



Economic Assessment of Indonesia, 2008

Should price subsidies be reduced further?

How can monetary policy be strengthened?

What can be done to improve the business environment?

How to encourage investment?

Would a more flexible labour code deliver lower unemployment?

How to make social protection more effective?

For further information

For further reading

Where to contact us?

Summary

Indonesia's economic performance has improved markedly over the last few years. The economy has recovered in earnest from the 1997-98 financial crisis, and GDP growth has been around 5½ per cent per year since 2004. This rate is below that of some regional peers, but high enough to deliver broad-based improvements in living standards. The contribution of private consumption has trended up, especially since 2004, on the back of robust credit creation.

Investment also appears to be rebounding, although it remains lower than elsewhere in the region when measured in relation to GDP. Export growth has been supported by high commodity prices. The momentum of the current expansion is expected to be maintained in 2008-09, with GDP growth likely exceeding 6% per year. Yet, the current level of growth is insufficient to speed up the pace of reduction in poverty and unemployment.

Therefore, raising the economy's growth potential and sustaining it over the longer term is Indonesia's foremost policy challenge. To achieve this, concerted efforts are required in several areas, especially if the goals set out in *Vision 2030* – a well thought-out initiative by a group of independent experts to achieve high growth – are to be fulfilled.

This Policy Brief presents the Executive Summary of the 2008 Economic Assessment of Indonesia. A draft of this Economic Assessment was prepared by the Economics Department and discussed at a meeting of the Economic Development and Review Committee, which is made up of the 30 member countries and the European Commission, on 9 June 2008. The Economic Assessment is published under the responsibility of the Secretary-General of the OECD.

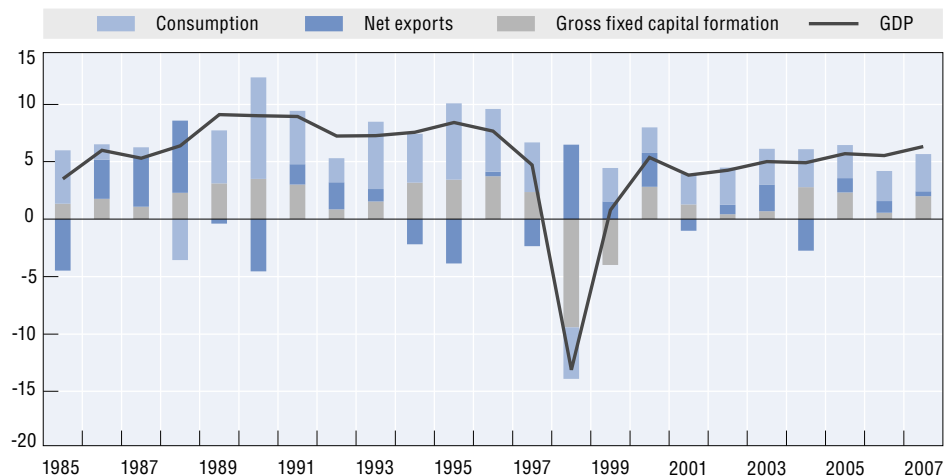
Against this background, the *OECD Economic Assessment of Indonesia* discusses a number of policy options for improving the business climate and making better use of labour inputs. Progress in these areas will contribute to enhancing economic efficiency further, so as to narrow the gap in relative living standards that currently exists between Indonesia and the more prosperous countries in the OECD area. ■

Should price subsidies be reduced further?

Responsible conduct of fiscal policy in an increasingly decentralised setting has delivered low budget deficits and falling public indebtedness in relation to GDP. The budget has therefore benefitted from an “interest dividend”, which has allowed the authorities to begin to reallocate scarce resources towards meritorious programmes in the social and infrastructure development areas. Emphasis on human capital accumulation, and particularly on improvements in the quality of services, including labour training, would be particularly welcome, given that Indonesia’s educational attainment indicators fare particularly poorly in relation to some regional comparator countries and the OECD area. Efforts are also under way to strengthen tax administration, to alleviate the income tax burden on the business sector and to improve value-added taxation. Decentralisation, which has put the local governments at the helm of service delivery since 2001, was implemented rapidly and yet without disruption. There is broad agreement that, based on its favourable public debt dynamics, Indonesia will in all likelihood continue to benefit from a relatively comfortable fiscal position in the years to come. Therefore, the time is now ripe for building on past achievements, which are commendable, and for strengthening the fiscal framework further.

Indonesia continues to subsidise fuel and electricity consumption by maintaining a sizeable gap between domestic and international oil prices. Subsidies are expected to make up about 20% of central government expenditure in 2008, with those on fuel taking up the lion’s share of the total. A few selected food items are also subsidised, but such outlays account for a small share of outlays on subsidies.

Figure 1.
INDONESIA’S GROWTH PERFORMANCE AND RELATIVE INCOME
GDP growth and contributions, 1985-2007



Source: World Bank and OECD.

Efforts to eliminate fuel price subsidisation have yielded mixed results. For example, a mechanism introduced in 2001-02 for automatically adjusting domestic prices so as to reduce the gap between domestic and international fuel prices was abolished not long after. These subsidies are an inefficient use of scarce budgetary resources at a time when resources are needed for human capital accumulation and infrastructure development, in addition to creating considerable fiscal stress when international fuel prices are high. First and foremost, a significant share of government spending on some subsidies (about two-thirds in the case of fuel, according to official estimates) accrue to individuals in the top two quintiles of the income distribution, rather than benefitting vulnerable social groups. These subsidies also make it difficult for the oil and electricity companies to pursue their commercial objectives independently of the government's social policies. Moreover, extensive subsidisation complicates the regulatory framework, because uncertainty in price setting discourages much needed private investment in these sectors. Finally, by keeping the price of fossil fuels artificially low, such price support encourages wasteful consumption and discourages a search for alternative sources of energy, with a detrimental impact on the environment. Therefore, the authorities' efforts to gradually reduce the gap between domestic and international energy prices would be welcome, provided that targeted compensatory measures (discussed below) are taken to shield the needy from the attendant price rises. The increase in domestic fuel prices by nearly 30% in mid-May was a step in the right direction, but the introduction of a formula-based mechanism for setting domestic fuel prices would have the advantage of making price changes transparent and removing them from the political arena. ■

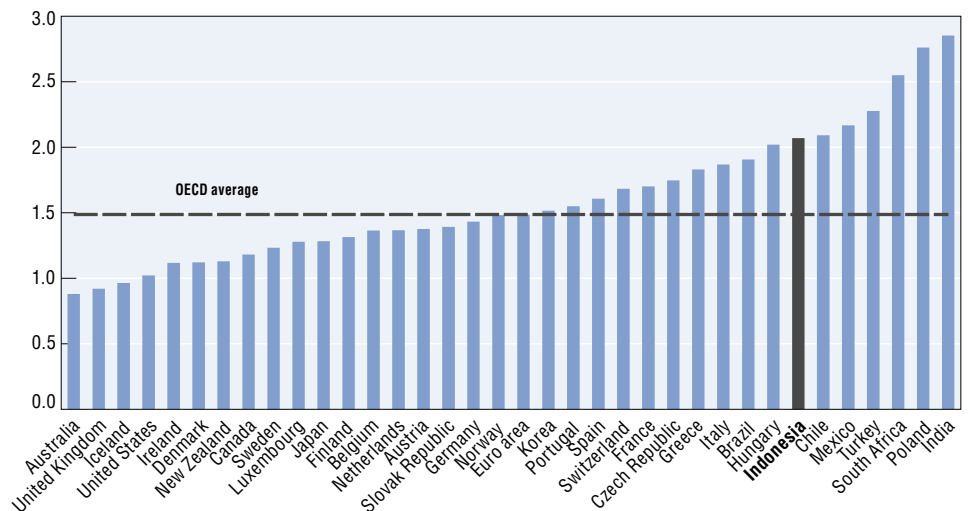
How can monetary policy be strengthened?

Monetary policy has been conducted within a fully-fledged inflation-targeting regime since mid-2005, when monetary targeting was formally abandoned. Following an upsurge in 2005-06 as a result of fuel-price hikes, inflation was reduced and kept within the end-year target range of 5-7% in 2007. Increases in food and energy prices are nevertheless weighing on inflation outcomes yet again. Headline inflation and expectations have risen and are now well above the ceiling of the target range of 4-6% for 2008. The effect of high food prices on inflation is particularly strong in emerging-market economies, where these items account for a comparatively high proportion of the consumer-price index. To strengthen credibility in the policy regime, the central bank is advised to react pre-emptively by tightening the monetary policy stance should the outlook for inflation and expectations deteriorate further. International experience shows that resolute, forward-looking action is

essential for anchoring expectations and enhancing policy credibility in countries that have a short track record with inflation targeting. Over the longer term, policy effort should also focus on lowering inflation towards the average of Indonesia’s main trading partners. The announcement of gradually decreasing targets for the coming years, from 4-6% in 2008 to 3-5% over the medium term, is therefore a welcome signal of commitment to inflation convergence, which will require a sustained effort to achieve those targets.

The steps taken to strengthen the financial sector since the financial crisis of 1997-98, including the most recent biennial Structural Reform Programme, have largely paid off: the banking system is sound, capital-adequacy and liquidity indicators have improved over the years, and the quality of loan portfolios has been strengthened. Nevertheless, State-owned banks have a large presence in the sector, in part due to the rescue of failing banks after the crisis, and the non bank sector is relatively small. Credit-to-GDP ratios are lower than in regional peers and Indonesia’s pre-crisis level, despite a robust expansion over the last few years. As in other countries with a large informal sector, access to credit is particularly difficult for small and unregistered enterprises, which tend to rely on informal, costly sources of finance. Indonesia would therefore benefit from further financial deepening, including in particular the development of the non bank market segment and an expansion of credit to small businesses. Progress in this area could unleash opportunities for entrepreneurship, but policy action should continue to be guided by high standards of financial-sector supervision and prudential regulations. ■

Figure 2.
PRODUCT MARKET REGULATIONS
Low scores indicate less restriction

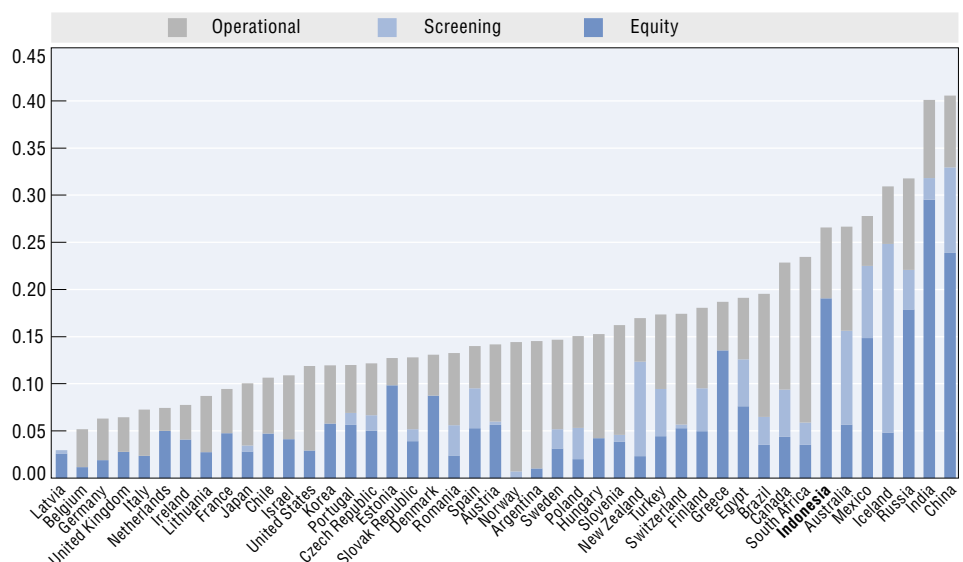


What can be done to improve the business environment?

Pro-competition product-market regulations tend to be growth-enhancing, because the reallocation of inputs towards higher-productivity sectors is unencumbered. An assessment of Indonesia's regulatory environment on the basis of the OECD methodology for gauging competitive pressures in product markets suggests considerable scope for improvement. In particular, despite recent deregulation efforts and reforms, Indonesia still fares particularly poorly in comparison with OECD countries in terms of the size and scope of government. For example, the government owns all or the majority of large firms in several sectors, including network industries. It is also involved in manufacturing and services, including banking and insurance. Sector-specific restrictions on private-sector involvement also remain, including in transport and retail distribution, as well as foreign ownership ceilings, as discussed below. Options are being put forward by the authorities for liberalising State-owned monopolies in key network industries, which would contribute to opening up opportunities for the private sector. The experience of several countries in the OECD area and beyond suggests that, with appropriately designed regulatory frameworks, the withdrawal of the State from network industries has been accompanied by an expansion of supply and a reduction in service prices, as well as increases in productivity.

There is near-consensual agreement that long-term growth is being held back more by supply- rather than demand-side constraints. The private sector can play a prominent role in the growth process, so long as the business climate can be improved considerably.

Figure 3.
FDI LEGISLATION
Low scores indicate less restriction



Economic and regulatory uncertainty, deficiencies in law enforcement and infrastructure bottlenecks are among the main barriers to entrepreneurship. Indonesia's ranking in international indicators of perceived corruption also suggests that there is significant room for improvement in that area too. The authorities are aware of the need to take decisive action to tackle these deficiencies, and there has been unequivocal progress in some policy domains in recent years. In particular, enactment of the Investment Law in 2007 was a considerable step forward. The Law makes the investment regime more transparent to investors, and ensures equal treatment for domestic and foreign investment. Screening, notification and approval procedures have been simplified, but ownership ceilings remain in many sectors. As a result, Indonesia's FDI legislation remains more restrictive than those of most OECD countries on the basis of the OECD methodology for assessing and comparing FDI regimes across countries. Further liberalisation of foreign ownership restrictions could therefore be envisaged in support of policy efforts to encourage investment and boost entrepreneurship. Policy effort in this area would therefore be welcome to nurture investor confidence in the new FDI regime. ■

How to encourage investment?

Indonesia's ratio of investment to GDP remains below those of regional comparator countries. This has raised concern among policymakers about the country's ability to lift and maintain potential growth over the longer term and to match the growth rates of the fastest-growing economies in the region, including China and India. At the same time, Indonesia has some of the weakest infrastructure development indicators in Southeast Asia, suggesting ample pent-up demand for such investment. A strong fiscal position is creating room in the budget for increasing government spending on infrastructure. But greater private-sector involvement in infrastructure development and maintenance would be essential. For that, regulatory uncertainty must be reduced, especially with reference to the pricing of water/sanitation services, fuels and electricity. Price subsidisation complicates investment decisions, because it makes it difficult for investors to assess the rates of return of projects. Existing restrictions on foreign ownership in these sectors also constrains private-sector involvement. The design of a new, pro-investment regulatory framework, including price liberalisation, free entry into network industries and the setting up of independent regulators would obviously be a complex task but could create attractive opportunities for the private sector to participate in infrastructure development.

The decentralisation programme that was implemented in 2001 granted local governments considerable autonomy to issue business regulations, including licenses, and to levy fees and user charges for the provision

of local services. Based on this prerogative, most jurisdictions have introduced several levies, often without the accord of the central government, as a means of raising revenue. Central government efforts to tackle this problem have so far yielded mixed results. Initiatives have nevertheless been put in place, including by independent think-tanks, to raise awareness among district-level policymakers of the undesirable effects of a proliferation of local regulations on business activity. These efforts seem to be bearing fruit. Several local governments are setting up one-stop shops as a means of facilitating business registration and the issuance of licenses. Also, legislation is under consideration by the central government to abolish local levies that are deemed in breach of nation wide regulations. Continued efforts to simplify business regulation procedures further and to make them more business-friendly would therefore be welcome. Steadfast progress in this area is crucial for rendering the regulatory framework more transparent and pro-investment.

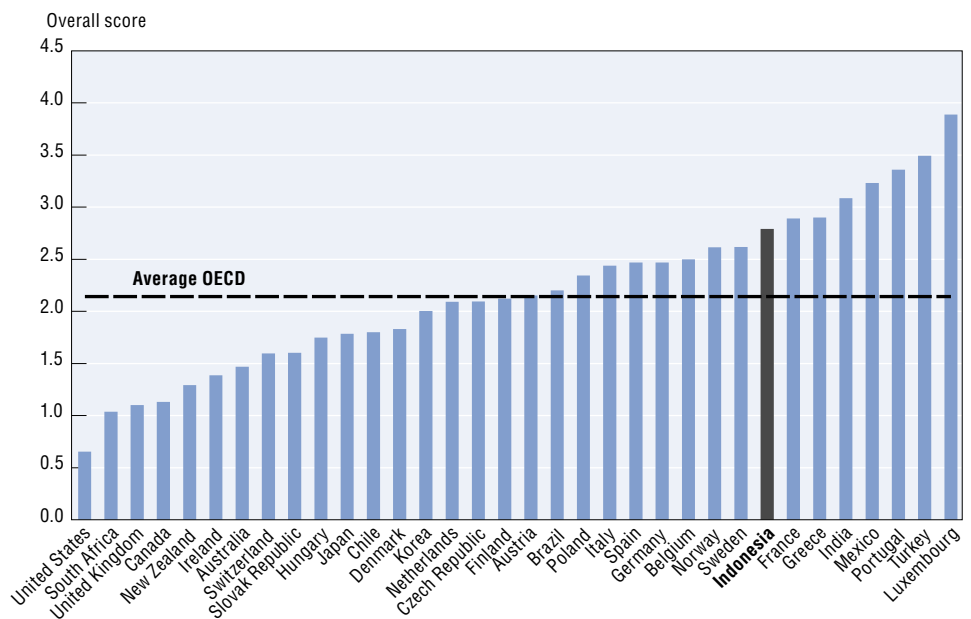
Decentralisation has put the local governments at the forefront of service delivery, including in public investment programmes. But capacity constraints have resulted in a backlog of investment projects. At the same time, delays in approval of local government budgets by the Ministry of Home Affairs, which is required by law, have taken a toll on the implementation of investment projects. In addition, a focus on short-term, calendar-year budgeting makes it difficult for local governments to carry out and finance multi year investment projects. Anecdotal evidence suggests that deficiencies in public procurement and tighter oversight in the context of the authorities' ongoing anti-corruption initiatives have made local government officials wary of executing budgetary commitments for fear of prosecution. This may be an unavoidable short-term cost of anti corruption efforts towards boosting accountability at the all levels of government over time. The stock of unspent budgetary appropriations, especially those financed through revenue sharing with the natural resource-rich jurisdictions, has increased over time, taking a toll on the government's ability to implement investment projects. There is, therefore, considerable scope for reducing capacity constraints at the local level and for making budgetary processes, including central government approval of local government budgets, swifter and better equipped to deal with the multi-year nature of investment projects. ■

Would a more flexible labour code deliver lower unemployment?

Better utilisation of labour inputs is another pre requisite for putting growth on a higher, sustainable trajectory. A tightening of labour legislation, especially with enactment of the Manpower Law of 2003, has contributed to poor labour-market outcomes. These include high

unemployment, persistent informality and a loss of dynamism in labour-intensive manufacturing sectors, such as textiles, clothing and footwear, in which Indonesia has a comparative advantage. Indonesia’s labour legislation is rigid in relation to most countries in the OECD area, and particularly in comparison with regional peers. On the basis of the OECD methodology for assessing the stringency of a country’s employment protection legislation (EPL), the Indonesian labour code is particularly restrictive on regular contracts, due essentially to bureaucratic dismissal procedures and costly severance-pay requirements. There are also constraints on the use of temporary and fixed-term contractual arrangements, because of strict provisions on the duration and number of extensions of such contracts, as well as on the nature of the activities and occupations to which such arrangements apply. Alternative indicators, such as those featured in the World Bank’s *Doing Business* reports, also underscore the stringency of Indonesia’s EPL in comparison with regional peers and OECD countries. Several options can be considered for making labour legislation more flexible. In particular, consideration could be given to simplifying procedures for dismissals in the case of regular contracts, relaxing restrictions on temporary work and fixed-term contracts, and reducing the burden of severance pay and long-term compensation on employers.

Figure 4.
EMPLOYMENT PROTECTION LEGISLATION
 Low scores indicate less rigidity



At about 65% of the median wage of salaried workers, the minimum wage is already relatively high in Indonesia in comparison with OECD countries. It has risen fast, especially after decentralisation in 2001, because the task of setting the value of the minimum wage is now under the local governments' purview. This increase has had a deleterious impact on labour-market performance: increases in the minimum wage that are out of step with productivity gains are likely to displace lower-skilled workers. As in the case of EPL stringency, the loss of dynamism in labour-intensive sectors can be attributed to a large extent to the rising relative value of the minimum wage. Therefore, further increases in the minimum wage could be capped so as not to exceed labour productivity gains. This, or, if it were possible, a gradual reduction over time would help to alleviate the adverse employment impact of such a high minimum wage (in relation to the median) on low-skilled workers and to facilitate formalisation in the labour market. ■

How to make social protection more effective?

Burdensome labour laws, including minimum-wage provisions, often penalise vulnerable workers, instead of protecting them. This is because legal provisions are not binding in the informal sector, where income is likely to be lower and job security more precarious. Also, increases in the minimum wage are most harmful to the workers at greatest risk of job losses in the formal sector. Therefore, policy initiatives to build effective social protection while making the labour code more flexible could yield considerable dividends, including in terms of labour-market performance. To make tangible progress in this area, several policy options could be considered. For example, unemployment insurance could be introduced in lieu of onerous dismissal/severance compensation entitlements. There are several options for designing an effective unemployment insurance scheme. But, as a general rule, it is important that such schemes be fiscally sound and affordable to workers and employers. At the same time, budget finances permitting, formal social insurance programmes could be developed. To this end, once credibility in the existing social insurance programme (*Jamsostek*) has been built, participation could be extended to the self-employed and employees in smaller enterprises on a voluntary basis, as envisaged by the 2004 Social Security Law (*Jamsosnas*). Policy action in this area would be welcome to broaden the array of options for saving for retirement and to facilitate access to health care for those workers and their families who are currently uninsured. In any case, it should be acknowledged that the attractiveness of coverage, both by unemployment and social insurance, depends ultimately on the perceived benefits of social protection and the affordability of

contributions, which may be a significant constraint for individuals on low incomes.

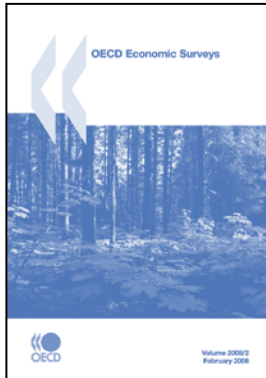
Indonesia already has a number of formal, government-financed safety nets. The authorities' efforts to strengthen these programmes since the 1997-98 financial crisis through community-based and targeted income transfers to vulnerable and poor individuals are commendable. These programmes are perceived to be working well, following efforts to improve targeting and governance in the delivery of benefits. Emphasis is now shifting towards enhancing social assistance by equipping vulnerable individuals with the minimum skills needed to pull themselves out of poverty. This change is of course welcome. To build on previous achievements, conditionality could be improved in the main existing income transfer programme (*Program Keluarga Harapan*) to strengthen the link between social protection and durable improvements in social outcomes. International experience, especially in the Latin America countries that pioneered the design of conditional income transfers, suggests that the most effective eligibility requirements are related to school attendance and participation in preventive health care programmes. Complementary initiatives can also be taken to improve the targeting of overall government social spending. A reduction in outlays on price subsidies for fuels and electricity, which are on balance poorly targeted, as mentioned above, would be a starting point. Budgetary resources could then be diverted to the financing of programmes that do reach the most vulnerable segments of society, improving the overall progressivity of social spending. ■

**For further
information**

For further information regarding this *Policy Brief*, please contact:
Luiz de Mello, e-mail: luiz.demello@oecd.org, tel.: +33 1 45 24 87 52, or
Diego Moccero, e-mail: diego.moccero@oecd.org, tel.: +33 1 45 24 14 20.



For further reading



OECD Economic Surveys: *Economic Surveys* review the economies of member countries and, from time to time, selected non-members. Approximately 18 Surveys are published each year. They are available individually or by subscription. For more information, consult the Periodicals section of the OECD online Bookshop at www.oecd.org/bookshop.

Additional Information: More information about the work of the OECD Economics Department, including information about other publications, data products and Working Papers available for downloading, can be found on the Department's website at www.oecd.org/eco.

Economic Outlook No. 83, June 2008.

More information about this publication can be found on the OECD's website at www.oecd.org/eco/Economic_Outlook.

Economic Policy Reforms: Going for Growth, 2008 edition.

More information about this publication can be found on the OECD's website at www.oecd.org/economics/goingforgrowth2008.

OECD publications can be purchased from our online bookshop:
www.oecd.org/bookshop

OECD publications and statistical databases are also available via our online library:
www.SourceOECD.org

Where to contact us?

OECD HEADQUARTERS

2, rue André-Pascal
75775 PARIS Cedex 16
Tel.: (33) 01 45 24 81 67
Fax: (33) 01 45 24 19 50
E-mail: sales@oecd.org
Internet: www.oecd.org

GERMANY

OECD Berlin Centre
Schumannstrasse 10
D-10117 BERLIN
Tel.: (49-30) 288 8353
Fax: (49-30) 288 83545
E-mail:
berlin.centre@oecd.org
Internet:
www.oecd.org/berlin

JAPAN

OECD Tokyo Centre
Nippon Press Center Bldg
2-2-1 Uchisaiwaicho,
Chiyoda-ku
TOKYO 100-0011
Tel.: (81-3) 5532 0021
Fax: (81-3) 5532 0035
E-mail: center@oecdtokyo.org
Internet: www.oecdtokyo.org

MEXICO

OECD Mexico Centre
Av. Presidente Mazaryk 526
Colonia: Polanco
C.P. 11560 MEXICO, D.F.
Tel.: (00.52.55) 9138 6233
Fax: (00.52.55) 5280 0480
E-mail:
mexico.contact@oecd.org
Internet:
www.oecd.org/centrodemexico

UNITED STATES

OECD Washington Center
2001 L Street N.W., Suite 650
WASHINGTON DC. 20036-4922
Tel.: (1-202) 785 6323
Fax: (1-202) 785 0350
E-mail:
washington.contact@oecd.org
Internet: www.oecdwash.org
Toll free: (1-800) 456 6323

The OECD Policy Briefs are prepared by the Public Affairs Division, Public Affairs and Communications Directorate. They are published under the responsibility of the Secretary-General.