INDONESIA: AVOIDING THE TRAP
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INDONESIA’S FUTURE: RISING OR FLOATING?
DOMESTIC MEGATRENDS CAN HELP GROWTH

DEMOGRAPHICS

RAPID URBANIZATION

RISING MIDDLE CLASS
BUT LABOR PRODUCTIVITY LAGS...

92% of differences in income per capita around the world can be explained by differences in labor productivity.

Value Added per Worker (2005 PPP$)
Seven of Indonesia’s top 10 export products are commodities

Indonesia under-exports in manufacturing
  - Half of ASEAN population but only 15% of manufacturing exports
  - Thailand: 15% ASEAN population and 34% of exports

There is a need to develop intermediate industries but this requires a lot of expertise and capital

Despite remarkable increase, FDI inflows lower than in ASEAN peers
  - FDI inflows to Indonesia: 1.9% of GDP
  - FDI inflows to Vietnam: 5% of GDP; Average Middle Income in ASEAN: 3.3% of GDP
HOW TO AVOID A PROLONGED SLOWDOWN? …and revive growth to above 6%
NOT A TRIVIAL QUESTION: BRAZIL IN 1980-2004; FLOATED AFTER STRONG GROWTH

Source: World Bank, World Development Indicators

Per capita GDP constant 2005 USD

Brazil

$1700

$4200

$4400

$5200

Only $200 increase in 23 years

Source: World Bank, World Development Indicators
Per capita GDP constant 2005 USD

**South Africa**

$3300

Only $400 increase in 32 years

$5800

Source: World Bank, World Development Indicators
REFORMS FOR HIGH QUALITY GROWTH, ABOVE 6%

REDIRECT PUBLIC SPENDING TO KEY DEVELOPMENT PRIORITIES

SUPPLY-SIDE REVOLUTION

REFORMS TO IMPROVE LIVING STANDARDS FOR ALL

IMPLEMENTATION
1. REDIRECT PUBLIC SPENDING

2011 National Budget (Central + Provinces + Districts)

- Health
- Infrastructure
- Education
- Energy
  - Fuel subsidy
  - Electricity subsidy
  - Non-energy subsidy

Source: 2012 CENTRAL GOVERNMENT BUDGET and WB staff calculation
THAT’S A FAIR THING TO DO

**Share of the benefits of electricity and fuel subsidies by consumption decile, 2012**

- **Bottom 20**: 6.4%
- **Top 20**: 50.9%

Source: Susenas, World Bank staff calculations
2. SUPPLY-SIDE REVOLUTION

CLOSE INFRASTRUCTURE GAP

CLOSE SKILLS GAP

MAKE MARKETS WORK FOR ALL
INFRASTRUCTURE GAPS HURT PRODUCTIVITY, COMPETITIVENESS AND GROWTH

- Road length grew only by 35% in the last 10 years while vehicle growth was 300%.
- Ports’ capacity: Jakarta’s Tanjung Priok (75% trade): 6 million TEUs/year; Singapore: 30 million TEUs/year
- Improved piped water to premises: Indonesia: 36%; Malaysia: 99%
- Doubling of power demand in 7 years: Huge investments needed to boost supply

✓ Indonesia has lost about 1 percentage point of growth due to infrastructure gap
✓ Given dynamism of domestic demand, supply bottlenecks = lost growth opportunities
✓ Closing the gap is crucial for attaining higher productivity, competitiveness and growth

REFORM OPTIONS

1. Boost public sector spending from 2.5% of GDP to 4.5% by 2019
2. Improve efficiency and quality of public investment, and coordination
3. Tackle land acquisition (implementation of new law)
4. Leverage private sector financing
SKILLS GAPS HURT PRODUCTIVITY, COMPETITIVENESS AND GROWTH

More Indonesians have higher degrees, but skills gaps remain:

- Mismatched employment: 50% of senior secondary and 15% of tertiary education graduates work in unskilled positions
- Unhappy employers: 70% of manufacturers say ‘very difficult’ to fill skilled positions

50 percent of senior secondary and 15 percent of tertiary education graduates find work in unskilled positions

Only about 5% of labor force receive formal on-the-job training

The of many sectors rests in large part on improving availability of skills rapidly

With ASEAN integration, risk of losing the best and not being competitive in the middle

REFORM OPTIONS

1. Strengthen the credibility of the quality assurance system; channel funds only to accredited institutions
2. Create more training centers to deliver relevant training and specific skills in higher value-added, strategic sectors
3. Support linkages between education institutions and employers
4. Improve basic education, starting with early childhood education
MARKET DYSFUNCTIONS HURT PRODUCTIVITY, COMPETITIVENESS AND GROWTH

- **Product markets.** Not well-prepared sector-specific regulations expose the economy to rent-seeking activities, create uncertainty and send mixed signals.
- **Labor market.** High severance pay and uncertain minimum wage setting mechanisms yield lose-lose outcomes.
- **Financial market.** Financing of the private sector (credit to private sector) is among lowest in ASEAN (firms retain cash for future use or borrow at high costs).
- **Land market.** Access to land is a big constraint for infrastructure development and industrial expansion.

**REFORM OPTIONS**

1. **Product markets:**
   1. Regulatory consistency and less uncertain business environment
   2. Continue simplification of investment procedures, including licensing
2. **Labor market:**
   1. Revision of severance pay provisions of the labor law
   2. Adoption a new minimum wage setting formula based cost of living and inflation
3. **Financial market:**
   1. Financial inclusion and legal infrastructure
The difference between growing by 6.5% and 4% = millions of jobs!

THE GROWTH-ENHANCING REFORMS HAVE HIGH EMPLOYMENT PAYOFF!
3. REFORMS TO IMPROVE LIVING STANDARDS FOR ALL

LOCAL SERVICE DELIVERED TO ALL
(health, waste management, water, sanitation)

ENHANCED SOCIAL PROTECTION

IMPROVED MANAGEMENT OF NATURAL RISKS
GOVERNANCE MATTERS FOR LOCAL SERVICE DELIVERY

More money does not improve access/quality... without good local governance

REFORM OPTIONS

1. Hold sub-nat. governments accountable to results
2. Reward those that perform well (performance-based transfers)
3. Provide technical support to sub-nat. gov. on public finance management
4. Inform the public about use of public resources in localities

Figure 0.4 Higher quality local education governance is associated with better education performance

Note: The results presented here show the estimated relationship between the ILEG Index and the UN examination score having controlled for other factors that could determine district examination scores (e.g. poverty levels). See Appendix 4, Table 1 for the full results.
Source: Indonesian local education governance survey, 2009 and 2012
MANY PEOPLE HAVE NO SOCIAL PROTECTION

REFORM OPTIONS

1. Strengthen existing social assistance programs (some work well, others no)
2. New programs covering the elderly, the disabled and the near-poor
3. Improve integration of different assistance programs and targeting
4. Sound implementation in social security reform
NATURAL RISKS THREATEN POVERTY REDUCTION

REFORM OPTIONS

1. A national program on hazardous micro-zoning to incorporate resilience into site design and construction standards
2. A financing framework for infrastructure development that incentivizes investment with built-in resilience
3. A national program on urban upgrading and ecosystem rehabilitation
4. MEET IMPLEMENTATION CHALLENGES

- A stronger Center of Government to manage the policy process and resolve policy conflicts
- Streamlined bureaucracy for enhanced accountability
- More strategic management of human resources across the public administration
- Better planning and budgeting procedures to deliver improved results with public spending
- Stronger accountability for service delivery at the local level
<table>
<thead>
<tr>
<th>Options</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Phase out fuel subsidy for premium and diesel over 5 years</td>
<td>Phasing out fuel subsidies would free up 2 percent of GDP by 2019.</td>
</tr>
<tr>
<td>2. Temper growth in central and subnational personnel spending</td>
<td>1.4 percent of GDP can be secured if central and subnational personnel spending could be tempered to grow in line with inflation rather than at 5 to 8 percent above inflation in recent years.</td>
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<tr>
<td>3. Increase tax revenues by improving tax administration and increasing tobacco excise tax</td>
<td>Tax administration measures could increase revenues by nearly 1.5 percent of GDP per year by 2019, while increasing excise tax on tobacco to 70 percent would increase revenues by 0.5 percent of GDP per year by 2019.</td>
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The poor and vulnerable did not benefit from past growth as well as the rich.

**Average real consumption growth, 2003 - 2013**

- **Annualized growth of mean national consumption**
  - Poorest: 1
  - 2: 1
  - 3: 1
  - 4: 2
  - 5: 2
  - 6: 3
  - 7: 3
  - 8: 4
  - 9: 5
  - Richest: 6

Household per capita consumption deciles:
- Poorest
- 2
- 3
- 4
- 5
- 6
- 7
- 8
- 9
- Richest
INDONESIA IS AT A CROSSROADS

GDP per capita (constant 2012 USD)

<table>
<thead>
<tr>
<th>Country</th>
<th>Year</th>
<th>GDP per Capita (2012 USD)</th>
</tr>
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<tbody>
<tr>
<td>Hong Kong SAR, China</td>
<td>1982</td>
<td>12,424</td>
</tr>
<tr>
<td>Japan</td>
<td>1970</td>
<td>20,017</td>
</tr>
<tr>
<td>Korea, Rep.</td>
<td>2000</td>
<td>14,274</td>
</tr>
<tr>
<td>Singapore</td>
<td>1991</td>
<td>24,218</td>
</tr>
<tr>
<td>Indonesia</td>
<td>2030</td>
<td>8,531</td>
</tr>
<tr>
<td>Assuming 10 percent real GDP growth 2013-2030</td>
<td>Indonesia</td>
<td>16,618</td>
</tr>
<tr>
<td>Assuming 6 percent real GDP growth 2013-2030</td>
<td>Indonesia</td>
<td>2030</td>
</tr>
</tbody>
</table>

Indonesia can get rich before growing old, with serious reforms!
A solid track record of good macroeconomic management

- Fiscal prudence (deficit capped at 3% of GDP);
- Crisis management and response (1997 and 2009);
- Good macro management leading to low volatility of growth despite dependence on natural resource

Structural reform agenda well-known

A good neighborhood: East Asia = the most dynamic region in the world (market opportunity and investment dynamism)

The country’s own forces: a dynamic, tech-savvy youth, formidable economic, cultural and geographical diversity, a rising middle class and a stable democracy.

With consistent reforms, Indonesia can avoid the trap!