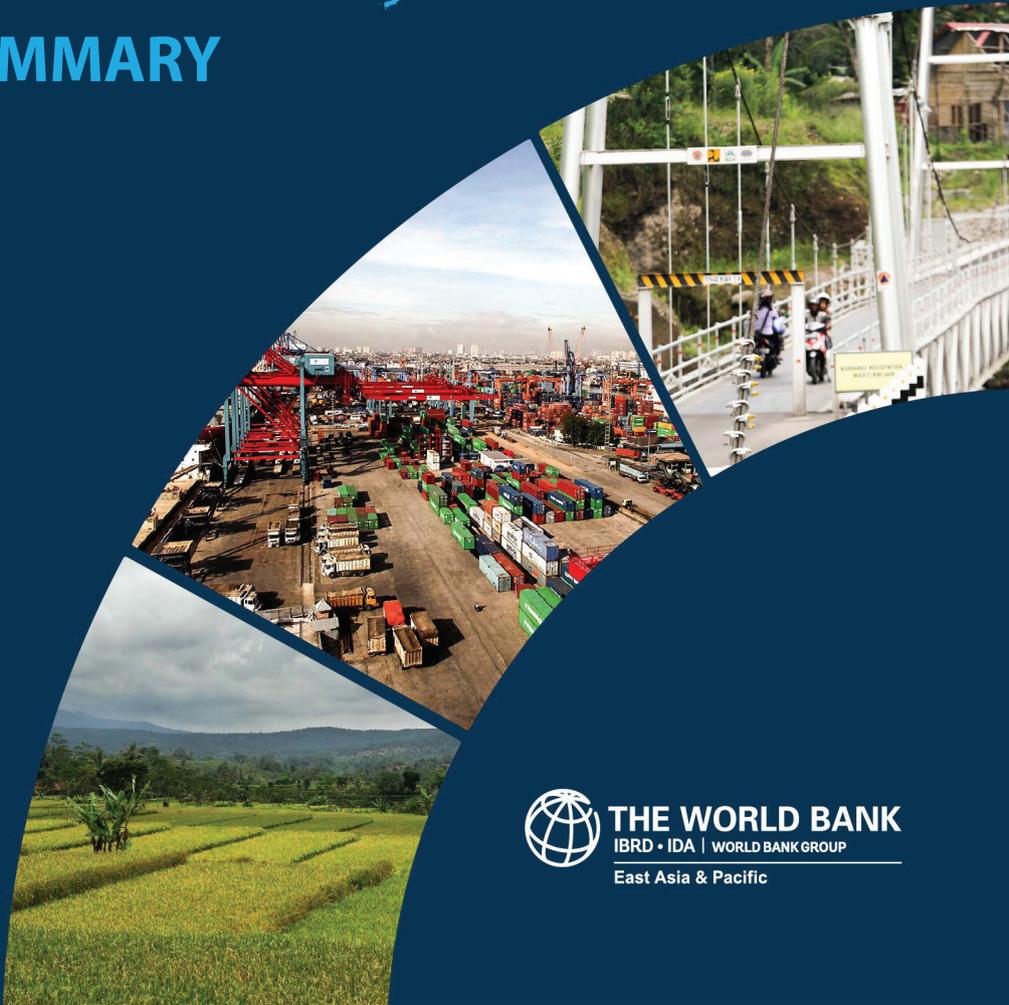


Pathways Towards Economic Security

INDONESIA POVERTY ASSESSMENT

EXECUTIVE SUMMARY



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FOREWORD



Indonesia arguably met its goal to eliminate extreme poverty when it reached 1.5 percent in 2022. Sustained economic growth combined with social protection has made this progress possible. Indonesia can now set its sights higher to improve the lives of the still one-third of Indonesians who remain economically insecure.

As Indonesia aims to become a high-income country by 2045, our analysis in this report uncovers opportunities as well as some important roadblocks to further progress. Even though economic growth has contributed to poverty reduction, nearly all sectors in rural, agricultural areas and in cities suffer from low productivity, while human capital development lags peer countries and half of Indonesian women remain excluded from the labor force.

Indonesians need better work opportunities offering higher income in higher productivity sectors. Despite a fast-growing digital sector, only one in ten Indonesian workers has a high-skilled job, and not enough workers have skills to take advantage of these opportunities when they arise.

These are areas in which policies can make a difference. Our analysis offers some perspectives that lead to a few recommendations. One set of recommendations focus on creating better opportunities. Integration into global value chains would increase Indonesia's productivity and help take advantage of its growing digital economy. Urban areas need investments to allow them to become the engines of productivity growth we have seen in other countries, while enhancing agricultural productivity would provide better livelihoods for farmers. More affordable, quality childcare would in turn help open opportunities for women.

Another set of recommendations focus on protecting people from staying and falling into poverty. Indonesia is prone to shocks, especially from weather-related incidents. Between 1990 and 2021, Indonesia experienced more than 300 natural disasters affecting more than 11 million people, with climate-related disasters accounting for around 70 percent of total disasters in this period. As usual, the poor and economically insecure carry a disproportionate burden when a disaster strikes.

Like many countries Indonesia needs to look at scaling up social protection, including both social assistance and insurance, as well as increasing financial inclusion. It is also vital to enhance the resilience of infrastructure to shocks. These measures would require resources, but Indonesian policymakers have options to increase financing for these "pro-poor investments". As our analysis of taxation and subsidy policies points out, Indonesia has opportunities to increase tax revenues while reducing spending on less effective and often regressive energy and agricultural subsidies. In this context, improving the efficiency and quality of sub-national governments' administration and spending, especially on education and healthcare, is also key to increase the quality of public services.

Our hope is that this Poverty Assessment will help inform and broaden public dialogue on opportunities and challenges as well as on possible solutions to creating better opportunities and protecting against poverty.

Satu Kahkonen

Country Director

World Bank Indonesia

Poverty in Indonesia



Poverty headcount rates using \$1.90, \$3.20 per-day 2011 PPP as well as national poverty line (NPL)



Gains in poverty reduction have basically eliminated extreme poverty (measured at US\$ 1.90 2011 PPP), while 16 percent of the population remained poor in 2022.

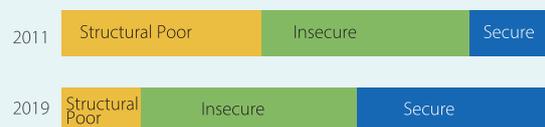
16%
of the population
remained poor



However, many more people are susceptible to falling into poverty, upon shocks.



Share of population classified as structurally poor, economically insecure, and economically secure



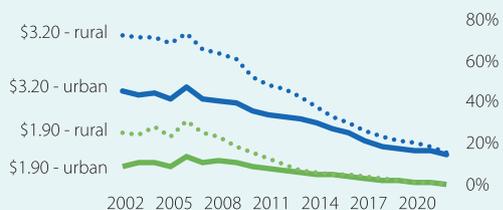
Urban and rural poverty rates have converged to similar levels.



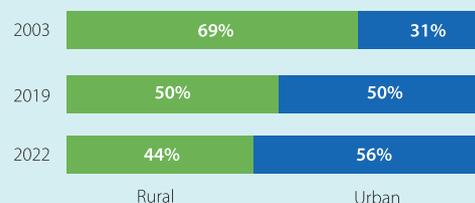
This means that the majority of the poor is now located in urban areas.



Poverty rates, by urban/rural



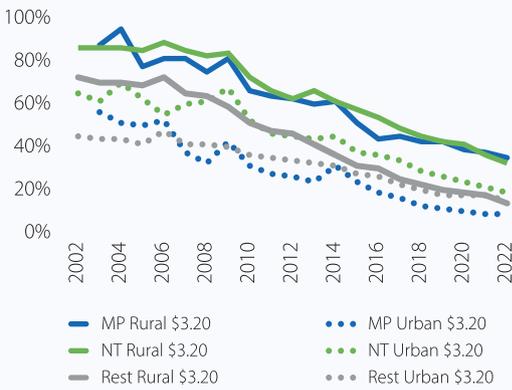
Share of the poor and the general population in rural and urban areas



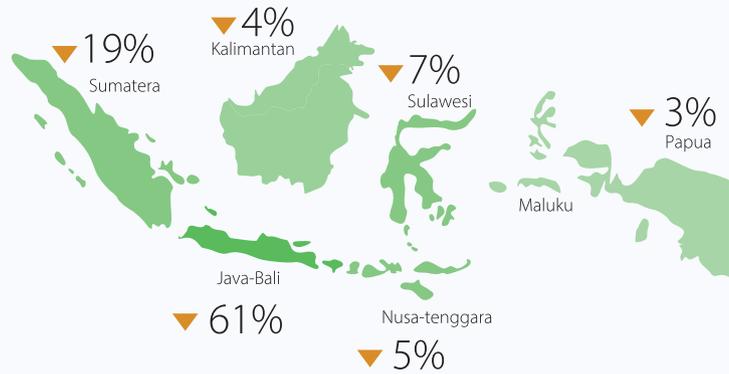
While generally catching up, rural Maluku Papua and rural Nusa Tenggara still have significantly higher poverty levels than the rest of Indonesia.

However, the majority of the poor live in Java, Bali, Sumatera and Sulawesi ... as Maluku Papua and Nusa Tenggara are less populous.

Poverty rates for Nusa Tenggara (NT), Maluku Papua (MP) and other regions



Share of the (extreme) poor, by region



Poorer households



Extreme poor Poor Economically insecure Economically secure

Are larger and have to take care of more dependent household members, mostly children		6.0	5.3	4.1	3.2
	Size				
		0.38	0.34	0.24	0.19
	Children				
Are more often working in agriculture rather than in services and more often either self-employed or casual workers		5.9	6.6	6.4	10.1
	Education				
		14%	15%	14%	5%
	Casual worker				
Have less often access to electricity and proper sanitation, use gas less often for cooking and less internet access		92%	97%	98%	100%
	Electricity				
		51%	66%	74%	89%
	Gas				
		10%	16%	25%	55%
	Internet				

“

Indonesia has made impressive gains in reducing poverty, with previously lagging regions catching up, and the Government’s goal to eliminate extreme poverty by 2024 practically met.



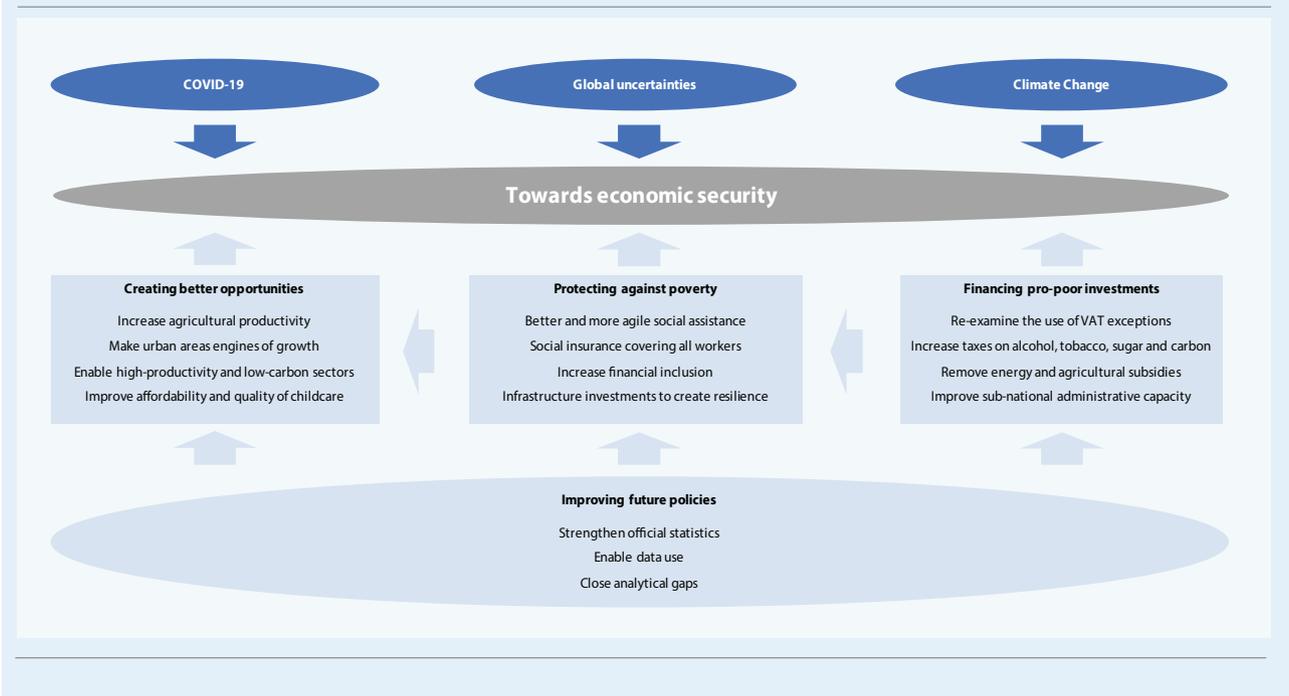
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Overview

Indonesia can build on its impressive track-record of poverty reduction to tackle more ambitious poverty reduction targets. Indonesia has made impressive gains in reducing poverty, with previously lagging regions catching up, and the Government’s goal to eliminate extreme poverty by 2024 practically met. As an aspiring upper middle-income country, however, Indonesia may want to widen its focus beyond extreme poverty by moving from the US\$ 1.90 2011 PPP poverty line to higher lines for middle-income countries. The focus should also include economically insecure households susceptible to falling back into poverty. Is Indonesia’s current effort ready for this challenge? Human capital outcomes are disappointing and worrying geographic disparities remain. Low productivity still prevents households from becoming economically secure. Shocks, including from climate change, continue to threaten reversal in poverty gains. We identify several major pathways to tackle these challenges in a comprehensive and sustainable manner (Figure ES1).

- (i) Create better opportunities in higher productivity and low-carbon work to help households become economically secure.
- (ii) Improve social protection and financial inclusion to mitigate harm from future shocks.
- (iii) Develop a more effective fiscal system for more pro-poor investments contributing to human capital through better public service delivery.
- (iv) Close data and knowledge gaps to improve future policies to support this agenda.

FIGURE ES1: Four pathways with policy priorities (green) towards economic security can tackle key challenges (orange) faced by Indonesia



Progress and challenges

Trends

Having eradicated nearly all extreme poverty, Indonesia can now turn to broadening its definition of poverty commensurate with its middle-income status.

Extreme poverty, defined by living on less than US\$ 1.90 2011 PPP per day, dropped from 19 percent in 2002 to 1.5 percent in 2022 (Figure ES2), practically meeting the Government's objective to eradicate extreme poverty ahead of its expected schedule of 2024. A small amount of extreme, frictional poverty is likely to remain for some time. With extreme poverty almost eliminated, poverty reduction strategies must widen their focus to also include poor – but not extremely poor – households. Lower middle-income countries use higher poverty lines set to US\$ 3.20 2011 PPP per day.

Even with a broader definition of poverty, Indonesia has made remarkable poverty reduction progress

FIGURE ES2: Poverty dropped starkly from 2002 to 2022 when measured with the absolute international poverty lines

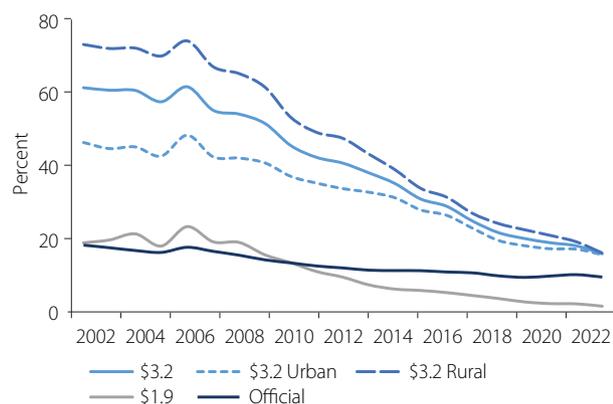
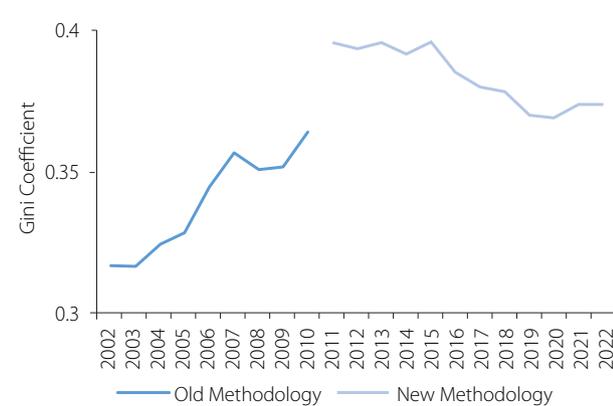


FIGURE ES4: Inequality increased substantially from 2002 until 2010 before stagnating and dropping from 2014 until 2019 and slightly increasing due to COVID-19 in 2021



while inequality slowly declined. Poverty, measured at the lower middle-income country line of US\$ 3.20 2011 PPP per day, also declined steeply from 61 percent in 2002 to 16 percent in 2022. Increased domestic consumption drove poverty reduction in the last decade, contributing to job growth in a tight labor market and increased real wages. The largely inclusive nature of growth (Figure ES3) reversed the previous trend of rising inequality when economic growth mostly benefitted wealthier households (Figure ES4).

Poverty reduction was broad-based, allowing most lagging regions to catch up, except for rural areas in two provinces. Poverty converged from 46 percent in urban areas and 73 percent in rural areas in 2002 to 16 percent in both urban and rural areas in 2022. Today, over half of the poor (56 percent) reside in urban areas. Similar but slower convergence occurred between regions. The two main lagging regions, Nusa Tenggara (NT) and

FIGURE ES3: Annualized consumption growth (by consumption percentile) became more pro-poor from 2011 onwards

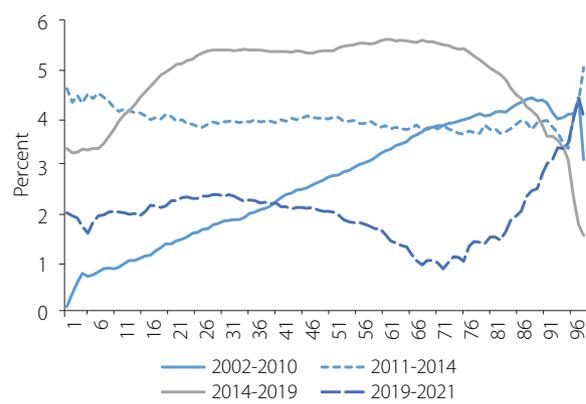


FIGURE ES5: Poverty rates across regions are converging, when using absolute poverty estimates

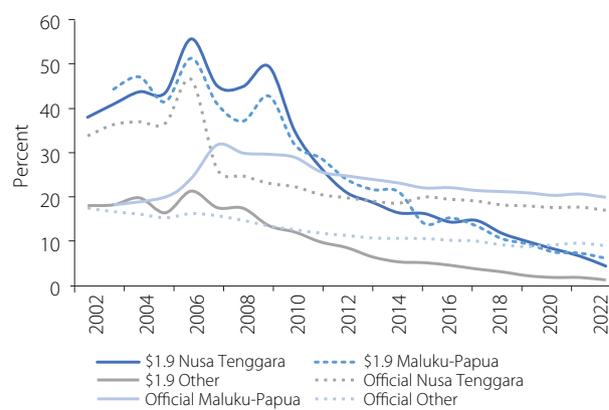
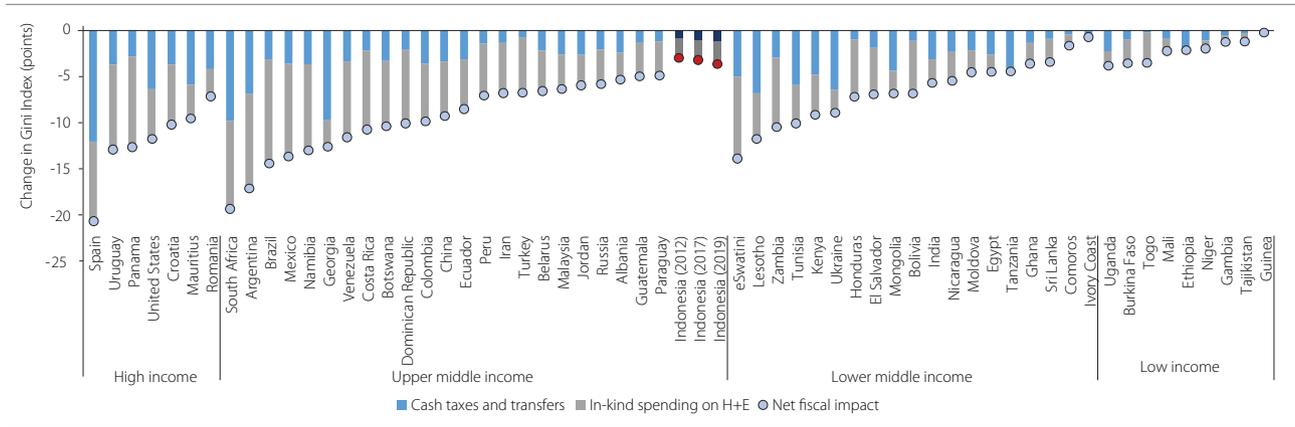


FIGURE ES6: Indonesia’s fiscal policies only have limited impact on inequality, especially compared to middle income countries



Maluku-Papua (MP), saw their poverty rates decline by 50 percentage points from around 80 percent in 2002 to below 30 percent in 2022, compared to a drop of about 40 percentage points in the remaining regions (Figure ES5). However, rural areas in Nusa Tenggara and Maluku continue to lag.

Fiscal policies contributed to reduce poverty and inequality, but low government revenue collection and costly subsidies reduce fiscal space and limit more pro-poor investments. Inequality decreased by around 3 points of the Gini coefficient through fiscal policies (Figure ES6). This is substantially less than the range of 5 to 15 points for most middle and high-income countries for several reasons. First, fiscal revenues are low relative to GDP compared to peers (Figure ES7). Second, agricultural subsidies are high and distort the market, without obvious benefits for the poor. Third, costly energy subsidies have re-emerged after a temporary

reduction, but with limited benefits for reduced poverty and inequality. Fourth, social assistance is more effective in reducing poverty (Figure ES8) but still insufficient to provide needed coverage and benefits despite its scale-up. Challenges in updating the targeting database increase inclusion and exclusion errors. Fifth, tight fiscal space led to under-investment in education and health, and—exacerbated by low administrative capacity of sub-national governments—hindered improvement in human capital outcomes and geographic disparities.

Low-productivity challenge

More than one-third of Indonesians remain at a such a low level of economic insecurity that a shock can push them into poverty. In 2019, 40 percent of Indonesians were economically insecure. Most of these households are non-poor but can fall into poverty when exposed to a shock. Economically insecure households can be forced to adopt adverse coping strategies, diminishing

FIGURE ES7: Indonesia’s government revenues relative to GDP per capita remains low, limiting space for investments

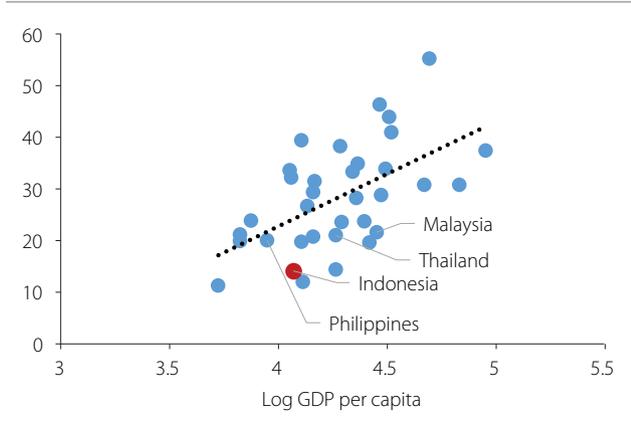
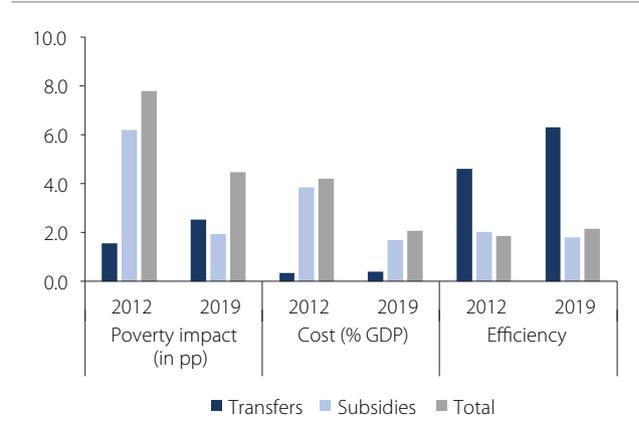


FIGURE ES8: Transfers are significantly more effective in reducing poverty than energy subsidies



their physical and human capital assets, which, in turn, reduces short and long-term productivity. They may also anticipate shocks and adopt conservative or risk-averse production and investment strategies, reducing their productivity even in the absence of a shock. Thus, regardless of whether adopted after or before a shock, adverse coping strategies reduce long-term productivity, which in turn lowers chances of securely escaping poverty.

Agriculture and low value-add (low-VA) services remained the most important drivers of poverty reduction, even though the work is often not very productive or sufficient to escape poverty. Agricultural incomes drove rural poverty reduction. However, many farmers remained poor as they were constrained to low-productivity subsistence and rice production. A distortionary set of incentives for agricultural producers and high prices for staples due to import restrictions contribute to slow diversification to higher value cash-crops, for which the soil might be more suited in some areas. Low-VA services played a key role in poverty reduction particularly in urban areas, with the share of workers rising in this sector. However, this work is often informal and low-productivity, with many workers remaining poor.

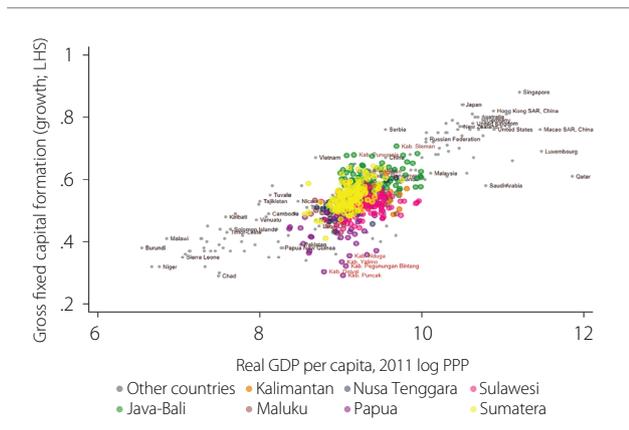
High-skilled jobs remain scarce in Indonesia, limiting pathways towards economic security. Some more productive opportunities were available—in manufacturing and high-VA services, for example. However, not enough workers had the right skills to take advantage of these opportunities. At the same time, the number of such high-skilled jobs – often found in manufacturing – remained well below expected levels relative to Indonesia’s development status. In fact, premature deindustrialization reduced the output share of manufacturing from 48 percent in 2002 to 41 percent in 2019 while the service sector expanded from 36 to 46 percent. While service-led development is possible, the increasingly inward-looking economy missed out on productivity increases from global value chain integration and export competition. Productivity of services dropped from an average of 4.0 percent from 2000 to 2013 to 1.7 percent from 2014 to 2019 as growth of low-VA outpaced high-VA service jobs (Figure ES10).

This absence of a productivity-increasing structural transformation undermines Indonesia’s potential, not only in sustainably reducing poverty and economic insecurity, but also in economic growth.

Low urban migration limits productivity gains as fewer workers can take advantage of positive agglomeration forces. Urban areas in Indonesia gained more productivity from agglomeration forces than from more productive workers moving to urban areas. The official Indonesian urbanization trend is largely due to change of classification as rural areas increased density to become more urban, rather than rural households moving to urban areas. Nevertheless, urbanization is, and will remain, an important force. Even though urban areas offered most higher-productivity work, such as in manufacturing and high-VA services, the number of such opportunities was insufficient. In addition, urban areas suffered from high cost of living (due to housing costs), traffic congestions undermining urban connectedness, and high air pollution. Thus, urban areas were not able to attract more workers, hence limiting further agglomeration gains. This also limited their spill-over effects into nearby rural areas, providing fewer opportunities for diversification from agriculture.

Many women remained excluded from the labor force, constrained by cultural norms and home care responsibilities, thus limiting livelihoods opportunities for households. While above 80 percent of men (although on a slowly decreasing trend) are in the labor force, only about 50 percent of women are either employed or looking for work. Cultural norms played an important role, translating into labor market discrimination. Women earned less than men, driven by a specific “female effect”. They also had care responsibilities for dependent household members, limiting their participation in the labor force. This explains a persistent small gender poverty gap, especially for women around child-bearing age. While caring for household members is work, it is often a less remunerative activity than participating in the labor market. This limits livelihoods for households, and can make the difference between being poor, economically insecure, or economically secure.

FIGURE ES9: Indonesia’s human capital index is lower than peers, with some areas lagging far behind



Human capital outcomes in Indonesia are slowly improving but remain below peer countries, especially in the Indonesian provinces of Maluku-Papua and Nusa Tenggara, undermining productive potential of the population and exacerbating inequality. Access to basic education is nearly universal since 2015, except for Nusa Tenggara and Maluku-Papua, where primary school enrollment rates stagnated at around 80 percent. At the secondary level, enrollment rates between poor and non-poor converged but plateaued at a relatively low level of around 80 percent. Learning quality remains a concern, as the expected 12.4 years of schooling translates to only 7.8 learning-adjusted years. Indonesia’s maternal mortality rate, and other key health indicators, fluctuated and remained significantly higher compared to peers. Accordingly, Indonesia’s human capital index improved only slightly from 0.5 in 2010 to 0.54 in 2020; this means that a child born in Indonesia today would only

FIGURE ES11: COVID-19 affected consumption growth from 2020 to 2021 (shown by consumption percentile) in urban areas much more strongly than in rural areas

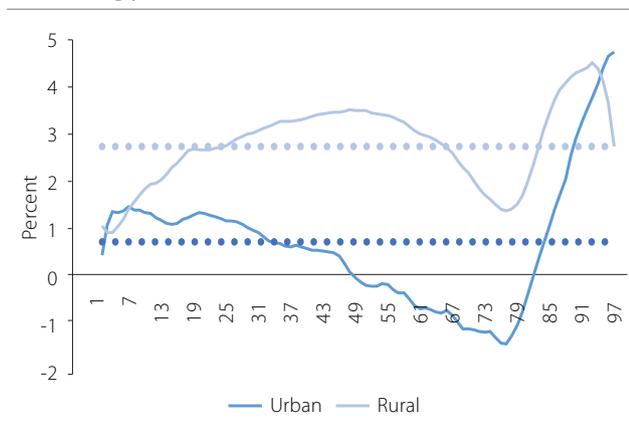
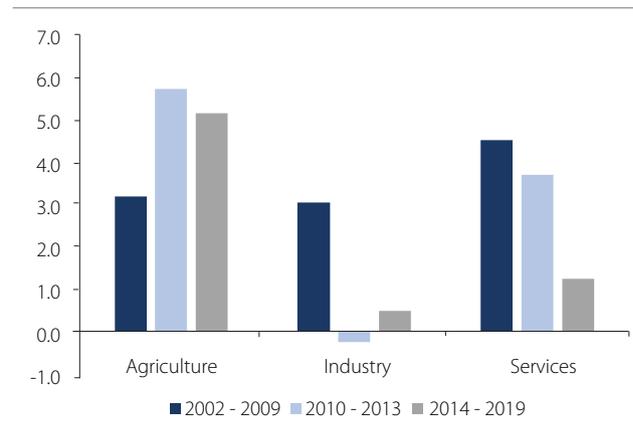


FIGURE ES10: Labor productivity growth is dropping especially in industry and services



be 54 percent as productive as if receiving full education and health. This is not only relatively low compared to Indonesia’s peers (Figure ES9), but also exhibits strong geographic disparities. Nusa Tenggara and Maluku-Papua, have worse outcomes, comparable to countries with significantly lower GDP per capita, a continued cause of inequality in the medium and long-term.

Shock challenges

Shocks, such as COVID-19, can threaten poverty reduction progress. The COVID-19 pandemic pushed Indonesia’s economy into a recession before rebounding in 2021. This provided a stark example of a severe shock affecting employment and health. It altered poverty reduction significantly, affecting better-off, but not the richest, households most, especially in urban areas (Figure ES11). The Government rapidly scaled-up social assistance, reaching more beneficiaries and increasing

FIGURE ES12: Share of social protection beneficiaries in March 2021, who received any benefit since the onset of the pandemic

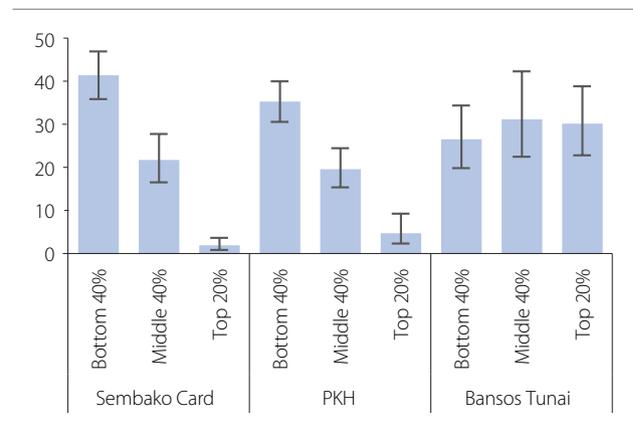
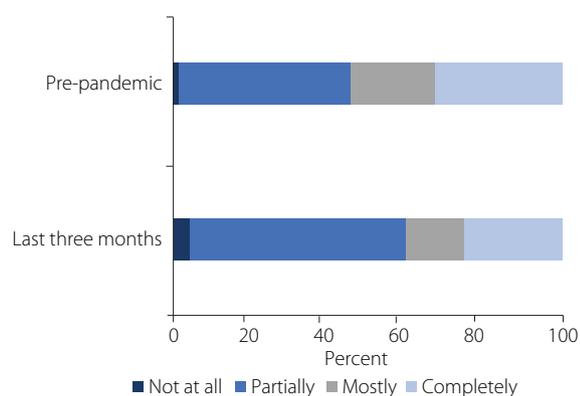
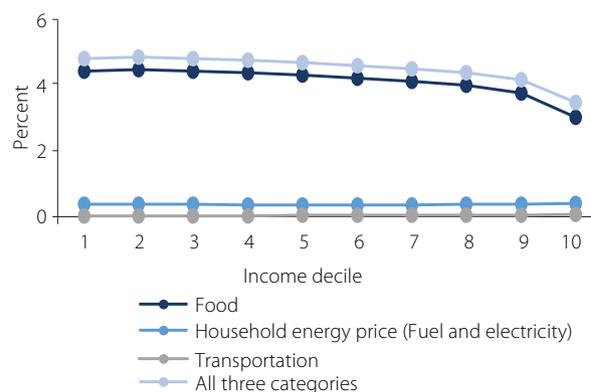


FIGURE ES13: Share of program beneficiaries assessing benefits as adequate

the level of benefits. However, not all households in need received benefits, nor were benefits always adequate. Even among the bottom 40, less than 40 percent received benefits from the expanded social assistance programs (Figure ES12). Less than half of program beneficiaries self-assessed the benefits of current programs as adequate at the time of the COVID-19 pandemic (Figure ES13). Also, the social insurance program did not manage to protect all workers. In particular, informal workers often neither had no access to sick leave nor were not eligible for government unemployment insurance.

Climate change is expected to increase the frequency and severity of natural shocks, which can trap poor households into poverty and push economically insecure households back into it. Between 1990-2021, Indonesia experienced more than 300 natural disasters, including 200 floods, affecting more than 11 million people. Climate-related disasters already accounted for around 70 percent of the total number of disasters from 1990 to 2021. Although climate change affects the whole population, the poor and economically insecure are likely to carry a disproportionate burden. They rely more often on agriculture, which is particularly negatively affected, and they often live in areas prone to risk without resources to protect assets and less savings to recover.

Climate change mitigation will particularly harm workers in carbon-intensive industries if they are not protected. Alongside Indonesia's development over the

FIGURE ES14: Increase in prices in the first half of 2022 significantly deteriorated purchasing power, but less for richer households

last decades, its greenhouse gas (GHG) emissions rose sharply, making Indonesia the seventh largest emitter in the world. Indonesia is the world's largest coal exporter, with coal exports representing 2 percent of GDP, or 13 percent of total goods exports. In 2021, the Government committed to substantial reduction of GHG emissions and reaching net-zero emission by 2060. Phasing out coal will particularly affect coal-producing communities, with coal mining workers representing 0.2 percent of total formal employees in 2018. However, a larger number of coal workers are informally employed. With coal mining concentrated in specific areas and communities, phasing-out coal will directly decrease employment in mining but also indirectly through firms depending on coal mining and their workers.

Combined with global uncertainties, such as Russia's invasion of Ukraine, these risks threaten poverty reduction progress in Indonesia if households are not protected. The war in Europe has triggered high volatility in prices, especially for food and fuel. The purchasing power of households in Indonesia deteriorated (Figure ES14), mostly because of the increase in food prices and the large food share in consumption. At the same time, the Government kept fuel prices constant by implicitly increasing fuel subsidies, adding to fiscal strains given the larger budgetary needs. With insufficient access to social protection and financial services, poor and economically insecure households are less able to weather shocks and might have to resort to adverse coping strategies.

Pathways towards economic security

On the path to high-income, Indonesia's poverty reduction policies need to be broadened through a multi-pronged approach: **creating better opportunities, protecting households against poverty, and focusing fiscal resources on pro-poor investments, while promoting better information and evidence for decision making.** Given Indonesia's development and ambition, a broader definition of poverty, for example around the US\$ 3.20 2011 PPP poverty line, would be more adequate. Better opportunities are needed in rural areas, through higher agricultural productivity, as well as urban areas, by making cities engines of growth. Higher productivity growth in low-carbon sectors can boost incomes and reduce poverty, while taking advantage of digital opportunities. However, shocks are inevitable and will become more frequent with climate change, but resilience can be fostered to minimize their harm. With about one-half of the non-poor population susceptible to falling back into poverty, better resilience and protection are needed. These measures will require public investments in a fiscally tight space. Policies need to ensure cost-effective design while raising revenues and lift constraints to improve human capital equitably across the country. Finally, policy makers need to close remaining data and knowledge gaps to inform more effective policies.

Creating better opportunities

Policies can support the private sector to create better, higher-productivity jobs, in the context of climate change, the ongoing redesign of global value chains (GVCs), and digitalization. To continue reducing broad poverty and help households to reach economic security, better opportunities are needed. Enhanced agricultural productivity can provide better livelihoods for farmers and allow them to escape poverty. Urban areas need investments to allow them to become engines of productivity growth. Better opportunities in low-carbon sectors with high-productivity growth can boost incomes. Integration into global value chains provides opportunities for Indonesia to increase its productivity through competitiveness. Digitalization similarly provides opportunities, and Indonesia can take advantage of its growing digital economy. Finally, more affordable and high-quality childcare can create jobs and provide opportunities for women to join the labor force.

Increasing agricultural productivity can boost agricultural incomes. Enhanced agricultural productivity using climate-smart approaches can provide better livelihoods for farmers and allow them to escape poverty, which is particularly relevant for households in remote areas. For the two-thirds of poor, rural agricultural households, their work is insufficient to escape poverty given low productivity. Improving agricultural extension services and market access can boost agricultural productivity. Removing agricultural subsidies focused on food production can encourage farming of cash crops, often better suited for some soil conditions. Current subsidies are expensive and show little benefits. Removing food import barriers can also help, as they keep food prices high without helping poor farmers—since most are net consumers of food—while diverting resources from higher value crops.

Investing in urban infrastructure can unlock the potential of cities to act as engines of growth and amplify rural spill-over effects. Urban areas need investments to become engines of productivity growth. Nurturing a more meaningful structural transformation can create more opportunities for workers in urban areas. Investments in urban infrastructure can help lower the cost of living in urban places. Together, these make cities more attractive places to live. More workers moving to urban areas increase agglomeration forces, helping to unlock productivity gains. This also contributes to job creation in nearby rural areas, creating opportunities outside agriculture.

Better opportunities are needed in low-carbon sectors with high productivity growth to boost incomes and reduce poverty. Competitiveness policies, including less restrictive trade and foreign direct investment policies as well as more effective anti-competitive policies, can foster job growth, while eco industrial parks and circular economy solutions can lower the carbon footprint of high-productivity sectors. Integration into GVCs attracts foreign direct investment for exports and can increase productivity, especially in low-carbon sectors. The current global remapping of GVCs provides opportunities for Indonesia to bolster its integration, but this would require reversing increasingly restrictive trade policies

and opening the economy for external opportunities. Similarly, digitalization can provide opportunities but requires digital skills, connectivity, and a supportive policy environment. At the same time, workers need to be equipped with the right skill mix to prepare for new jobs; for example, policies must increase the level and quality of secondary and especially tertiary education and invest in technical and vocational trainings (TVET).

Offering affordable childcare can create jobs, foster female labor force participation, and improve productivity. With affordable childcare, women can shift from unpaid to higher-productivity work, improving labor market skills and firm productivity. Childcare helps close the gender wage gap, which is still substantial in Indonesia. Childcare creates jobs, and fosters early childhood learning, with long-term benefits for an economy's productivity.

Protecting against poverty

A combination of social assistance, social insurance, financial inclusion, and resilient infrastructure investments can help keep households out of poverty. Better opportunities are essential to sustainably lift households out of poverty and economic insecurity. However, social protection measures need to complement job creation to help poor households and to protect others from falling into poverty. Social assistance can be better targeted and be more comprehensive. A more agile social assistance system and expanded coverage of social insurance, including informal workers, are needed to improve household resilience against falling into poverty. Improved financial inclusion can help households smooth income shocks without resorting to adverse coping strategies. Investments in resilient infrastructure and climate-smart agricultural production are also important to limit the impact of shocks.

Scaling-up social assistance includes improving targeting and providing more adequate benefits. COVID-19 provided lessons on how to improve Indonesia's social assistance system. First, coverage of the targeting database can be expanded beyond the bottom 40 percent to include all households, to support swift and flexible expansion of targeting in the case of shocks. Second, targeting accuracy can be improved—

for example, through regular updating of the targeting database and calibrating eligibility criteria to reflect new poverty definitions. Third, adequacy of benefits can be improved. Such an improved social assistance system will better mitigate negative shock effects on households, who will therefore reduce the use of destructive coping strategies and be better able to make longer-term investments in higher-productivity activities.

Expanding coverage of social insurance to all workers can increase protection and productivity. In addition to social assistance, social insurance can help mitigate the impact of harmful shocks. Unemployment and health shocks are the most important household-level shocks, and unemployment and health insurance can provide protection. However, unemployment insurance is now only available to salaried, usually formal, workers in Indonesia. In addition, health shocks often have implications for labor incomes, due to lower productivity or unavailability to work because of sickness or care needs. Only formal workers have protection for these events currently. Thus, poorer households, who have less secure work, benefit the least from protection, not only making them susceptible to falling into poverty, but also limiting progress on inequality.

Including the poor in the digital financial system can play a critical role in creating shock resilience and reducing poverty. Many Indonesian households remain unbanked; even though financial inclusion has improved, half of all adults in the bottom 40 still did not have a bank account in 2021. The lack of an account reduces the ability to save, which can smooth consumption during a shock and replace lost assets. It also excludes households from receiving digital payments—for example, from government delivering social assistance quickly and efficiently in response to a shock. Including more households in digital financial services can foster resilience against shocks as a complement to social assistance and insurance. Establishing a well-functioning and fully interoperable payment system together with digital IDs and open banking policies can expand financial services and make them more attractive for households, ultimately contributing to increased resilience.

Investing in resilient infrastructure and climate-smart investments can reduce the harmful effects of natural disasters. Shocks from disasters put poverty reduction progress at risk. Although poor households are not necessarily more exposed to natural disasters, they are less resilient and, thus, suffer the most from shocks. For example, in areas affected by the September 2018 earthquake in central Sulawesi, over one in five households from the bottom 40 percent were still in temporary housing seven months later, compared to 13 percent of the top 20 percent. Climate change will also reduce expected agricultural yields due to changes in precipitation, temperature, and extreme weather events. Thus, investments in resilient infrastructure and climate-smart agricultural production are important to limit shock devastation in the first place.

Financing pro-poor investments

Increasing tax revenues and removing wasteful subsidies can create fiscal space to make pro-poor investments, while increased sub-national administrative capacity can improve public services. Investments in education, health, and social protection will require more financial resources than currently available. Tax revenues can be increased through a reduction of value-added tax (VAT) exemptions as well as excise taxes on tobacco, alcohol, and sugar-sweetened beverages, which will create beneficial health effects. A carbon tax can raise revenue and incentivize a shift to a low-carbon economy, while reducing air pollution. Removing distortionary subsidies—especially for energy and agriculture—can also create additional fiscal resources. A well-functioning social assistance system can mitigate the adverse effects on the poor from these measures, at a fraction of the cost of current policies. The additional fiscal resources from these measures could be redirected to finance pro-poor investments to create better jobs and alleviate poverty. In addition, improving the administrative capacity of sub-national governments would increase spending quality, especially in education and health, to improve human capital and attenuate geographic disparities.

Removing VAT exemptions and increasing taxes on alcohol, tobacco, sugar, and carbon can generate additional government revenue. A practical way to quickly increase VAT revenue is to eliminate exemptions and preferred rates for various goods and services. While these items often represent a greater share of poorer

household consumption, they are also consumed by richer households and usually in greater amounts. One-third of potential VAT revenues (0.7 percent of GDP) in Indonesia are lost through the current exemptions structure, enough to have funded the entire expanded social assistance budget in 2019. Tobacco, alcohol, and sugar-sweetened beverages have adverse health effects, with large cost implications for public health. Increasing tax on these goods will reduce their consumption, saving costs for the public health system while generating government revenue. Finally, a carbon tax can increase revenue while making investments in high-carbon sectors less attractive. This will help increase Indonesia's competitiveness—for example, with respect to exports to countries that levy import tariffs on high-carbon products, like the EU's carbon border adjustment mechanism. These reforms can hurt poor households, potentially reducing their income, but social assistance programs can compensate households. This would cost only a fraction of revenues gained but have a much larger effect on reducing inequality.

Removing energy and agricultural subsidies can raise further fiscal resources. Energy subsidies are costly and ineffective in reducing poverty and inequality. While an ambitious reform in 2015 started to reduce energy subsidies, social assistance was not scaled-up fast enough with sufficient compensation. This might have contributed to a political economy gravitating back to subsidies, which returned from costing 0.7 percent of GDP in 2016 to 1.7 percent of GDP in 2019. However, they reduced poverty only by 2.4 percentage points, as much as a core set of social assistance programs that cost only 0.4 percent of GDP. Social assistance is not only more efficient to reduce poverty but it is also strongly progressive in lowering inequality. Most fuel subsidies, on the other hand, are not well targeted and can even be regressive, while contributing to higher GHG emissions. The Government also spends 2 to 3 percent of GDP on agriculture, mostly on subsidies for agricultural products. However, subsidies are not well targeted to poor farmers, are largely ineffective, distort the agricultural market, and undermine agricultural productivity. Revisiting agricultural expenditures to enhance competitiveness and productivity can lead to large fiscal savings.

Increasing sub-national administrative capacity can improve quality of spending, service delivery, and human capital, while attenuating geographic disparities. Indonesia started to decentralize about two decades ago. Sub-national governments (SNGs) became responsible for about 40 percent of total government expenditures for service delivery in education and health. However, the quality of subnational spending is limited in both allocative and technical efficiency. Allocative efficiency suffers from misalignment of SNG resources, under-serving areas with higher poverty rates, thus exacerbating geographic disparities and worsening inequality. Technical efficiency is undermined by growing SNG budgets without improvement of service delivery outcomes. Improving administrative capacity, with a focus on the lowest-capacity SNGs, can improve

overall outcomes and make them more equitable, while helping overcome stark geographic disparities in non-monetary poverty.

Improving future policies

Strengthening official statistics to enable data use and close analytical gaps can help inform and improve policy design. Closing some important gaps can improve official statistics. For example, Indonesia needs to create an absolute poverty line and create an appropriate rural consumer price index (CPI). Use of Indonesia's impressive data collection can be increased by providing more open access to data. New challenges—such as the role of structural transformation and informality, and their implications for poverty—will need new policies based on new and better data and evidence.



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