .. | .. | 0.2 | 4.0 | 1.3 | 0.0 | -0.8 | 1.7 |
| Current account balance | 3.2 | 4.8 | 0.1 | 0.7 | 0.2 | -2.7 | -3.2 | -3.0 |
| Exports GNFS | 26.2 | 42.8 | 35.0 | 22.0 | 23.8 | 23.0 | 22.5 | 22.3 |
| Imports GNFS | 26.9 | 33.9 | 32.0 | 19.2 | 21.2 | 23.2 | 23.1 | 22.7 |
| Trade balance | -0.8 | 8.9 | 2.9 | 2.8 | 2.7 | -0.2 | -0.7 | -0.4 |
| Financial account balance | .. | .. | 0.0 | 3.5 | 1.5 | 2.7 | 2.4 | 4.9 |
| Net direct investment | 2.2 | -2.8 | 1.8 | 1.5 | 1.3 | 1.5 | 1.3 | 1.7 |
| Gross official reserves (USD billion) | 14.9 | 29.4 | 34.7 | 96.2 | 110.1 | 112.8 | 99.4 | 112.0 |
| Monetary (% change)³ | | | | | | | | |
| GDP deflator ¹ | 9.9 | 20.4 | 14.3 | 7.3 | 7.5 | 3.8 | 4.7 | 5.4 |
| Bank Indonesia interest key rate (%) | .. | .. | 9.1 | 6.5 | 6.6 | 5.8 | 6.5 | 7.5 |
| Domestic credit | .. | .. | 28.7 | 17.5 | 24.4 | 24.2 | 22.1 | 15.9 |
| Nominal exchange rate (average, IDR/USD) ⁴ | 2,249 | 8,422 | 9,705 | 9,090 | 8,770 | 9,387 | 10,461 | 11,865 |
| Prices (% change)¹ | | | | | | | | |
| Consumer price Index (eop) | 9.0 | 9.4 | 17.1 | 7.0 | 3.8 | 3.7 | 8.1 | 8.4 |
| Consumer price Index (average) | 9.4 | 3.7 | 10.5 | 5.1 | 5.3 | 4.0 | 6.4 | 6.4 |
| Indonesia crude oil price (USD per barrel, eop) ⁵ | 17 | 28 | 53 | 79 | 112 | 113 | 107 | 60 |

Source: ¹ BPS and World Bank staff calculations, ² MoF and World Bank staff calculations (for 1995 is FY 1995/1996, for 2000 covers 9 months), ³ Bank Indonesia, ⁴ IMF, ⁵ CEIC.

Note: GDP figure is using GDP base year 2010 (SNA 2008).

Appendix 3 A& B: Medium-term Fiscal Projections and Fiscal Space Reforms

(All figures are percent of GDP (2000 Base))

| A. Baseline MT fiscal projections with development spending | 2013 | 2014 | 2015 P | 2016 P | 2017 P | 2018 P | 2019 P |
|---|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| Total CG revenues and grants | 15.8 | 15.2 | 13.5 | 13.4 | 13.3 | 13.3 | 13.3 |
| o/w tax | 11.9 | 11.3 | 10.9 | 10.9 | 10.9 | 10.9 | 10.9 |
| o/w non-tax | 3.9 | 3.9 | 2.6 | 2.5 | 2.4 | 2.4 | 2.3 |
| Total CG expenditure | 18.2 | 17.3 | 18.1 | 17.4 | 18.2 | 18.8 | 19.3 |
| o/w central personnel spending | 2.4 | 2.4 | 2.7 | 2.7 | 2.7 | 2.7 | 2.7 |
| o/w material spending | 1.9 | 1.6 | 2.2 | 2.2 | 2.2 | 2.2 | 2.2 |
| o/w capital | 2.0 | 1.3 | 2.5 | 2.7 | 3.4 | 3.7 | 4.1 |
| o/w energy subsidy | 3.4 | 3.4 | 1.2 | 1.1 | 1.1 | 1.1 | 1.1 |
| o/w social assistance (inc. SJSN) (central only) | 1.0 | 1.0 | 1.0 | 1.2 | 1.3 | 1.3 | 1.4 |
| o/w transfers to sub-national | 5.6 | 5.7 | 6.0 | 5.1 | 5.2 | 5.3 | 5.3 |
| CG Fiscal balance (Unconstrained) | -2.3 | -2.1 | -4.6 | -4.0 | -4.9 | -5.5 | -6.0 |
| <i>Fiscal Deficit Rule of 2.5% of GDP for CG</i> | -2.5 | -2.5 | -2.5 | -2.5 | -2.5 | -2.5 | -2.5 |
| Fiscal Space (additional required) | 0.2 | 0.4 | -2.1 | -1.5 | -2.4 | -3.0 | -3.5 |
| Public Debt | 26.1 | 23.6 | 26.3 | 27.3 | 29.3 | 31.7 | 34.4 |
| Notes: Expanded Development Spending (Total) | | | | | | | |
| o/w infrastructure (central and sub-national) | 2.0 | 2.0 | 2.8 | 3.1 | 3.8 | 4.1 | 4.6 |
| o/w health (central and sub-national) | 1.0 | 1.0 | 1.3 | 1.6 | 1.8 | 2.1 | 2.4 |

| B. MT fiscal projections with development spending & fiscal space reforms | 2013 | 2014 | 2015 P | 2016 P | 2017 P | 2018 P | 2019 P |
|---|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| Total revenues and grants | 15.8 | 15.2 | 13.5 | 14.4 | 15.4 | 16.3 | 17.4 |
| o/w tax | 11.9 | 11.3 | 10.9 | 11.8 | 12.8 | 13.7 | 14.8 |
| o/w non-tax | 3.9 | 3.9 | 2.6 | 2.5 | 2.5 | 2.5 | 2.6 |
| Total expenditure | 18.2 | 17.3 | 18.1 | 17.4 | 18.2 | 18.8 | 19.4 |
| o/w central personnel spending | 2.4 | 2.4 | 2.7 | 2.5 | 2.4 | 2.3 | 2.1 |
| o/w material spending | 1.9 | 1.6 | 2.2 | 2.2 | 2.2 | 2.2 | 2.2 |
| o/w capital | 2.0 | 1.3 | 2.5 | 2.7 | 3.4 | 3.7 | 4.1 |
| o/w energy subsidy | 3.4 | 3.4 | 1.2 | 1.1 | 1.1 | 1.1 | 1.1 |
| o/w social assistance (inc. SJSN) | 1.0 | 1.0 | 1.0 | 1.2 | 1.3 | 1.3 | 1.4 |
| o/w transfers to sub-national | 5.6 | 5.7 | 6.0 | 5.2 | 5.5 | 5.8 | 6.2 |
| Fiscal balance (Unconstrained) | -2.3 | -2.1 | -4.6 | -3.1 | -2.9 | -2.5 | -2.0 |
| <i>Fiscal Deficit Rule of 2.5% of GDP for CG</i> | -2.5 | -2.5 | -2.5 | -2.5 | -2.5 | -2.5 | -2.5 |
| Fiscal Space | 0.2 | 0.4 | -2.1 | -0.6 | -0.4 | 0.0 | 0.5 |
| Public Debt | 26.1 | 23.6 | 26.3 | 26.4 | 26.4 | 26.1 | 25.3 |
| Notes: Fiscal Space Reforms – Increase from Baseline | | | | | | | |
| 1. Increase tax by improving compliance in non-oil and gas income tax and VAT | | | | 0.4 | 1.0 | 1.5 | 2.1 |
| 2. Increase tax by increasing tobacco excise rate and motor vehicle rates | | | | 0.5 | 0.9 | 1.3 | 1.7 |
| 3. Increase non-oil and gas resource non-tax revenue by improving compliance | | | | 0.1 | 0.1 | 0.2 | 0.3 |
| 4. Control central personnel spending | | | | 0.1 | 0.3 | 0.4 | 0.5 |
| Total increase in fiscal space | | | | 1.1 | 2.3 | 3.4 | 4.7 |

Source: Ministry of Finance. Projections from World Bank's Medium-term fiscal framework model for Indonesia, updated in March 2015.

Table Notes:

2013: Actual figures. 2014: Preliminary actual figures. 2015 expenditure is the approved revised budget. 2015 revenue is World Bank projection. 2016-2019 are World Bank projections.

Macro assumptions: For both scenarios 2016-2019 assumes an enhanced real GDP growth scenario of 5.7-6.4 percent per annum from the big infrastructure push. Commodity prices are expected to continue to moderate, based on World Bank commodity outlook, February 2015.

Aggregate revenue is total central government revenues and grants excluding subnational own source revenues. Central government expenditure includes transfers to regions. Fiscal balance is central government fiscal balance and is shown as unconstrained by the fiscal deficit rule of 2.5% for Central Government i.e. expenditure is not cut back in order to stay within the rule, in order to show the additional amount of fiscal space that is needed to fund development priorities.

Infrastructure spending is total estimated capital and current spending on infrastructure by central and subnational government. Capital spending is approximately 85 percent of total infrastructure spending. For simplification purposes, in the above projection, increased infrastructure spending is reflected as only an increase in capital spending.

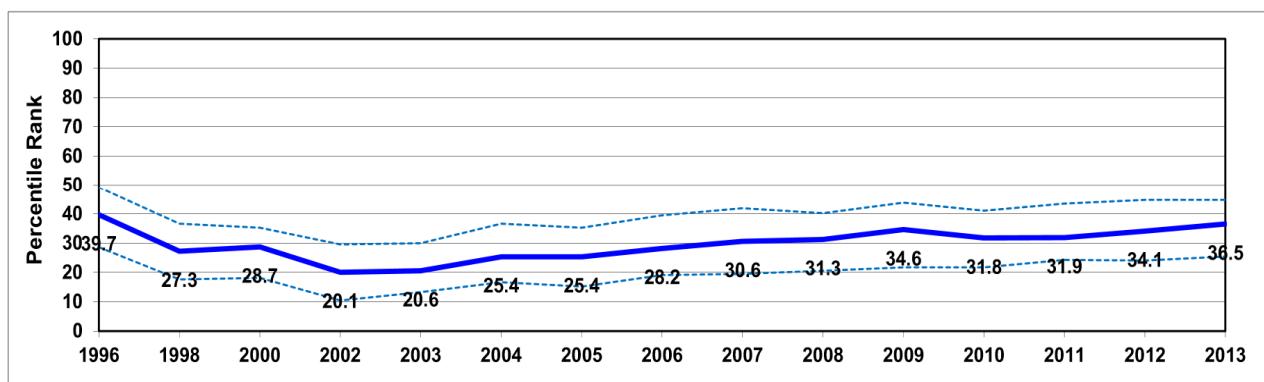
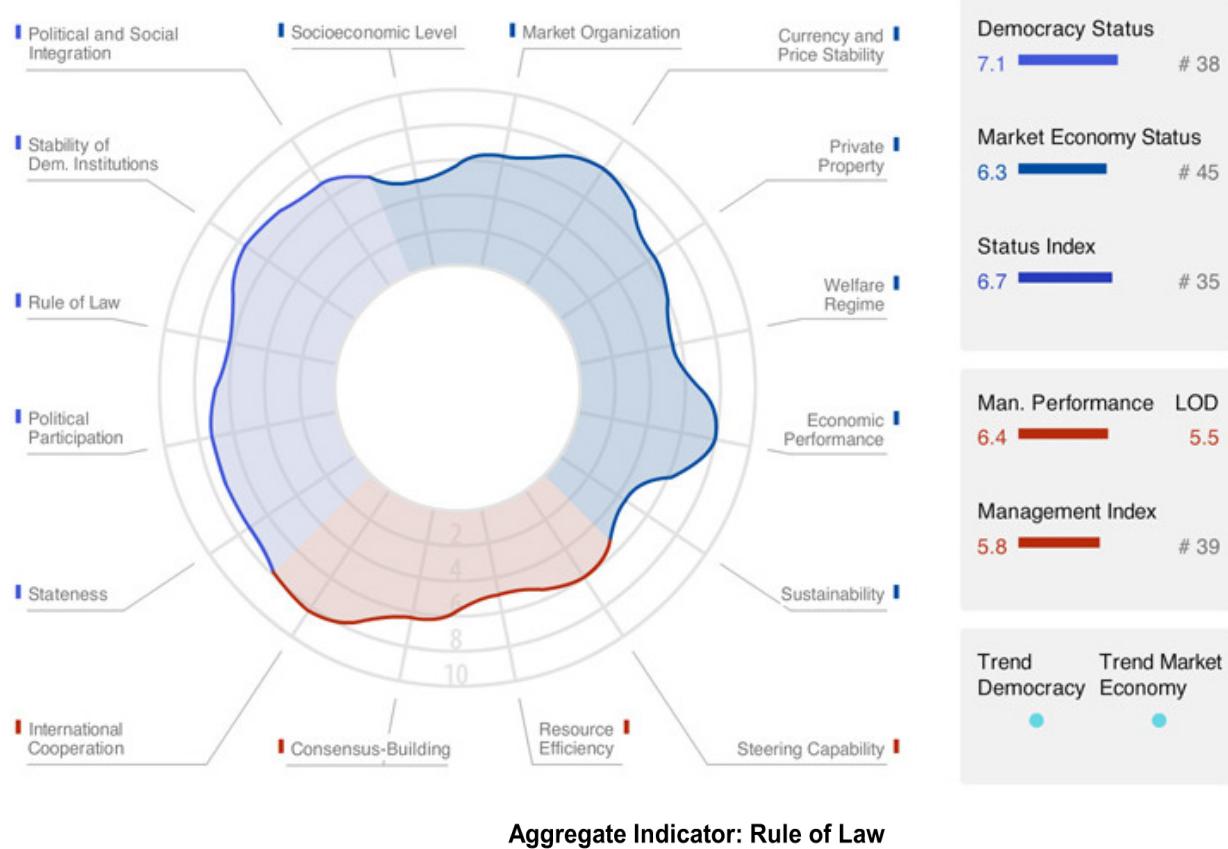
Social assistance spending figure is central government only and includes estimated SJSN health costs from 2014 onwards. It includes increased social assistance spending from health as well as non-health programs.

Health spending figure is total estimated spending on health by central and subnational government. Increased health spending is reflected in increased social assistance and material spending.

Fiscal space reforms: 1) Increase tax from non-oil and gas income tax and VAT assumes a baseline compliance rate of 47% of potential increasing to 65% by 2019 through administration improvements; 2) Assumes gradual increase in tax rates in tobacco from 44% of the retail price to 70% to create additional 0.7 percent GDP of revenue by 2019, and reform of vehicle excise schedule to create additional 1 percent of GDP of revenue by 2019; 3) Increase tax from non-oil and gas resource non-tax revenue assumes a baseline compliance rate of 47% of potential increasing to 100% by 2019 through administration improvements; 4) Assumes that personnel spending instead of growing at the same pace as nominal GDP i.e. 5 percentage points above CPI, stays flat in real terms i.e. grows at the same rate as CPI.

Appendix 4: Key Governance Indicators

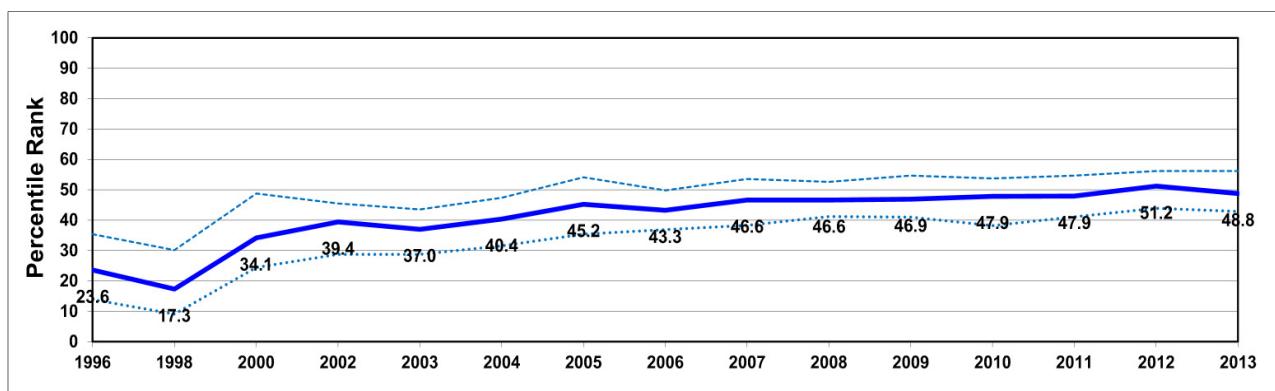
BTI 2014 | Indonesia Country Report



| Indicator | Notes | Indonesia | Brazil | Mexico | Thailand |
|-------------|---|--------------|--------|-------------|----------|
| Rule of Law | Measures perceptions of the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, property rights, the police, and the courts, as well as the likelihood of crime and violence. Slowly stabilizing democracy that has developed since the ousting of Soeharto in 1998 has led to a steady, fairly consistent improvement. Decentralization laws have transformed administrative structure. The judicial branch has grown more independent, but at the same time is considered the most corrupt in Southeast Asia. | High 30s ± 8 | 50s | Mid 30s ± 8 | 51 ± 5 |
| Source/Year | Sample Indicator | | | | |
| GI/2011 | GI - Global integrity indicators* (GI) (0=lowest; 100=highest) | 80.669 | N/A | 68.175 | N/A |
| BTI/2012 | Transformation Management (1=lowest, 10=highest) | 5.797 | 7.286 | 5.521 | 4.131 |
| WJP/2012 | Criminal Justice (1=highest, 0=lowest) | 0.447 | 0.485 | 0.401 | 0.593 |
| WJP/2012 | Civil Justice (1=highest, 0=lowest) | 0.495 | 0.555 | 0.351 | 0.432 |

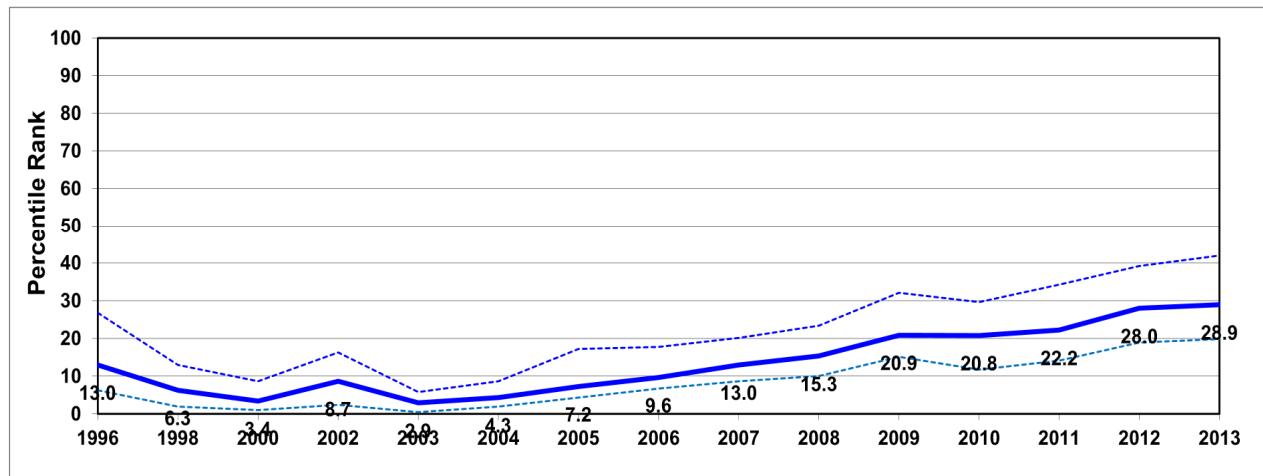
Indonesia, 1996-2013

Aggregate Indicator: Voice & Accountability



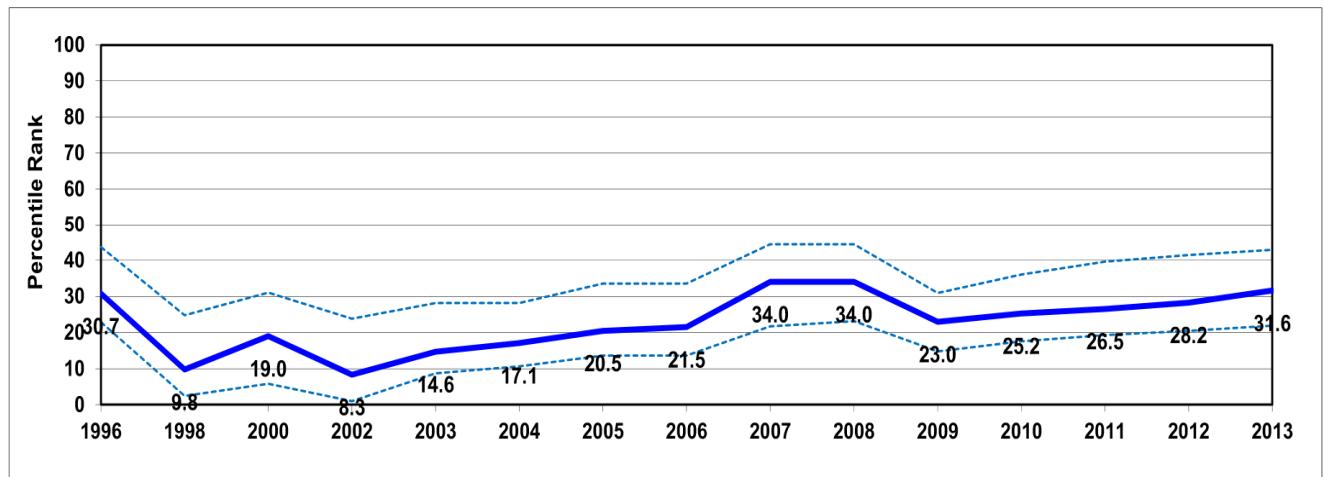
| Indicator | Notes | Indonesia | Brazil | Mexico | Thailand |
|--------------------------|--|-----------|---------------|--------|--------------|
| Voice and Accountability | A measure of how much agency citizens have in choosing their government as well as freedom of press, expression, and association. The number of NGOs has blossomed since the late 1990s, a majority of them advocacy-based CSOs. They have been relatively successful in influencing democracy building and empowering citizens, though not private sector accountability or public budget policies. Some indicators imply that civil society participation is decently higher than it is perceived to be. Marginalized voices still have difficulty finding voices to represent them. | High 40s | High 50s -60s | 50s | Mid 30s, ± 5 |
| Source/Year | Sample Indicator | | | | |
| WJP/2012 | Fundamental Rights (1=highest, 0=lowest) | 0.4563 | 0.695 | 0.564 | 0.659 |
| BTI/2012 | Status of Democratic Development (1=lowest, 10=highest) | 6.85 | 8.15 | 6.95 | 4.85 |
| IPD/2012 | Freedom of assembly, demonstration (0=no freedom of assembly, etc.,4=strong freedom of assembly) | 4 | 4 | 4 | 3 |
| IPD/2012 | Freedom of the press (freedom of access to information, protection of journalists etc.) (0=no freedom of the press,4=strong press freedom) | 4 | 4 | 2 | 3 |

Aggregate Indicator: Political Stability and Absence of Violence



| Indicator | Notes | Indonesia | Brazil | Mexico | Thailand |
|---|---|-----------|---------------|------------------|----------|
| Political Stability and Absence of Violence | Steady upward trend since 2003. The late 1990s and early 2000s saw a fair amount of communal violence, which is now moderate to low. Whereas conflict used to be predominantly ethnic or separatist in nature, large-scale mass protests in recent years have been labor union related. | 29 ± 10 | High 30s ± 13 | Mid-low 20s ± 10 | 9 ± 10 |
| Source/Year | Sample Indicator | | | | |
| IPD/2012 | Intensity of internal conflicts of an ethnic, religious or regional nature (0=no conflict,4=serious conflicts) | 2 | 0 | 1 | 3 |
| IPD/2012 | Intensity of social conflicts (excluding conflicts relating to land) (0=no social conflict,4=serious social conflicts) | 2 | 1 | 2 | 3 |
| WJP/2012 | Order and Security (1=highest, 0=lowest) | 0.716 | 0.636 | 0.496 | 0.631 |

Aggregate Indicator: Control of Corruption



| Indicator | Notes | Indonesia | Brazil | Mexico | Thailand |
|-----------------------|---|-----------|--------|---------|----------|
| Control of Corruption | Gradual improvement since 2002. The establishment of the Anti-Corruption Commission in 2004 has been instrumental to this, and there have been several highly publicized successes over the years, though parliamentary resistance and strife with police and judiciary has made progress slow. | 32 ± 10 | 55 ± 5 | 39 ± 12 | 40-50 |
| Source/Year | Indicator | | | | |
| WJP/2012 | Absence of Corruption (1=highest, 0=lowest) | 0.305 | 0.523 | 0.368 | 0.407 |
| IPD/2012 | Level of "petty" corruption between citizens and the administrations (0=very low level of corruption,4=high level of corruption) | 4 | 3 | 4 | 3 |
| IPD/2012 | Level of "political corruption" (e.g. vote buying, illegal campaign financing, bribery etc.) (0=very low level of corruption,4=high level of corruption) | 4 | 4 | 4 | 3 |
| IPD/2012 | Level of corruption between administrations and foreign businesses (0=very low level of corruption,4=high level of corruption) | 4 | 3 | 3 | 2 |

Appendix 5: Public Consultations around the SCD Content

Indonesia's Development Policy Review (DPR) Consultation and Dissemination Events & Products

The DPR for Indonesia followed a strategic consultative process and coordinated dissemination plan. The tables below depict these events and products.

A. Consultation and Dissemination Events

| Description | Date |
|---|---------------|
| Official Launch of the DPR | June 21, 2014 |
| PUBLIC | |
| Middle Income Trap International Conference, Bali | December 2013 |
| Middle Income Trap National Conference, MoF, Jakarta | February 2014 |
| PUBLIC SECTOR | |
| High Level Working Seminar, Ministry of Trade | February 2013 |
| Indonesia 2013 Investment Summit | November 2013 |
| CMEA (Echelons 1-2) | July 2014 |
| MoF Investor Seminar | December 2014 |
| PRIVATE SECTOR | |
| Korean KOTRA Seminar | March 2013 |
| Bank of Tokyo Mutsubishi | April 2013 |
| Bosch Senior Executives | May 2014 |
| Deutsche Bank | July 2014 |
| CIMB Annual Conference, Bali | August 2014 |
| Seminar with French Investors | December 2014 |
| Indonesia Bankers Association Conference | December 2014 |
| NOMURA All Access Seminar | January 2015 |
| ACADEMIA | |
| ISC Conference at Univ Negeri Jakarta (concept stage) | November 2012 |
| University of Indonesia | November 2013 |
| Seminar KANOPI (Univ of Indonesia) Indonesia Economic Outlook | November 2014 |
| KANOPI FEUI 12 th Economix Seminar | November 2014 |
| University of Indonesia | November 2014 |
| MEDIA | |
| KOMPAS | July 2014 |
| OTHERS | |
| JICA Indonesia Seminar, Tokyo | August 2014 |

B. Multimedia Releases

As part of the dissemination efforts for the DPR, below is a series of online video reports highlighting issues raised in the DPR. These three-minute videos were released leading up to and after the official launch of the DPR aimed to (i) brand the report, (ii) engage a wide spectrum of stakeholders in Indonesia, and (iii) sustain the discussions. All video clips are available on the World Bank external website for Indonesia.

| Description | Release Date |
|---|----------------|
| Logistics Optimizing Indonesia's Main Sea Port | February 2014 |
| Education Indonesia: Improving quality of teachers for better education results | April 2014 |
| Inequality: Poverty, Jobs, & Social Security Informal agriculture workers in Indonesia try to avoid poverty | May 2014 |
| Making a living as an informal worker in Indonesia | May 2014 |
| Finding work for a fresh graduate in Indonesia | June 2014 |
| Indonesia has developed—but not everyone feels it | June 2014 |
| Many in Indonesia still live just above the poverty line | September 2014 |
| Dewi and Putri: How inequality separates two girls from Indonesia | November 2014 |
| Infrastructure Video Blog: World Bank Vice President for East Asia and Pacific Visits Indonesia | December 2014 |

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