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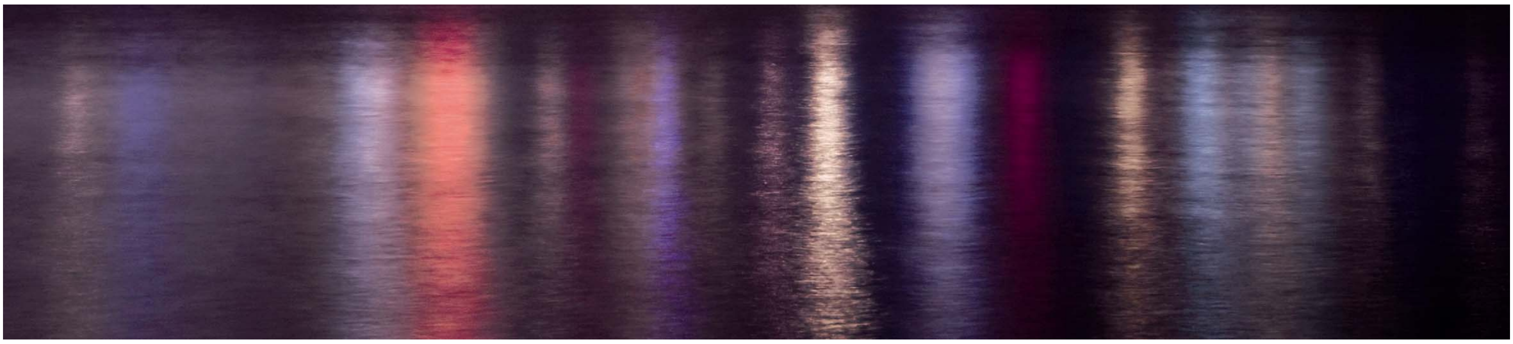
OVERVIEW



Summary

Improved macro-economic and structural policy settings since the Asian crisis have yielded strong and remarkably stable economic growth, as well as a marked reduction in poverty. Further institutional and policy reform would boost productivity growth and help the government reach its objective of becoming one of the 10 largest economies in the world by 2025, while promoting a socially inclusive and green development path.

The country is in a favourable situation to undertake necessary reforms

Real GDP is projected to grow at around 6% this year and next, led by robust domestic demand. Monetary policy should, as planned, ensure that inflation will remain on a downward trend, using interest rates, liquidity management and macro-prudential measures. Indonesia's infrastructure and social spending needs are substantial and will need to be efficiently financed. A substantial reduction in energy subsidies, which fail to achieve their social goals and have significant fiscal costs, would free up resources for pressing social and economic needs. At the same time, well targeted cash-transfer schemes will be necessary to keep poverty from worsening and thereby help to overcome resistance to energy price increases. Wide communication on the gains and distributional benefits of this reform, together with a rule linking subsidised fuel prices to international oil prices that does not have to be renegotiated every year would ease implementation.

There is significant scope to raise revenues by improving the tax system and tax administration. Broadening tax bases and improving compliance, particularly by high-income individuals, would make the system fairer. This should be achieved by allocating more audits where risks of underpayment are higher, making more intensive use of existing information, setting up more large-taxpayer offices and enhancing administrative capacity. Removing exemptions and raising the tax rate on economic rents in the resource sector would generate higher revenues efficiently. Efforts to bring the self-employed into the tax net should be reinforced.

Faster productivity growth will boost living standards

Formalisation of workers and firms will be a key source of productivity growth and could be encouraged by preventing excessive increases in the minimum wage, introducing a sub-minimum wage for youth and implementing reforms to make the formal labour market more attractive to workers and firms. One option to effectively protect workers against job-loss risks in the future would be to introduce limited unemployment saving coupled with individual unemployment-insurance accounts, while removing rigidities in the formal labour market. A simplification of the cumbersome licensing process would reduce the administrative burden facing companies.

Notwithstanding a vibrant financial sector, firms' access to finance could be eased by making the information collected by the credit bureau available to all financial institutions. Underdeveloped financing sources such as venture capital and micro-finance could be deepened by removing current restrictions to entry. The Master Plan for the Acceleration and Expansion of Indonesia's Economic Growth, which is meant to speed up infrastructure development, can be supported by additional public outlays without endangering fiscal sustainability. A lack of qualified workers also hampers productivity gains, and public resources should focus on the most cost-efficient programmes that manage to develop the skills of school dropouts and workers. Support to small firms could be made more effective by clarifying responsibilities within the central government and between it and local authorities, and by consolidating existing schemes. Relaxing those restrictions on inward direct investment that cannot be justified by public-interest concerns and removing the non-tariff barriers that are detrimental to trade and growth would also be useful.

Key policy recommendations

Monetary policy and the financial regulatory framework

- Achieve the inflation target and, as planned, reduce it over time. This would be achieved by relying on interest rate, liquidity management and macro-prudential measures.
- Step up efforts to pass a micro-finance law, and expand the sectoral coverage of the regulatory framework.

Policies to finance key development programmes

- Significantly diminish fossil-fuel and electricity subsidies, and implement enhanced compensatory cash-transfer programmes to prevent a rise in poverty. Communicate widely on the efficiency and distributional benefits of reform. As an interim measure, re-establish a rule linking fuel prices to developments in international oil markets, to remain valid until subsidies are markedly reduced.
- Move the resource-sector tax regime closer to a system of taxing rents. Review export taxes, considering their implications for the whole economy, including international trade. Phase out exemptions from VAT. Revisit corporate tax holidays granted to firms in "pioneer industries".
- Enhance efforts to bring the self-employed into the tax net, including by reducing temporarily penalties for previous non-compliance for first-time taxpayers only. Increase resources devoted to auditing high-risk and affluent taxpayers, and make more use of third-party information to assess tax liabilities.

Policies to spur microeconomic efficiency

- In provinces where minimum wages are already high in relation to average wages, resist increases that exceed trend productivity gains. Introduce a sub-minimum wage for youth directly linked to the general minimum wage. Reduce onerous severance payments and ease dismissal procedures in the formal labour market. In return introduce unemployment benefits possibly coupled with individual unemployment saving accounts.
- Systematically review all significant existing business licenses at the national and local levels, with a view to simplification, and ensure licensing remains cost-effective.
- Make information collected by the credit bureau available to all non-bank financial institutions.
- Public finances permitting, increase public outlays on cost-effective infrastructure projects beyond what is already planned.
- Ease access to education and training for students from disadvantaged backgrounds. Rigorously assess the cost-efficiency of all existing programmes aimed at upgrading dropouts' and workers' skills, and phase out those found to be inefficient.
- Clarify government responsibility in the delivery of support to small firms. Regularly assess the efficiency of existing programmes and redirect resources to the most cost-effective schemes.
- Re-examine the effectiveness of policies to encourage the formation of clusters, to reserve certain industries for small firms alone, and to require foreign direct investors to partner with local SMEs.
- Assess the impact of non-tariff measures on trade and the domestic economy, and remove those that are found detrimental to growth. Remove the new regulations that restrict the range of products a general importer can import. Relax remaining barriers to foreign direct investment, unless they address valid public-interest concerns.

Assessment and recommendations

The key challenges

Indonesia is Asia's fifth largest economy, the fourth most populous nation in the world and endowed with abundant natural resources (Table 1). Thanks to a series of strong policy reforms and improved governance, significant progress has been achieved in social and educational dimensions since the 1997-98 Asian crisis, and the quality of human capital has been markedly enhanced. Strong macroeconomic performance can be attributed to successful policy management and to the substantial reforms undertaken since the Asian crisis that strengthened the macroeconomic framework and liberalised the international trade regime. Considerable investments in network industries have boosted potential output, and further improvements are expected with the gradual implementation of the Master Plan for the Acceleration and Expansion of Indonesia's Economic Growth. The economy has also been supported by the dynamism of its small firms, which have accounted for most of the job creation and half of the production growth since 2008 (Figure 1). Gains in total factor productivity have been increasing over time, a pattern that is observed in many other countries in the region (Table 2; Park, 2010).

The economy is still far from growing sustainably at the 7-9 % per year rate that would be needed to achieve the government's objective, laid out in May 2011, of becoming one of the 10 largest economies in the world by 2025. To a large extent, institution building is a precondition for Indonesia to reach this ambitious growth objective. Looking forward, the demographic dividend will fade over the next decade. At this stage of economic development, a key challenge for the country is to enhance its productivity, which will in turn raise prosperity, even though data limitations frequently do not allow strong policy recommendations to be made. It will be critical for sustainability that the fruits of high growth are enjoyed by all. Although the poverty rate has continued to decline in recent years, inequality has turned up.

Environmental sustainability features prominently in the government's development strategy. GHG emission reduction targets have been set at the national level (26% by 2020, compared to a business-as-usual scenario, 41% with international support) and have been supplemented by targets at the sectoral level. Despite some progress, there is still significant scope to boost carbon productivity (Figure 2). As underlined in the 2010 *Economic Survey*, there is also evidence that Indonesia's forestry resources are being unsustainably depleted. It will thus be crucial to slow the pace of deforestation by tackling, in particular, illegal logging.

Table 1. **Selected indicators for Indonesia**

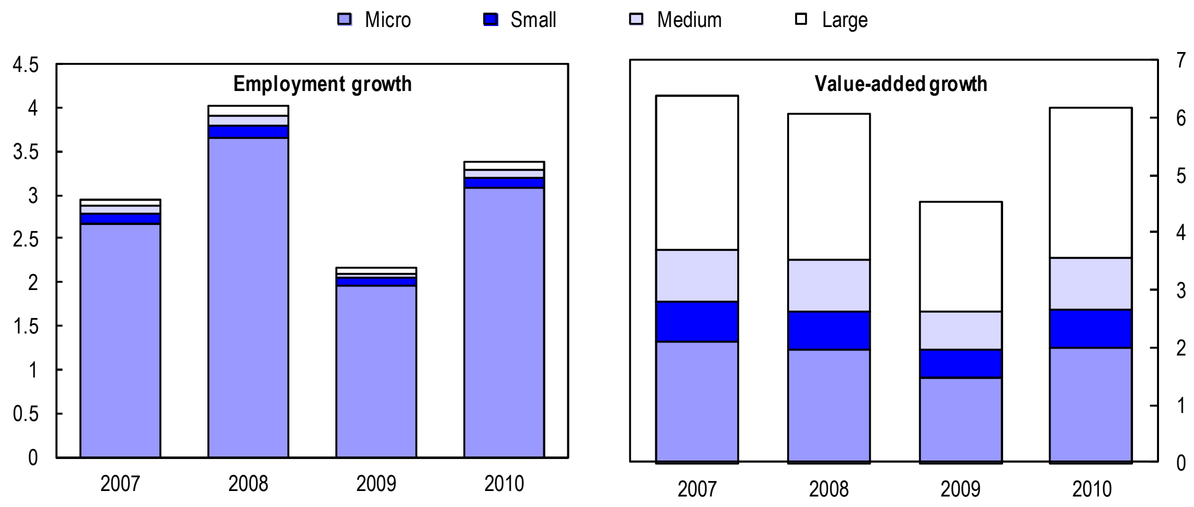
	1995	2000	2005	2007	2008	2009	2010	2011
Population								
Total, million	194.8	206.3	220.9	224.2	227.6	234.4	237.6	241.0
Age distribution (per cent)								
0-14	33.1	30.2	28.5	27.7	27.4	27.0	26.7	26.4
15-64	62.7	65.0	66.3	66.9	67.2	67.4	67.7	67.9
65+	4.2	4.7	5.2	5.4	5.5	5.6	5.6	5.7
Absolute poverty rate[1] (per cent)	-	19.1	16.0	16.6	15.4	14.2	13.3	12.5
Gini coefficient	0.36	-	0.36	0.36	0.35	0.37	0.38	0.41
Net enrolment ratio (secondary education, per cent)	-	46.7	56.0	65.7	64.5	65.1	67.3	-
Employment and inflation								
Employment (million)	80.1	89.8	93.4	99.9	102.6	104.9	108.2	109.7
Informal employment (per cent of employment)	-	-	69.5	69.5	69.6	69.3	66.9	62.2
Unemployment rate (per cent)	-	6.1	11.2	9.1	8.4	7.9	7.1	6.6
CPI inflation (per cent, end-of-year)	9.0	9.3	17.1	6.6	10.2	2.8	7.0	3.8
Supply and demand								
GDP (current trillion *rupiah*)	454.5	1 389.8	2 774.3	3 950.9	4 948.7	5 606.2	6 436.3	7 427.1
GDP (current USD billion)	202.4	166.1	285.6	432.2	512.7	543.3	708.8	846.1
GDP growth (real, per cent)	8.2	4.9	5.7	6.3	6.0	4.6	6.2	6.5
GDP per capita growth rate (real, per cent)	6.1	4.5	4.4	5.3	4.9	3.6	2.3	5.4
Demand (growth, per cent)								
Private consumption	12.6	1.6	4.0	5.0	5.3	4.9	4.7	4.7
Public consumption	1.3	6.5	6.6	3.9	10.4	15.7	0.3	3.2
Gross fixed investment	14.0	16.7	10.9	9.3	11.9	3.3	8.5	8.8
Exports	7.7	26.5	16.6	8.5	9.5	-9.7	15.3	13.6
Imports	20.9	25.9	17.8	9.1	10.0	-15.0	17.3	13.3
Supply (per cent of nominal GDP)								
Agriculture	-	15.6	13.1	13.7	14.5	15.3	15.3	14.7
Mining	-	12.1	11.1	11.2	10.9	10.6	11.2	11.9
Manufacturing	-	27.7	27.4	27.0	27.8	26.4	24.8	24.3
Services[2]	-	44.6	48.3	48.1	46.8	47.8	48.7	49.1
Public finances (state government, per cent of GDP)								
Revenue	15.7	14.8	17.9	17.9	19.8	15.1	15.5	16.3
Expenditure	14.4	15.9	18.4	19.2	19.9	16.7	16.2	17.4
Nominal balance	1.3	-1.2	-0.5	-1.3	-0.1	-1.6	-0.7	-1.1
Gross debt	-	88.8	47.3	35.2	33.1	28.4	26.1	24.3
External sector (per cent of GDP)								
Trade balance	3.2	15.1	6.1	7.6	4.5	5.7	4.3	4.1
Current account balance	-3.2	4.9	0.1	2.4	0.0	1.9	0.7	0.2
In USD billion	-6.4	8.0	0.3	10.5	0.1	10.6	5.1	1.7
International reserves (gross, USD billion)	-	-	34.7	56.9	51.6	66.1	96.2	110.1
Outstanding external debt (end-of-year)	-	85.3	45.8	31.6	30.2	31.8	28.6	26.5

1. Per cent of people below the national poverty line, where the latter is the value of per capita expenditure per month needed for a person to stay in decent living conditions.
2. Includes electricity, gas, water and construction.

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

Figure 1. **Contributions to employment and value-added growth by type of firm**

Percentage points



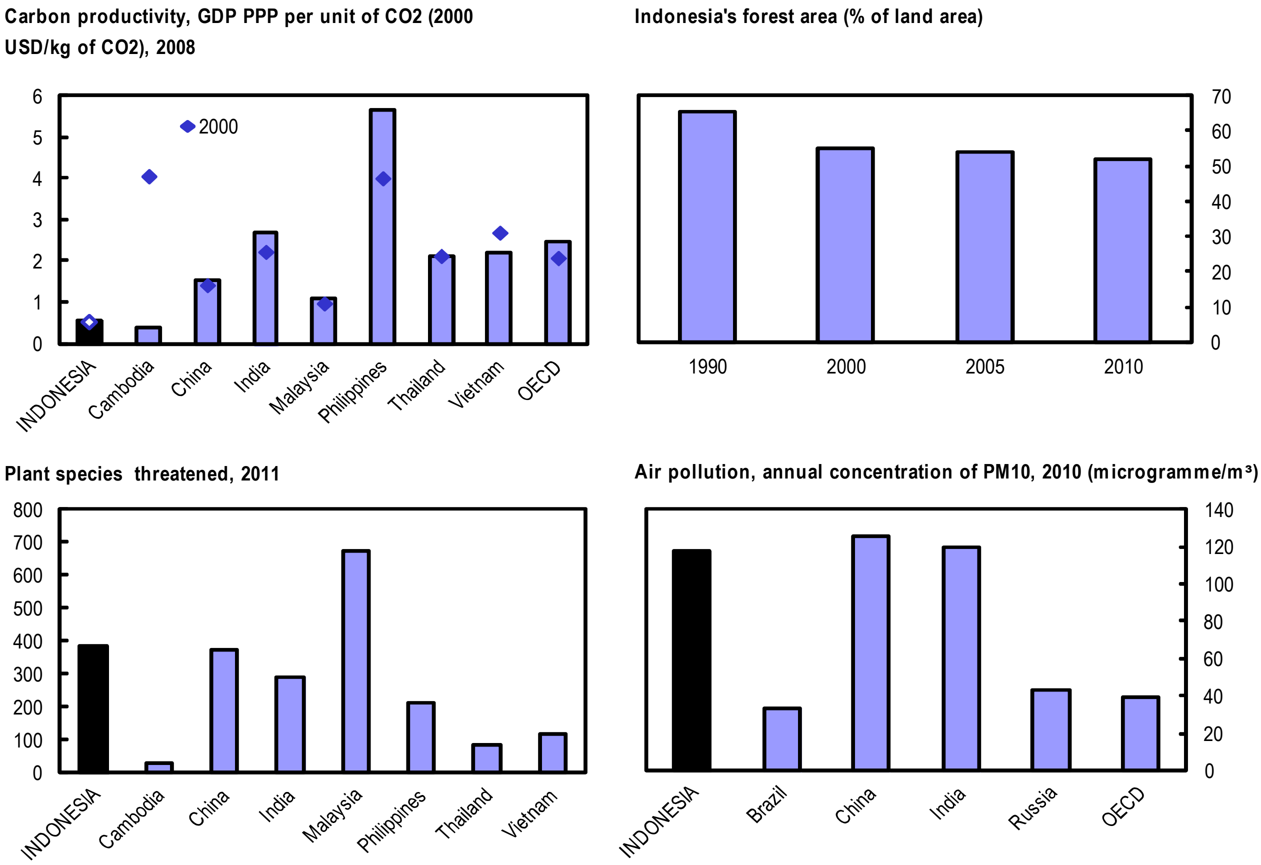
Source: Ministry of SMEs and Co-operatives.

Table 2. **Potential output growth and contributions**

	GDP growth	Potential GDP growth	Contribution to potential output growth		
			TFP	Capital	Labour
1980-89	6.4	6.5	1.0	3.7	1.8
1990-97	7.6	6.0	0.9	3.9	1.3
1998-99	-6.2	1.9	-0.2	1.1	0.9
2000-09	5.1	4.1	1.5	1.7	1.0
2007	6.3	5.2	2.1	2.0	1.2
2008	6.0	5.6	2.1	2.3	1.3
2009	4.6	5.6	2.2	2.1	1.3
2010	6.2	5.8	2.2	2.3	1.3
2011	6.5	5.9	2.2	2.4	1.3

Source: OECD calculations using a production function approach detailed in OECD (2010).

Figure 2. **Selected green-growth indicators**



Source: International Energy Agency, World Bank, World Health Organisation.

Recent macroeconomic developments and short-term prospects

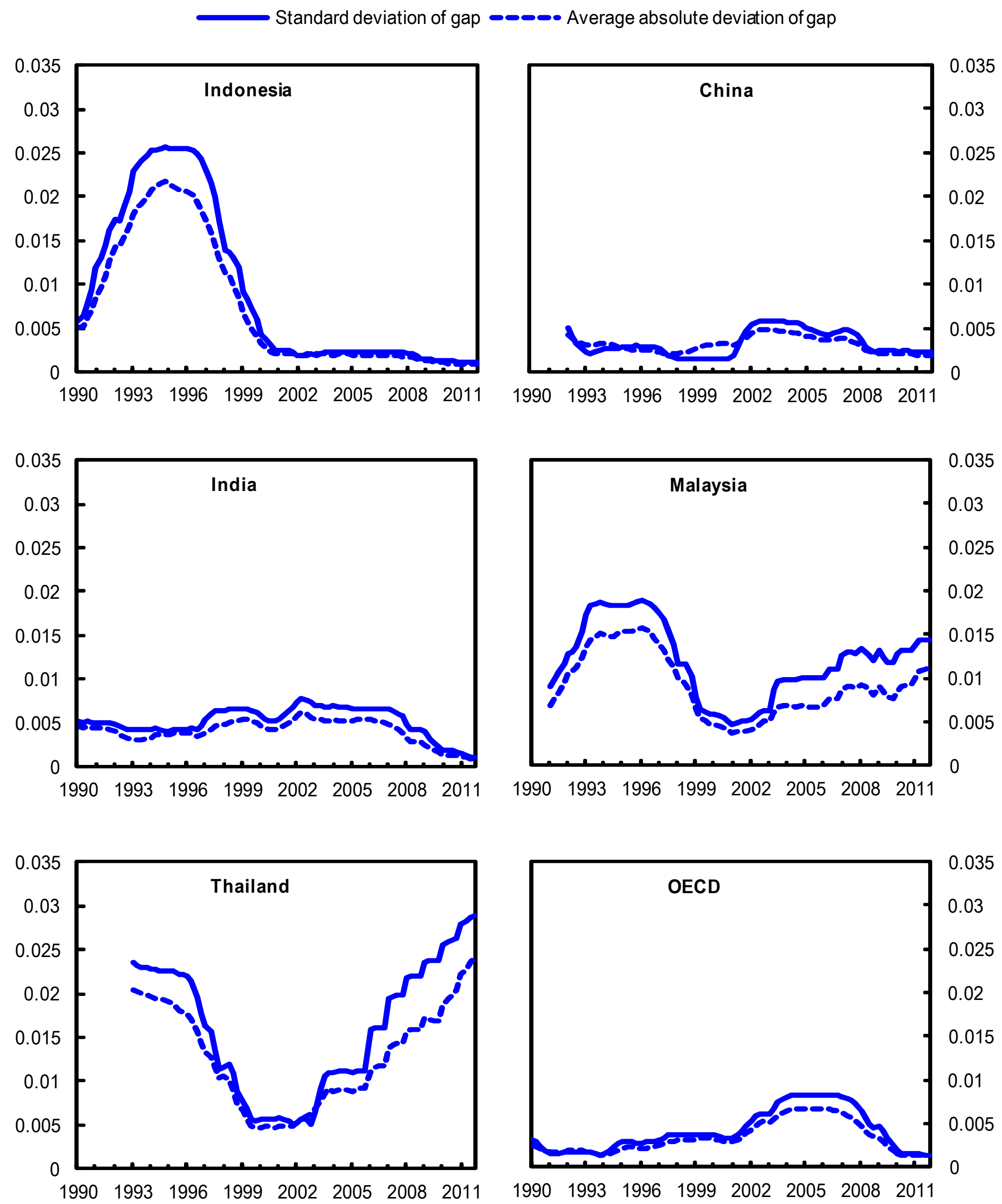
The macro-economic framework is sound, and the country's sovereign credit rating has recently been raised to investment grade by two of the three largest international rating agencies. A deep national market with strong domestic demand growth has shielded the economy from downturns in other parts of the world. Indeed, the amplitude of the cycle has diminished markedly over the years, including in the 2008-09 global crisis, in contrast with the experience of other Asian economies and to some extent in OECD countries (Box 1). To a large extent, the adoption of an inflation target and rules-based prudent fiscal frameworks in the mid 1990s contributed to economic stability. In addition, although international tariffs have declined markedly since the Asian crisis, the economy still relies on international trade much less than regional peers, and was thus insulated from the 2009 global trade collapse.

Box 1. **Business cycles in Indonesia**

This box compares the business cycle in Indonesia, selected Asian economies and the OECD. Given the paucity of long time series for many of these countries, the approach is restricted to the 1990-2011 period and relies on the methodology used in Dalsgaard *et al.* (2002). Cycles are computed on a quarterly basis using the gap between actual GDP and its trend, where the latter is derived from a Hodrick-Prescott filter. The amplitude of the cycle is then proxied by either the standard deviation of the gap within a six-year overlapping period or the average absolute size of the gap.

The amplitude of business cycles in Indonesia fell sharply after the Asian crisis and has stayed relatively low since then (Figure 3). By contrast, Malaysia and Thailand have experienced a rise since 2002. Volatility also increased in OECD countries in the second half of the 2000s but has remained low.

Figure 3. **Amplitude of business cycles**



Source: OECD calculations.

The decreasing amplitude of output gaps in Indonesia is mainly related to increased stability of domestic demand. This reflects an improved economic policy framework and governance that have led to macroeconomic and political stability. But another explanation could be that official statistics fail to capture the large size of the informal sector and its potentially greater volatility.

Although measured cycles have become smaller, concordance statistics, which measure the extent of business cycle synchronisation, show that Indonesia's cycles have continued to move in line with those of Thailand and Malaysia, even in the aftermath of the 2008-09 global crisis. Despite recent free-trade agreements with China and India, no change in synchronisation with these economies is discernible thus far.

The economy is expected to grow at around 6% this year and next (Table 3). This is lower than the official projections, mostly reflecting differences in the assumed global environment (Table 4). Private consumption and investment are likely to be the main drivers of growth. Limited fiscal stimulus would also sustain domestic demand. The current account is set to deteriorate somewhat, as the balance of investment income worsens, and to move into a deficit for the first time since the last quarter of 2008. Import growth is likely to exceed export gains. These trends are of little concern in a developing economy like Indonesia, merely reflecting the fact that investment needs exceed domestic savings, with the difference financed by external borrowing and import growth continues to be led by productivity-enhancing capital goods.

Table 3. **OECD Economic projections**

	2010	2011	2012	2013
Real GDP (per cent)	6.2	6.5	6.0	6.2
Inflation (end-year, per cent)	7.0	3.8	4.2	4.7
Current account (per cent of GDP)	0.7	0.2	-0.8	-1.4
Public deficit (per cent of GDP)	-0.7	-1.6	-2.1	-1.9

Source: OECD, September 2012.

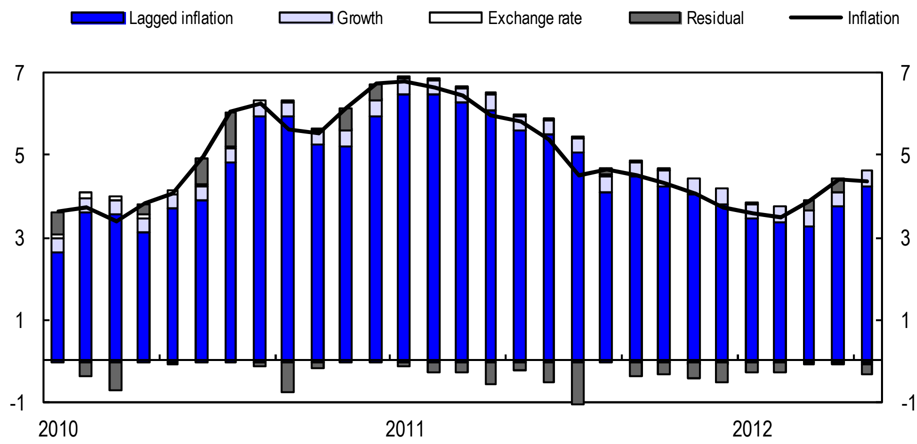
Table 4. **Indonesian government projections**

	2010	2011	2012	2013
Real GDP (per cent)	6.2	6.5	6.5	6.8
Inflation (end-year, per cent)	7.0	3.8	6.8	4.5
Current account (per cent of GDP)	0.7	0.2	0.4	0.6
Public deficit (per cent of GDP)	-0.7	-1.6	-2.2	-1.6

Source: Government financial statement (audited), August 2012.

Headline inflation has markedly decelerated up until very recently, following food price developments. It remains unclear nonetheless whether this slowdown will be permanent, as a significant part of the deceleration remains unexplained (Figure 4). Good inflation management and lower transport costs may have played a role, but their effects are hard to quantify. While average inflation declined after the global financial crisis compared to the 2002-07 period, pressures have not fully dissipated. Strong domestic demand is likely to push up inflation in 2013. In addition, labour markets are tight, and expected rises in the minimum wage could encourage significant wage demands. Credit growth has been rising but is still much lower than in 2008 and is dominated by borrowing for working capital and investment rather than consumer loans. Recent developments in global markets suggest that the Indonesian crude oil price is unlikely to exceed the trigger set out in the revised 2012 Budget, which would have allowed the central government to raise the price of subsidised fuel. In the absence of such a hike, inflation would most likely edge up gradually but would remain below the ceiling of its target range.

Figure 4. **Year-on-year inflation developments and contributions**



Note: Contributions have been derived using a standard Phillips curve equation.
Source: OECD calculations.

The main risks to the short-term outlook are external. Increased global risk aversion, in large part related to the euro area crisis, could reverse the capital inflows of the past few years, endangering the financing conditions for government and banks alike and cutting growth. On the other hand, recent sovereign rating upgrades allow Indonesia to tap into many investment funds that are restricted to holding investment-grade assets. In addition, it is likely to remain relatively sheltered from a slowdown in world trade, unless other Asian economies and commodity prices are significantly affected. At the time of writing there are increasing signs of slowdown in Indonesia's main trading partners.

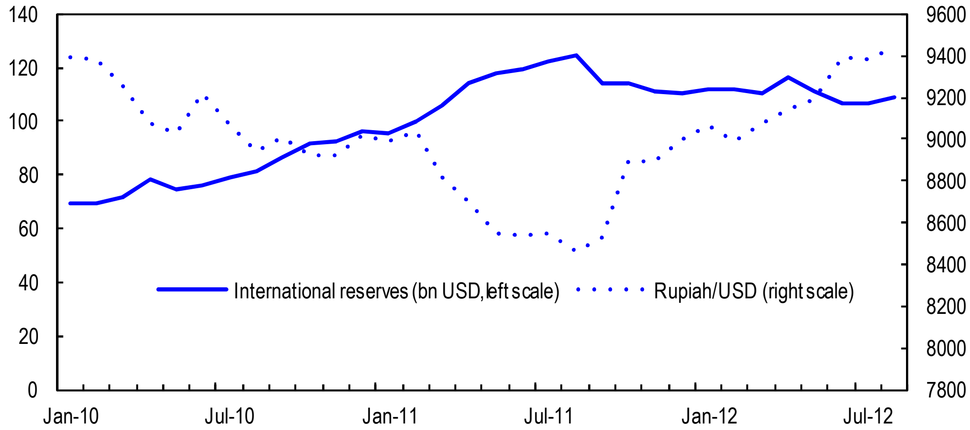
Macroeconomic policy considerations

Indonesia's general macroeconomic and financial frameworks have improved significantly over the last few decades. Inflation has been brought down from more than 58% in 1998 to 4.6% in 2011. As underlined in the 2010 *Economic Survey*, financial markets have proven more resilient than in the past. Thanks to prudent management and strong economic growth, fiscal outcomes have been enviable by any standard. Still, refinements to the framework and the conduct of policies could foster the country's adaptability to new challenges. Stepped-up efforts in fighting corruption will also be necessary.

Monetary policy

The monetary policy framework combines inflation targeting with a flexible, though not fully floating, exchange rate. The main instrument to achieve price stability is the policy rate (BI rate). However, other instruments supplement Bank Indonesia (BI)'s tool box. Since 2008, BI has managed capital inflows through foreign-exchange intervention. A one-month minimum holding period for BI's short-term paper that applies to both residents and non residents was introduced in July 2010, and programmes such as the government's bond stabilisation framework, which defines the conditions under which the authorities can buy such securities, have been put in place to cope with potential reversals in capital flows. These actions proved successful, in particular during the autumn of 2011 when global financial turbulence increased the volatility of capital inflows and the exchange rate (Figure 5). Evidence suggests that the exchange rate remained broadly consistent with fundamentals during that period (Box 2). Since then, the *rupiah* has depreciated.

Figure 5. **Exchange rate and international reserves**



Source: Datastream.

Box 2. **Equilibrium exchange rate for the *rupiah***

This box examines the degree of misalignment of the rupiah using the Fundamental Equilibrium Exchange Rate (FEER) method, developed by Williamson (1994).

The FEER is defined in real effective terms as the exchange rate consistent with the economy being in both internal and external balance. As in Wren-Lewis and Driver (1998), the FEER is estimated by modelling only the current account and using conventional aggregate trade equations. This has the advantage of simplicity, and as a consequence it is relatively easy to examine the sensitivity of FEER estimates to key assumptions. One of the disadvantages is that it does not ensure the consistency between the assessments of trend output and structural capital flows. More importantly, any feedback from the FEER to the inputs for trend output and structural capital flows is ruled out. Last, this method gives no indication of the main factors influencing the value of the currency.

Deviation of the real effective exchange rate from its equilibrium level is calculated using quarterly data from the OECD Economic Outlook and IMF's International Financial Statistics. Trade elasticities were derived from the estimation of standard trade equations for Indonesia, whereby trade volumes are expressed as a function of demand and competitiveness. Pain et al. (2005) provide a justification for these specifications.

FEER estimates of misalignment rely heavily on how the current account target is calibrated. To compute this target, long-term projections for the current account are derived using United Nations population projections and an equation for the current account reported in Cheung et al. (2010) for emerging and developing countries. This equation incorporates demographic and convergence effects. Depending on the specification used and the period considered the long-term average of the current account balance for Indonesia is found to lie around a surplus of 0.3 to 1% of GDP.

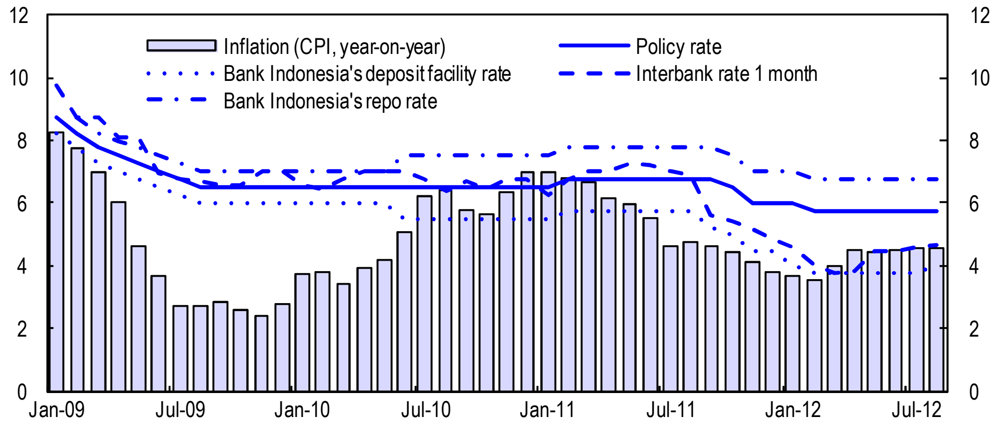
Overall, the rupiah appears to have been broadly at equilibrium in 2011. The real effective exchange rate was slightly overvalued by 0.2-1.5% on average, depending on the current account target chosen. This is consistent with IMF estimates for that year (IMF, 2011a).

Source: OECD calculations

In the context of an increasingly uncertain international environment, BI's communication strategy has focused on achieving the inflation target and reducing exchange-rate volatility. The central bank has indicated that it will henceforth manage the quantity rather than the price of money. BI has maintained its policy rate constant since February 2012 and has lowered the floor of the band for interbank interest rates to remove excess liquidity. One main consequence is that interbank rates have drifted away from the policy rate (Figure 6). This may have weakened the strength of traditional interest-rate transmission channels, as changes in the policy rate have not been systematically followed by similar moves in the interbank rate.

Figure 6. **Interest rates and inflation**

Per cent



Note: The deposit facility (FASBI) rate is the rate of Bank Indonesia's overnight deposit facility for commercial banks. It applies to idle money that private banks leave with the central bank when they have excess liquidity. The rate does not apply to banks' statutory reserves at the central bank.
Source: Bank Indonesia.

BI has also sought to deepen foreign exchange markets by supplying US dollar term deposits. In addition to managing liquidity, it intends to have recourse to macro-prudential measures to ensure financial stability. A maximum loan-to-value ratio for property loans and minimum down payments on vehicle loans have been announced. The monetary authorities have also signalled that they could hike reserve requirements for some categories of banks.

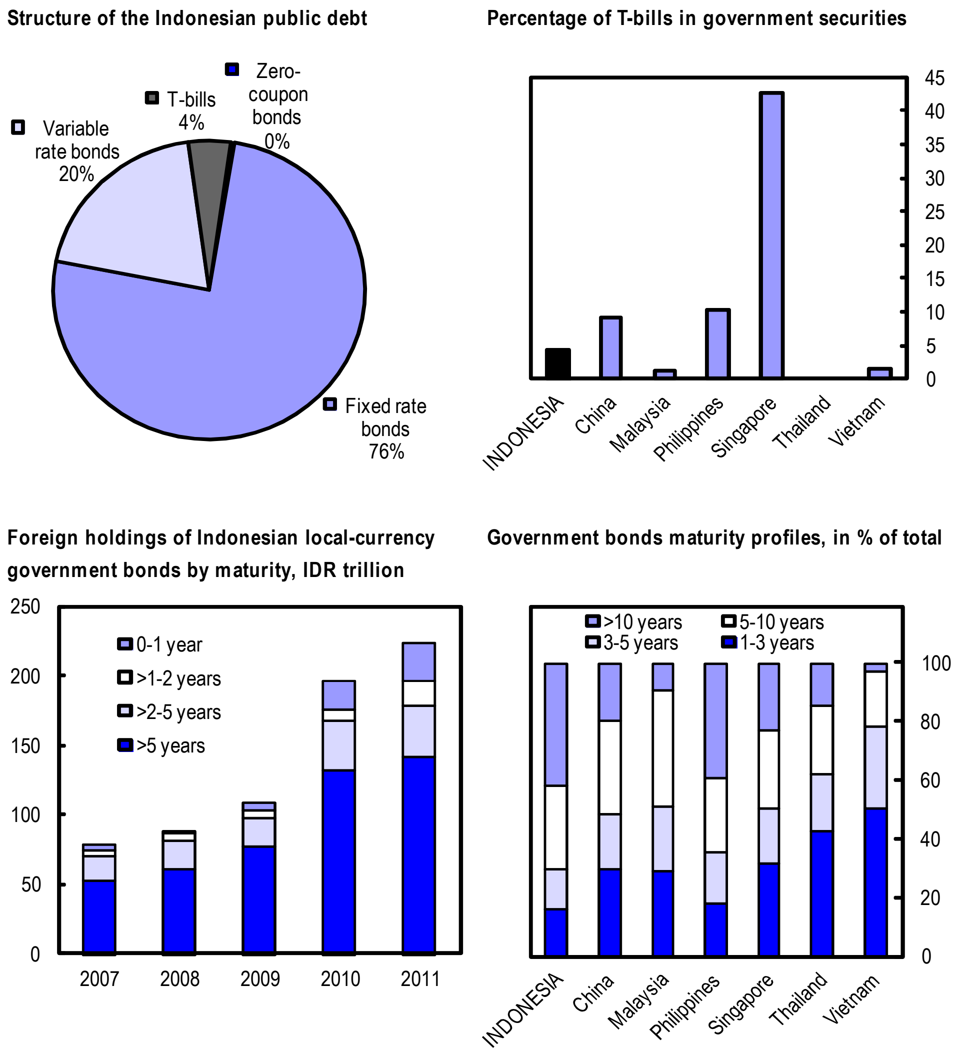
While changes in reserve requirements may help to manage credit growth, very little is known about their impact on inflation, as their effectiveness can be eroded by financial innovation or regulatory arbitrage. Moreover, this type of measure may be less effective in shaping expectations about the policy stance because market players can more easily interpret the signals sent by interest-rate moves. In particular, raising interest rates to tighten the monetary stance sends a clear signal that reining in inflation is the primary objective of monetary policy. In this context, it would be preferable to rely on both interest-rate increases and liquidity or macro-prudential measures to achieve the inflation target.

Efforts to manage large-scale capital inflows have led to a major shift in the size of the central bank's balance sheet. BI's capital declined significantly through to the third quarter of 2011 when it was close to its required floor of IDR 2 trillion. It has risen since then, as the pace of international reserve accumulation has slowed. Looking forward, if BI's capital were to fall significantly and approach its statutory minimum, monetary policy could be affected. It would thus be preferable to phase out BI's capital requirement, which serves no essential purpose in modern central banking.

A number of policy options could strengthen BI's financial position. Injecting funds to meet the capital requirement needs legislative approval and could be perceived as a threat to its independence. Selling some of BI's assets, such as land and buildings, could provide only limited short-term relief. A more promising option would be to lower the cost of monetary operations by using repurchase agreements selling and repurchasing T-Bills (*Surat Perbendaharan Negaran*, SPN) rather than Bank Indonesia Certificates (*Sertifikats Bank Indonesia*, SBIs) as the main instrument for open-market operations. The Indonesian monetary authorities already use T-Bills for some operations but are constrained by their limited supply (Nasution, 2012). The small share of T-Bills in public debt and the relatively high average maturity of government securities, even those owned by foreign investors, suggest that there is room to increase the issuance of T-Bills, even though this would increase public finance vulnerability (Figure 7). SBI issuance could then be gradually scaled back. Such a switch would also encourage banks to make loans, rather than hold SBIs, and thereby help to strengthen their intermediation function. Any change, if desired, would ideally be made in the context of a broader review of the financial relationship between BI and the central government.

Figure 7. **Public debt structure**

End-year 2011



Source: Asiaonline, Ministry of Finance.

Financial regulation framework

Smoothing the transition to a single regulator for financial markets

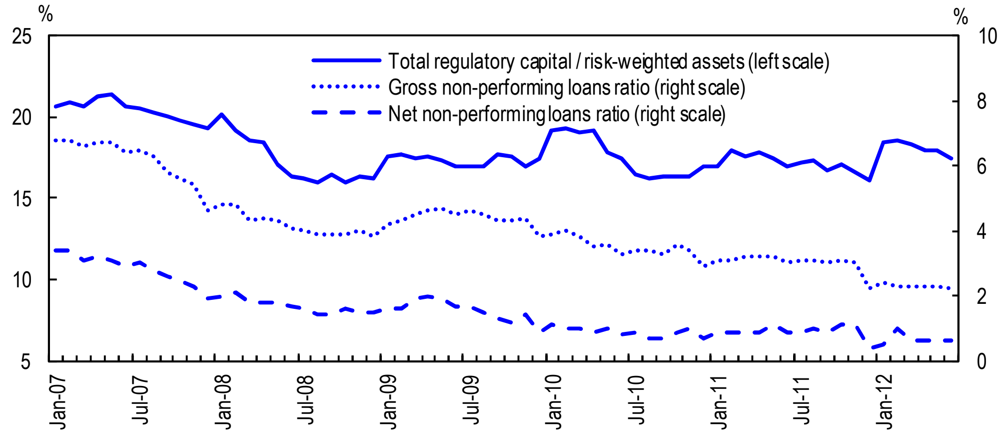
In October 2011, enabling legislation was passed to implement a unified financial supervisory model. A new Financial Services Authority (*Otoritas Jasa Keuangan*, OJK) will oversee all such activities as of end-2013. One of the main issues will be to ensure that the new agency is properly staffed and can draw on the current expertise of BI and the Ministry of Finance. In addition, given the very short transition period, implementing regulations will need to be issued as soon as possible to ensure that the new financial authority, which will be responsible for micro-economic oversight, works in close collaboration with the central bank, which is in charge of macro-prudential supervision.

The banking supervisory framework meets international standards and has been improved to deal with problem banks. At the moment, a bank can be placed into surveillance only because of liquidity problems or when its capital ratio falls below 8%. Other troubled banks can be put into intensive surveillance at the discretion of the financial authorities. Nonetheless, the financial system safety-net law needs to be passed to ensure that the authorities can adequately deal with systemic risk. A memorandum of understanding on mutual coordination to safeguard the stability of the financial system was signed in June 2012 by the government, BI, OJK and the Deposit Guarantee Corporation, but it will need to be reviewed once the new regulatory authority is in place. One result was the establishment of a crisis-management protocol, defined under the OJK law, that sets out the actions to be taken by each institution in the event of a financial crisis. In any case, the existing legal protection in the Act governing the functioning of each authority needs to be strengthened to ensure legal protection to officials involved in the management of a potential crisis will effectively be provided, especially given the record of the judicial uncertainty that the former Minister of Finance faced in the aftermath of decisions taken during the 2008 global crisis.

Deepening financial markets

Despite some progress, financial markets are still shallow. Deepening them would help to maintain financial stability over the medium term and ease access to finance, especially for small firms. The soundness of the banking sector has improved over time (Figure 8). In June 2010, BI introduced a policy package to develop money markets. A wider range of instruments has been provided, and banks have been encouraged to conduct more transactions in the wholesale market. Still, some segments of the financial markets, such as venture capital and micro-finance, remain insufficiently developed.

Figure 8. **Banking soundness indicators**



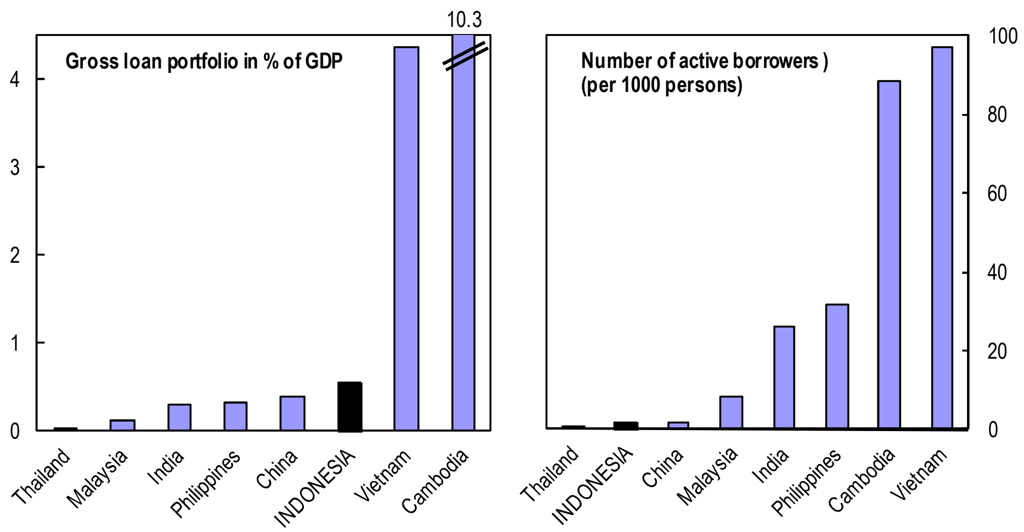
Source: Bank Indonesia.

As in other countries in Asia, most venture capital companies do not provide genuine risk capital (Naqi and Hettihewa, 2007). In February 2012, the Minister of Finance issued a decree to encourage venture-capital providers to focus on non-bankable firms (those that do not have access to bank loans) and introduced regulations on entry, licensing and capital requirements. These changes go in the right direction, but it will be important to assess their effect regularly. Efficient monitoring will require a significant improvement in the quality and coverage of statistics, in particular a clear distinction between venture capital and private equity. The government has also granted venture capital companies tax exemptions for certain investments made in particular industries. This support should be reconsidered, as it risks distorting the allocation of scarce capital and increasing rent-seeking behaviour. Moreover, the existing restriction of 85% on foreign ownership of venture-capital companies could hamper entry and would best be removed.

As in many developing economies, micro-finance has expanded rapidly in recent years, although Indonesia does not appear to be at the forefront in the size of its micro-finance markets (Figure 9). The largest proportion of micro-finance institutions are within the formal sector, and the market is dominated by a few commercial banks. However, many of the micro-finance providers are informal, as they have a strong incentive to operate in the least regulated market segment. As banks incur a financial penalty when they lend to institutions without a legal status, the financing source of these informal micro-loan providers is restricted. In 2009, a decree created a regulatory framework under existing laws to govern non-bank and non-co-operative financial institutions that operate outside the regulatory framework. But the decree has not been fully implemented, and efforts should be stepped up to put it into operation.

Figure 9. **Indicators of micro-finance**

2010



Source: Mixmarket.

Another way to deepen markets would be to inject stronger competition in banking. At the moment, the market is highly concentrated, with the large banks, such as *Bank Rakyat Indonesia*, holding dominant market positions in rural and micro-finance. Even though the market is *de jure* open to newcomers, the minimum capital requirement is fairly high for commercial banks and rural banks in some regions, and it is not easy to obtain a license (World Bank, 2010a). A move from the current single-licence model for banking operations to a multi-license approach similar to that in other countries in the region is under discussion. Also, caps on bank ownership (foreign or domestic) became effective in July 2012 except for banks that fulfil a range of criteria such as passing a prudential examination that focuses on good corporate governance practices and financial soundness. This measure is not retroactive. However, it may deter large acquisitions, particularly by foreign financial firms, even if the Indonesian banking sector would remain open by regional standards. It would thus be useful to investigate to what extent these recent and mooted regulatory changes could effectively hamper entry and, if required, reconsider them in this light.

Fiscal policy

Fast growth and sound budget management have put the country on a strong fiscal footing. Since the 2003 Fiscal Law, public deficits have been capped at 3% of GDP and public debt at 60%. The gross public debt burden has been markedly reduced to an estimated 24.3% of GDP in 2011 from a peak of 88% in 2000, and public deficits have consistently remained below the 3% threshold.

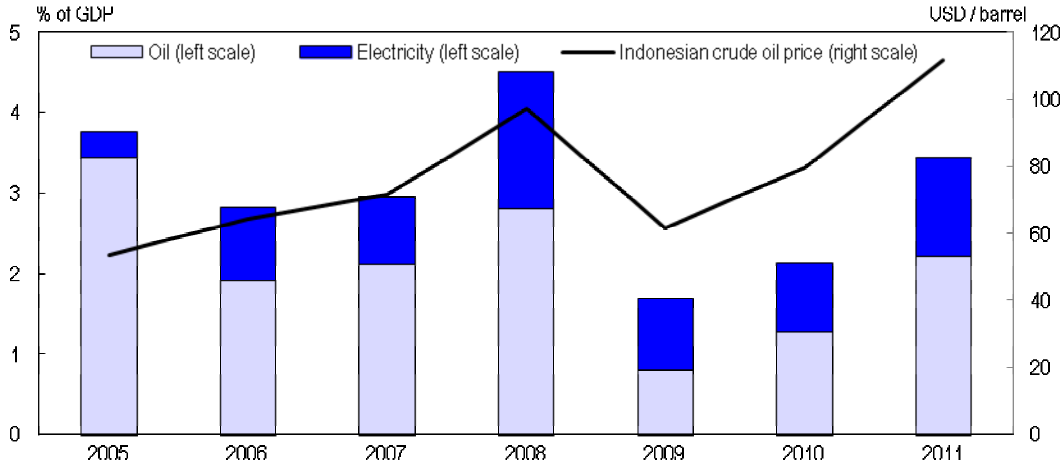
Changing the spending mix

The fiscal resources put into energy subsidies would be better used elsewhere. Energy subsidies are expected to amount to almost 19% of central-government spending in 2012 and reach 24.1% in the 2013 draft budget (Figure 10). By contrast, spending on social assistance and infrastructure remains insufficient for the country's needs (Table 5). Rethinking the spending mix is required to achieve the authorities' ambitious development objectives, fund the 2014 establishment of public health insurance and at the same time eliminate the budget deficit by 2015 as envisaged in official medium-term economic projections. As underlined in the 2010 *Economic Survey*, energy subsidies, which mostly take the form of under-pricing of energy use, distort consumption decisions, encourage carbon emissions and are ineffective as social policy. Indeed, they benefit mostly the richest: in 2009, 40% of the gasoline subsidies to households went to the richest 10% and less than 1% to the bottom 10% (World Bank, 2012a). Fuel subsidies are estimated to be regressive, as their share in income is three times higher for the most affluent households than for the poorest. Even though the Constitution prevents complete liberalisation of domestic fuel prices, it is still possible to significantly reduce energy subsidies.

Government proposals in 2011-2012 to reduce fossil-fuel and electricity subsidies have faced fierce political resistance. In the end, the proposed hike in electricity prices was rescheduled to 2013. Plans to reduce the volume of subsidised fuel have also been postponed, with the exception of all government vehicles used by officials and state-owned enterprises (both central and regional). In addition, the vehicles owned by plantation and mining companies are also prohibited from using subsidised fuels. Measures to improve energy efficiency have also been announced. To contain the cost of energy subsidies, a conditional rule, which is valid only for this year, allows the government to raise the price of subsidised fuel if the average Indonesian crude oil price over six months exceeds USD 121 per barrel (*i.e.* exceeds by 15% the assumption set in the revised 2012 Budget). But developments in the oil price suggest it is likely to stay below this threshold. In the draft 2013 Budget, the government has proposed an increase in electricity tariffs, while exempting poor households.

Postponing the rise in energy prices is likely to raise doubts about the government's commitment in this area and endanger the fiscal situation. A rise in energy subsidies in the event oil prices increase but remain below the threshold would boost overall spending directly and through an increase in education spending, which are required legislatively to amount to 20% of general-government spending. This will be only partially offset by a rise in revenues from the oil and gas sector. Moreover, the risk of hitting the 3% of GDP deficit ceiling may prompt a decrease in spending in growth-enhancing programmes. This would be particularly detrimental to long-term growth.

Figure 10. **Oil and electricity subsidies in Indonesia**



Source: Ministry of Finance, Indonesian Directorate General of Oil and Gas.

Table 5. **State budget realisation**

Percentage of GDP

	1990	2000	2005	2010	2011
Revenues and grants	21.6	14.8	17.9	15.5	16.3
Tax revenues	11.3	8.3	12.5	11.2	11.8
Income tax	4.2	4.1	6.3	5.5	5.8
Value added tax	4.2	2.5	3.7	3.6	3.7
International trade taxes	1.5	0.5	0.5	0.4	0.7
Non taxes revenues	10.3	6.4	5.3	4.2	4.5
Government expenditures	20.3	15.9	18.4	16.2	17.4
Central government expenditures	16.8	13.6	13.0	10.8	11.9
of which: Personnel	3.6	3.1	2.1	2. 3	2.4
Interest payments	2.5	3.6	2.4	1.4	1.7
Subsidies	1.8	4.5	4.4	3.0	4.0
Inter-government transfers	3.5	2.4	5.4	5.4	5.5
Education spending	-	-	2.8	3.5	3.6
Health spending	-	-	-	0.5	0.6
Social programmes	-	-	0.9	1.1	1.0
Infrastructure	-	0.8	0.9	1.5	1.7
Public deficit	1.2	-1.2	-0.5	-0.7	-1.1
Public debt	-	88.8	47.3	26.1	24.3

Note: State government includes central and regional governments.

Source: Ministry of Finance.

Reallocating energy subsidies to high-quality spending programmes, although necessary, is likely to continue to face strong opposition. A package of measures combining a gradual removal of subsidies with targeted cash-transfer schemes to compensate poor households from the rise in energy prices, similar to those introduced successfully in 2005 or 2008, together with extensive communication on these compensation programmes would protect the poor and could help to overcome resistance to reform. In the short term a conditional rule allowing the authorities to hike subsidised fuel prices when the world oil price moves up rapidly could prevent an excessive increase in the fiscal burden. In addition, making this rule valid until subsidies are significantly reduced would ease reform implementation. A similar rule was introduced in 2002 but had to be abandoned because it was poorly communicated and resulted in public protests. Widespread communication on the benefits of reforms and their distributional effects and on the compensation package that will prevent poverty from worsening, would reduce the likelihood of this happening again. This could be done by a new independent agency, as was recommended in the 2010 *Economic Survey*.

The spending mix could also be improved at the regional level. At the moment civil service salaries represent more than 40% of regional expenditure. In most regions, they are funded through central government transfers from the general allocation fund (*Dana Alokasi Umum*, DAU), so that regional governments have no incentive to save on salary spending and spend more on infrastructure. A moratorium on the recruitment of administrative employees was enacted in mid-2011 to limit the rise in personnel expenditures. Switching the financing of salaries of regional civil servants from the DAU to revenues from increased local taxation, as currently proposed in the context of the changes to the inter-governmental finance law, would improve incentives and help to keep public accounts on a sustainable path over the medium term. This should be done, however, alongside a comprehensive civil service reform, including a review of pay scales and performance management.

Improving budget execution

Budget execution remains a major challenge, particularly for capital spending. Although the latter increased markedly in 2011, disbursements amounted to only 82% of what was expected in the revised 2011 Budget (World Bank, 2012a). In addition, spending is often disbursed only at the end of the year, which can undermine its effectiveness and quality.

Recent moves to a medium-term expenditure framework and changes to the procurement system are expected to improve planning capacity and budget execution. In addition, the Land Acquisition Law is likely to speed up the implementation of infrastructure projects, especially in the energy and raw materials sectors. A team has been set up of evaluators and monitors (*Tim Evaluasi dan Pengawasan Percepatan Penyerapan Anggaran*, TEPPA) aiming at accelerating budget execution. Incentives, such as financial penalties to individual ministries at the central level, have also been introduced, and the government is preparing a regulation on budget execution.

Efforts should also be pursued to cut spending delays at the regional level. The government plans to introduce multi-year general guidelines on the use of regional transfers for specific purpose (*Dana Alokasi Khusus*, DAK), but this will be challenging, since regional budgets still rely on annual planning and accounting systems. Over the long term, enhancing governance, especially at the local level, is likely to facilitate the speed and quality of spending decisions.

There is scope to make better use of the large amount of idle funds that have been accumulated over the years in regional public accounts because spending has fallen short of that initially planned. Such funds amounted to IDR 60 trillion on average per year from 2007 to 2010. The government plans to restrict the level of idle funds to no more than three months of routine expenditure. But it is vital that these resources be allocated to areas where needs are most pressing. The government has proposed that a minimum of 20% of regional budgets be dedicated to capital expenditure (including maintenance). However, given the extreme regional diversity of infrastructure needs, setting a standard minimum requirement may not be appropriate. It would be more effective to encourage regions to allocate more resources to capital expenditure by adjusting financial incentives.

Box 3. **Recommendations on macroeconomic and financial-market policies**

Monetary policy

- Achieve the inflation target and, as planned, reduce it over time. This would be achieved by relying on interest rate, liquidity management and macro-prudential measures.

Financial markets

- Step up efforts to pass a micro-finance law, and expand the sectoral coverage of the regulatory framework.

Fiscal policy

- Significantly diminish fossil-fuel and electricity subsidies, and implement enhanced compensatory cash-transfer programmes to prevent a rise in poverty. Communicate widely on the efficiency and distributional benefits of reform. As an interim measure, re-establish a rule linking fuel prices to developments in international oil markets, to remain valid until subsidies are markedly reduced.

The tax system

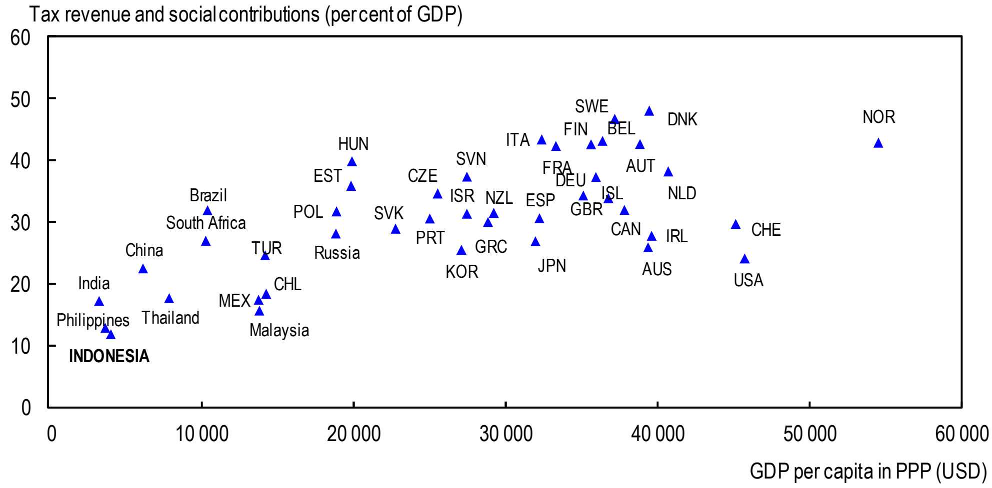
Raising revenues to finance needed social and infrastructure spending

The country will face considerable financing needs as it expands the coverage of its social security system and develops its infrastructure. Lowering energy subsidies would free up resources, but programmes in priority areas will also need to be financed through higher tax revenues. Although it has increased over the years, the tax-to-GDP ratio of less than 12% is low by international standards (Figure 11). To a large extent, this reflects widespread informality and tax evasion. But recent examples from other developing countries like Peru or Vietnam show that significant increases in tax revenues are possible despite the existence of large informal sectors. According to the 2013 draft Budget, the tax-to-GDP ratio is expected to remain broadly stable, despite an increase in VAT revenues. Over the medium term, raising tax revenues would proceed by modifying the tax mix and to a greater extent by increasing compliance. The appropriate objectives in the choice of tax instruments would be to raise sufficient revenues while minimising distortions and keeping the tax system easy to administer.

The tax structure appears to be broadly in line with OECD best practice. Corporate income tax rates in Indonesia have declined to 25% and are close to those of many neighbouring countries. Indonesia still relies more heavily on corporate tax revenues, but to some extent, this may reflect strong profits in Indonesia's natural resource sector, which accounts for more than a fourth of corporate tax receipts (Figure 12).

Figure 11. **Tax-to-GDP ratio and GDP per capita**

2009

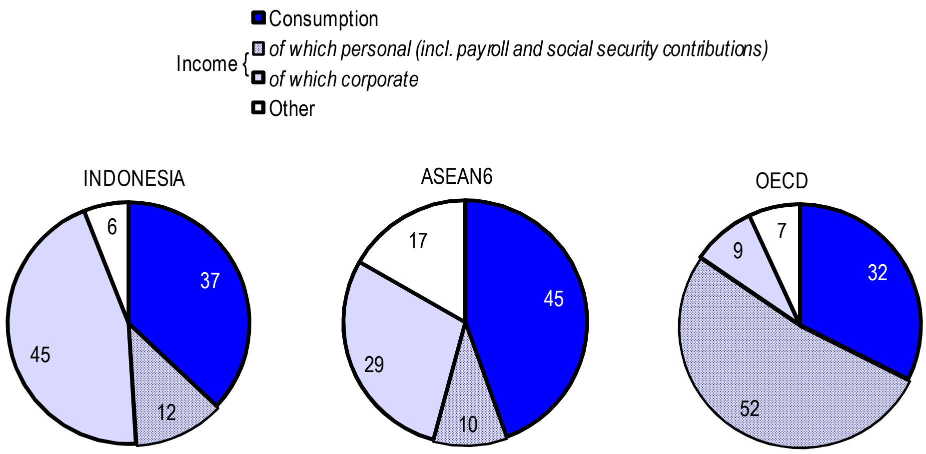


Note: Non-tax revenues such as royalties are not included. Data are for 2008 for India and central government only for Malaysia.

Source: OECD Revenue Statistics, IMF Government Finance Statistics, Indonesia Ministry of Finance, Philippines Department of Finance.

Figure 12. **Tax structure**

Per cent of tax revenues



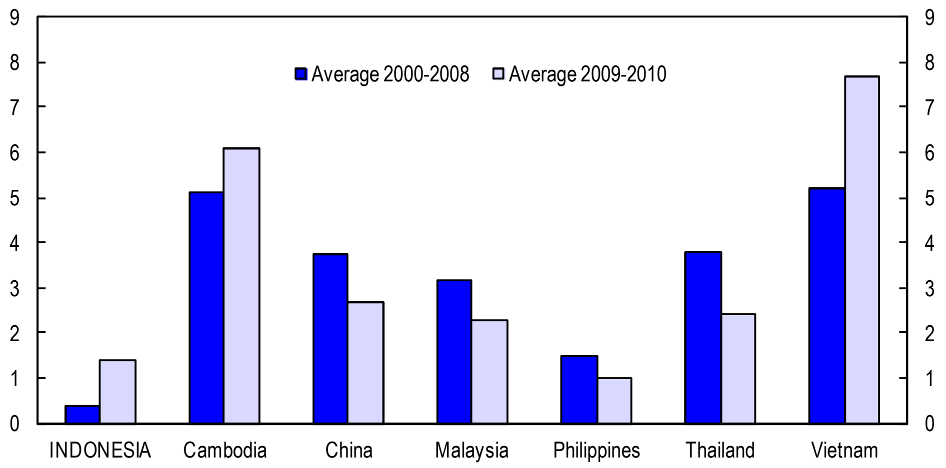
Note: ASEAN6 includes Cambodia, Laos, Malaysia, Philippines, Thailand and Vietnam. Australia, Japan and Poland are not included in the OECD average due to missing 2010 data.

Source: OECD Revenue Statistics, IMF WEO database, Indonesia Directorate General of Tax.

Foreign direct investment (FDI) inflows have been increasing, albeit from a comparatively low level (Figure 13). They grew by 18.5% in 2011. According to the latest A.T. Kearney FDI confidence index, Indonesia moved from the 20th to the 9th most attractive FDI destination from 2010 to 2012 (A.T. Kearney, 2012). While further corporate tax cuts might attract more FDI, a number of other factors may play important roles (Lipsey and Sjöholm, 2011). It may be preferable to focus on the main factors holding back investment, such as poor infrastructure conditions and weak governance in some areas. In any case, alternative revenue sources, including personal income tax revenues, are more difficult to expand in Indonesia than in the average OECD country with a more advanced tax administration and a smaller informal sector, suggesting that it is better not to erode corporate income tax revenues but to make further progress in raising compliance and tax revenues more generally.

Figure 13. **FDI net inflows in selected Asian economies**

Per cent of GDP



Source: World Bank.

Increasing taxation in the resource sector

The estimated government revenue take in the oil and gas sector is lower in Indonesia than in some other countries (Johnston, 2008; Agalliu, 2011). Fiscal arrangements in the oil sector take the form of production-sharing contracts in which the contractor bears the entire risk of exploration and development. At the same time, the exploitation of new or marginal fields, which involves taking more risk than those already producing, is likely to become increasingly important, given the declining trend of Indonesian oil production. Thus, if the government wishes to raise its take, it may also need to bear more of the risks involved in exploration and development, moving toward a system of taxing resource rents.

The tax burden on the mining sector is not far from the average faced by all other sectors, which seems too low, given that this sector benefits from resource rents (Chapter 1). The optimal way to capture such rents would be to tax profits at a high rate above a certain threshold that guarantees that any given project is sufficiently profitable. This would get the incentives right and account for all costs, including exploration and development. If abandoning the current royalty system is too difficult to implement, another possibility would be to continue to levy royalties while losses are incurred, but shift the tax base onto rents once profits begin to accrue. Such a system already exists in Israel's gas sector (OECD, 2011). A possible first step in the direction of taxing rents more would be to extend the non-deductible 10% net profits tax on mining activities in state reserve areas to the standard mining licenses, while recognising all past exploration and development expenses. If deemed necessary, this rate could be raised at a later date.

Indonesia applies export taxes to crude palm oil and cocoa beans, and the government has recently announced the introduction of a new 20% export tax on selected mineral ores. Export taxes on commodities are part of the country's development strategy to foster the development of processing industries. While export taxes reduce overall economic efficiency in the short term by moving production away from the lowest-cost location, they can spur productivity gains in the downstream activity through network and learning effects over the medium to long term. Export taxes can also help to reduce price volatility or achieve food-security objectives. This was an important motivation behind the palm oil tax. Also, in some cases such as mining, they could be used to curb pollution-generating production activities. Finally, export taxes can be seen as a source of public revenue, although in the case of mining levying a higher tax on resource rents (as suggested above) is likely to be a less distortive way to generate resource revenues.

There is evidence that export taxes have contributed to the development of downstream industries, including through FDI in the case of the cocoa industry in Indonesia, but they also hurt other sectors, notably cocoa growers. International experience points to mixed results of such a strategy, with success stories in some countries and failures in others. In particular, these taxes are likely to divert international trade and have been prohibited in many regional trade agreements (Piermartini, 2004). They can also harm the international competitiveness of Indonesian producers and slow their integration into the world economy. More generally, relying on export taxes appears to be a more risky strategy than directly tackling the underlying factors constraining the development of downstream activities, such as infrastructure bottlenecks and poor governance, which are a prerequisite for a sustainable development path. Progress in these areas is likely to take time to materialise, and the authorities therefore view export taxes as an alternative instrument. However, they are clearly only second best, and their economy-wide effects, including their effects on international trade, will need to be carefully monitored.

Moving to a greener tax system

A carbon tax would be an effective instrument to reduce emission intensity in electricity generation and industry. Currently carbon taxes do not exist in Indonesia, and indeed the large energy subsidies are equivalent to taxes applied at negative rates. Reducing fossil-fuel subsidies would help to reduce the carbon footprint of the economy, but this should not be seen as a precondition for introducing a carbon tax at an initially relatively modest level, as suggested by Ministry of Finance (2009). Such a tax is currently under consideration by the Indonesian authorities, together with a cap and trade system. A low initial rate might help to reduce the political resistance towards such a tax as well as its impact on international competitiveness.

As discussed in the 2010 *Economic Survey*, Indonesia also grants implicit subsidies through a range of tax expenditures, such as support to biofuels. However, full-cycle energy savings associated with biofuels that are produced with palm oil or jatropha, as in Indonesia, are still being debated, particularly as existing regulations that prohibit forest clearing for biofuels are difficult to enforce (OECD, 2012a). Hence, current support to biofuels needs to be carefully reviewed.

Removing tax exemptions

Many tax exemptions give rise to unnecessary distortions. Following public consultations with a number of industries, the government recently announced a set of temporary corporate income tax holidays over five to ten years for large investment projects in so-called "pioneer industries", including base metals, textile machinery, oil refining and equipment for renewable energy and telecommunications. Tax holidays, especially when granted to selected industries, distort corporate taxation, create opportunities for policy capture and may make it difficult for the tax authorities to evaluate the foregone revenues. They should thus be reconsidered. Investment tax credits are usually found to be a better instrument to support investment than exempting profits, provided they are available to all economic activities.

Indonesia's VAT appears to be generally well designed. It is levied at a single rate of 10% on domestic added value and on imports. But a considerable number of products and activities are exempt and in June 2012, further exemptions were granted to public transportation services. The exemptions create revenue losses, although the size of the losses is hard to evaluate. IMF estimates suggest that phasing out exemptions and boosting the efficiency of VAT administration to Thailand's level could increase revenue, which currently represents some 4% of GDP, by 1.8% of GDP without raising the rate (IMF, 2011b). This should be a priority.

Employer-provided fringe benefits and allowances often amount to a non-negligible share of compensation packages for high-income employees, but are not taxed at the personal level. Subjecting these benefits to personal income taxes could help to broaden the tax base and increase the redistributive effect of personal income taxes. This is likely to boost public revenues despite the deductibility of fringe benefits from the corporate tax base, as recipients of such benefits often have a marginal tax rate above the corporate tax rate.

Increasing tax compliance

The greatest potential for increasing the fairness of the tax system and fiscal space lies in improving tax collection. For almost all tax instruments, Indonesia's take is low. Thanks to a substantial overhaul of the tax administration (Directorate General of Taxes or DGT), the number of taxpayers and the compliance ratio for filing annual returns have risen markedly over the last few years. But there is substantial scope to expand the effective personal-income tax base. Less than 60% of taxpayers who are required to file an annual income tax return actually do so, and more than 80% of revenues are paid by 3% of households (Nugraha and Lewis, 2011).

A tax census is underway to detect undeclared economic activity and bring it into the tax net. It is directed in particular at the self-employed, who, unlike formal-sector employees, are not subject to tax-withholding and can thus escape tax more easily. This initiative is useful but is likely to face significant implementation challenges. It should be complemented by measures to make voluntary compliance easier, including removing the necessity to apply for a tax identification number and using an already existing numbering system instead, such as the one used for national identity cards. For employees with one single source of income subject to withholding taxes, the requirement to file annual tax returns could be reconsidered. In addition, reducing the penalties for past non-compliance of first-time taxpayers for a limited period would encourage more people to register as taxpayers.

Reducing the extent of tax evasion, particularly by high-income individuals, is key to boosting tax revenues and enhancing the legitimacy of the tax system. This could be done through greater use of third-party information and indicators of tax liabilities, such as purchases of costly consumption items, which DGT has now been authorised to use, although the implementation of this authorisation is still pending. The authorities have also successfully used deterrence in the form of public denunciation of tax evaders and legal sanctions like travel bans and prison terms.

A key element in the success of tax administration reform has been the establishment of large taxpayers' offices. But there are only four such offices, and there seems to be scope to roll out more across the country. In addition, the DGT headquarters should continue to provide local offices with assistance to manage property taxes, which will formally be delegated to them as of 2014, given their low staffing levels and limited expertise. A simplification of the assessment of the tax basis for property taxes would also help to ease the burden on these field offices.

In view of the administration's limited capacity, tax audits should apply procedures that focus more on high-risk taxpayers than at present. Although tax audits in Indonesia have become more risk-focused, valuable resources are still committed to automatic audits of taxpayers with a low risk profile. This diverts resources and leads to long delays. It would be preferable to abolish automatic audit requirements and instead to focus on those cases where there is evidence of, and opportunity for, non-compliance.

Box 4. **Recommendations on raising tax revenues**

Broadening the tax base

- Move the resource-sector fiscal regime closer to a system of taxation of rents.
- Review export taxes, considering their implication for the whole economy, including international trade.
- Phase out exemptions from VAT.
- Revisit corporate tax holidays granted to firms in "pioneer industries".

Improving tax compliance

- Enhance efforts to bring the self-employed into the tax net, including by reducing temporarily penalties for previous non-compliance for first-time taxpayers only.
- Increase resources devoted to auditing high-risk and affluent taxpayers, and make more use of third-party information to assess tax liabilities.

Improving microeconomic efficiency

Fostering formalisation

Increasing the share of economic activity in the formal sector is a crucial goal, as it would increase productivity, which has been particularly lacklustre in small firms, and allow any given amount of tax revenue to be raised with lower rates and thus less in the way of efficiency losses.

Reforming the labour code

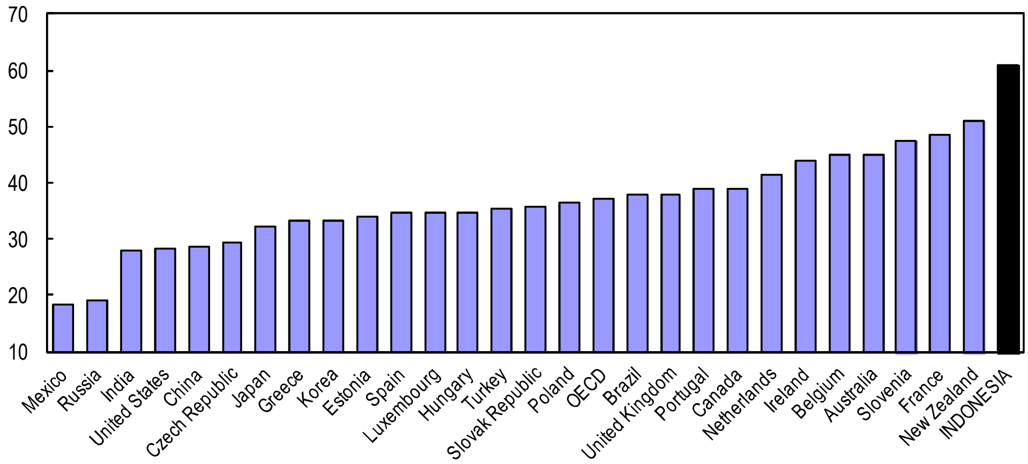
Labour costs are an important factor bearing on efficiency and incentives to formalise. They have been increasing at a faster pace in Indonesia than in other South-East Asian economies. This reflects, in particular, high minimum wages in some provinces combined with generous severance payments and stringent employment protection legislation for some employees.

Relative to average wages, Indonesia has one of the highest minimum wages in the world, equal to 65% of the average wage of salaried workers, although the situation varies somewhat across provinces (Figure 14). This lowers employer incentives to formalise (Suryahadi *et al.*, 2003). Very often large increases are observed in provinces where the minimum wage is already well above the estimated living wage (Chapter 2). In such provinces, increases in the minimum wage should be limited to trend productivity gains. The introduction of a sub-minimum wage for youth directly linked to the general minimum wage could also offset the impact of a high minimum wage on labour-market entrants. Such an instrument already exists in many OECD countries and in India.

An effective way to encourage formalisation while enhancing worker protection would be to rely on a two-pronged strategy of introducing unemployment benefits, which do not currently exist, and cutting onerous severance payments and easing dismissal procedures for workers with permanent formal-sector contracts. At the moment much of the labour code is poorly enforced and affords only weak protection to workers. By contrast the provision of unemployment benefits would pool job-loss risks and could benefit more workers. However, such a measure is often found to be costly in countries where job-search requirements are difficult to monitor. One option would be to limit, at least initially, the level of the unemployment benefit and complement it with individual unemployment saving accounts, which would be potentially tax-supported and could be drawn down during the job-search period. This alternative would be less costly than the introduction of a standard unemployment benefit system but is also likely to be more difficult to administer by both workers and the government. Yet, it would strengthen incentives for the employed to avoid job loss and those of the unemployed to return to work quickly.

Figure 14. **Ratio of minimum wage to average wage by country**

Per cent, 2010



Note: Data are for 2011 for Indonesia.
Source: Employment Outlook database and Going for Growth (OECD, 2012b).

Improving the business environment

A heavy regulatory burden can also influence firms' decisions to become formal. Considerable progress in reforming regulation has been achieved in recent years, but improvements have concentrated mostly on making it easier to start a business. The system of business licensing is still complicated, lengthy and costly and acts as a barrier to entry. On average, running a business is still more cumbersome in Indonesia than on average in OECD or Asia-Pacific Economic Cooperation countries, and the burden is particularly heavy for small firms (World Bank, 2012b).

Decentralisation in 2001 and the resulting transfer of regulatory oversight to localities are reported to have worsened the business environment (KPPOD, 2008). The number of levies and costs firms have to cope with has increased, creating excessive red tape and regulatory uncertainty. Sub-national licensing is currently being reviewed. The focus is on eliminating illegal taxes and user charges. Some efforts have been made, but more are required to remove licensing requirements that are detrimental to growth or inconsistent with national regulations. More generally, there is a need to methodically evaluate the costs and benefits of new and existing licences and make more systematic use of regulatory impact assessments (RIAs).

Since the mid-1990s, the government's strategy to streamline the business licensing process has been based on one-stop shops. These are local government offices that consolidate the processing of business licenses from separate departments into one location to provide faster, simpler and less costly services. Most Indonesian cities have by now complied, and a one-stop-shop system is being implemented for central-government licenses. The national government has also approved legislation mandating the simplification of local licensing requirements, but progress has been uneven across provinces. Regional governments' failure to implement the law could be sanctioned. This will pave the way for a single-license model that is currently under discussion. Going forward, the authorities could also envisage relying extensively on regulations that would apply to anyone who engages in certain business activities, rather than licenses. This approach enables businesses to enter or expand in markets more easily and would reduce the scope for illegal side payments (OECD, 2012c).

Diminishing tax compliance costs, especially for small firms

There is ample room to lower compliance costs and thereby encourage more firms to become formal, even though taxation does not appear to be the major factor behind informality in Indonesia. The World Bank's 'Paying Taxes' publication ranks Indonesia 130th out of 183 economies with respect to the ease of paying taxes. Costs are particularly high for small firms. A specific turnover-based tax regime for small firms with low rates (micro firms will continue to be exempt) is being discussed within the government. Examples from other emerging-market economies, like Brazil's *Simples Nacional* programme, suggests that a simpler taxation system for micro and small firms can promote the creation of start-ups and the formalisation of unregistered workers. Nevertheless, preferential tax treatment for small firms needs to be carefully designed to avoid discouraging firms' development as the advantages of the special regime will be lost if firms grow beyond the revenue threshold.

The use of electronic interactions between taxpayers and authorities presents significant scope for easing tax procedures, at the stages of registering, filing and paying taxes. Some steps have already been taken in this direction, but electronic filings still account for less than 1% of annual tax returns. Further progress could be achieved by allowing taxpayers without access to computers to pay taxes using automatic teller machines, such as in Singapore, Malaysia, India and Hong Kong.

Boosting investment

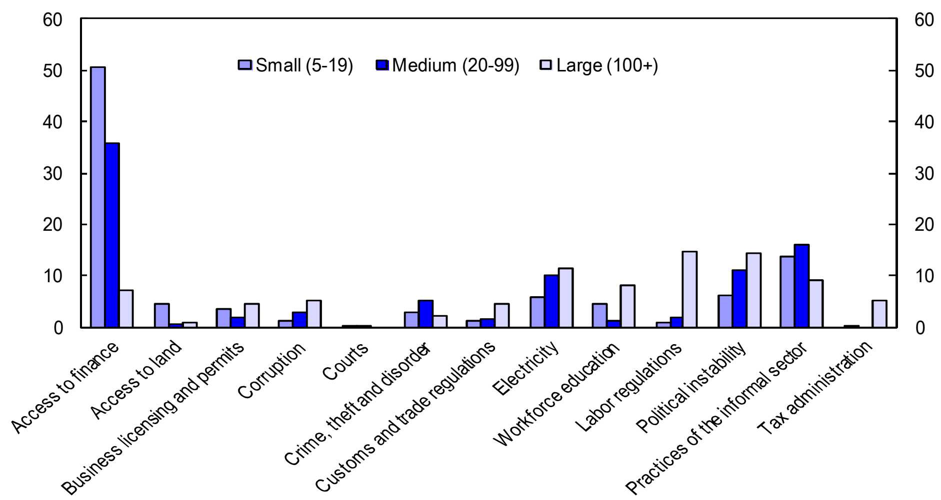
Another option to spur productivity growth is to remove obstacles to investment, especially for small firms.

Easing access to finance

According to the World Bank's Entrepreneurship Survey, access to finance is by far the greatest impediment to investment for small and medium-sized Indonesian firms (Figure 15). While the lack of financial instruments prevents excess liquidity from being channelled into financing tangible investment, small firms face additional difficulties.

Figure 15. **Principal obstacles to investment by size of Indonesian firms**

Per cent of responses, 2009



Source: World Bank, Enterprise Survey for Indonesia.

Poor credit information and difficulties in enforcing contracts are likely causes of high credit costs. One way to reduce the cost of screening clients is through the establishment of credit registries that provide information on firms' payment histories. A public credit bureau (*Biro Informasi Kredit*, BIK) has existed in Indonesia since 2006. It has helped to improve transparency and information. Its information is restricted to credit and, as in many other countries, is more oriented toward consumer credit than commercial lending. A limitation of the BIK is that access to it is limited and subject to the approval of the banking supervisor. Letting non-bank financial institutions access all the information collected by BIK could spur lending to small firms.

Many small businesses cannot get credit because they are unable to provide the types of collateral required and face harsher bank lending terms than larger firms. Some of these issues may be tackled by policies developed by BI in the Indonesian Financial Inclusion framework. But the authorities need to clarify land-rights provisions covering both individual and communal rights to secure firms' property rights to assets they can pledge as collateral. In addition, stronger creditor rights would allow lenders to reduce the risk of future losses. This is particularly important, given the weak judicial system. Simplification of costly loan-recovery procedures would also be helpful.

To ease access to bank lending, in 2007 the government put in place the people's business credit KUR programme (*Kredit Usaha Rakyat*) which provides government credit guarantees to firms which are profitable but could otherwise not get credit from banks. KUR is estimated to have had a positive impact on wages and production (BRI, 2009). A limitation of the programme is that it is concentrated on the trading sector and certain regions. One way to expand coverage of the programme would be to allow more banks to qualify for the scheme, even though this would increase fiscal risk. The government could also improve awareness amongst entrepreneurs of available financing options. Finally, now that the programme has been in place for few years, it would be useful to reduce the number of ministries involved in its design and implementation.

Encouraging infrastructure investment

There is a broad consensus that the unsatisfactory state of infrastructure is holding back economic activity and investment in Indonesia. In particular, high transport costs are weighing on production efficiency. Despite some improvement, the road and railway networks remain in poor condition, and the capacity of seaports appears to be limited. The quality of electricity supply also remains a major concern.

The Land Acquisition Law, passed in December 2011, allows the government to take over land for development while owners are guaranteed compensation. Implementing regulations were issued in August 2012. It is expected to accelerate infrastructure development. In addition, the Master Plan for the Acceleration and Expansion of Indonesia's Economic Growth (*Masterplan Percepatan dan Perluasan Pembangunan Ekonomi Indonesia*, MP3EI) provides a strategic direction for investors on where the government's economic development focus will be in the next 15 years. The MP3EI foresees that about IDR 1924 trillion (around 26% of GDP) will be allocated to infrastructure sectors from 2010-14. But about 72% of these funds are expected to be financed by the private sector or through public-private partnerships or foreign direct investments, which will be challenging in the current business environment. The government could consider raising, even substantially, the amount of infrastructure investment it intends to finance, which was only 1.7% of GDP in 2011. This would not endanger fiscal sustainability if revenues were raised, as discussed above. If carried out properly, increased infrastructure would have large pay-offs at the country's current stage of development. In any case, all new infrastructure should be as resilient as possible to natural disasters, whose impact falls most heavily on the poor.

But, injecting more money in the sector will not be sufficient. New regulators have been established in rail transportation and water and sanitation, as recommended in the 2010 *Economic Survey,* and a set of guidelines clarifies the use of private-public partnerships in network industries. Additional reforms are required to lower regulatory uncertainties, including strengthening the powers of existing regulators and improving co-ordination between national and local authorities. In addition, removing electricity subsidies to consumers would improve the finances of the state-owned electricity producer, which are in wretched shape, and attract private investment. Until subsidies are significantly reduced, adequate compensation to the company, as suggested by the OECD Guidelines on Corporate Governance of State-Owned Enterprises, would improve its balance sheet.

Better enforcing intellectual property rights

Finally, more stringent enforcement of intellectual property rights (IPR) would encourage investment. IPR legislation has been updated to meet international standards, and special measures have been taken to meet the needs of small firms, but intellectual property piracy remains a major concern. It is important to allocate more resources to better enforce IPR regulations. In addition, policies should reduce the time and cost of enforcement procedures and improve firms' confidence in the process. Streamlined procedures would make patent litigation more accessible to small firms, as evidence from the United Kingdom has shown (Cusmano and Dean, 2011).

Improving the availability of qualified labour

Productivity gains can also be achieved by raising the general level of skills in the workforce. At the moment, workers' skills often do not meet employers' expectations, and there remains a critical need to broaden basic skills. The level of education of SME owners is also low.

International evidence points to the importance of teaching quality as a key factor in determining educational outcomes. Despite some budgetary allocations to tackle this issue following the 2005 Teacher Law, efforts to monitor progress in teaching quality through regular assessment of teachers' pedagogical skills need to be maintained.

Easier access to education for students from disadvantaged backgrounds will expand the pool of skilled workers. As indicated in the 2010 *Economic Survey*, enrolment is particularly low in secondary education, suggesting the need to facilitate the transition from primary to higher levels of education. Even if a complete understanding of the factors determining dropping out from school is lacking, early withdrawal could be curbed by extending conditionality in income-support programmes to include secondary-school attendance. Financial support to students from poor families could be provided through a higher per-student transfer under the School Operations Fund programme (*Bantuan Operasional Sekolah,* BOS) – which includes direct block transfers to schools to finance non-payroll recurrent expenditures – for schools located in remote areas and catering to poor students. Alternatively, conditional cash transfers would ease access to education of disadvantaged students.

Programmes have been put in place to provide skills to the large number of youths who drop out without any qualification. But there is no follow-up monitoring to check whether these programmes have proven successful in lifting skills and in favouring integration into the formal labour market. It would be useful to rigorously assess the cost efficiency of all existing programmes aiming at upgrading dropouts' skills and phase out those found to be inefficient.

Employer surveys suggest that a large number of educated workers do not have the expected level of skills given their level of education. Vocational schools offer an alternative path to providing students with the generic skills necessary to find a job. The sector has expanded rapidly in recent years, and the authorities wish to expand it further to reach a 30/70 general/vocational ratio by 2015. Rather than increasing further the number of vocational training providers, it would be preferable to concentrate vocational schools' curricula on on-the-job and practical training that is highly valued by employers. In addition, removing formal education from the negative investment list, as is currently being discussed, would facilitate entry of foreign providers.

Changes to the tertiary-education sector are also required to make it more responsive to firms' needs. In August 2012, the authorities passed a Higher Education Bill to increase the autonomy of higher education institutions. Greater autonomy for tertiary-education institutions will allow them to adapt more quickly to firms' skill needs and give them incentives to ensure high-quality teaching. A range of cost-sharing instruments could be used to alleviate the financial burden borne by poor students. A 2009 law already mandates that scholarships be available for at least 20% of the student population. Better availability of student loans would also ease access, especially in the current context of improved governance and targeting as well as more developed banking activity.

Employer-provided training is scarcer in Indonesia than in other South-East Asian economies. Firm-based training could be encouraged through the creation of a national training fund, similar to those existing in Malaysia or Latin America, which would consolidate resources allocated to training and direct them to their most cost-efficient use. Participation of employer representatives in the management of this fund would ensure that feedback from the labour market is incorporated into training content.

Reviewing support to small firms

Although support to SMEs is generally rated as effective by firms, some changes could improve the efficiency and consistency of public assistance delivery. Since 2008 support has been, by law, a government function. Most central-government ministries are currently involved in the delivery of support, but local governments also provide their own programmes. A lack of effective coordination has resulted in a plethora of sometimes overlapping measures and an inefficient delivery of support. More clearly defined responsibilities among the different levels of government and within the central government would help to improve coordination and ensure resources are used efficiently.

Moreover, the authorities only monitor rather than evaluate programmes, focusing on those that are strategic (Suryahadi *et al.*, 2010). It is essential to regularly assess the cost-effectiveness of existing programmes. To be credible and prevent policy capture, it would be preferable to assign this task to an independent agency. Once such a rigorous evaluation is undertaken, it may be possible to consolidate support by phasing out inefficient measures and directing resources to the most cost-effective schemes.

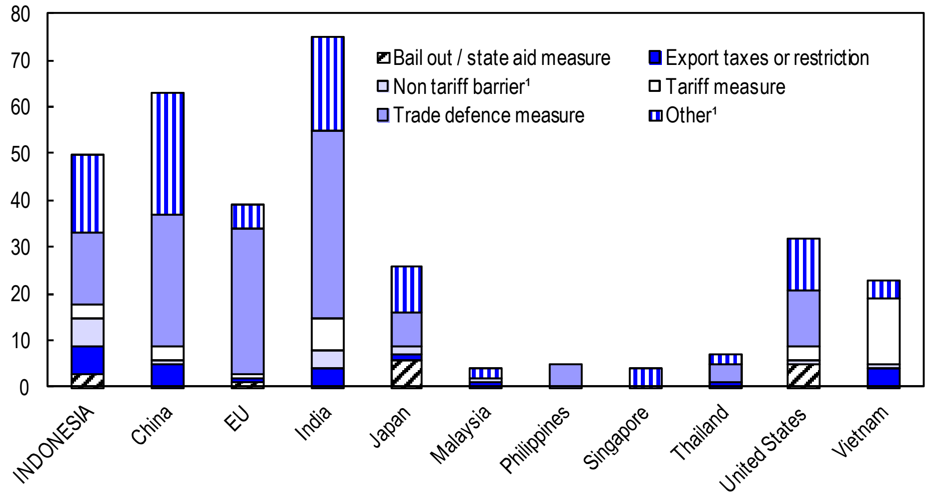
One of the main strands of policy support has been to encourage the formation of SME clusters, and a number of corporate tax incentives have recently been introduced for this purpose. Although clusters can be the source of productivity gains and facilitate the delivery of support, there is also evidence that most Indonesian SME clusters tend to grow spontaneously without government intervention (Marijan, 2006). It may thus be useful to examine the effectiveness of such policies. In addition, Indonesia has been protecting small firms by reserving certain industries for them and requiring partnerships with them in its FDI policies to foster technological spillovers. However, this restriction could also discourage foreign companies from investing in Indonesia, thereby hampering firms' growth, and needs to be reconsidered.

Opening the economy further to foreign trade and investment

Despite Indonesia's longstanding commitment to free trade, several non-tariff measures have been erected since the end of 2008, reflecting concerns that the economic crisis could spread through Asia. The number of new trade-restricting measures is lower than in China and India but notably higher than in regional peers (Figure 16). Most seriously, new regulations to restrict the range of products a general importer can import are expected to come into effect by the end of this year. While the government has remained committed to lowering tariff rates, it has had recourse to non-tariff measures, which can be put in place by one of the many government agencies that have prerogatives in this area, without formal coordination. Only some of these measures can be justified on public health and environmental grounds. It would be useful for an independent agency to carefully examine the impact of these non-tariff measures on trade and the domestic economy and roll back those that are found detrimental to growth. As indicated in the 2012 OECD *Review of Regulatory Reform*, reducing the number of ministries and agencies that have the ability to erect non-tariff barriers could prevent an excessive rise in such barriers in the future (OECD, 2012c).

Figure 16. **Restrictions to trade in Indonesia and selected economies**

Increase from end 2008 to June 2012



1. Other measures include public procurement, competitive devaluation, consumption subsidy, export subsidy, import ban, import subsidy, intellectual property protection, investment measure, local content requirement, migration measure, quota, sanitary and phytosanitary measure, state trading enterprise and state-controlled company, sub-national government measure, technical barrier to trade, and trade finance. Non tariff barriers are those not included in other measures.

Source: Global Trade Alert.

Despite some progress through the publication of a negative investment list in 2007, FDI restrictions have remained relatively stringent in Indonesia. Foreign equity ceilings are lower than on average in Asia in all sectors except banking, mining, oil and gas and electricity (World Bank, 2010b). Moreover, lower-order regulations issued by Ministries or regional governments have sometimes been inconsistent with the Investment Law, creating confusion. Some of these regional regulations have been revised or harmonised with central-government regulations and the negative investment list was also updated in Presidential Decree 2010/36. While many sectors were liberalised for investment, a few others became more restrictive (OECD, 2012c). In March 2012, a government decree tightened FDI restrictions in mining and required foreign mining companies to progressively divest their holdings down to 49% by the tenth year of operation. Moreover, some restrictions have remained in place in key sectors such as pharmaceuticals, distribution, telecommunications, maritime transport and education. In some cases, these could be justified on the grounds of environmental protection, national security, public health and cultural heritage. The authorities have announced that they may revise the negative investment list to spur FDI in some of these sectors. They should consider further relaxing barriers to FDI in sectors where they still exist, unless they are justified by valid public-interest concerns. Indeed, FDI is usually believed to be beneficial to growth and development, as it is a source of technology transfer, allows risk diversification and can deepen financial markets (Kose *et al.*, 2009).

Box 5. **Recommendations to spur microeconomic efficiency**

Labour market and business environment

- In provinces where minimum wages are already high in relation to average wages, resist increases that exceed trend productivity gains. Introduce a sub-minimum wage for youth directly linked to the general minimum wage. Reduce onerous severance payments and ease dismissal procedures in the formal labour market. In return introduce unemployment benefits possibly coupled with individual unemployment saving accounts.
- Systematically review all significant existing business licenses at the national and local levels, with a view to simplification, and ensure licensing remains cost-effective.
- Make the information collected by the credit bureau available to all non-bank financial institutions.
- Public finances permitting, increase public outlays on cost-effective infrastructure projects, beyond what is already planned.

Human capital

- Ease access to education and training for students from disadvantaged backgrounds. Rigorously assess the cost-efficiency of all existing programmes aimed at upgrading dropouts' and workers' skills, and phase out those found to be inefficient.

Support to small firms and foreign trade and investment

- Clarify government responsibility in the delivery of support to small firms. Regularly assess the efficiency of existing programmes and redirect resources to the most cost-effective schemes.
- Re-examine the effectiveness of policies to encourage the formation of clusters, to reserve certain industries for small firms alone, and to require foreign direct investors to partner with local SMEs.
- Assess the impact of non-tariff measures on trade and the domestic economy and remove those that are found detrimental to growth. Remove the new regulations that restrict the range of products a general importer can import. Relax remaining barriers to foreign direct investment, unless they address valid public-interest concerns.

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Annex

Progress in structural reform

This Annex reviews progress in the area of structural reform based on the policy recommendations made in the 2010 *Economic Survey*.

Survey recommendations	Action taken since last Survey
FISCAL POLICY FRAMEWORK	
Increase spending on growth-enhancing programmes.	Spending on capital expenditures rose markedly in nominal terms in 2011 but still came in well below budget targets, as did social expenditures. Education spending increased by 5% in nominal terms in 2011, while infrastructure spending went up by 57% in nominal terms relative to 2010 (World Bank, 2012a).
MONETARY POLICY FRAMEWORK	
Stick to the commitment of lowering the inflation target range to 3.5-5.5% by 2014, and move from an end-year to a year-average target.	The inflation target has been reduced to 3.5%-5.5% for 2012.
FINANCIAL MARKETS	
Pass and implement the Financial Services Authority (*Otoritas Jasa Keuangan*, OJK) bill as soon as possible in order to specify the roles, functions and degree of autonomy of the OJK.	The OJK bill has been passed, and implementation is planned for 2013-14.
LABOUR MARKETS	
Introduce unemployment insurance while capping minimum wage increases and reducing severance payments.	No action taken. Minimum wage increases have remained high in some provinces.
Simplify dismissal procedures for permanent contracts, and ease the use of temporary and fixed-term contracts.	The government is planning to improve the rules and regulations on severance pay and fixed-term contract workers.
ENVIRONMENT, DEFORESTATION AND CLIMATE CHANGE	
Follow up on the Ministry of Finance green paper, and swiftly review the most cost efficient measures to slow deforestation rates. Make sure the timber legality standard is enforced.	A presidential decree for a National Action Plan For Reducing Greenhouse Gas Emissions ("RAN-GRK") was signed in September 2011. The plan spells out the 2020 emission-reduction targets in five main sectors.
Ensure energy policies are consistent with the objective of emissions reduction.	Energy policies continue to favour the burning of coal and diesel in power generation. In January 2012, the government established a guaranteed feed-in tariff for small renewable-energy producers, to be paid by the state energy company. In May 2012 the government decided to spend IDR 3.4 trillion on new geothermal energy plants.
Stick to the commitment and the planned timetable to phase out fossil fuel subsidies by 2014, and extend the commitment to a medium-term removal of electricity subsidies.	An attempt by the government to lower fuel subsidies and electricity subsidies failed to get parliamentary approval in May 2012. However, the government was authorised to raise the price of subsidised fuel if the world oil price exceeds a certain threshold. In the 2013 draft Budget the government has proposed to raise electricity tariffs by 15%. Poor households would be exempted from the hike.
Introduce a carbon tax.	A carbon tax, together with a cap and trade system, are under consideration.
Review support to biodiesel and ethanol.	No progress made.

INFRASTRUCTURE	
Use the Medium Term Expenditure Framework more effectively to improve multi-year budget appropriations for infrastructure projects, and improve coordination among ministries responsible for infrastructure development.	Recent moves to a medium-term expenditure framework at the central level are expected to improve planning capacity and budget execution, although regional budgets still rely on annual planning.
Undertake systematic value-for-money tests to assess the relative and absolute cost effectiveness of PPPs.	The National Development Planning Agency BAPPENAS has developed regulatory impact assessment tools.
Provide incentives to local governments to allocate budget resources for roads, water and sanitation by making transfers conditional on appropriate upkeep.	No progress made.
Establish independent regulatory bodies in the sectors currently lacking them, and legally entrench the power and responsibilities of all regulatory bodies.	New regulators have been established in rail transportation and water and sanitation.
Grant independence to existing regulatory entities by eliminating the need for ministerial approval of their decisions and by funding their budgets through license fees and levies on firms.	No progress made.
Lower FDI restrictions on equity and on foreign key personnel in telecoms, transport and electricity.	No progress made. The negative investment list is currently under review.
Realign average water tariffs to cost-recovery levels, and use existing cash-transfer programmes to compensate low-income households.	No progress made.
Reform eminent domain legislation to expedite the process of land acquisition.	A land reform act has been passed that is expected to expedite the process of land acquisition.
Reduce restrictions on cabotage by foreign vessels so as to raise competition in the shipping industry. Allow shipping companies to determine freely their freight and passenger tariffs, and, if necessary, auction subsidies to ensure the provision of services on unprofitable routes.	No progress made.
SOCIAL POLICIES	
Raise government spending on education at the secondary level.	Spending on the secondary education has been increased in recent years. Plans to expand spending on secondary education in 2013 have been announced.
Carry out regular assessments of teachers' pedagogical skills and regular monitoring of teacher attendance to tackle the problem of their absenteeism.	Additional funds have been allocated to scholarships for teachers to pursue undergraduate and graduate degrees. A joint ministerial decree was issued in 2011 to impose a minimum teaching load of 24 hours per week for teachers.
Raise government spending on health care, and carry out a comprehensive costing of Jamkesmas. Public finances permitting, include coverage for patient transport and related costs under Jamkesmas.	Overall social expenditures rose by only 3.3% in nominal terms in 2011 and Jamkesmas itself increases as much as IDR 1 trillion per year. A costing review of Jamkesmas has been carried out.
Carry out a comprehensive actuarial costing of existing social protection programmes to allow the appropriate associated financing instruments to be identified.	A study on comprehensive actuarial costing was carried out in early 2012. Discussions within the government on the basis of this study are now ongoing.
Better integrate the different social-protection mechanisms.	In November 2011, the Social Security Administrative Bodies Law (BPJS Law) established two new social security administrators (for health and employment, respectively). Once implemented in January 2014 it will consolidate existing health-insurance schemes (including Jamkesmas) and expand coverage substantially. In July 2015 accident and life insurance as well as a pension scheme are to be provided.
GOVERNANCE	
Pursue efforts to fight corruption and strengthen governance. Step up reforms to the court system.	In December 2011 the President issued a new regulation, which outlines strategies for corruption prevention in law enforcement and other agencies as well as enforcement and asset recovery from corrupt practices. Progress in lowering corruption perceptions has been slow.

Chapter summaries

Chapter 1. Improving the tax system

Indonesia has come a long way in improving its tax system over the last decade, both in terms of revenues raised and administrative efficiency. Nonetheless, the tax take is still low, given the need for more spending on infrastructure and social protection. With the exception of the natural resources sector, increasing tax revenues would be best achieved through broadening tax bases and improving tax administration, rather than changes in the tax schedule that seems broadly in line with international practice. Possible measures to broaden the tax base include bringing more of the self-employed into the tax system, subjecting employer-provided fringe benefits and allowances to personal income taxation and reducing the exemptions from value-added taxes. Similarly, broad-based investment credits would be a less distortive way to enhance investment incentives than selective tax holidays. Introducing a targeted, simplified tax regime for small and medium-sized enterprises, as currently planned by the government, could foster their integration into the tax system in the longer run, even if its short-run revenue potential is limited.

Upgrading tax administration has made substantial progress in Indonesia since 2002, although there is still scope to improve the training of tax officers and the administration's audit and litigation capacities, while strengthening internal control systems and enhancing the transparency of administrative decisions. The audit system could be further improved by allocating more tax audits on the basis of compliance risks.

In the natural resources sector, particularly in mining, there is a case for increasing the government's share of resource rents through higher tax rates imposed on these rents, as opposed to taxing revenues. This would imply a willingness of the government to bear a larger share of the exploration and development risk than heretofore, which Indonesia, with its improved access to international financial markets and a diversified resource portfolio, is now well placed to do. In the mining sector, a powerful rent tax regime with a large government take would serve the country better than export taxes and ownership restrictions that have been decided recently.

Chapter 2. Promoting SME development

Micro, small and medium-sized firms (MSMEs) are a key source of employment and economic growth in Indonesia. They contributed to the country's economic resilience during the 2008-09 financial crisis. But many suffer from low productivity, curbing their role in boosting living standards. There are several ways to spur MSME productivity growth over the medium term.

The first route would be to encourage the formalisation of small firms. Lessening red tape through simplification of the licensing process and lowering tax compliance costs would help. Avoiding excessive rises in the minimum wage in provinces where it is already at a reasonable level would also be important. Looking forward, it would be useful to remove rigidities in the formal labour markets, while moving to some form of unemployment benefit system to insure workers against job-loss risks.

The second route would be to boost investment. Clarifying property rights for real estate, and making the information collected by the credit bureau available to all financial institutions would ease access to finance. At the same time, the development of financing alternatives such as venture capital, leasing or micro-finance would enhance credit supply. The poor state of infrastructure, in particular in the transportation and electricity sectors, is also perceived as an important impediment to investment and could be remedied by increasing public infrastructure spending on cost-effective projects.

The third route would be to enhance the quality of human resources. The country suffers from a lack of skilled workers, and policies should aim both at increasing the pool of workers and making education and training institutions more responsive to evolving labour-market demand.

Indonesia has a long tradition of supporting MSMEs. But responsibilities between the different levels of government and within the central government need to be clarified to minimise overlap and inefficiencies. A rigorous assessment of existing programmes would allow schemes to be consolidated and scarce public funds to be directed to their most cost-effective uses

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Further information

For further information regarding this overview, please contact:

Peter Jarrett, e-mail: peter.jarrett@oecd.org;
tel.: +33 1 45 2486 97; or
Annabelle Mourougane, e-mail: Annabelle.mourougane@oecd.org;
tel.: +33 1 45 24 76 81; or
Jens Arnold, e-mail: jens.arnold@oecd.org;
tel.: +33 1 45 2487 22.

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