WORLD BANK GROUP

IEP
INDONESIA
ECONOMIC
PROSPECTS

Unleashing Indonesia's Business Potential

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Table of Contents

CLICK THE SIDE BUTTONS TO GO TO THE SECTION YOU WISH TO READ.

LIST OF FIGURES, TABLES, AND BOXES

FIGURES

TABLE

BOXES

Preface

The Indonesia Economic Prospects (IEP) is a bi-annual World Bank report that assesses recent macroeconomic developments, the outlook, and risks, as well as specific development challenges for the Indonesian economy. In doing so, the IEP aims to inform the public policy debate and is geared towards a wide audience, including the general public, the government, the private sector, civil society organizations, and other domestic and international stakeholders.

The IEP is a product of the World Bank Jakarta office and receives strategic guidance from an editorial board chaired by Satu Kahkonen, former Country Director for Indonesia and Timor-Leste, and from Carolyn Turk, Country Director for Indonesia and Timor-Leste. The report is prepared by the Macroeconomics, Trade and Investment (MTI) Global Practice team, under the guidance of Lars Christian Moller (Practice Manager), Cecile Thioro Niang (Practice Manager) and Habib Rab (Lead Economist). The report is co-led by Wael Mansour (Senior Economist), Csilla Lakatos (Senior Economist), and Alexandre Laure (Senior Private Sector Specialist).

Deviana Djalil provided administrative support and coordinated the organization of the report launch event. The dissemination is organized by Gb Surya Ningnagara, Jerry Kurniawan and Maulyati N. Slamet under the guidance of Lestari Boediono Qureshi. The report was designed and typeset by Arsianti.

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Part B was prepared by Alvaro Gonzalez (Lead Economist), Alexandre Laure (Senior Private Sector Specialist), Aufa Doarest (Economist), and Agnesia Adhissa Hasmand (Private Sector Specialist). Part B summarizes findings from an extended World Bank team for the Indonesia Investment and Competitiveness Program of the Finance, Competitiveness, and Innovation (FCI) global practice. Part B benefited from the comments of Habib Rab (Lead Economist), Francesco Strobbe (Lead Financial Sector Economist), Wael Mansour (Senior Economist), and Csilla Lakatos (Senior Economist). Inge Susilo (Program Assistant) provided administrative support.

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Previous report editions:

- December 2023: Climate Action for Development
- June 2023: The Invisible Toll of COVID-19 on Learning
- December 2022: Trade for Growth and Economic Transformation

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Abbreviations

ADR	Alternative Dispute Resolution
AHU	Administrasi Hukum Umum
AMDAL	Analisa Dampak Lingkungan
ARA EMARA	Assessment of Reserve Adequacy for Emerging Markets
APBN	Anggaran Pendapatan dan Belanja Negara
ASEAN	Association of Southeast Asian Nations
BI	Bank Indonesia
BKPM	Badan Koordinasi Penanaman Modal
BPS	Badan Pusat Statistik
BOS	Bantuan Operasional Sekolah
BOP	Balance of Payment
Bulog	Badan Urusan Negara
CAD	Current Account Deficit
CAR	Capital Adequacy Ratio
CIT	Corporate Income Tax
CPI	Consumer Price Index
EMDE	Emerging Market and Developing Economy
EMBI	Emerging Markets Bond Index
EAP	East Asia Pacific
FDI	Foreign direct investment
FX	Foreign Exchange
GDP	Gross Domestic Product
GEC	Global Export Consortium
GOI	Government of Indonesia
GRP	Good Regulatory Practice
GVC	Global Value Chains
HHI	Herfindahl Hirschman Index
IEP	Indonesia Economic Prospects
IFC	International Finance Corporation
IMF	International Monetary Fund
INA	Indonesian Investment Authority
IT	Information Technology
JCOL	Job Creation Omnibus Law
JKK	Jaminan Kecelakaan Kerja
JKM	Jaminan Kematian
JKN	Jaminan Kesehatan Nasional
KBLI	Klafisikasi Baku Lapangan Usaha Indonesia
KKPR	Kesesuaian Kegiatan Pemanfaatan Ruang
LAR	Loan at Risk
LCR	Liquidity Coverage Ratio
LHS	Left Hand Side
MSMEs	Micro, Small and Medium Enterprises
MoF	Ministry of Finance
NBFI	Bank Financial Institutions
NIB	Nomor Identifikasi bisnis/Business Identifcation Number
NFA	National Food Agency
NPL	Performing Loans
NSFR	Net Stable Funding Ratio
OECD	Organisation for Economic Co-operation and Development
OMO	Open Market Operation
OPEC	Organization of the Petroleum Exporting Countries
OSS	Online Single Submission
PBG	Persetujuan Bangunan Gedung
PKH	Program Keluarga Harapan
Posyandu	Pos Pelayanan Terpadu
Puskesmas	Pusat Kesehatan Masyarakat
Pustu	Puskesmas Pembantu
REER	Real Effective Exchange Rate
RHS	Right Hand Side
ROA	Return-On-Assets
ROE	Return-On-Equity
RPDR	Regulatory Policy and Delivery Review
RRR	Reserve Requirement Ratio
Sakernas	Survei Angkatan Kerja Nasional
SBN	Surat Berharga Negara
SIUP	Surat Izin Usaha Perdagangan
SIMBG	Sistem Informasi Manajemen Bangunan Gedung
SLF	Sertifikat Laik Fungsi
SPHP	Stabilisasi Pasokan dan Harga Pangan Program
SRBI	Sekuritas Rupiah Bank Indonesia
Susenas	Survei Sosial Ekonomi Nasional
SVBI	Sekuritas Valas Bank Indonesia
TDP	Tanda Daftar Perusahaan
TFP	Total Factor Productivity
THL	Tax Harmonization Law
THR	Tunjangan Hari Raya
TPAF	Tax Policy Assessment Framework
VAT	Value-Added Tax
WBES	World Bank Enterprise Survey
Yoy	year-on-year

Executive Summary

Table of Contents
Executive Summary
A.1. Recent Economic Developments
A.2. The Policy Stance
A.3. Structural Trends
A.4. Outlook and Risks
A.5. Policy Priorities
B.1. Introduction
B.2. Performance of the Private Sector
B.3. Tackling Regulatory Uncertainty, the Next Challenge
B.4. Takeaways and Policy Recommendations

Executive Summary

I. Economic Update

At 5.1 percent in Q1-2024, GDP growth remains resilient surpassing the middle-income countries' average. Robust private consumption accounted for 57 percent of GDP growth. This reflects consumer confidence supported by softening inflation in non-food products, the hike in civil servant wages, and robust performance in consumer services. Public consumption rebounded in Q1-24 driven by election-related and social spending. This rebound outweighs the negative contribution to growth of net exports as weak global demand and commodities price volatility have dampened exports earnings.

Inflation accelerated again in 2024, after dipping throughout 2023, driven by persistent pressures from food prices. Headline inflation rose to 2.8 percent yoy in May but remains within Bank Indonesia's target of 2.5±1 percent. Adverse climate conditions reduced domestic rice harvests and affected food prices more broadly. The government had stepped up efforts to curb food inflation by increasing the quota for rice imports for 2024 to 4.1 million tons (up from 3.1 million tons in 2023) and extending the rice aid program to June. Price stabilization policies such as rice price ceilings imposed by the National Food Agency had unintended consequences, compounding temporary supply shortages. Meanwhile, fuel subsidies have stabilized transport fares and eased administered services inflation to 1.0 percent yoy.

The fiscal stance expanded slightly amid rising social spending and subsiding commodity windfalls. The budget posted a small surplus of 0.1 percent of GDP in Q1-24. Fiscal revenues declined by 4.2 percent yoy as commodity windfalls subsided and economic activity moderated. Tax efficiency challenges have reduced the revenue gains from the previous VAT rate hike. Meanwhile, spending grew by 18 percent due to a rise in personnel and material spending as the GoI boosted social assistance to mitigate the effects of El-Nino climate patterns on food prices. Pressures on energy subsidies are re-emerging amid geopolitical tensions, which raises international oil prices, and currency depreciation. Increasing spending pressures coupled with rising interest payments could crowd out priority and pro-growth spending, such as public investment. Nevertheless, public debt declined to 39 percent of GDP, with most of the debt stock in domestic currency (72 percent) and with maturities above one year (88 percent), reducing currency and rollover risks.

Bank Indonesia maintained a "tight interest rate, loose macroprudential" policy mix to strike a balance in supporting the currency and macroeconomic stability. In April 2024, BI raised its policy rate by 25 bps, bringing it to 6.25 percent—the highest since 2016. The rate hike came as delays in anticipated policy rate cuts in advanced economies triggered notable portfolio and other investment outflows causing currency pressures in many emerging markets, including Indonesia. This situation was compounded by rising domestic demand for foreign currency. To soften the impact on the economy, BI is using macroprudential incentives to support credit growth. This includes expanding the coverage of Reserve Requirement Ratio discounts to specific sectors. The expanded liquidity incentives are estimated to boost private sector credit by an additional 1.6 percent by the end of 2024.

Going forward, the economy is expected to benefit from a pick-up in public consumption and investment but will face headwinds, notably from worsening terms of trade. GDP growth is projected to average 5.1 percent over the period 2024-26. Consumption will continue to drive growth, supported by a pick-up in public consumption as new social spending programs from the incoming administration take effect. Headline inflation is expected to remain stable, averaging 3 percent in 2024 and 2.9 percent thereafter, well within BI's target band but facing upward pressure from food an energy prices. With increased social spending and public investment, the fiscal deficit is expected to be higher but remain within the 3 percent rule. The external position is expected to remain challenging due to sluggish recovery in global trade and financing pressures. The current account deficit is projected to gradually widen and reach 1.6

percent of GDP by 2026, as lower commodity prices and global uncertainty hamper exports. The outlook is subject to multiple downside risks. High interest rates could weigh on borrowing costs and tighten access to external financing, raising public debt servicing costs. External shocks such as a potential intensification of armed conflicts or geopolitical uncertainty could result in a sharper-than-expected decline in the terms of trade, resulting in lower revenues and a tighter fiscal position.

Social spending packages planned under the upcoming five-year economic program have the potential to enhance human capital formation within a sustainable fiscal framework. A gradual implementation of the programs coupled with tax reforms, which could bring yearly additional revenues of 1-1.5 percent of GDP, would help the government adhere to its fiscal rules. Those rules have helped build a transparent and credible macroeconomic policy framework.

The authorities prudent and consistent macroeconomic policy framework has so far been a cornerstone of Indonesia's successful economic performance. Such management was acknowledged by the markets. For example, credit default swap rate and the JP morgan emerging market bond index (EMBI) spread for Indonesia have consistently fallen since the pandemic and are lower than several comparator countries. Credit rating agencies have also maintained investment grade for sovereign credit including stable outlook. As a result, this enabled the country to successfully navigate external shocks, attract investment, and boost growth.

In this context, reforms to boost domestic revenue mobilization remain a top priority. The implementation of the Tax Harmonization Law will support this effort. However, given a tax gap of 6 percent of GDP, additional reforms to broaden the tax base, enhance compliance, and reduce widespread informality among businesses will be important. Specific reforms could include lowering tax thresholds, removing tax exemptions that do not benefit the poor, and improving audit mechanisms to enhance compliance. In the medium-term, tax collection could also be improved through third-party data that helps track and verify incomes/revenues. Along with the need to boost revenues, improving quality spending is paramount particularly for social protection, health, and boosting human capital. This could be done by redeploying resources from less effective programs and subsidies, like energy subsidies, to spend on social protection that serves all Indonesians across their lifecycle. Existing systems such as the national health insurance could also be leveraged.

Beyond these short to medium-term cyclical issues, four structural challenges to growth are emerging and merit closer attention. In addition to maintaining macroeconomic fundamentals amid a more complex global environment, tackling these structural challenges will solidify development gains of the past two decade and ensure faster and more inclusive growth going forward.

First, a gradual increase in manufacturing concentration points to competitiveness challenges. The rising share of food and beverages combined with the expansion of several commodity-based industries have led to a narrowing base for economic growth and reduced diversification in the manufacturing sector. This could be a source of increasing vulnerabilities to sectoral downturns and the volatility of commodity prices. The marked expansion of basic metals and metal products industries accounted for one-third of manufacturing growth during 2021-23. Conversely, other priority industries have underperformed relative to their pre-COVID averages. Food and beverages—by far the largest contributor to manufacturing value added—slowed, while textiles and apparel, has faced with increasing challenges, including reduced export demand, and tightening import restrictions.

Second, despite robust growth overall, there is scope to accelerate subnational income convergence to sustain inclusion gains. Progress to reduce regional income inequalities since the 1990s slowed during the last decade. There has been also little improvement in the catch-up of other regions with Java-Bali. Further, the divergence in income per capita in Nusa Tenggara compared to the rest of the country, has been contributing to the growth inequality in eastern Indonesia. The slowdown in convergence of investment partly explains the distribution and dynamics of regional growth disparities, particularly when considering Java-Bali, which has been driving investment trends.

Third, post-pandemic labor market trends have slowed progress in reducing inequality after a decade of improving inclusion. Between 2015-19, Indonesia made important progress to ensure that

Table of Contents
Executive Summary
A.1. Recent Economic Developments
A.2. The Policy Stance
A.3. Structural Trends
A.4. Outlook and Risks
A.5. Policy Priorities
B.1. Introduction
B.2. Performance of the Private Sector
B.3. Tackling Regulatory Uncertainty, the Next Challenge
B.4. Takeaways and Policy Recommendations

gains from robust growth are more evenly distributed. During this period, growth increasingly favored the poorest half of the population and began reversing the trend of increasing inequality of the previous decade. For the top 10 percent, the pace of consumption growth fell by half, while doubling for the poorest 10 percent of people. In 2015, growth for the bottom half outpaced the top for the first time in a decade. A strong labor market, increasing returns to skills and a rise in wages in all sectors pushed the Gini Index down by nearly 4 points. However, in the aftermath of COVID-19 the Gini Index began to slowly rise again, now at 0.36. After accounting for inflation, median wages have yet to fully recover to their pre-pandemic levels.

Fourth, inclusive growth will require mobility to take on new jobs in higher productivity sectors, and in higher productivity places. Spatially, Indonesia is one of the least mobile countries in the world, and the trends are worsening. The internal migration rate between provinces was just 2.3 percent in 2023. This is lower than pre-pandemic, lower than the global average of 8 percent, and far from the frontier, which reaches 39 percent in some of the world's most mobile countries like Australia. Partially because of these trends, there has been no long-term convergence in welfare between Indonesia's island groups over the past two decades. Therefore, enabling mobility will be important to match workers with jobs and locations that offer higher earnings and improved standards of living.

As Indonesia navigates these complex economic dynamics, the next phase of growth will require a boost to private sector dynamism. Addressing structural challenges and leveraging potential growth areas is crucial for sustaining the progress made thus far. This calls for a strategic focus on enhancing productivity, improving regulatory frameworks, and ensuring inclusive growth. Central to this is the role of the private sector, which is poised to remain a significant driver of economic expansion and innovation. As such, the focus must shift towards unleashing Indonesia's business potential and fostering a robust and dynamic private sector capable of propelling the country towards high-income status.

II. Unleashing Indonesia's Business Potential

Indonesia stands at a critical juncture in its economic development, with the private sector poised to assume a more pivotal role in driving growth and innovation. To transcend its middle-income status, Indonesia must accelerate annual growth to more than 6 percent. This would require a productivity increase of 3 percent—one percentage point higher than recent averages. Attaining the ambitious goal of high-income status by 2045 demands a significantly more dynamic and productive private sector. This report examines the necessary pathways to fostering such a transformation by analyzing private sector dynamics, evaluating current performance, assessing the impact of regulatory reforms, and addressing the persistent challenges that lie ahead.

Indonesia's private sector is characterized by many small firms, but economic dominance of a few large firms. Indonesia's private sector is vast, home to 66 million businesses, of which 9 million are formally registered. It is predominantly composed of micro, small, and medium-sized enterprises (MSMEs), with a significant presence in wholesale and retail (54%), accommodation and food services (20%), and the processing industry (14.5%). On the other side of the size spectrum, the enduring dominance of giant firms sets Indonesia apart from peers like India, Mexico, the Philippines, and Türkiye. These industrial giants have played a significant role in Indonesia's development but have recently begun to exhibit slowing productivity growth.

Reforms to boost private sector development have been notable, but regulatory and productivity gaps still exist. Indonesia has been on a transformative journey since 2015, implementing significant economic reforms to enhance the business environment. Reforms such as the Job Creation Omnibus Law in 2020 and investment liberalization have yielded tangible improvements. Notably, establishing the Online Single Submission (OSS) system has harmonized business registration and licensing processes, significantly easing the operational burden for businesses through adopting a risk-based approach. Despite the strides made, the country's private sector grapples with significant challenges. Regulatory unpredictability and corruption persist as major hurdles, impeding smooth business operations. Objective measures indicate that access to finance and regulatory compliance costs are substantial productivity constraints. The perceived improvement in business licensing is overshadowed by the increased time required to meet regulatory requirements, posing a significant challenge for businesses.

The first challenge for Indonesian firms is to improve labor productivity. The performance of Indonesian firms, particularly in terms of labor productivity, lags that of firms in comparator countries. Labor productivity declined from US$7,530 per worker in 2015 to US$5,336 in 2023, partly due to the economic impacts of the COVID-19 pandemic. Indonesian firms also exhibit lower average sales and employment figures than those in Türkiye, Mexico, and India.

Potential growth had been declining due to weaker labor input, human capital formation, and productivity growth. While investment and labor previously fueled growth, the post-pandemic period has seen a moderation, with total factor productivity (TFP) particularly affected. TFP growth in the 2010s was half that of the 2000s. The decline in TFP and human capital aligns with lower labor productivity growth (see Indonesia Economic Prospects June 2023 for more details). These findings highlight the importance of improving private sector productivity to create jobs with rising labor productivity.

The second challenge is the market dominance of large firms exhibiting falling productivity growth. A significant feature of Indonesia's private sector is the pronounced firm size and performance inequality. A few large firms dominate the market, while most enterprises remain small and less productive. In the past 31 years, the top 5 percent of large manufacturing firms continue to accrue a disproportionately large revenue share. This is not necessarily a problem if firms are growing large through productivity gains that have strong multiplier effects across the economy through better jobs, supply chain linkages, innovation, and other spillovers.

Globally, larger firms, defined by annual sales, generate more employment. However, this relationship is notably weaker in Indonesia than in comparator economies. This suggests that sales growth in larger Indonesian firms does not translate into as much employment as in other economies. However, large Indonesian firms offer higher wages than their smaller counterparts, like trends observed in comparator economies. The analysis also finds that large Indonesian firms demonstrate inefficiencies in resource allocation, particularly in the employment of labor and capital resources compared to their market share. Unlike in comparator economies, such inefficiencies are less pronounced.

The third challenge lies in addressing the underlying uncertainty and bias in implementing regulations. Uncertainty results in discretion from enforcers of government mandates. Discretion leads to bribery and petty corruption, which continues to hamper firm productivity by diverting resources from investment and increasing operational costs. Large firms are better able to navigate these frictions due to higher financial and administrative resources. Large firms can afford specialized legal and compliance teams to interpret and adhere to regulations, mitigating compliance costs. In contrast, smaller firms often lack the resources and expertise to navigate constantly evolving regulatory landscapes, leading to comparatively higher compliance costs. This uncertainty also exposes all firms to corruption, which is more burdensome for smaller firms.

Enhancing regulatory consistency and fostering access to international markets are key to unleashing the potential of the Indonesian private sector and driving sustained economic growth. To enhance regulatory consistency, establishing a more predictable regulatory environment is crucial. This involves consistently applying rules across regions and sectors to reduce uncertainty and boost business confidence. Meanwhile, to foster Access to International Markets, easing access to global markets can enhance the competitiveness of Indonesian firms and make large firms more productive. Policies integrating local firms into global value and supply chains will require upgrades in technology, management, and, increasingly, greening production.

By addressing these key areas, Indonesia can create a more dynamic and resilient private sector capable of driving long-term economic growth and improving the quality of life for its citizens. The journey towards a more prosperous Indonesia requires sustained effort and a commitment to reform, ensuring that the benefits of economic growth are widely shared across all segments of society.

A. Economic Update

A. Economic Update

1. Recent Economic Developments

At close to double the world average, Indonesia's growth remained robust.

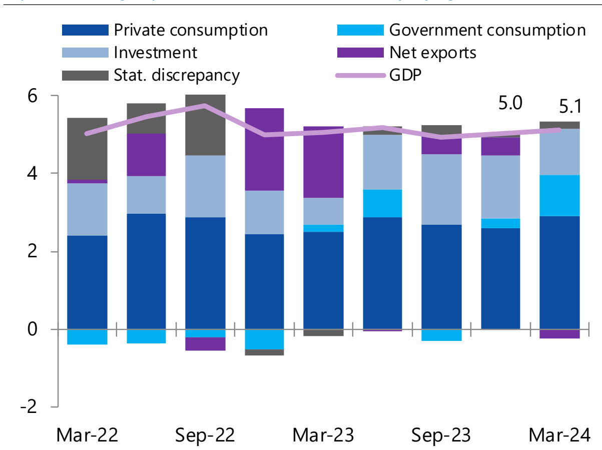
Despite steady recovery, global economic conditions remain challenging. Exceptionally weak global trade growth in 2023—the slowest expansion outside global recessions in the past 50 years—has been exacerbated by restrictive policies and fragmentation. Commodity prices, despite recent volatility, have fallen from their 2022 peaks. Nevertheless, geopolitical tensions have sustained pressure on the price of oil and other commodities even as global growth remained weak (World Bank 2024c). Delays in anticipated policy rate cuts in advanced economies have led to foreign capital outflows and the sharp depreciation of several emerging market and developing economy (EMDE) currencies.

Indonesia's GDP growth remains resilient. The economy grew by 5 percent in 2023 and by 5.1 percent in the first quarter of 2024 (Q1-24). This is close to double the world average at 2.6 percent and higher than the middle-income country average at 4.5 percent. As consumer confidence remained strong and supported by declining inflation, robust private consumption accounted for more than 60 percent of 2023 growth (Figure A.1). Public spending in 2023 was softened by delays in budget execution but accelerated in Q1-24 with increased election and social spending. Weak global demand and commodities price volatility dampened exports earnings and normalized commodity windfalls. The contribution of net exports to growth remained steady at 0.7 percentage points (ppts) in 2023 but turned negative in Q1-24. Capacity utilization has been increasing and averaged 73.6 percent in Q1-24, above the pandemic low of 69.1 percent (Figure A.2).

Inflationary pressures are re-emerging as climate conditions and supply bottlenecks impact food prices.

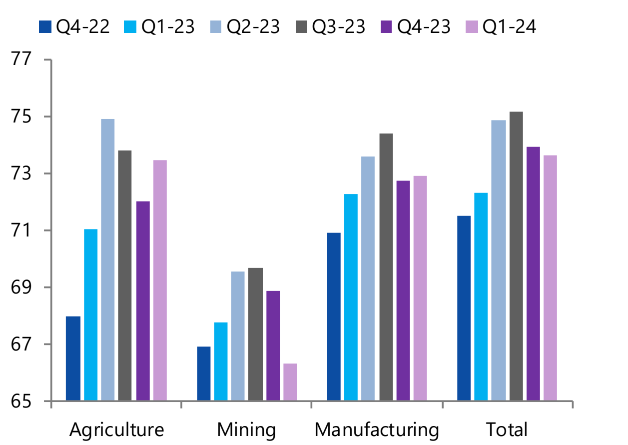
After decelerating in 2023, inflation picked up again in 2024 as pressure from food prices intensified. Headline inflation accelerated to 2.8 percent yoy in May (from 2.6 percent in January) but remained within Bank Indonesia's (BI) 2024 target band of 2.5 +/- 1 percent. The increase was driven by renewed pressures on food prices (Figure A.3). Basic food inflation rose by 8.1 percent yoy mirroring escalating prices of staple crops

Figure A.1: GDP growth remains solid, supported by strong private and public demand.
(percentage points contribution to yoy growth)



Source: BPS, World Bank staff calculations.

Figure A.2: Capacity utilization has been increasing
(percent of total capacity)



Source: BI, Business Activity Survey, World Bank staff calculations.

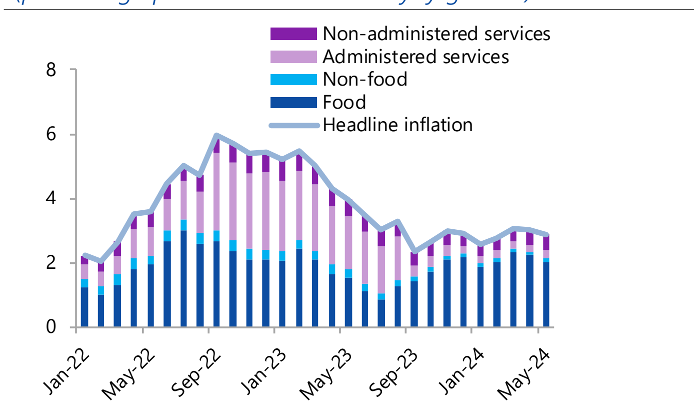
and basic food items like rice, chicken meat, and eggs, which were heavily impacted by climate shocks. Drier than normal conditions brought by the El Niño in 2023 reduced and delayed rice harvests in early 2024. This coincided with the cyclical increase in demand during Islamic festivals falling in March and April. Additionally, El Niño-induced drought reduced domestic corn production and raised corn farmgate prices in 2023 until the peak harvest season in April 2024, when prices started to decline again. This further caused a rise in the prices of poultry products which rely on corn for feed. The Rupiah depreciation also had adverse effects on imported food items including agriculture inputs. Meanwhile, fuel subsidies partially stabilized transport costs and kept administered services inflation to 1.0 percent yoy (from 0.8 percent in January) despite rising demand during holidays period. On the other hand, core inflation edged up to 1.9 percent yoy partly driven by a temporary consumption boost and the early disbursement of employees' holiday allowances. Overall, core inflation remains subdued and reflects a persistent, albeit closing, negative output gap.

Food inflation is at historical highs, partly due to policy challenges related to the domestic food value chains, particularly in rice. The government (GoI) stepped up efforts to curb persistent food inflation by increasing the quota for rice imports for 2024 to 4.1 million tons (up from 3.1 million tons in 2023) and extending the rice aid program to June.[1] Nonetheless, domestic food inflation remains high especially when compared to global and peer averages (Figure A.4). In addition to climate shocks, which considerably reduced domestic production for staple crops especially that of rice (down 17.5 percent in the first 4 months of 2024), price stabilization policies had unintended and adverse consequences. Price ceilings imposed by the National Food Agency (NFA) had compounded supply shortages as mills reduced production to avoid financial losses, and retailers faced challenges sourcing subsidized medium-grade rice.[2] Moreover, the GoI through BULOG—the state-owned food logistics company—prioritized the allocation of this subsidized rice to administer the rice aid program. As a result, temporary shortages were observed at the more regulated modern markets, while prices escalated at the mostly informal traditional markets. In response to shortages, the NFA had to relax the cap on mill and retail rice prices, from March till June,[3] and raised the import quota for other volatile food items such as garlic and corn.

Tight global monetary conditions are impacting Indonesia's external financing, triggering pressure on foreign currency reserves and the Rupiah.

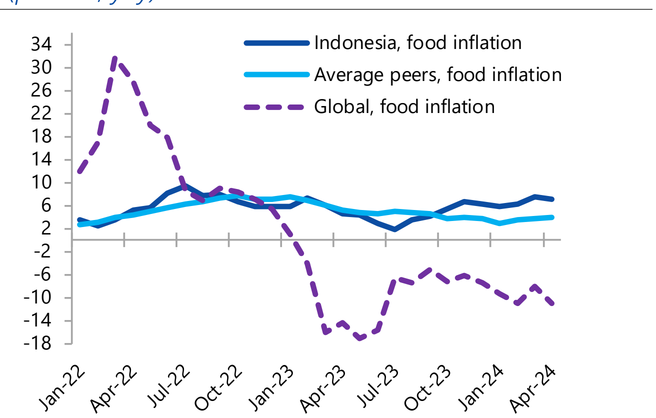
Global financial conditions remained tight as expectations of US policy rate cuts diminished. By the end of 2023, global markets anticipated that major advanced economy central banks would pivot from monetary tightening to easing. Subsequently, however, expectations around the pace and depth of policy rate cuts moderated. In the US, tight labor markets and fluctuating core inflation data have

Figure A.3: Headline inflation eased, but food price inflation remained strong…
(percentage points contribution to yoy growth)



Source: BPS, World Bank staff calculations.
Note: Administered services consist of housing, water, electricity, and fuels and transportation.

Figure A.4: …partly due to challenges in the domestic food supply chain, particularly in rice
(percent, yoy)



Source: FAO, World Bank Commodity Price Pink Sheet, World Bank staff calculations.
Note: Peer countries are Thailand, India, the Philippines, Malaysia, and Vietnam.

[1] In November 2023, the government announced the distribution of 10 kilograms of rice per month to the bottom 40 percent households.
[2] This changed though in March where BULOG started to distribute subsidized medium-grade rice to both traditional and modern retailers as part of the Price Stabilization Program (SPHP).
[3] In addition to rice, the NFA is also relaxing the retail reference prices for sugar, corn, eggs, and chicken meat until May 31.

prompted the Federal Reserve to push back against market expectations of aggressive rate cuts. Between December 2023 and May 2024, global markets went from pricing in six US Fed Rate cuts (each by 25 bps) in 2024, to only one. Global financial conditions have therefore tightened, leading to an increase in the yield of the 10-year US Treasury bills (T-bills) by 40 basis points (bps) year-to-mid-June (now at 4.5 percent). This prompted debt and equity portfolio outflows from EMDEs, with notable outflows and currency pressures in the East Asia region.

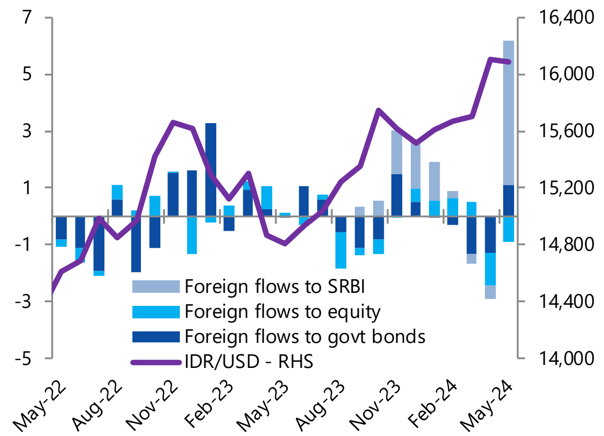
In tandem, there were notable portfolio and other investment outflows from Indonesia, as well as rising domestic demand for foreign currency (FX). Portfolio investment, which is particularly susceptible to shifts in short-term investor sentiment, recorded a net outflow of 0.5 percent of GDP in Q1-24, a reversal from the inflows of 1.4 percent of GDP in Q4-23. This trend accelerated in April, with non-resident investors offloading US$1.5 billion in Indonesian sovereign bonds, US$1.0 billion in equities, and US$0.7 billion in SRBI (BI's local currency securities) (Figure A.5). Outflows from Indonesia in March-April were larger than ASEAN EMDE peers (Figure A.6). Concurrently, Indonesia's yield spread against US T-bills has narrowed and has been below that of other EMDEs since mid-2022 (Figure A.7). The situation changed in May after BI raised its policy rate. In parallel, Indonesian residents have increased investment in money market instruments abroad, reversing "other investment" account from a surplus to a deficit of 1.3 percent of GDP. Pressures were compounded by an apparent rise in FX demand domestically. Corporations had to shore up their FX buffers ahead of the dividend and foreign debt payment season in Q2-24. Foreign Direct Investment (FDI), which picked up by 0.3 ppts reaching 1.8 percent of GDP in Q1-24, remains the largest source of external finance, partly offsetting pressures from short-term portfolio volatility.

Worsening terms of trade led to a widening current account deficit. The goods trade surplus narrowed to 2.9 percent of GDP in Q1-24, down 0.5 ppts from Q4-23, on the back of declining exports. This is mostly attributed to declining commodity exports, namely mining, reflecting delays in mining permit approvals and the decline of global commodity prices. While the Rupiah saw a relatively sharper nominal depreciation, the real effective exchange rate (REER)[4] weakened modestly compared to Asian peers (Figure A.8). The simultaneous depreciation of several trading-partner currencies against the US Dollar partly explains why the weaker Rupiah did not correspond to increased competitiveness of Indonesia's exports. Tourism receipts benefitted and posted the largest surplus since the pandemic (at 0.3 percent of GDP). Indeed, foreign tourist arrivals in Q1-24 rose by 25.4 percent yoy, with a monthly average of 1 million tourists—close to the pre-pandemic average of 1.3 million. As a result, the services trade deficit moderated to 1.3 percent of GDP. Meanwhile, the income account remained unchanged at 2.2 percent of GDP (broadly, the same level since 2018). As a result, the Q1-24 current account deficit (CAD) widened by 0.3 ppts and recorded -0.6 percent of GDP (Figure A.9).

Worsening external conditions have pressured BI's foreign currency reserves and the Rupiah, but the impact softened after the central bank hiked its policy interest rate. With CAD and portfolio outflows deteriorating, BI's FX reserves dropped rapidly by US$4.2 billion in April. Using the assessment of reserve adequacy for emerging markets (ARA EM) methodology,[5] Indonesia's ratio of reserves to ARA EM metric recorded 1.1 by end-2023. While this is within the [1.0-1.5] band recommended by the IMF, the ratio is among the lowest of ASEAN peers (Figure A.10). Outflows have also pushed the Rupiah to multiyear lows, crossing the exchange rate of 16,200 per US$ in April. This prompted BI to react and raise the policy interest rate in April, spurring significant portfolio inflows in May (Figure A.5). As a result, FX reserves was up by US$2.8 billion, and it now covers 6.3 months of imports. The Rupiah temporarily improved thereafter, but overall, it depreciated by 6.0 percent year-to-mid-June. The Rupiah's depreciation is deeper than the depreciation of JP Morgan's EM Currency Index at 4.5 percent during the same period.

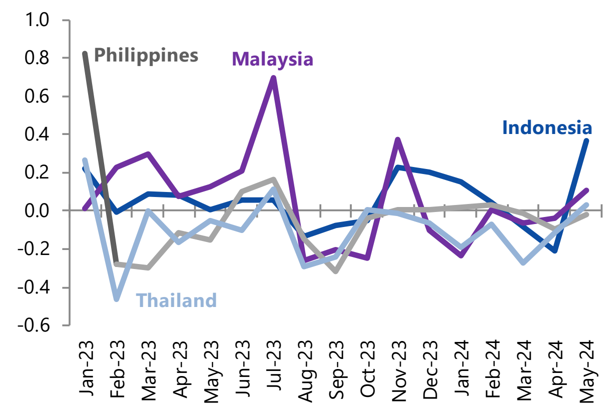
[4] REER is measure of the Rupiah against a trade-weighted basket of currencies after adjusting for inflation.
[5] ARA EM metric, developed by the IMF, gauges the adequacy of international reserves. The ratio of reserves to ARA EM metric depicts the coverage of a country's FX reserves against four potential drains on the BoP: export income, broad money, short-term debt, and other liabilities. In general, ratios in the range of 1.0 – 1.5 of the metrics are considered broadly adequate for precautionary purposes (IMF, 2023).

Figure A.5: April saw the largest capital outflows in the past two years
(LHS: US$ billion; RHS: IDR/US$)



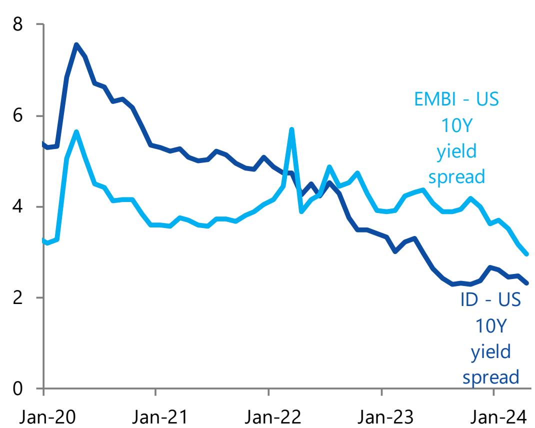
Source: BI, IDX, MoF, World Bank staff calculations.

Figure A.6: Portfolio outflows were larger than those observed in ASEAN EM peers, but situation revered in May after BI policy rate hike
(portfolio outflows in percent GDP)



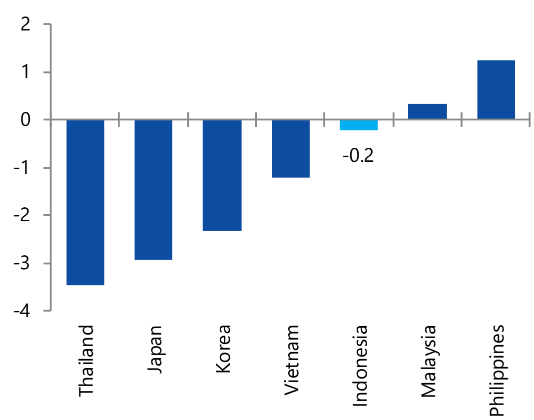
Source: IIF, BI, IDX, World Bank staff calculations.

Figure A.7: Indonesia's sovereign yield spread against the US is narrower than for EM peers
(percentage points)



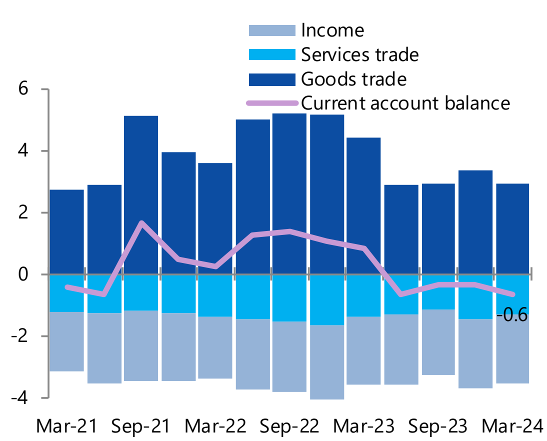
Source: JP Morgan, CEIC, World Bank staff calculations.
Note: EMBI is JP Morgan Emerging Market Bond Index yield.

Figure A.8: The Rupiah depreciated modestly in real effective terms among regional peers
(percent change, year-to-April)



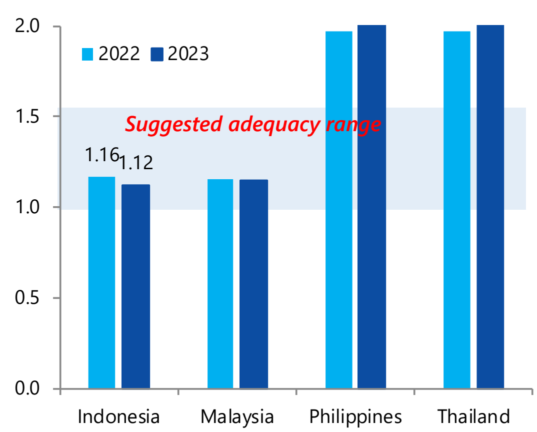
Source: JP Morgan Real Effective Exchange Rate, CPI based (2010=100), Haver Analytics, World Bank staff calculations.
Note: Downward movement represents a depreciation.

Figure A.9: The current account deficit widened due to narrower surplus in goods trade
(percent of GDP)



Source:BI, CEIC, World Bank staff calculations.

Figure A.10: Indonesia's ratio of reserves to IMF's ARA metric was the lowest among peers
(ratio, at end of the year)



Source: IMF Assessment of Reserve Adequacy, April 2024.

Banking sector vulnerabilities remain low, liquidity buffers adequate, and profitability strong thanks to growing lending to the private sector.

Bank asset quality is healthy, and banks have adequate buffers to withstand potential adverse shocks. System-wide non-performing loans (NPL) ratio remains low at 2.3 percent as of March 2024 (Figure A.11). The capital adequacy ratio (CAR) stood at 26 percent, well above the regulatory minimum of 10.5 percent, and the level of provisioning was at 206 percent of NPLs, providing ample loss-absorption capacity. Notably, the system-wide loan at risk (LAR) ratio[6] continued to trend down to only 11.1 percent as of March, much lower than its levels of over 20 percent during COVID-19.[7] Although a very limited set of forbearance measures have been extended until March 2024, with no further extensions, any vulnerabilities that remain hidden are contained and unlikely to be systemic for the overall banking system. However, the transfer of credit risks via credit insurance to the non-bank financial institutions (NBFI) sector warrants close monitoring. Efforts to reduce information asymmetry between banks and insurers and facilitate better pricing of risks would be beneficial.

Banking sector profitability remains stable, as strong lending growth rates continue to support the economy. As of March 2024, return-on-assets (ROA) and return-on-equity (ROE) stood at 2.6 and 14.6 percent, respectively, surpassing pre-pandemic levels. The banking sector continues to expand lending to the private sector. After two and a half years of growth, lending to the private sector expanded by 12.4 percent yoy in March (Figure A.12), albeit at a slower pace as credit-to-GDP ratio has seen some decline. Moreover, the growth of loans used for investment and working capital has outpaced the growth of loans used for consumption. As of February, lending to micro, small and medium enterprises (MSMEs) stood at IDR1,468 trillion (6.5 percent of GDP) and accounted for 20.3 percent of all bank lending. This is an increase from the lower baseline of 18 percent during COVID-19 and marks an improvement in financial inclusion for the underserved segments of the economy.

System-wide funding and market liquidity are still ample with BI conducting regular liquidity management operations to balance different policy objectives. Funding liquidity impacts the banking sector's ability to repay deposits and other short-term liabilities. Market liquidity refers to the ability of the banking sector to sell assets in a timely fashion without a significant loss. The liquidity coverage ratio (LCR) and the net stable funding ratio (NSFR), designed to gauge bank liquidity conditions in times of stress, stood at 219 and 134 percent respectively, as of March 2024. Both are above the 100 percent regulatory minimum. While the loan-to-deposit ratio remains stable at 84 percent, the liquid asset-to-deposit and short funding ratio has seen a consistent decline since mid-2021, in part due to the growth of deposits during the commodity boom. As of March 2024, it stood at 17.8 percent, below EAP peers' average and lower than 24-27 percent during the pandemic. Taken together, these developments indicate that funding and market liquidity remain ample as BI conducts regular open market operations to drain excess liquidity and maintain an appropriate balance in the market following the end of "twist operation" in September 2023. The decline in the liquid asset ratio, while largely reflecting banks' continued willingness to lend instead of hoarding excess liquidity, warrants close monitoring of potential funding stress in the case of an adverse shock. Ensuring adequate liquidity support for the growing NBFI sector also requires attention as it will impact market development for this segment of the financial sector.

Borrowing costs and domestic funding conditions remain relatively stable due to largely contained risks, although funding costs are elevated relative to peers due to structural factors. Corporate bond issuance activities were subdued in every month of 2023 compared to the same period in 2022, with issuance totaling IDR830 million throughout 2023, and remains weak in Q1-24. Corporate borrowing costs remained stable, as the 10-year AA corporate bond yield stood at 8.9 percent in April 2024. Ten-year sovereign yield remained manageable at 7.1 percent in April following a rise in non-resident holding of government debt in 2023 for the first time since the pandemic. The capital market still lacks depth, with limited secondary trading, relative to global and regional peers and Indonesia's own economic growth. The lack of local long-term investors constrains market development and contribute to higher cost of borrowing relative to some ASEAN peers and emerging market peers.[8]

[6] LAR is a forward-looking indicator of bank asset quality defined as the sum of NPLs, restructured loans, and special mention loans.
[7] The nine largest banks saw a LAR level exceeding 20 percent between 2021-2022 but all have since seen continued improvement.
[8] Peer countries with lower cost of borrowing relative to Indonesia, after controlling for other factors, include Malaysia. Thailand, the Philippines, Vietnam, as well as global peers such as Colombia, Hungary, Peru and Mexico. See Buzas et al (2021).

Figure A.11: Banks have adequate buffer to withstand potential adverse shocks
(percent)

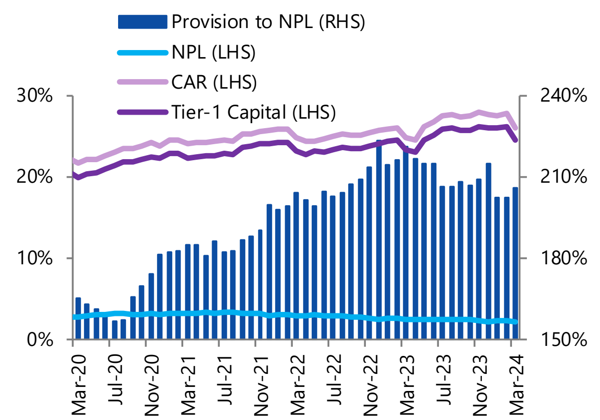
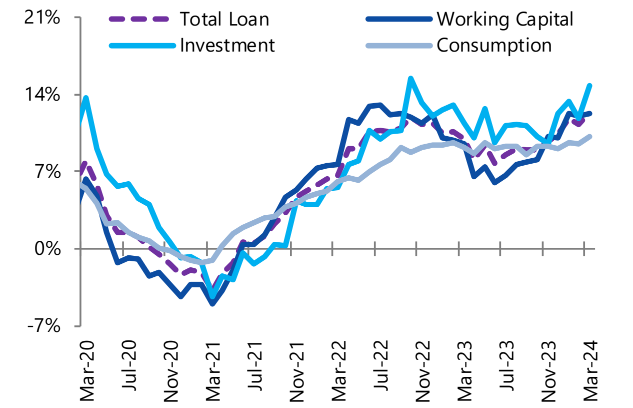


Figure A.12: Lending to the private sector expanded in March
(percent, yoy)



Source: OJK, World Bank staff calculations.

2. The Policy Stance

Fiscal policy has expanded amid a combination of rising social spending, debt service obligations, and subsiding commodity windfalls.

After two years of fiscal consolidation, the fiscal stance loosened slightly. The fiscal accounts posted a much smaller surplus in January to April of 2024 (4M-24) compared to the same period in 2023 (Figure A.13). Government revenues declined by 7.7 percent yoy as the effect of commodity windfalls subsided. At the same time, spending grew by 10.9 percent due to rising primary expenditures (notably personnel and material spending) as the GoI boosted social assistance to mitigate the effect of El-Nino on food prices. Meanwhile, net financing needs stood at 0.3 percent of GDP in April, the smallest in ten years for similar periods.

Revenues were impacted by subsiding commodity windfalls. January to April revenues stood at 4.1 percent of GDP, down from 4.8 percent of GDP a year earlier, explained mostly by the decline in natural resource revenues and tax revenues (Figure A.14). The drop in tax revenues was mostly attributed to Income Tax and VAT, as domestic demand softened and commodity prices gradually declined. The government cited higher tax refunds as companies overpaid their taxes based on estimated revenues but then requested refunds due to worse-than-expected business performances.[9] Among non-tax revenues, natural resource revenues contracted the most, particularly in the oil sector, as several oil fields depleted.[10]

Tax efficiency challenges have reduced the revenue gains from the VAT rate hike. Since the implementation of the Tax Harmonization Law (THL) in April 2022, VAT collection rose to 3.5 percent in 2022 and further to 3.7 percent in 2023. This increase can be partly attributed to the VAT rate hike as well as the commodity price boom, which boosted domestic income and resulted in higher VAT collection. Indeed, the commodity-led income boost has offset the decline in demand that typically accompany a VAT hike due to rising prices. Estimates suggest that the absolute effect of the rate hike on VAT revenues was only 0.3 and 0.4 percent of GDP in 2022 and 2023, respectively.

Growth in total government spending accelerated. Total spending rose to 3.8 percent of GDP in 4M-24, slightly higher from 3.7 percent in 4M-23. Personnel and material spending as well as interest payments were the largest contributors (Figure A.15). Personnel spending rose significantly following an 8 percent increase in civil service salaries and the early disbursement of Eid allowance (*Tunjangan Hari Raya*/THR) in March. Material spending also picked up mostly due to the disbursement of the school operational assistance (*Bantuan Operasional Sekolah*/BOS) and spending related to election preparation (APBN Kita, May 2024). Interest payments stood broadly unchanged at 0.7

[9] Low commodity prices drag down state revenue, The Jakarta Post, March 25, 2024 (limited access)
[10] APBN Kita, March 2024.

percent of GDP, despite the depreciation of the Rupiah. Meanwhile, the GoI maintained the cash transfer and rice aid programs to mitigate the impact of rising food prices and announced an extension of the assistance to June 2024. As a result, social protection spending is expected to be 7.8 percent higher than the initial budget allocation for 2024 (Figure A.16).[11] In anticipation, MoF extended the "automatic adjustment" mechanism that locks 5 percent of the allocated budget from each ministry/agency as contingency fund for shifting expenditure priorities.[12]

After a material drop at the start of the year, pressures on energy subsidies are re-emerging amid geopolitical tensions and recent currency depreciation. For January-to-April, subsidies dropped by 16.4 percent. However, pressures are re-emerging as the Middle East conflict weighs on global energy prices combined with the depreciation of the Rupiah. In May, oil prices and the Rupiah were 1.7 and 8.3 percent higher than in the 2024 budget assumptions, respectively.[13] It is estimated that a depreciation of IDR500 against the US$ or every US$5 increase in the oil price will raise the total subsidy spending by 0.1 percent of GDP, if demand remains unchanged. The rising pressure from subsidy spending coupled with rising interest payments could crowd out priority and pro-growth spending, such as public investment. The latter remained broadly flat, averaging 1.3 percent of GDP since 2019. Compared to peers, public capital stock remains relatively low (Figure A.17).

Public debt remained flat, but global monetary tightening and rising financing costs are changing the composition of investors. With a budget balance in small surplus, central government debt to GDP stood at 38.6 percent in April, down from 38.8 percent by end-2023. Most of the debt stock is domestic (71.1 percent of total debt) and primarily medium to long-term (more than 90 percent). This reduces rollover and exchange rate risks. The largest share of government bonds is held by commercial banks (24 percent), followed by BI with an increasing share since the pandemic (Figure A.18). BI's purchases since 2023 have occurred though on the secondary market[14] and are aimed at supporting yields rather than providing emergency financing as was the case during COVID-19. Indeed, the bid-cover ratio has been declining, reflecting weakening demand for GoI bonds despite higher yields (up 43 bps since April 2023 for long-term bonds). This follows global monetary tightening and investors' appetite to purchase advanced economies' debt. As a result, non-resident holding of Indonesia's sovereign debt declined by 2.6 percent yoy in levels and by 1.2 ppts as a share.

Figure A.13: Fiscal balance posted a small surplus…
(percent of GDP)

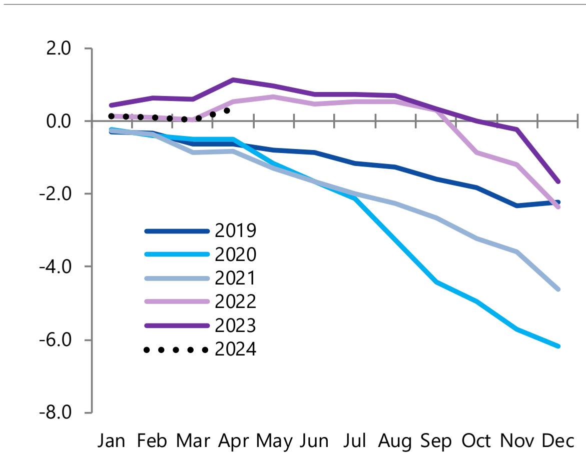
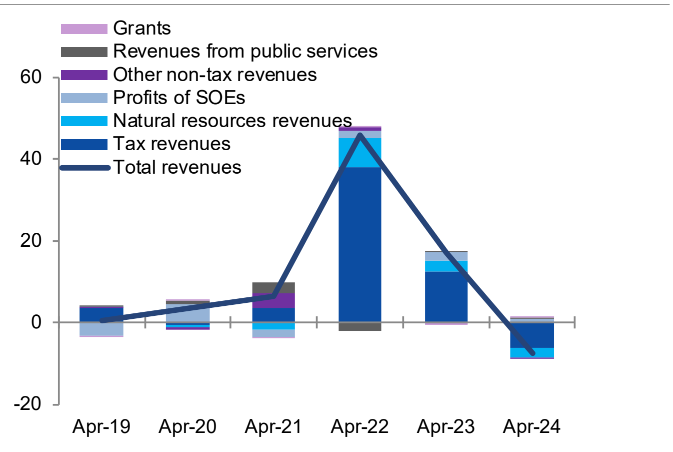


Figure A.14: …as revenues declined with subsiding commodity windfalls
(contribution to revenue growth, percent, ppts)



[11] Social protection spending is estimated to reach IDR 536 trillion in 2024 (2.4 percent of GDP), compared to an allocated budget of IDR 497 trillion (2.2 percent of GDP).
[12] The ministry of finance has used this mechanism for emergency funds since 2022.
[13] The 2024 Budget assumes an oil price of US$82 per barrel and a rupiah currency of IDR 15,000 to the US$.
[14] During the COVID period, Bank Indonesia and the Ministry of Finance agreed on the 'burden-sharing' mechanism, where BI supported the MoF in financing the deficit. The support from BI was first introduced in April 2020 through a BI-MoF joint decree. The program was time bound and ended in 2022.

Figure A.15: At the same time, expenditure growth picked up significantly
(contribution to spending growth, percent, ppts)

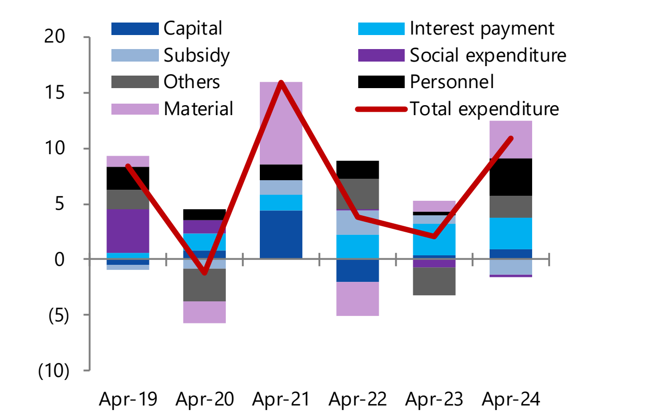


Figure A.16: And the government increased its social protection spending
(IDR trillion)

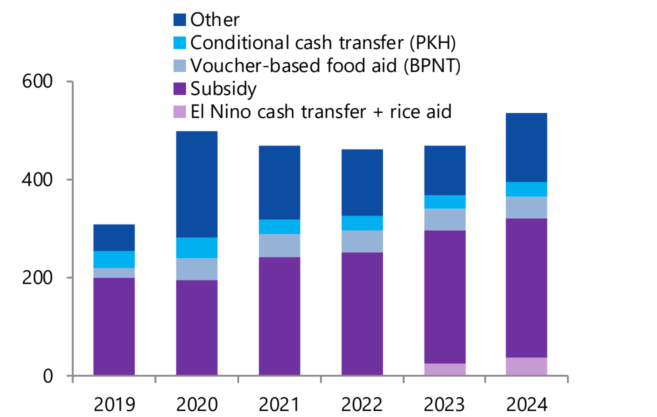


Figure A.17: Indonesia's general government capital stock is among the lowest among peers
(percent of GDP)

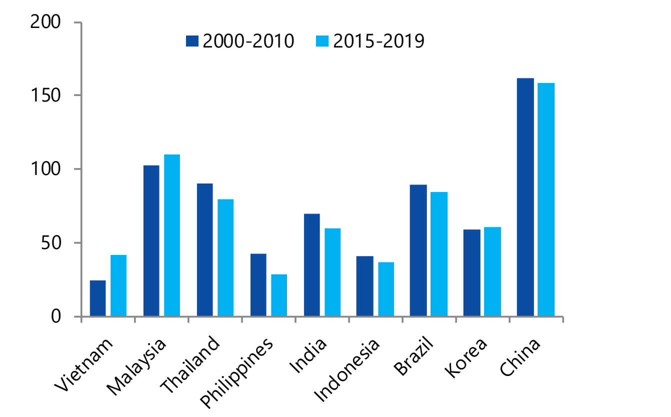
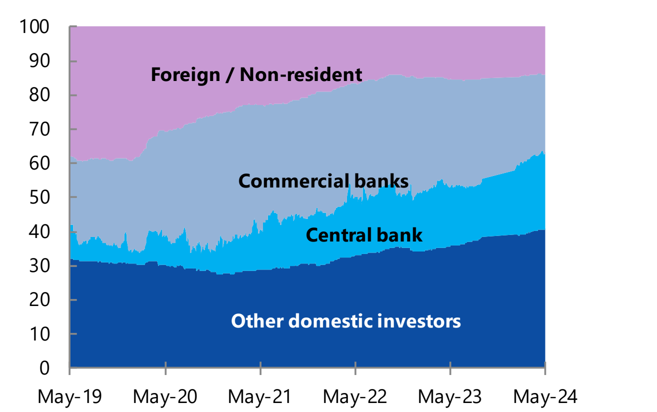


Figure A.18: Demand for Indonesian government bonds lessened
(percent of total government bond)



Source: Ministry of Finance, CEIC, World Bank Commodity Monitor, IMF Investment and Capital Stock Database, World Bank staff calculation.

Bank Indonesia raised its policy rate to maintain currency stability and adequate external buffers, while it also provided macroprudential liquidity incentives to spur private credit growth.

Faced with mounting pressures on FX reserves and the currency, BI increased its policy rate. External pressures prompted BI to unexpectedly raise the policy rate by 25 bps in April, bringing it to 6.25 percent—the highest since 2016. BI rate hike, the first in six months, surprised market analysts who were factoring in cuts as early as Q2-24 to accommodate the normalizing domestic demand. The monetary policy adjustment was motivated by a focus on addressing currency volatility and FX reserves accumulation through widening the spread against the US Federal Fund Rate.

This move complements efforts initiated by BI in Q4-23 to issue new securities—the SRBI, SVBI and SUVBI[15]—designed to attract foreign currency from non-residents and domestic investors.

The rate hike helped reverse portfolio outflows. The BI rate hike translated in higher interest on the SRBI, improving the appeal for these securities especially among non-resident investors (Figure A.5). Indeed, ownership significantly increased from 18.3 to 27.3 percent between April and May (see Box A.1). This has also influenced the return of foreign capital flows into government bonds (US$1.1 billion) in tandem with the issuance of government JPY bonds (US$0.6 billion). These recent developments allowed BI to intervene more actively on the exchange market and soften Rupiah volatility.

[15] SRBI is an IDR security first issued by BI in mid-September 2023. The SVBI and SUVBI are US$ denominated securities. The SVBI are conventional securities, while the SUVBI are sharia-compliant ones. Both were first traded in mid-November 2023 (see IEP December 2023).

To soften the impact of the policy rate hike on the economy, BI is using macroprudential liquidity incentives in support of private credit expansion. BI maintains a "tight interest rate, loose macroprudential" policy mix, where the rate hike is complemented by easing the reserve requirement ratio (RRR) to boost liquidity for private credit. As such, BI decided to expand the coverage of the 400 bps RRR discount to additional growth-driving sectors.[16] These include green economy, creative economy, wholesale trade, and export-oriented sectors. The incentive, which will become effective in June, is estimated to stimulate an additional 1.6 percent of private sector credit (IDR115 trillion) by the end of 2024.

BOX A.1
A deeper look at SRBI: BI's new instrument to maintain the stability of FX reserves

In response to the US Fed rapid tightening cycle, which started in 2022, BI introduced a local currency security SRBI (*Sekuritas Rupiah Bank Indonesia*) aimed at attracting portfolio flows. In Q3-23, the 10-year UST yield reached a 16-year high, prompting Indonesia's yield differentials to reach historical lows. This triggered substantial portfolio outflows (0.3 percent of GDP in Q3-23) fueling pressure on FX reserves and the currency. Indeed, the Rupiah had been sensitive to changes in the net FX reserves position[17] (Figure A.19), a proxy for BoP flows. Faced with these challenges, BI introduced new securities—the SRBI— in September 2023 primarily aimed to attract foreign investors. The introduction of SRBI replaced BI's "twist operation"[18] as a tool to improve the yield differential against US T-bills.

To increase its attractiveness, SRBI offers a higher interest than Indonesia's local currency government securities (SBN). SRBI is issued by BI in recognition of short-term debt using SBN held by BI as underlying assets. SRBI is an Open Market Operation (OMO) instrument that has served a dual mandate of absorbing excess liquidity, and attracting portfolio flows to maintain currency stability and external buffers. SRBI is thus eligible for ownership by non-residents. Compared to sovereign bonds, SRBI is a shorter-duration asset, with maturities of 6, 9, or 12 months. The interest rates of SRBI have been consistently higher than sovereign bonds (SBN). For example, during the SRBI auctions in early May 2024, the 1-year SRBI offered a return of 7.5 percent versus 6.7 percent on the 1-year SBN.

The introduction of the SRBI has had unintended consequences. As a higher yielding instrument, the SRBI appeared to be crowding out government borrowing. Commercial banks reduced their holdings of government securities and turned towards BI's new securities. Between September 2023 and February 2024, commercial banks' ownership of government bonds declined from 30.4 to 25.6 percent of total outstanding. In response, BI intervened on the secondary market to purchase government securities, increasing its holding from 16.2 to 20.7 percent. To prevent further crowding out, BI temporarily reduced the volume of SRBI issuances, cutting it by half from IDR 49.4 trillion to IDR 25.6 trillion between February and March 2024.[19] Other risks include crowding out foreign equity investors who face higher credit risk but with relatively less attractive returns. Equity outflows from the Indonesia's stock market exchange were indeed observed lately in April-June.

In the wake of a more hawkish Fed, April saw broad-based portfolio outflows, including from SRBI. In Q1-24, non-resident investors held approximately 22 percent of total outstanding SRBI, while the remainder was largely owned by domestic commercial banks. However, as global monetary conditions have tightened, foreign investors have been selling their SRBI holdings. As a result, the share of foreign ownership in SRBI fell to 18 percent by the end of April 2024. Following the hike in BI policy rate in April 2024, interest on the 1-year SRBI simultaneously jumped by 500 bps (Figure A.20) to reach 7.5 percent in early May. This marks an even wider differential against the 1-year SBN at 6.8 percent. Going forward, BI decided to auction SRBI more frequently (from once to twice a week) to attract more portfolio inflows. With higher rates and more frequent auctions, SRBI posted IDR 81.6 trillion of foreign inflows and the share of foreign ownership rose sharply to 27 percent of total outstanding SRBI in May.

[16] The headline RRR is currently set at 9 percent for commercial banks. With this incentive, the RRR for banks that lend to certain activities could be as low as 5 percent. This incentive has been implemented since October 2023 for credit in eligible sectors, such as downstreaming, tourism, and MSMEs (see IEP December 2023).
[17] Net FX reserves subtract predetermined short-term drains (from non-residents and residents, in up to one year) from the official reserves.
[18] Under the "twist operation", BI sold short-term and purchased long-term government securities (SBN) in the secondary market to increase the attractiveness of SBN yields (see IEP June 2023).
[19] There is a cost associated to BI for issuing such instruments, referred to as sterilization costs. The cost is computed as the yield spread against a Treasury's return on risk-free investments (such as, the yield on 1-year UST, currently around 230 basis points), multiplied by the total volume of issuances. A ballpark estimate for the sterilization costs of SRBI issuances points to 0.25 percent of total BI's assets.

Figure A.19: The stability of Rupiah has been parallel with changes in net FX reserves
(LHS: billion US$; RHS: US$ / IDR)

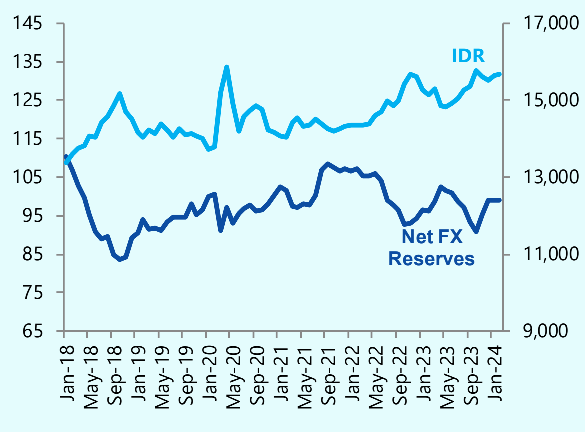
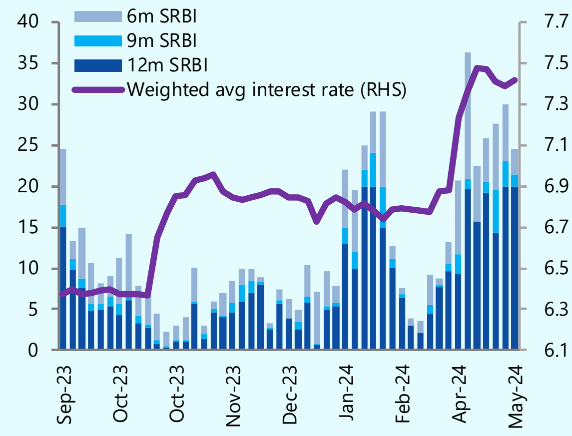


Figure A.20: SRBI yields rose significantly following the April hike in BI Rates
(LHS: SRBI issuances in trillion IDR; RHS: percent)



Source: BI, IMF, World Bank staff calculations.
Note: Net reserves subtract predetermined short-term drains from the official reserve position.

3. Structural Trends

Within these near-term developments and policy responses, there are four important structural trends that will need closer attention going forward. First, a gradual increase in manufacturing concentration points to competitiveness challenges for the sector as a whole.

Post-COVID-19, the growth of the manufacturing sector has been bolstered by the marked expansion of basic metals and metal products industries. Basic metals, and metal products and electronics have grown at an annual average growth rate of 14.5 percent and 10.1 percent in 2022 and 2023, respectively, compared to only 5.9 percent and -0.6 percent in 2017-19. Supported by GoI's downstreaming policies and mining sector expansion, together these two sectors accounted for one-third of manufacturing growth post-COVID (Figure A.22). Notably, exports of iron and steel products reached a record high of US$27.8 billion in 2023, a more than fifteen-fold expansion from 2016.

Several other priority manufacturing industries[20] have underperformed relative to their pre-pandemic averages. Food and beverages, by far the largest contributor to manufacturing value added (35.1 percent of the total in 2023), slowed from an annual average growth of 7.8 percent pre-COVID-19 to 4.7 percent after. While benefitting from robust domestic demand and the recovery of hospitality services, its growth has been dampened by inflationary pressures and weak exports. Similarly, textiles and apparel, has faced increasing challenges post-COVID, including shrinking export markets in major advanced economies and tightening import restrictions. These challenges have led to considerable layoffs and a steady decline in the sector's share in manufacturing value added, from 6.2 percent in 2019 to 5.2 percent in 2023. Other higher value-added priority industries such as transport equipment and machinery, performed robustly, whereas rubber products and furniture contracted post-COVID. Overall, the share of manufacturing in GDP remained below 20 percent in 2023.

Service sector growth has been resilient, consistently outpacing manufacturing both pre- and post-COVID. With average annual growth rates above 6 percent, services have accounted for more than half of GDP growth (Figure A.21). Services have also proved to be more resilient to multiple economic pressures (COVID-19, geopolitical tensions, conflicts, commodity price shock), supported by the steady growth of higher value-added services such as information and communication technology, as well as financial services (Figure A.23). Transportation and accommodation and food services, benefitting from a strong post-COVID rebound, accounted for about one third of post-COVID services growth. Wholesale and retail growth has been stable, at around a quarter of services value added.

[20] Ministry of Industry defines as priority industries food and beverages, textiles, electronics, automotive, and chemicals.

The shift towards commodity-based industries have led to an increasing concentration of manufacturing value added. The concentration of industries[21] within the manufacturing sector has steadily increased over the last decade (Figure A.24). In contrast, the services sector concentration has remained broadly stable. Whilst the growth of commodity-based processing is reflective of Indonesia's comparative advantage, the competitiveness of other manufacturing industries will be important for long-term value addition. For example, low-skill labor intensive tradables (e.g., textiles, apparel, furniture), medium-skill global innovator manufacturing (e.g., machinery and equipment, motor vehicles, electrical equipment), and high-skill global innovators (e.g., computers and electronics, pharmaceuticals)—all of which Indonesia has capacity in–tend to have strong pro-development characteristics (i.e., value addition, productivity, tradability, jobs). These industries tend to have stronger global value chain linkages than commodity-based processing, and therefore tend to be associated with higher productivity and better job creation. The competitiveness and growth of these manufacturing industries will be heavily influenced by the quality and competitiveness of service sector inputs.

Figure A.21: Services growth has been accounting for more than half of GDP growth
(percentage points contribution to yoy growth)

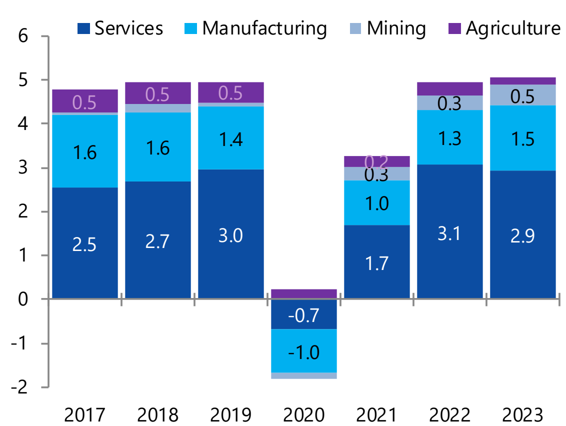
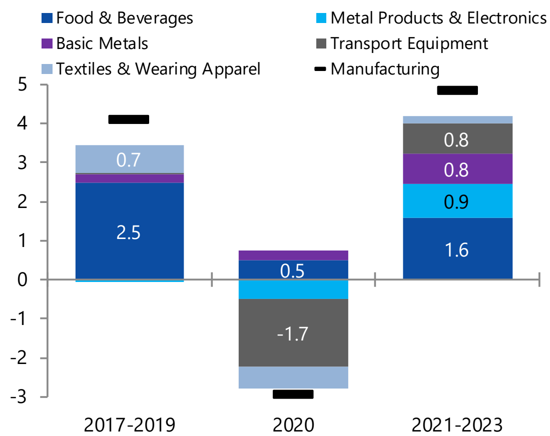


Figure A.22: Post-COVID19, the manufacturing sector has experienced notable shifts
(percentage points contribution to yoy growth)



Source:BPS, World Bank staff calculations.

Figure A.23: The services sector growth has been resilient, consistently outpacing manufacturing
(percentage points contribution to yoy growth)

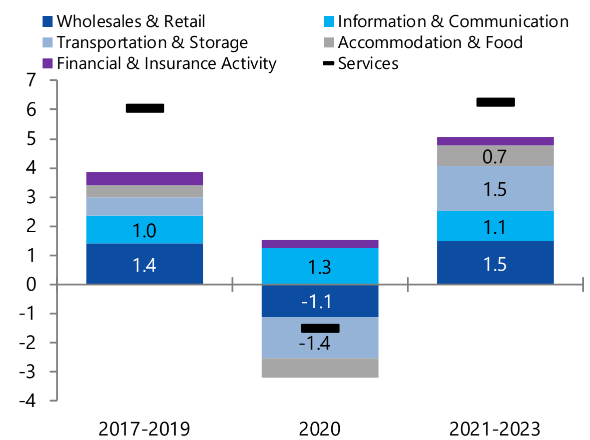
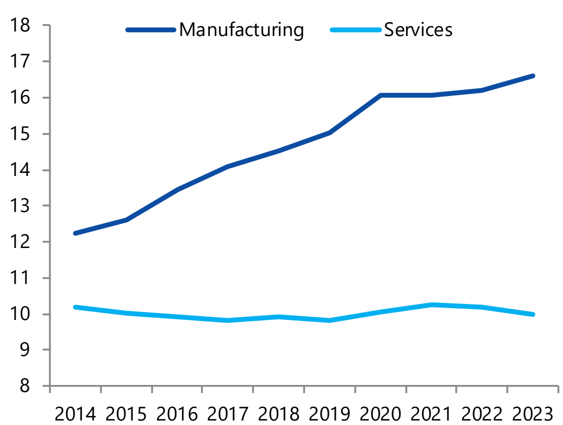


Figure A.24: The manufacturing sector is becoming less diversified
(Herfindahl-Hirschman index of concentration)



Source:BPS, World Bank staff calculations.

[21] The Herfindahl-Hirschman Index (HHI) is a widely used measure of market concentration. HHI = suml (si)2, where si represents the share of each industry in the total.

Second, despite robust growth overall, there is scope to accelerate subnational income convergence to sustain inclusion gains.

Regional income disparities have declined over the past three decades but have lately been stalling. Between 1993-2002, there was convergence with catch-up.[22] Subnational income differences have declined as several provinces have been catching up with Java-Bali's economic performance (Figure A.25). During 2003-2012, there was convergence with faltering catch-up. Regional income disparities narrowed, while Java-Bali's economic dominance persisted. The last decade was a period of deceleration for both convergence and catch-up. Progress in reducing regional income inequalities slowed and there has been little improvement in the catch-up of other regions with Java-Bali's GDP per capita. Notably, when excluding Nusa Tenggara, convergence appears strongest, indicating that this region significantly influences the income gap (Figure A.26). Further, there has been a divergence in income per capita trends in Nusa Tenggara compared to the rest of the country, contributing to the narrative of growth inequality in eastern Indonesia.

The slowdown in convergence of investment offers insights into the distribution and dynamics of growth across regions (Figure A.27). Convergence appears to be weaker when excluding Java-Bali, pointing to the region's significance in driving investment trends and its weight in capital allocation within Indonesia (Figure A.28). Investment in physical assets remains uneven across regions, which in turn underscores the gaps in infrastructure and technology. Other factors driving convergence—labor force participation, human capital, structural reforms, investments, technological progress, and capacity for subregional governance—have also varied across regions and requires further analysis to determine their impact and binding constraints to convergence and catch-up.

Understanding subnational economic growth are vital for evaluating the effectiveness of policies aimed at fostering balanced development and reducing inequality across the archipelago. While income convergence was observable in Indonesia, progress has been uneven across regions. This is particularly evident in disadvantaged areas of East Indonesia, where the progress stalled the most. The temporary nature of stronger income convergence seems to coincide with periods of rising catch-up propelled by commodity booms. This suggests that the economic convergence may be vulnerable to the volatility of commodity price cycles.

Figure A.25: Subnational income convergence and catch-up have slowed down
(mean log deviation of income per capita)

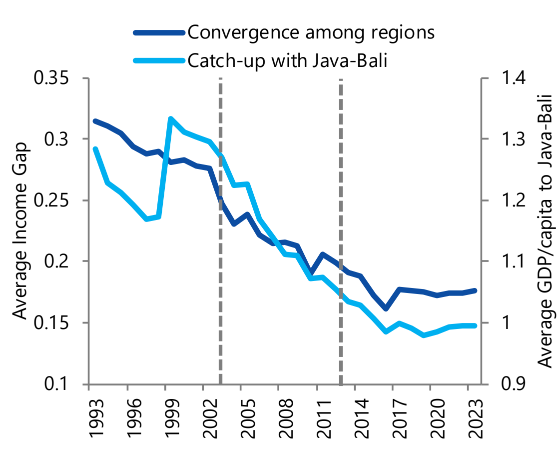
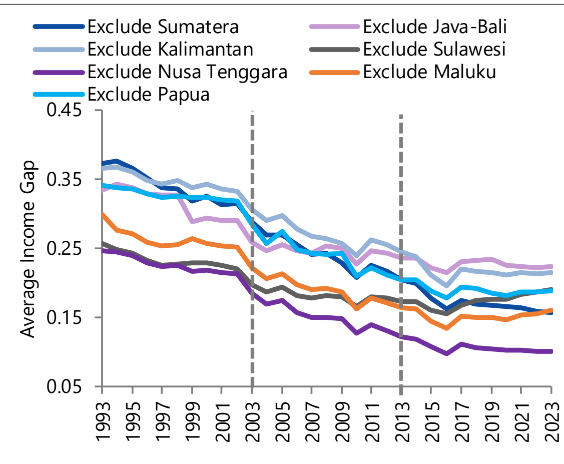


Figure A.26: Income convergence is strongest when excluding Nusa Tenggara
(mean log deviation of income per capita)



[22] Convergence evaluates whether income per capita gaps between regions are narrowing. Convergence occurs when the mean log deviation decreases over time, indicating that poorer regions are approaching the income levels of wealthier ones (known as sigma convergence in the economics literature). Catch-up is measured by comparing the average income per capita of different regions relative to that of the most developed region, Java-Bali.

Figure A.27: There has been also convergence in subnational capital formation
(mean log deviation of income per capita)

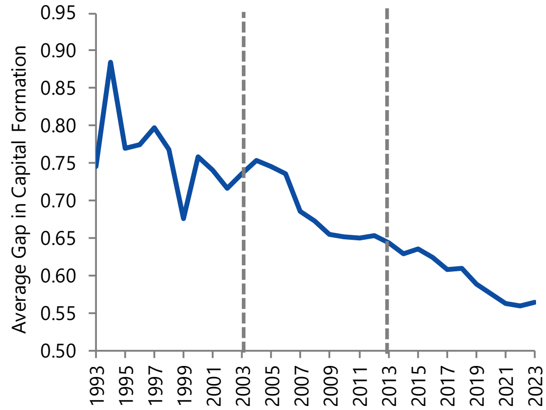
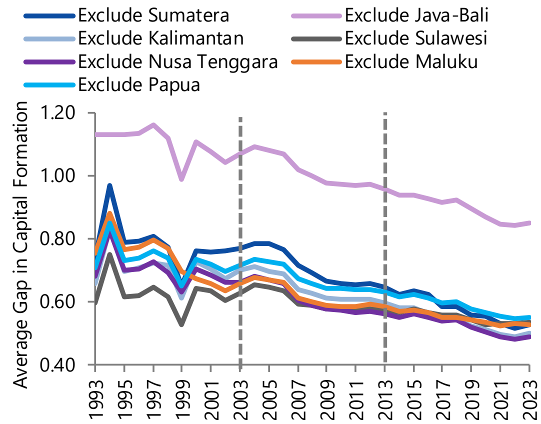


Figure A.28: But GFCF convergence is primarily driven by Java-Bali
(mean log deviation of income per capita)



Source: BPS, SUSENAS, World Bank staff calculations.
Note: Graphs show sigma-convergence; negative slope indicates a higher degree of convergence. GDP per capita and Gross Fixed Capital Formation (GFCF) are both in 2010 constant prices. Balanced panel of 26 parent provinces as in the pre-decentralization era.

There is also scope to make growth more inclusive by tackling labor market trends, which have exacerbated inequality since the pandemic.

In two decades, Indonesia has twice undergone major shifts in the inclusiveness of economic growth. The pace of economic growth began accelerating in the early 2000s, following the Asian Financial Crisis. For individuals and families, this growth took the form of rising labor income fueling private consumption. Although the wellbeing of the poorest steadily improved in the early 2000s, taken as a whole, Indonesia's growth was regressively distributed. The commodity boom behind the high growth rate yielded concentrated returns among those who were already well-off. Through 2014, the richest 10 percent of people enjoyed consumption growth of 6 percent per year after accounting for inflation, while the poorest 10 percent of people, saw a modest 2 percent growth per year over the same period (Figure A.29). Because those with top incomes started from a higher base, faster growth at the top meant that the absolute increase in consumption was even more skewed. Between 2003-14, the richest 10 percent of the population obtained 43 of the total increase in consumption, almost 22 times that of the poorest 10 percent. These trends rapidly increased inequality. The Gini Index rose ten points—from 0.29 in 2003 to a peak of 0.39 in 2014, the highest value yet measured in Indonesia (Figure A.30).

Since 2014, growth increasingly favored the poorest half of the population and began reversing the trends of the previous decade. For the top 10 percent, the pace of growth fell by half (to 3 percent per year), while at the same time doubling to nearly 4 percent for the poorest 10 percent of people. In 2015, growth for the bottom half outpaced the top for the first time in a decade, and from 2014 to 2019, falling inequality pushed the Gini Index down by nearly 4 points. This remarkable turnaround was driven by a stronger labor market. Returns to skills began increasing, and the share of skilled workers in the labor force rose from 33 percent in 2014 to 39 percent in 2019. As the sources of growth shifted into areas with higher demand for labor, wages began climbing in agriculture, industry, and services alike (Figure A.31). Faster job creation in services and manufacturing led to a sectoral shift into more remunerative work, and more than compensated for a modest drop in the agricultural labor force (Figure A.32). The agriculture sector nonetheless sustained output and wage growth, signaling rising labor productivity.

Maintaining the inclusive trend is not a given as signs of slackening have recently emerged. Progress in reducing inequality stagnated, and in the aftermath of COVID-19 the Gini Index began to slowly rise again (Figure A.30). Moreover, after falling during the pandemic, median wages have not yet fully recovered after accounting for inflation.

Figure A.29: Annualized growth rate by percentile of consumption, adjusted for inflation
(percent, yoy)

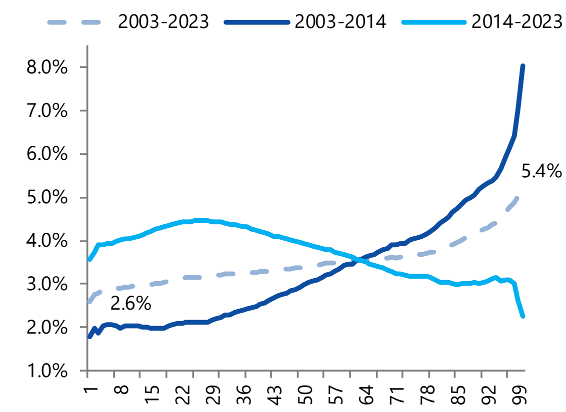


Figure A.30: Gini index began to slowly rise post-pandemic
(index)

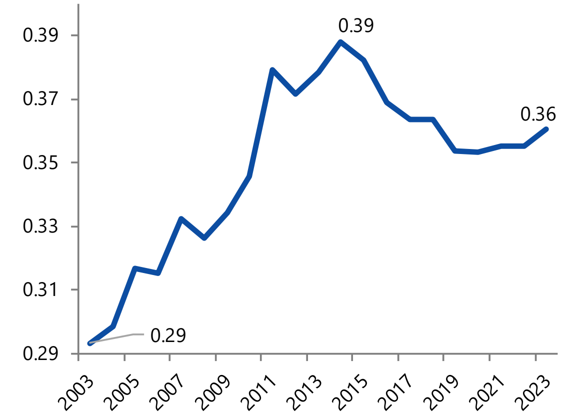


Figure A.31: Annualized inflation-adjusted median wage by sector
(percent)

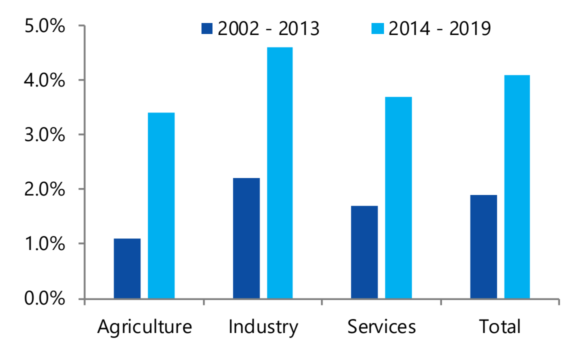
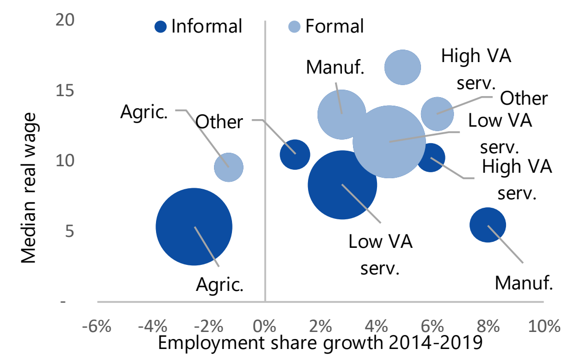


Figure A.32: Growth in share of employment by median wage for formal and informal sectors
(percent)



Source: Sakernas 2003-2024, World Bank staff calculations
Note: Welfare is measured using reported household consumption expenditure and expressed in real terms by adjusting for district and yearly price differences.

Fourth, inclusive growth will require mobility to take on new jobs in higher productivity sectors, and in higher productivity places.

The path of structural transformation followed by countries that are now high income has remained remarkably consistent for more than a century, including the consequences on the labor market. Nearly all countries transitioning from low, to middle, and then high-income levels have seen falling employment shares in rural agriculture and significant domestic migration, as workers are drawn into growing sectors with high labor demand. Policymakers should anticipate similar trends as Indonesia transitions to a high-income country. As new higher productivity activities emerge, they will compete to attract workers by offering higher wages. But this process is not necessarily inclusive, and in fact, often generates widening inequality. This is because productivity growth is not constant across sectors or geography. Some sectors and some locations inevitably grow faster than others. Thus, if workers are immobile, many will be unable to take part in the benefits of structural transformation.

Low levels of worker mobility suggests that if current trends continue, Indonesia faces a situation more akin to the less inclusive pattern than the more inclusive one. Spatially, Indonesia is one of the least mobile counties in the world, and the trends are worsening. The internal migration rate between provinces was just 2.3 percent in 2023. This is lower than pre-pandemic, lower than the global average of 8 percent, and far from the frontier, which reaches 39 percent in some of the world's most mobile countries like Australia. Moreover, even recent migration for Indonesians aged 18-30, which has been consistently the highest among all age groups, has been declining in the past two years. Meanwhile, around 30 percent of migrants aged 56+ are back to their district of birthplace. Indonesia's limited mobility patterns contributes to the striking lack of mobility from low-income districts to high income ones. In fact, the typical migrant in Indonesia is far more likely to be moving out of a more dynamic labor market, than into one (Figure A.33). Close to 70 percent of all migration originates in top two quintiles of district by median income, compared to just 6 percent outmigration from the poorest quintile of districts. Furthermore, only 24 percent of migrants move from poorer to richer districts.

Partially because of these trends, there has been no long-term convergence in welfare between Indonesia's island groups over the past two decades (Figure A.34). Median welfare—as measured by consumption per capita—in Sumatera, Java-Bali, and Kalimantan has largely remained at or above the national median. Sulawesi, Maluku-Papua, and Nusa Tenggara have made remarkably little progress closing the gap. At 93 percent, Sulawesi's typical level of welfare relative to the national median is nearly unchanged over the past 20 years. Nusa Tenggara has made very slow progress. At the current pace of convergence, closing the gap to the national median would require another 140 years. Maluku and Papua have in fact lost ground, and if current trends continue will likely not converge to the national median.

Figure A.33: A 5-year migration flows by district income level

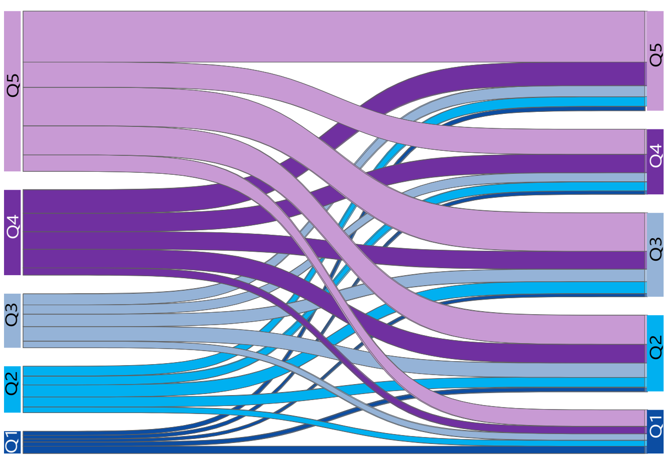
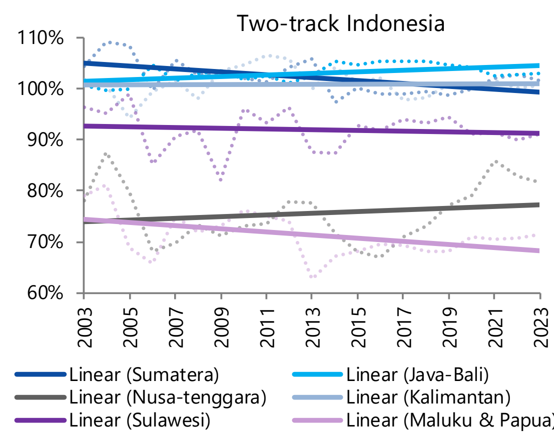


Figure A.34: Regional convergence in median consumption per capita



Source: SUSENAS survey data and World Bank Staff Calculations.
The labels Q1-Q5 refers to the poorest to the richest quintile of districts, ranked by median per consumption per capita. Values on the left of the graph indicate the typical welfare level of the district a migrant is leaving from, scaled by the share of total domestic migrants, while the value on the right indicates the welfare level of the destination district.

4. The Outlook and Risks

Indonesia's economy is projected to remain resilient throughout the outlook period, though slightly easing as terms of trade soften and domestic demand normalizes toward trend growth. GDP growth is projected to average 5.1 percent over 2024-2026 (Table A.2). Private consumption will continue to drive growth but is expected to face headwinds as household purchasing power is affected by cost-push inflation pressures. Public consumption growth will reflect an increase in civil servant salaries in 2024, further supported by new social spending programs from the incoming administration. Investment is expected to gain momentum over the outlook period, bolstered by earlier reforms and new government projects, including an acceleration in the construction of the new capital city. Exports and imports are projected to grow at a more modest pace, given the high base effects and uncertain global demand.

Inflation is projected to remain within BI's target band but faces upward pressure from global food and energy prices. Headline inflation is expected to remain relatively stable, averaging 3 percent in 2024 and approximately 2.9 percent thereafter in 2025-2026 (Table A.2). This is well within BI's inflation target band of 2.5 +/- 1 percent. Inflation expectations are also anticipated to remain anchored within this range. With the output gap estimated to close in 2025 and domestic demand normalizing, core inflation is expected to remain subdued over the outlook period. However, global energy and food prices are anticipated to exert upward pressure on inflation. This follows multiple armed conflicts and climate shocks that are disrupting global supply chains, as well as the new round of OPEC+ production cuts that are increasing oil prices. The authorities remain committed to maintaining inflation within their target range, including by utilizing subsidies, price controls, and measures to ease domestic supply chain bottlenecks—all actions that have been employed in recent years.

The external position is expected to remain challenging due to weak global trade and financing pressures. The current account deficit is projected to gradually widen and reach 1.6 percent of GDP by 2026, as softer commodity prices and global uncertainty hamper exports. FDI will continue to be the largest source of external financing, with competitiveness reforms, industrial downstreaming, and the construction of the new capital yielding results and attracting new projects. BI's monetary stance will remain focused on guarding against rapid or excessive capital outflows. However, monetary policy will have less leeway due to tighter inflation targets and persistently high interest rates in advanced economies. Nevertheless, BI will be more accommodating and is anticipated to lower policy rates in 2025, albeit at a much slower pace and in alignment with normalization of US monetary policy. Foreign currency reserves are projected to remain adequate, covering 6 months of imports.

The fiscal stance is projected to loosen going forward as the government ramps up social spending and public investment, still within the 3 percent budget deficit rule. The extension of existing social assistance programs,[23] heightened subsidy spending driven by currency depreciation, and higher interest payments are all expected to push the fiscal deficit to 2.5 percent of GDP by the end of 2024. This is above the 2.3 percent indicated in the budget law. In the medium-term, the deficit is projected to stabilize at around 2.5 percent (Table A.2). This follows a gradual increase in spending to accommodate the incoming administration's programs, including those related to public investment and infrastructure. Subsidies are projected to stabilize throughout the outlook period in line with softening commodity prices. Meanwhile revenues are forecasted to improve steadily as tax receipts strengthen from another 1 ppt hike in the VAT rate planned for 2025. With higher fiscal deficits coupled with costlier financing due to sustained unfavorable global monetary conditions, public debt is projected to remain broadly flat in the medium-term at an average of 38.7 percent of GDP up to 2029.

Social spending packages planned under the upcoming five-year economic program have the potential to enhance human capital formation within a sustainable fiscal framework. Social programs were at the heart of the presidential election campaign and several announcements point to a ramping up of social spending including through existing and new programs. These include the flagship school meal program (Box A.2), If they are implemented fully and simultaneously, estimates show that the fiscal cost of these programs combined could reach 3 percent of GDP in the first year (2025) and around 2 percent of GDP thereafter. Gradual implementation coupled with tax reforms, which could bring yearly additional revenues of 1-1.5 percent of GDP, would help the government adhere to its fiscal rules. Those rules have helped build a transparent and credible macroeconomic policy framework. This has enabled Indonesia to successfully attract investment, boost growth, and navigate external shocks.

The risks to Indonesia's growth outlook remain tilted to the downside amid heightened uncertainty. An intensification of armed conflicts and other geopolitical tensions could disrupt trade and commodity markets, push up inflation, and affect global economic activity. Most notably disruptions to global oil supply from the conflict in the Middle East could have notable effects on prices of energy, transport, as well as supply chains globally. Moreover, successive climate change shocks are having detrimental effects on global food production notably for staple crops, undermining the disinflation process. Weaker-than-expected growth in China, triggered for instance by a more prolonged and deeper property sector downturn, or a sharper slowdown of the US economy could have notable negative spillovers, particularly for EMDEs. All these external shocks could have implications on Indonesia's growth through a sharper decline in the terms of trade, resulting possibly in lower revenues and a tighter fiscal position. Domestically, rising social spending with no additional revenues and expenditure efficiency measures could deepen the fiscal deficit while slow implementation of structural reforms could have implication on productivity and growth.

[23] Including the extension of cash transfer and rice aid program to the first half of 2024.

BOX A.2
International experience with School Meals

School meals are a very popular intervention: in 2022, 418 million children were benefiting from school meals worldwide, surpassing pre-pandemic coverage levels (World Food Program - State of School Feeding Worldwide, 2022). School meals can have multiple objectives: improved health and nutrition, increased attendance and learning, as well as social protection. At the same time, the objective of school meals is evolving, with an increasing emphasis on the quality of food, the role meals can play in resilience building and shock response, as well as for strengthening linkages to local market development. With this evolution comes greater complexity in design and implementation. Importantly, international evidence shows that school meals are most effective when they are complementary with other education, health, and nutrition interventions, as well as basic safety nets. Thus, their introduction or expansion should not come at the cost of lower spending or attention on other essential human capital interventions. Overall, it is essential to define and set clear objectives for such programs. This would ensure effective implementation and that supported interventions are the most cost-effective way to achieve the desired outcomes.

Evidence. Evidence on returns to school meals is uneven across objectives, and the modality and quality of implementation can make a big difference on final outcomes. In education, the evidence is relatively strong regarding impacts on school attendance in low- and lower-middle income countries where educational access is the issue, but the benefit of school meals on school participation is likely to be limited in countries where school enrolment is already high. Evidence on learning outcomes is less robust than for traditional pedagogic interventions (with higher variance, and stronger for more vulnerable groups such as poor students and girls for example). With respect to nutrition, school meals are not designed to impact stunting, as they are not targeted to the first 1,000 days of life. However, school meals may have an impact on dietary diversity and anemia among school-going children, though this will depend on the specific commodities offered. Generally, school meals can be effective where there are concerns for food security. To achieve better nutrition outcomes, more than 80 percent of national school meal programs combine food with the provision of school health and nutrition interventions (such as micronutrient supplementation, deworming, health/nutrition education curricula, school health policy interventions) to improve health outcomes and help ensure complementarity with stunting interventions aimed at the first 1000 days. School meals also indirectly benefit the economic wellbeing of the households of beneficiaries, an impact that is strongest in high-poverty settings where expenditures on food represent a larger share of household income.

Targeting. Decisions on targeting of school meals can have implications for program efficiency and effectiveness. Universal targeting, where food is supplied for all students at a given education level, is frequent in high-income settings, while in lower- and middle-income countries geographic targeting of high poverty areas or food insecurity areas is quite common. Income-targeting – where students receive free meals based on an assessment of their socioeconomic conditions – is not common outside of some higher income contexts, due to a combination of capacity constraints (existence of systems to support reliable targeting at school or individual level in cost-effective ways) as well as concerns about stigma limiting take-up or perceived unfairness at school level.

Management models. In terms of implementation, practices range from highly centralized to fully decentralized models with significant tradeoffs in terms of the required implementation capacity, level of accountability and risk (e.g., for ensuring quality control of food refrigeration, storage, preparation and delivery to avoid health hazards). Programs in middle and high-income countries tend to rely more on local procurement that support local and small-holder production by generating a stable demand for their products. Programs with local procurement can also strengthen accountability and facilitate the adoption of culturally appropriate menus. However, such programs require a relatively high level of management capacity of local governments and schools. Usually, centralized models can better manage food sourcing risks, and simplify oversight and quality control to avoid food poisoning etc. Possibly, supply chain models can be combined to form mixed models, such as by centralizing procurement of non-perishable staples and decentralize procurement of perishables. However, this may again increase complexity of implementation.

Cost. Costs across school meal programs vary widely. The main factors influencing cost are the chosen intervention modality (a meal, snack or take-home ration), the quality of the meal (composition and size), the procurement type (local or centralized), the number of beneficiaries, and the geographical context, logistics and climate conditions.

Sources: Bundy et al. (2024), Alderman, Bundy and Gelli (2024).

5. Policy Priorities

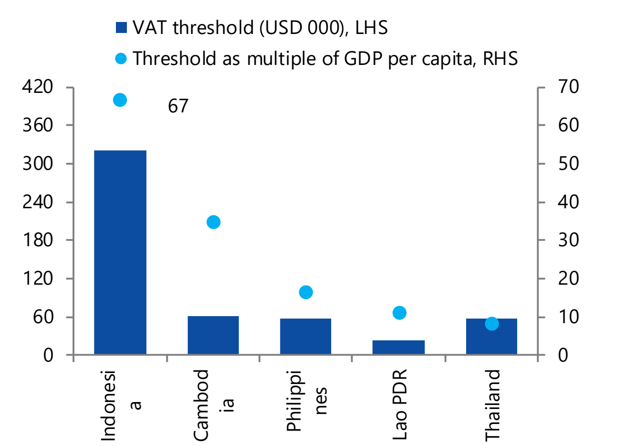
Fiscal gains from a VAT rate hike could be enhanced if tax efficiency of collection improves.

Indonesia faces efficiency challenges that limit the potential of tax rate hikes to generate additional tax revenues. At only 0.53, the VAT C-efficiency ratio[24] is 0.17 points below the average of regional peers (a ratio of 1 indicates a highly efficient tax collection system).[25] This indicates that potential revenues that could have been collected with the current rate are almost double that of actual tax collections. If the C-collection ratio improved to a level that is equal to regional peers, estimates show that the fiscal returns from the VAT rate hike could increase by up to 32 percent, on top of current gains. Shortfalls stem from both the policy design of the VAT and low tax compliance. Evidence from other countries suggests that a statutory VAT rate hike may yield minimal to no additional revenue gains if non-compliance challenges persist. The low tax efficiency is hence due to the narrow tax base and low compliance, which results in limited additional tax collection if the rate is increased.

The low efficiency of tax collection can be attributed to tax policy, tax compliance and the structure of the economy. First, Indonesia's tax policy design features low rates, high thresholds, and numerous exemptions, resulting in a narrow tax base (Figure A.35).[26] Second, tax compliance is low due to challenges of enforcement, prevalence of tax evasion, and low tax morale among taxpayers.[27] Third, the economy is characterized by high informality, which excludes many businesses from the tax system. Moreover, a shallow financial sector limits firms' access to formal financing, which leads to firms having to rely on retained earnings to finance business operations, incentivizing tax evasion. The shallow financial sector also restricts the ability of the tax authority to monitor and enforce, limiting evidence from the banking sector that could be used for auditing. Studies have shown that utilizing formal financial institutions for deposits and working capital credits help tax authorities to track income and assets, thereby improving tax collection (Gordon and Li, 2009, Lompo, 2024).

While raising tax rates addresses part of the reforms from a policy design perspective, these would need to be coupled with measures to broaden the tax base and enhance compliance. The impact of VAT rate increase will be constrained by the narrow tax base and exacerbated by low compliance. Reforms initiated through the THL in 2021 could be complemented by both short and medium-term measures. For the short-term, the reforms could be complemented with lower tax thresholds, the removal of tax exemptions, and improvements in audit mechanism to enhance compliance. In the medium term, options to raise tax collection could be implemented through improved access and availability of third-party data to track and verify incomes/revenues, as well as efforts to formalize the economy. Higher tax take can in turn finance social assistance to compensate the poor impacted by the higher VAT rate.

Figure A.35: Indonesia's high VAT thresholds narrow the tax base and lower the efficiency of collection
(US$ 000 for VAT threshold, LHS; ratio of threshold to per capita GDP in 2022, RHS)



Source: IMF Tax Policy Assessment Framework (TPAF), World Bank staff calculations.

[24] The C-efficiency ratio measures the actual tax collection to what could have been obtained if the standard VAT rate is applied to all domestic final consumption. It is used to analyze how effective the tax rate is in raising revenues. A ratio of 1 signifies a one-to-one increase in revenues, hence an efficient tax collection system.

[25] Tax Policy Review in Indonesia: Corporate Income Tax, Alternative Final Tax, and Value-Added Tax, World Bank Working Paper, forthcoming.

[26] In Indonesia, the threshold for a mandatory tax registration is currently US$320,000, six times higher than the average threshold in OECD countries (US$57,000 in 2022). This means that only firms with US$320,000 of gross turnover sales are required to register for VAT. Indonesia's 2023 World Bank Enterprise Survey reveals that only 0.3 percent of small firms are currently paying VAT, as firm size distribution in Indonesia is heavily skewed toward micro and small firms. Therefore, the high VAT threshold substantially narrows the VAT tax base. Moreover, there are more sectors in Indonesia exempted from tax compared to peers, such as the mining and drilling products.

[27] Tax morale is generally defined as the intrinsic motivation to pay taxes, which significantly influence the level of tax compliance as many tax systems depends on the self-reporting mechanism of incomes/revenues, OECD Library.

Along with the need to improve revenue collection, improving quality spending is paramount, particularly for social protection, health, and boosting human capital.

Amid rising fiscal pressures, redeploying spending from less effective programs to boosting spending on social protection is important for human capital formation and growth. Despite the recent increase in social protection spending, there remain expenditure gaps to provide social protection that serves all Indonesians and across their lifecycle (Table A.1). Compared to recent expenditure trends, an additional spending of around 0.5 percent of GDP is needed to close this gap. Existing fiscal constraints imply that expanding coverage will have to be gradual and thus requires prioritization and sequencing of different programs. Initially, financing can be met by reallocating existing expenditures, such as redeploying resources spent on energy or other less effective subsidies to direct social assistance. However, as pressure on energy subsidies keep mounting, the fiscal space also shrinks further. This then reenforces the urgency of revenue reforms to finance priority spending.

Improved spending efficiency could be implemented by leveraging the existing system, such as the National Health Insurance (*Jaminan Kesehatan Nasional*/JKN) for health spending. JKN can be leveraged by designing payment systems that encourage primary care utilization, improve the quality of services, and reduce unnecessary hospital care. Performance based subnational fiscal transfers and improved use of data will be key to improving accountability and encouraging subnational government for better use of spending. The government could also invest more in equipment, supplies, and human resources for health to improve the quality of care at all levels (Pustu, Posyandu, Puskesmas, hospitals, laboratories). Investment in appropriate training to enhance the competence of healthcare providers and abolish entry barriers for new medical professionals to register and practice in different localities is also important to improve the quality of health personnel.

Table A.1: Fiscal needs to reform the social protection program that serves all and across life cycle

Program	Reform Scenario	Cost (% of GDP)	2022 Budget (% of GDP)	Additional Spending Needs (% of GDP)
PKH and Sembako	Expanded PKH, Sembako to 40% coverage with tapered benefit levels.	0.77	0.37	0.40
Elderly Assistance	Expanded elderly assistance to 70% coverage for elderly.	0.17	0.15	0.02
Disability Assistance	Expanded disability assistance to 70% coverage for people living with disabilities.	0.03	0	0.03
JKK and JKM	Offer a government contribution of 0.54% of minimum wage* to all adults.	0.12	0	0.12
Pension	Offer a pension contribution by the government of 3% of minimum wage* to all adults.	0.71	0	0.71
Total additional spending needs (percent of GDP)				**0.5**

Source: World Bank (2020), World Bank staff calculation.
Note: *The observed minimum wage for all workers from the 2018 labor force survey and is assumed to grow at the rate of wage growth in the economy.

Table A.2: Selected Macroeconomic Indicators

	2019	2020	2021	2022	2023	2024	2025	2026
	Actual					WB projection		
Real GDP growth and inflation, percent change								
Real GDP	5.0	-2.1	3.7	5.3	5.0	5.0	5.1	5.1
Consumer Price Inflation (CPI) (average, %)	2.8	2.0	1.6	4.1	3.7	3.0	2.9	2.9
Consumer Price Inflation (CPI) (end of period, %)	2.6	1.7	1.9	5.5	2.7	3.1	2.7	2.8
Private Consumption	5.2	-2.7	2.0	5.0	4.9	4.9	5.0	4.9
Government Consumption	3.3	2.1	4.3	-4.5	2.9	5.4	4.0	4.8
Gross Fixed Investment	4.5	-5.0	3.8	3.9	4.4	4.5	5.4	6.0
Exports	-0.5	-8.4	18.0	16.2	1.3	4.1	4.0	3.5
Imports	-7.1	-17.6	24.9	15.0	-1.6	2.1	2.9	3.5
Fiscal accounts, central government, percent of GDP								
Revenues	12.4	10.7	11.8	13.5	13.3	12.9	13.1	13.2
of which Tax Revenue	9.8	8.3	9.1	10.4	10.3	10.5	10.7	10.8
Expenditures	14.6	16.8	16.4	15.8	14.9	15.4	15.6	15.6
Primary Balance	-0.5	-4.1	-2.5	-0.4	0.4	-0.2	-0.1	0.0
Fiscal Balance	-2.2	-6.1	-4.6	-2.4	-1.7	-2.5	-2.5	-2.4
Central Government Debt(a)	30.2	39.3	40.7	39.5	39.0	39.0	39.1	38.9
Balance of Payments, percent of GDP unless indicated otherwise								
Current Account Balance	-2.7	-0.4	0.3	1.0	-0.1	-0.9	-1.4	-1.6
Exports, Goods and Services	17.9	16.8	20.8	23.9	21.4	20.9	20.6	20.3
Imports, Goods and Services	18.2	15.1	18.3	20.7	19.3	18.8	18.6	18.6
Net Foreign Direct Investment	1.8	1.3	1.5	1.4	1.1	1.3	1.4	1.5
Gross Reserves (months of imports of goods and services)	7.6	10.2	8.0	6.0	6.5	6.8	6.6	6.4
Memorandum items								
Nominal GDP (IDR trillion)	15,833	15,443	16,977	19,588	20,892	22,576	24,198	25,943
Real GDP Per Capita (IDR thousand)	40,459	39,203	40,237	41,952	43,661	45,476	47,409	49,429

B. Unleashing Indonesia's Business Potential

Table of Contents
Executive Summary
A.1. Recent Economic Developments
A.2. The Policy Stance
A.3. Structural Trends
A.4. Outlook and Risks
A.5. Policy Priorities
B.1. Introduction
B.2. Performance of the Private Sector
B.3. Tackling Regulatory Uncertainty, the Next Challenge
B.4. Takeaways and Policy Recommendations

B. Unleashing Indonesia's Business Potential

1. Introduction

Unlocking the private sector's dynamism will be essential to Indonesia's success in reaching high-income status by 2045. To graduate from the ranks of middle-income countries in the next 20 years, the World Bank forecasts that Indonesia must boost its growth rate to at least 6 percent annually, surpassing the 5 percent annual average observed over the past five years (World Bank, 2023). Realizing this ambitious growth target requires a marked improvement in the productivity of the private sector. According to projections by Ikhsan et al. (2022), achieving 6 percent economic growth will require a productivity growth rate of 3 percent—one percentage point higher than the average total factor productivity (TFP) growth in recent years.

To achieve that kind of productivity growth, the private sector must find new dynamism and deepen its economic sophistication. The private sector accounts for over 90 percent of all jobs. Eliminating obstacles to its development will be critical to enhancing productivity, accelerating economic growth, ensuring financial and environmental sustainability, and creating high-quality jobs. A more dynamic private sector can also help improve health and educational outcomes, leading to further productivity, wages, and quality of life gains.

Recognizing the importance of private sector development, the government launched a bold and ambitious reform effort to unlock the private sector's dynamism. The spirit of these reforms was on target, but their implementation needs to catch up and be addressed. We argue how.

1.1 Profile of the Private Sector

The Indonesian economy is home to 66 million private businesses, of which 9 million are registered. Notably, half of these firms were established in the past 15 years, reflecting a dynamic entrepreneurial spirit. Recent legislative changes, such as introducing the 'Sole Proprietorship' legal entity under the Job Creation Omnibus Law, have spurred a rise in newly registered businesses. The private sector predominantly comprises mature, small, and medium-sized enterprises (MSMEs), critical for local economies and employment. MSMEs operate mainly in the wholesale and retail sector (54 percent), followed by accommodation, food and beverage (20 percent), processing industry (14.5 percent), and other services (5.75 percent).

MSMEs dominate Indonesia's business landscape and are pivotal to its economy. These enterprises constitute 99% of all businesses and contribute 61% to the nation's Gross Domestic Product (GDP). The export contribution of MSMEs has also increased, from 14.4% in 2020 to 15.7% in 2021. Efforts to integrate these businesses into the global market through Global Value Chains (GVC) and Global E-Commerce (GEC) are underway, further enhancing their economic impact (Indonesian Chamber of Commerce, 2024).

Despite the vibrant MSME sector, Indonesian firms generally have limited international exposure and minimal participation in global trade. This is a significant hurdle, especially given the favorable female participation rates in the private sector compared to peer countries. A comparative analysis using World Bank Enterprise Survey data highlights Indonesia's position relative to India, Mexico, the Philippines, and Türkiye. These comparisons underscore the need for Indonesia to bolster its global trade footprint. Enhancing international engagement and participation is crucial for the nation's journey toward high-income status and economic prosperity.[28]

[28] International Finance Corporation (IFC). *Creating Markets in Indonesia: Country Private Sector Diagnostic*. 2019. https://www.ifc.org/en/insights-reports/2010/cpsd-indonesia

1.2 Overview of Economic Reforms

As a result of consistent reform, Indonesia's business environment has improved since 2015, according to recently collected data from the World Bank Enterprise Survey (WBES).[29] Indonesia embarked on a substantial regulatory reform program about a decade ago, during President Joko Widodo's first term. In 2015, Indonesia's first National Strategy for Regulatory Reform was released. Since then, sixteen economic reform packages, including regulatory reform components, have been announced. Many critical global Good Regulatory Practice (GRP) elements have been strengthened.[30] Finally, bold financial sector reforms, to financial sector reforms to improve the functioning of the financial sector contributes to an improving business environment.

Indonesia's first-generation reforms focused on building strong foundations for economic competitiveness (infrastructure, governance, macroeconomic management, human capital). In the early 2000s, the country shifted towards enhancing market efficiency, a trend that gained momentum with regulatory reforms in 2015. The momentum continued with the Job Creation Omnibus Law in 2020, marking a move towards fostering innovation, liberalizing the foreign investment regime, and improving market efficiency. While Indonesia has performed well in implementing fundamental reforms, notable challenges remain in achieving efficiency reforms.

The Job Creation Omnibus Law represents Indonesia's most ambitious reform to investment and trade in decades, significantly changing business licensing procedures. It amended 76 national laws to simplify and harmonize business regulations and licensing, increase high-value investment and jobs, and empower MSMEs. It also created the Indonesian Investment Authority (INA, the Indonesian sovereign wealth fund), which mandated the crowding in of private capital to sustainable and digital sectors in Indonesia. This comprehensive law aims for a long-term, systemic transformation of Indonesia's regulatory landscape to attract foreign investment and stimulate economic growth. It helped improve Indonesia's business regulatory regime in a de jure sense.

These reforms and policies significantly reshaped perceptions of the business environment. Analysis of the World Bank Enterprise Survey for 2015 and 2023 reveals notable shifts in perceptions of what constrained the Indonesian private sector (see Table B.1). In 2015, businesses cited informal competitors, tax rates, political instability, licensing, and access to finance as their top concerns. By 2023, the landscape had changed, with access to finance, crime, theft and disorder, political instability, corruption, and competition from the informal sector emerging as the predominant issues.

Objective measures of constraints on private sector development also evolved between 2015 and 2023. Using the same survey data but objective data, we conducted an empirical analysis to identify variables that most significantly impacted firm-level productivity (see Table B.2). The findings indicate that access to finance remained the most detrimental factor in 2015 and 2023. While the quality of electricity was a critical issue in 2015, by 2023, it had been supplanted by corruption, which, though present in 2015, was only the fourth most significant constraint. Additionally, the skills of workers, a substantial impediment in 2015, gave way to the regulatory compliance costs faced by firms in 2023.

The government is committed to making doing business for MSMEs easier. Government Regulation No. 7 of 2021 underscores the central and regional governments' support for MSMEs through several key measures: (i) easing business licensing, (ii) providing incentives and financing, (iii) promoting partnership schemes, and (iv) offering legal assistance and protection. It introduces several initiatives such as single licensing, including business identification number (NIB), national standards, and halal certificates, for low-risk activities of micro and small enterprises. It also dedicated promotional and development spaces for micro and small enterprises, prioritizing MSME products in government procurement, allocating business sectors for micro and small enterprises, and incentivizing partnership schemes between medium and large enterprises with micro, small, and cooperative businesses, among others.

[29] World Bank Enterprise Surveys (WBES) are nationally representative firm-level surveys with top managers and owners of businesses in over 150 economies, reaching over 170 in upcoming years, that provide insight into many business environment topics such as access to finance, corruption, infrastructure, and performance, among others. Comprehensive data enable easy comparisons across economies and time. The information collected through our surveys is publicly available at the economy and firm level. The Enterprise Analysis team also conducts targeted surveys that provide an even deeper understanding of the business environment. Visit: www.enterprisesurveys.org

[30] A good reference on Good Regulatory Practice (GRP) can be found here: https://asean.org/book/asean-handbook-on-good-regulatory-practice/

[31] See the June 2022 Indonesia Economic Prospects for a more complete discussion of financial sector issues and reforms in Indonesia. See link: https://www.worldbank.org/en/country/indonesia/publication/indonesia-economic-prospect#2

Table B.1: Opinion on top 5 constraints in 2015 and 2023

Rank	2015	2023
1	Informal competitors	Access to finance
2	Tax rates	Crime, theft, and disorder
3	Political instability	Political instability
4	Licensing and permits	Corruption
5	Access to finance	Informal competitors

Source: World Bank Enterprise Surveys

Table B.2: Major constraint to productivity in 2015 and 2023

Rank	2015	2023
1	Access to finance	Access to finance
2	Quality of electricity	Corruption
3	Skills[32]	Business regulation (Time spent complying with regulations)
4	Corruption	

Source: World Bank Enterprise Surveys

The government turned to digital technologies to speed up compliance with regulatory requirements and remove discretion. It adopted a risk-based approach to business licensing. It issued the licenses through an online platform called the Online Single Submission (OSS) system, comprising sixteen sectoral business licenses across eighteen ministries/agencies, which aims to facilitate investments and make it easier to do business in the country. Business activities are now grouped based on risk level, determining the required licensing. To start and carry out business activities, businesses must comply with (i) Basic Requirements for Business Licensing,[33] (ii) Sectoral Risk-Based Business Licensing (assigned based on their Standard Business Classification/KBLI), and (iii) Business Licensing to Support Business Activities (PB UMKU, formerly known as commercial/operational licenses) to carry out a business activity.

As a result of these efforts the business environment improved. The business registration process, which previously required a Trading Business License (SIUP) and Company Registration Certificate (TDP), has been replaced by a Business Identification Number (NIB).[34] From August 2021 to October 2023, 9 million firms registered.[35] Using the OSS system, 97 percent of the enterprises are micro, small, and medium enterprises.[36] Business licensing reforms have positively impacted many micro, small, and medium-sized businesses. Obtaining the basic requirements for business licensing, such as suitability of space utilization activities (KKPR), environmental approval, building approval, and functional certificates (SLF), is challenging enough that the process becomes even more daunting when acquiring sectoral risk-based business licensing.

Despite these successes in businesses environment reforms, regulatory constraints have emerged as a significant impediment to firm productivity. The most notable is the inconsistent implementation of rules across the country. Moreover, lingering concerns about regulatory unpredictability and associated corruption remain. Survey data reveal the economic impact of these challenges. Productivity remains stubbornly low, with an industrial structure characterized by giant firms decoupled from the economic activity of numerous small enterprises—a persistent and pernicious feature of Indonesia's economic landscape. Understanding the current situation is key for further progress.

[32] Analysis of skill in 2015 was possible due to the skill module 2015. However, an analysis could not be done again due to the lack of the skills module in WBES 2023, for which tax and environment modules had been included instead.
[33] Includes Suitability of Space Utilization Activities (KKPR), Environmental Approval, Building Approval and Building Function Certificate (SLF).
[34] Based on Article 7, paragraph (1) of the Job Creation Law, risk-based business licensing is carried out based on the determination of the risk level and the business scale rating of business activities.
[35] Online Single Submission – Ministry of Investment (BKPM), May 2024.
[36] Less than US$300,000 in start-up capital at registration or less than US$950,000 in revenues (when company information is updated).

2. Performance of the Private Sector

2.1 How well does the average private firm perform?

Improvement in Indonesian firm performance stopped in 2023, potentially due to the COVID-19 crisis. From 2009 to 2015, Indonesia experienced stable labor output growth. However, the emergence of COVID-19 and subsequent economic downturn from 2020 to 2022 decreased sales for most firms (World Bank, 2023), leading to a decline in labor productivity during this timeframe. Labor productivity decreased from US$7,530 per worker in 2015 to US$5,336 per worker in 2023.

Indonesian firms also perform poorly compared to those in similar countries.[37] Indonesian firms have the lowest average labor productivity. Among the six comparable countries, Turkish firms boast the highest labor productivity at US$183,551 per worker. Labor productivity for firms in Mexico, India, and the Philippines is US$18,265 per worker, US$15,419 per worker, and US$9,253 per worker, respectively. Nevertheless, Indonesian firms could cope with the COVID-19 pandemic and recover faster than their peers in the Philippines. The average annual productivity of Indonesian firms declines by 4.2 percent. On the other hand, firms in the Philippines had a slower recovery rate that with average productivity decline of 20.7 percent.

Indonesian firms sold less and employed fewer workers than firms in other economies. Despite its large domestic market, sales of manufacturing firms in Indonesia were around US$775,000. This is significantly lower than average sales in other large countries such as Türkiye (US$4 million) and India (US$1.1 million). Regarding employment, firms in different countries employ more workers in Indonesia. On average, firms in Indonesia employed 20.1 workers, significantly less than Mexico in 2023 (29 workers) and Türkiye (21.9 workers).

Figure B.1: Average Indonesian firm labor productivity (2009-2023)

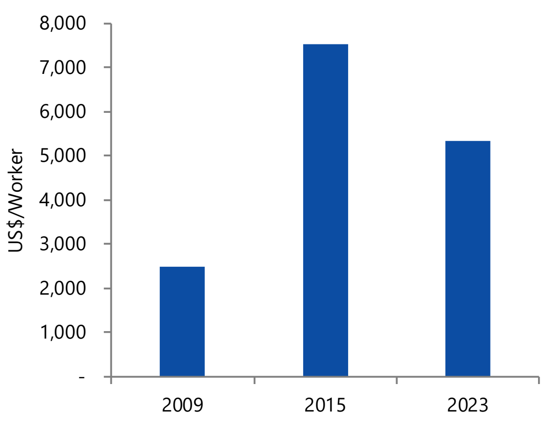


Figure B.2: Labor productivity Indonesia vs. comparators

Source: World Bank Enterprise Surveys.
Note: 1. Local currencies are expressed in 2009 US$. 2. Labor productivity is defined as value added per worker. 3. Turkiye experienced a dramatic devaluation of the Turkish Lira since 2013 and during the time of data collection (2019). This has resulted in some difficulties in estimating the real value of the domestic currency, and for this reason, we do not provide labor productivity for Turkiye in this figure.

[37] We use the WBES to compare manufacturing firms' contributions to employment and productivity in India (2022), Mexico (2023), the Philippines (2023), and Türkiye (2019) against Indonesia (2023).

Figure B.3: Average number of workers per firm

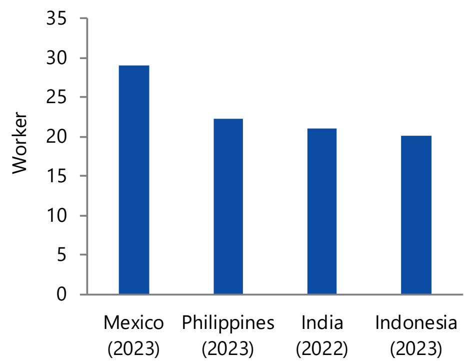
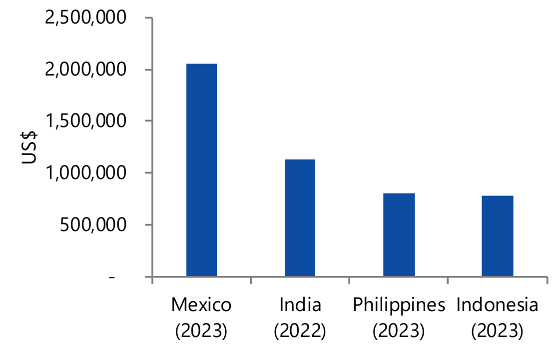


Figure B.4: Average sales per firm



World Bank Enterprise Surveys.
Note: All local currencies are expressed in 2009 US$.

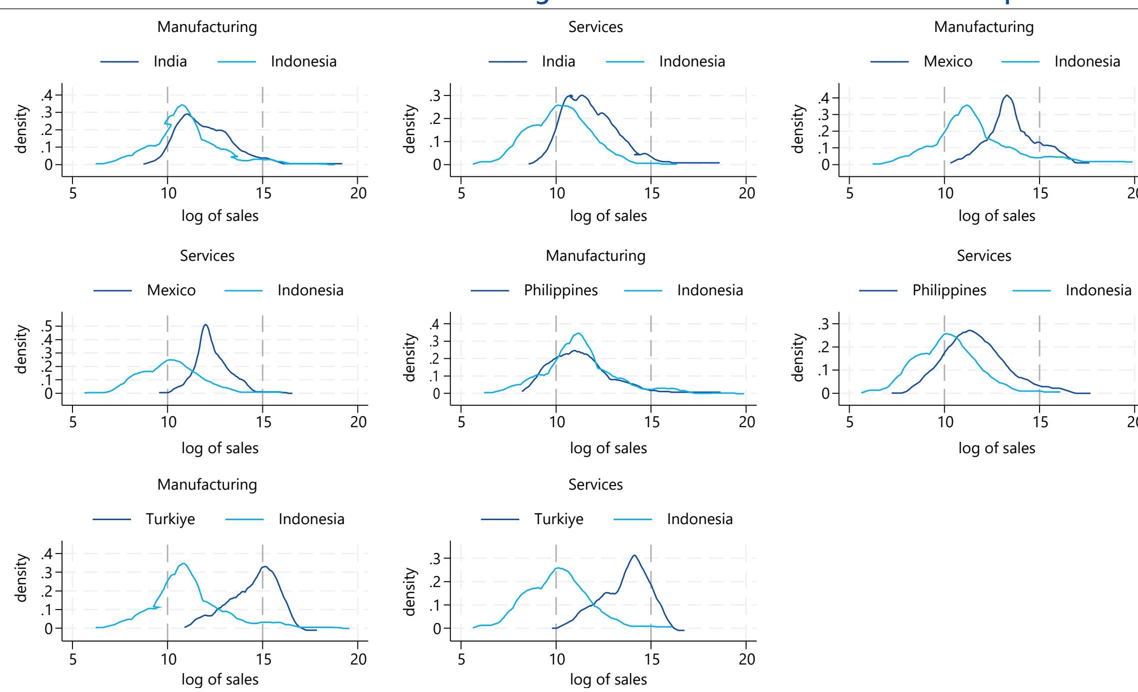
2.2 Sales inequality: the presence of large firms in the economy

Indonesia's economy is characterized by a large mass of small-scale enterprises and a handful of major players, particularly in the manufacturing sector. Figure B.5 compares the distribution of firms' annual sales in the manufacturing and service sectors separately. Most of Indonesia's distribution curve, whether in services or manufacturing, is situated to the left of the curves of other economies. This indicates that the average Indonesian service or manufacturing firm is smaller in scale.

A notable aspect of Indonesia's private sector is the small number of significantly large firms compared to the rest of the economy. Figure B.5. depicts a long right tail in the distribution of firms based on sales. The presence of long tail indicates the dominance of a few large firms in the economy. This long tail is only apparent in the size distribution for Indonesia. It does not appear in the distribution curve of other comparator economies.

Distributional analysis confirms the dominance of large firms in Indonesia's economy. Compared to India, Mexico, Philippines, and Türkiye, Indonesia has

Figure B.5: Kernel densities of sales of manufacturing and services firms: Indonesia vs. comparators



Source: World Bank Enterprise Surveys.
Note: All local currencies are expressed in 2009 US$.

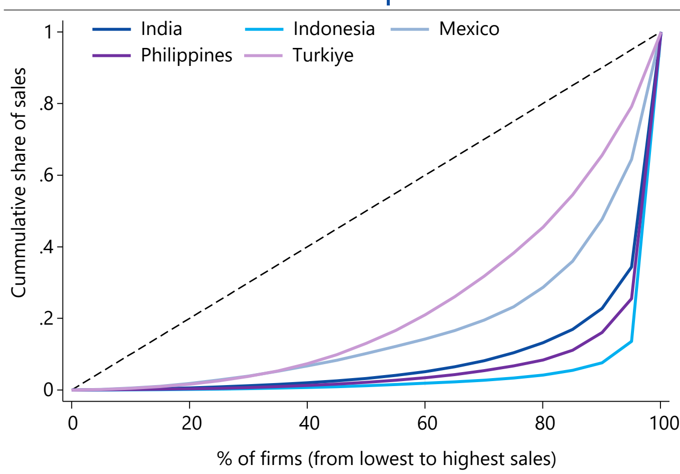
heightened revenue inequality between firms. New evidence shows that a smaller proportion of Indonesian firms control a larger share of total revenue than other economies such as the Philippines. This suggests that a smaller percentage of giant firms in Indonesia control a more significant share of the total revenue compared to the Philippines or any other peer economy. Such distributional pattern for Indonesia has been persistent historically. Figure B.6 displays the Lorenz curve of manufacturing firms in Indonesia based on sales. The top 5 percent of large firms have dominated sales in the past 31 years.

This skewed and persistent distribution toward larger Indonesian firms may have profound implications. It could indicate a concentration of economic power and market influence among a select group of firms, potentially hindering competition and innovation within the manufacturing sector. The question is whether this distribution affects other performance indicators, like overall labor productivity.

At the same time, large firms could play a pivotal role in the economic development of developing Indonesia, providing substantial advantages that smaller enterprises struggle to match. Chief among the potential benefits is large firms' capacity for higher productivity and innovation. Large firms can lower production costs by leveraging economies of scale and scope while investing significantly in quality improvements and adhering to international standards. This propensity for innovation is tightly linked to their productivity benefits, positioning them as key drivers of economic advancement.

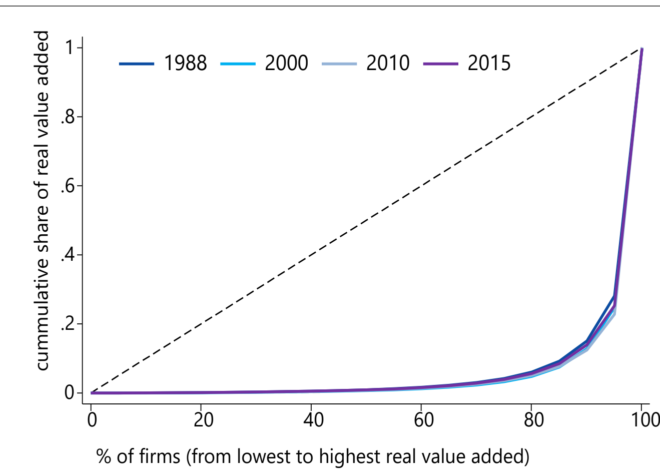
The presence of large firms can generate positive spillovers that benefit the broader economy. These firms disseminate valuable knowledge and best practices to smaller enterprises through agglomeration and robust supply chain linkages. Empirical evidence from South Korea illustrates how large companies' growth positively influences vendor SMEs' growth rates. Similar trends are observed in Europe and the United States, where small and medium-sized enterprises gain from being integrated into the supply chains of larger corporations, enhancing their growth and competitiveness.

Figure B.6: Analysis of manufacturing firm sales distribution: Indonesia vs. comparators



Source: World Bank Enterprise Surveys.
Note: All local currencies are expressed in 2009 US$.

Figure B.7: Analysis of manufacturing firm sales distribution: Indonesia across time



Source: Indonesia Central Statistics Agency (*Badan Pusat Statistik, BPS*)[38]

[38] Indonesia's BPS (*Badan Pusat Statistik*) manufacturing data is a comprehensive dataset provided by the Indonesian Central Statistics Agency. This data encompasses various aspects of the manufacturing sector and medium and large firms, including production volumes, employment statistics, and economic output. The data is collected through regular surveys and censuses conducted by BPS.

2.3 The Performance of Large Firms

Despite the presence of large firms, Indonesia's average performance still needs to improve. This raises questions about these large firms' relative performance and economic contribution. We want to know their contributions to employment, average wages, and reallocation performance.

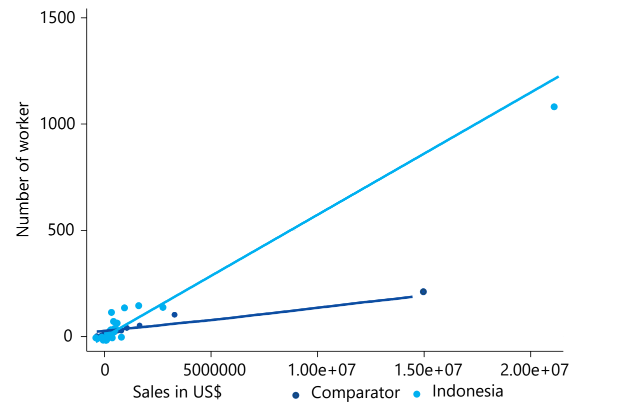
Furthermore, large firms contribute to better labor market outcomes by offering higher wages and more secure employment.[39] Workers in these enterprises typically earn significantly more than smaller firms, with wage premiums averaging around 22% higher per hour. This premium is even more pronounced in lower-income countries, where large firms provide formal jobs with valuable non-monetary benefits such as health insurance. These aspects enhance worker welfare and contribute to a more stable and productive labor force.

Job creation and economic growth are also closely tied to the activities of large firms. They significantly contribute to net job creation and labor productivity growth, impacting national economies. For instance, in countries like Vietnam, Côte d'Ivoire, and Serbia, the most prominent firms account for a considerable portion of total tax revenue and exports, underscoring their critical role in supporting public finances and international trade.

2.3.1 Employment

One important question is how large firms affect employment. Figure B.8 illustrates the relationship between sales and employment, controlling for firm, sector, and country characteristics across firms in Indonesia and comparator economies. As expected, the figure shows a positive correlation between sales and jobs for firms in Indonesia and comparator economies. Indonesian firms and their counterparts exhibit a similar positive association between sales and jobs, where higher sales are linked with higher employment levels. This encouraging trend is consistent across both groups. However, despite this similarity, the strength of the correlation differs. Firms in comparator economies show a significantly stronger correlation between sales and employment than Indonesian firms, indicating a lower employment response to sales growth for Indonesian firms.

Figure B.8: Relationship between firm sales and employment – Indonesia vs. comparators



Source: World Bank Enterprise Surveys
Note: All local currencies expressed in 2009 US$.

2.3.2 Efficient allocation of resources

Understanding how well utilized scarce resources are allocated and used in the economy is crucial for comprehending firm-level productivity dynamics and overall economic health. Allocative efficiency measures whether there is an optimal distribution of resources among firms, where firms' most productive use of land, labor, and capital are allocated enough of these resources to turn them into valuable products and services. This understanding of allocative efficiency enables an assessment of the effective deployment of resources across diverse businesses. Efficient allocation rewards the most productive firms, contributing to overall economic growth. In contrast, inefficiencies in allocation can lead to suboptimal outcomes, with less productive firms receiving an undue share of resources.

To understand these efficiencies, we examine the relationship between market shares at the industry level and the average allocation of labor and capital that firms in the same industry employ. Specifically, we investigate whether firms with above (below) average market share in sales employ more (less) capital and labor than the average firm. This analysis helps determine if the market allocation is efficient. Where well-performing firms benefit the economy more, low-performing firms employ less than above-average resources.

Allocative inefficiency arises when firms with market shares deviate from the average overuse or

[39] International Finance Corporation (IFC) Making It Big: *Why Developing Countries Need More Large Firms 2020*. https://thedocs.worldbank.org/en/doc/717891604534837739-0090022020/original/110520MakingItBigWhyDevelopingCountriesNeedMoreLargeFirms.pdf

underuse labor and capital resources. In Indonesia, a negative correlation is evident between a firm's market share and its employment of labor and capital. This inefficiency is observed regardless of whether a firm's market share is above or below average. Conversely, in comparator economies, only capital allocation exhibits a positive correlation with market share. Firms with higher market shares employ more capital, while those with lower market shares employ less. These comparator countries have no significant relationship between market share and labor allocation.

The results call into question the contribution to productivity from large firms in the Indonesian manufacturing economy.

3. Tackling Regulatory Uncertainty, the Next Challenge

However, the structural inefficiencies of Indonesia's corporate landscape are only part of the story. The other challenge lies in the realm of regulatory uncertainty. As Indonesian businesses navigate the complex legal and regulatory framework, they are often affected by inconsistent policies and unpredictable enforcement. This volatile environment affects entrepreneurial initiative and deters potential investments that could catalyze the much-needed economic dynamism and productivity enhancements. Thus, to comprehend the full spectrum of obstacles impeding Indonesia's economic ascent, we must delve into the intricacies of its regulatory climate.

Regulatory uncertainty may also reinforce Indonesia's private sector structure rigidities because large firms can better navigate such an unpredictable landscape. Typically, larger firms have more significant financial and administrative resources to manage complex regulatory environments; an uncertain regulatory environment favors them compared to smaller firms. Large firms can afford specialized legal and compliance teams to interpret and adhere to regulations, mitigating compliance costs. In contrast, smaller firms often lack the resources and expertise to navigate constantly evolving regulatory landscapes, leading to comparatively higher compliance costs. Such uncertainty also exposes all firms to potential dubious practices to complete transaction. For smaller firms, such practices present an onerous cost.

Despite consistent improvement, including through the recent Job Creation Omnibus Law, there are indications that constraints within the business environment may continue to hinder productivity growth in Indonesia. Analysis shows that bribery and regulatory burdens negatively impact firm productivity, while improved access to finance has a positive effect. Bribery fosters corruption and inefficiency, diverting resources and increasing costs, while navigating regulations consumes time and reduces operational efficiency. Conversely, better access to finance enables firms to invest in growth and technology, enhancing competitiveness. Thus, the subsequent section will focus on these critical variables—corruption, bribery, and time spent with government regulation—to assess potential solutions for improving firm performance in Indonesia (see Figure B.9 and Figure B.10).

Time spent by managers dealing with government regulation has increased. Businesses flourish in environments characterized by transparent, efficient, and predictable regulatory frameworks. Transparency involves clear communication of rules, open processes for regulatory changes, and easy access to relevant information. Businesses thrive when they have a clear understanding of the rules and expectations. Efficiency in regulation entails minimizing compliance burdens for businesses and governmental entities. Predictability within regulatory systems fosters a sense of certainty for enterprises, which is crucial for strategic planning and operational decision-making. Clear delineation of rules and their consistent application mitigates uncertainties, averting potential setbacks and delays that can dampen investment enthusiasm and impede economic growth. By addressing these three elements—a regulatory framework can be developed that supports business growth.

Indonesia's complex and inconsistent regulatory landscape leads to significant enforcement issues. The discordance between central and local laws and regulations creates varying compliance burdens for business across regions (see Figure B.10). For example, in West Java, executives dedicate approximately 4 percent of their time to navigating these regulatory hoops. In stark contrast, the regulatory demands impose a negligible burden on senior management

Figure B.9: Senior management time spent dealing with requirements of government regulation

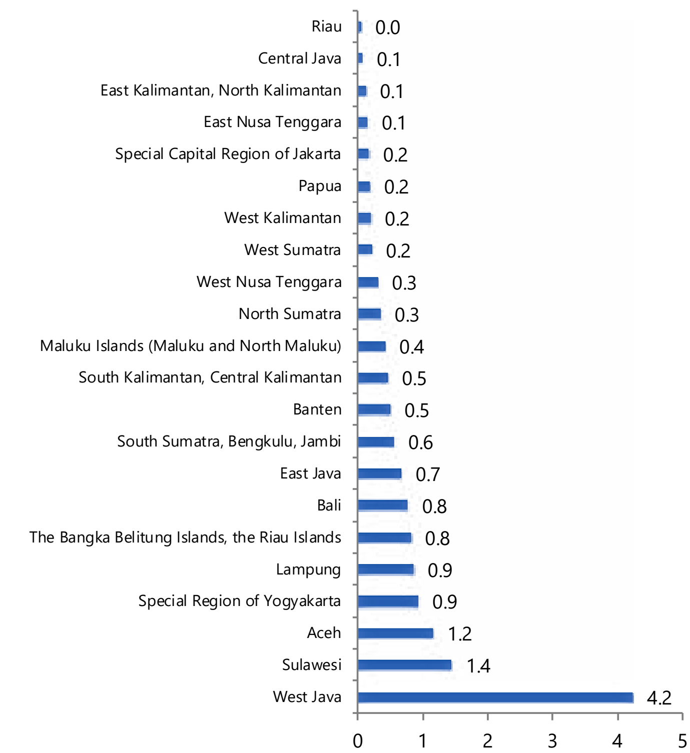
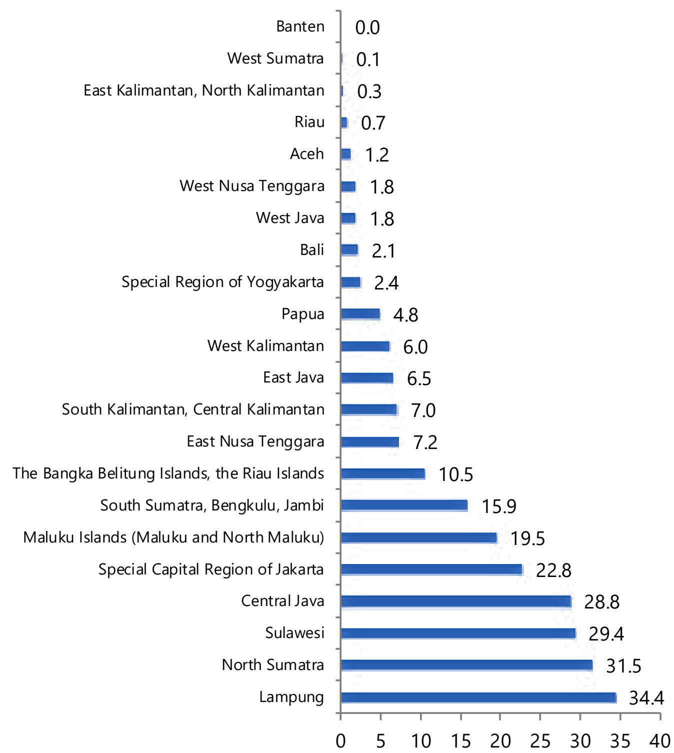


Figure B.10: Bribery depth (percent of public transactions where a bribe was requested)



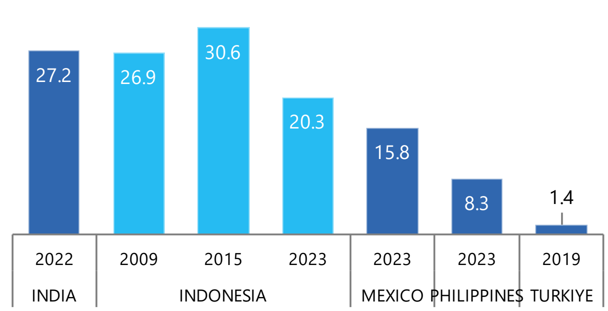
Source: World Bank Enterprise Survey data

in Riau, Central Java, and East and North Kalimantan. Such disparities underscore the pressing need for concerted efforts to streamline regulatory frameworks and enhance consistency in enforcement across Indonesia's diverse jurisdictions.

Corruption remains a major constraint in the business environment. This was identified by 23.6 percent of surveyed firms. Navigating opaque and discretionary regulations often pushes businesses toward illicit avenues, with bribery emerging as a coping mechanism of choice. The prevalence of corruption in public transactions across Indonesia fluctuates significantly. It correlates positively with senior management's time complying with government regulations (17 percent, discounting West Java as an outlier

Corruption is declining, but the expectation of 'gifts' to expedite the bureaucratic processes has increased, and corruption remains among the top constraints to productivity. Bribery incidence peaked at 31 percent in 2015 and fell to 20 percent in 2023, yet Indonesia's rate is still higher than most countries, second only to India (Figure B.11). The drop in Indonesia's corruption was likely a result of less cumbersome regulations. However, firms frequently find themselves compelled to navigate unofficial channels alongside official ones when securing business registration and construction permits. Indeed, 29.5 percent of surveyed firms indicate the necessity of offering gifts to public officials to expedite bureaucratic processes. Therefore, this underscores the need for sustained anti-corruption efforts, aided by streamlined regulations that reduce opportunities for bribery.

Figure B.11: Bribery incidence (percent of firms that report at least one bribe payment request)



Source: World Bank Enterprise Surveys (years indicate when the survey was implemented).

Finally, corruption undermines firm performance. Table B.3 reveals a clear negative correlation between bribery and productivity firms that engage in or are expected to engage in bribery more frequently than average tend to exhibit lower productivity than those that report fewer incidents of bribing government officials. This finding underscores the detrimental impact of corruption on economic efficiency and business operations.

The negative relationship between bribery and firm productivity is evident across different forms and stages of corruption. Each coefficient in Table B.3 indicates the effect of various bribery-related factors on productivity, with negative values indicating a detrimental impact. Firms deeply involved in bribery and those frequently having to pay bribes have considerable reduction in productivity. But other factors also, such as times spent dealing with regulations, the expectations to bribe, including to bribe tax officials, are all associated with reduced productivity. The consistent negative coefficients across all variables emphasize that both the anticipation and practice of bribery and associated regulatory burdens significantly diminish firms' productive capacities.

Table B.3: Relationship between bribing and firm productivity

Expected to bribe	Expected to bribe tax officials	Bribery depth	Bribery incidence	Time spent w/ Regulation
-0.009***	-0.006**	-0.025***	-0.023***	-0.010***

Source: World Bank Enterprise Surveys
Note: The table presents correlation coefficients between selected indicators of bribery and productivity of firm. *** statistically significant at the 0.001 level.

3.1 Regulatory Uncertainty

An unpredictable regulatory process further weakens the business environment, inhibits competition, and deters potential investors. The uncoordinated design and uneven implementation of business-related laws and regulations exacerbate deficiencies in the business climate by increasing regulatory uncertainty. This is especially daunting for prospective investors, who are typically less willing to deal with such uncertainty than incumbent businesses (World Bank 2020).[40]

Indonesia's regulatory reforms have yet to achieve the desired impact. The World Bank's Regulatory Policy and Delivery Review (RPDR) praised the government for introducing or strengthening many critical aspects of global Good Regulatory Practice (GRP) by 2020, especially at the executive level. However, the Review highlighted that these advances remain insufficiently established or only partially applied. Key areas requiring improvement include regulatory overlap and conflict due to poor coordination, overproduction of low-quality regulations, inadequate planning leading to frequent annulments, and a lack of clarity for innovative, technology-based activities. The Review emphasized that piecemeal reforms cannot resolve Indonesia's regulatory system's deeper institutional and structural issues. It recommended three broad actions: improving coordination across the regulatory system; ensuring the development of new regulations is evidence-based and transparent; and enhancing the transparency, efficiency, and currency of existing rules.

As a result of incomplete reforms, the specter of regulatory uncertainty looms large, casting a shadow over firms' investment endeavors and innovation prospects. Hallward-Driemeier, Khun-Jush, and Pritchett (2010) argue that this uncertainty, stemming from ambiguous policy implementation, jeopardizes firms' capacity to realize returns on their investments and innovative pursuits. A pivotal distinction is drawn between policies enshrined in official documents and their practical execution, as reflected in the actions of governmental authorities. Even when policies remain ostensibly stable on paper, their implementation uncertainty persists, posing intricate business challenges.

Moreover, regulatory uncertainty exerts a tangible drag on employment expansion. The authors' analysis reveals stark disparities among firms within the same national jurisdiction in navigating diverse regulatory requisites, be it the duration to procure operational licenses or to clear imported goods through customs. These disparities align closely with the proportion of firms grappling with heightened uncertainty regarding prevailing policies and regulations in their

[40] World Bank. *Indonesia Systematic Country Diagnostic Update.* Washington, DC: World Bank, 2020. https://documents1.worldbank.org/curated/en/717421594076964759/pdf/Indonesia-Systematic-Country-Diagnostic-Update.pdf

operational milieu. Furthermore, a discernible negative correlation emerges between heightened variability in policy execution and firm-level employment growth, underscoring the inhibitive impact of regulatory unpredictability.

Regulatory officials with discretionary powers play a pivotal role in this narrative. Excessive discretion can sometimes lead to challenges. In some cases, officials may expedite approvals in exchange for incentives, bypassing legal mandates such as granting construction permits without adhering to prescribed quality standards. Conversely, regulatory processes may be slowed for certain businesses, leading to consistency in the time required for regulatory endorsements and increasing regulatory uncertainty. In the subsequent analysis, the report identifies where and how Indonesian businesses encounter regulatory uncertainty. The analysis is directed towards three pivotal regulatory compliance domains: business registration, acquisition of construction permits, and tax inspections, each serving as barometers of regulatory uncertainty.

3.1.1 Business Registration[41]

Establishing businesses in Indonesia presents major challenges. While companies must register only once, obtaining pertinent information on requirements, procedures, and associated fees is challenging, accessible through a web portal or the regulator's office. Ostensibly, no informal requisites or procedures exist beyond the official ones. However, the reality belies this simplicity, as businesses often find themselves compelled to dispense informal fees to expedite the establishment and business licensing processes. These informal payments are perceived as essential lubricants to grease the wheels of bureaucratic machinery and navigate ambiguities inherent in the information provided to the registrar's office.

This challenge is exacerbated by the need for a robust information system, which hinders businesses from understanding the complex processes, costs, and timelines in starting operations. Entrepreneurs are still grappling with bureaucratic complexities despite efforts made by various ministries to make all requirements easily accessible including through the online platforms[42] for business establishment and licensing procedures. This complexity assumes heightened significance against the backdrop of the risk-based business licensing framework, wherein the business licensing procedures are contingent upon risk classifications. The forthcoming revisions to Government Regulations No.5 Year 2021—about implementing risk-based licensing—promise to provide greater clarity for business stakeholders navigating the intricate terrain of establishing a business.

Facilitated by Job Creation Omnibus Law enactment, the government enhanced the online platform for the business registration process (AHU Online) and the business licensing process (OSS) leading to improvements in starting a business.[43] The legislation streamlined and digitized the registration process, consolidating various steps into a single online platform and adopting a risk-based approach for OSS. The platform now provides comprehensive information and step-by-step procedures to guide businesses, reducing bureaucratic hurdles and expediting approvals. Additionally, the law standardizes procedures and clarifies guidelines, enhancing transparency and efficiency to foster a more favorable business environment, encouraging investment and economic growth. Challenges remain, including ensuring full digital adoption and integration nationwide, addressing interoperability challenges, improving the digital literacy of users, and resolving occasional technical issues with the online system.

3.1.2 Construction permits

Indonesia's construction permit regime is complex and lacks transparency, engendering a climate of uncertainty for businesses. The complex approval processes need more transparency, leaving applicants in the dark regarding the fate of their submissions. Adverse decisions are rendered devoid of justification, and avenues for appeal are conspicuously absent. This opacity fosters an environment ripe for hidden "fees" and breeds a culture of uncertainty.

Recent reforms have ushered in changes to the construction permit landscape. These reforms aim to replace Building Permits and Environmental Permits with Building Approval and Environmental Approval, respectively. However, this overhaul poses a difficulty for larger firms embarking on investments necessitating these additional approvals. Although the SIMBG (Building Management Information System)

[41] The coverage of business registration in this section encompasses the company's establishment and business licensing processes, which are part of business entry procedure.
[42] Company establishment & Business Licensing's procedure and requirement are available on the following platforms respectively: The platforms are AHU Online (https://panduan.ahu.go.id/doku.php) and OSS (https://oss.go.id/informasi).
[43] AHU Online is one of the government/agency's systems that has been integrated into the OSS system.

and AMDALNET (Environmental Approval System) have been integrated into the OSS system since 2023, only some activities/requirements can be processed online directly through the OSS. Medium-high risk and high-risk activities were only integrated from AMDALNET into the OSS system in March 2024).

Consequently, medium to high-risk projects grapple with augmented compliance costs, requiring a cumbersome blend of online and offline procedures and entailing interactions with various public entities at both central and local levels. For example, the Building Approval (PBG) procedure, which uses the digital SIMBG platform, aims to streamline approvals. However, it is currently slowed by lingering analog practices and the need for fully digital documentation. Additionally, the verification of technical documents by professional teams can be complex. These complexities render these projects more susceptible to corruption and discretionary practices among public officials, exacerbating the challenges inherent in Indonesia's construction permit ecosystem. Addressing these issues will help realize the benefits of faster and more efficient building approvals, enhancing the construction process for businesses.

3.2 Efficiency and uncertainty in regulatory compliance

To understand how regulatory complexity affects firms, we extend our analysis by looking into the dynamics of efficiency and discretion across a broader spectrum of regulatory compliance regimes. Since there are more than 800 licensing regimes in the Indonesian regulatory system, we focus on universal government transactions no matter what part of the world a firm operates.[44] This way, we can compare how well Indonesia compares to the rest of the world. Leveraging insights from multiple rounds of World Bank Enterprise Surveys conducted in Indonesia, we provide empirical evidence of the interplay between regulatory efficacy and uncertainty, offering a new understanding of Indonesian businesses' regulatory landscape.

3.2.1 Efficiency and discretion: Cross-country analysis

The WBES provides invaluable data on how regulations affect efficiency and uncertainty. For instance, the average transaction time gauges regulatory efficiency, while the variance indicates uncertainty.[45] A high variance suggests variability in wait times, reflecting uncertainty, whereas a low variance signifies more predictable transactions.[46] Therefore, the variance is crucial for identifying and addressing regulatory inefficiencies and uncertainties that may compromise regulatory frameworks. The analysis was conducted for Indonesia and four comparator countries and covers seven regulatory transactions, It resulted in data for 35 country/regulatory pairs. Figure B.12 illustrates the efficiency and uncertainty levels associated with these regulatory interfaces.

The finding indicates that regulatory transactions vary in efficiency and uncertainty levels. Graphed are all of the regulatory transactions recorded by the WBES undertaken by firms in four comparator countries, plus Indonesia, in the latest round of surveys. They are mapped by the average time it took to complete the transaction (efficiency) and the variance across firms of the time it took to complete these transactions (uncertainty).

Few regulatory interfaces qualify as efficient and predictable (quadrant 1). At the same time, many are inefficient and highly uncertain (quadrant 3). Among intermediate cases, some are efficient but highly uncertain (quadrant 2), and a smaller number are inefficient but predictable. Most regulatory transactions show high discretion (28 out of 35), indicating significant variation. Interestingly, many efficient transactions also have high discretion (23 out of 28), underscoring the complexity of regulatory processes.

There are notable differences between firms of different sizes and their experience with regulatory interfaces. Figure B.14 shows that, on average, large firms took longer to complete the regulatory procedures than small and medium firms. However, the variance (CoV, in the chart) was lowest for the large firms, followed closely by medium firms, indicating that these two categories faced less uncertainty when complying with regulations than small firms.

[44] Currently, there are 318 Sectoral Business Licensing and 550 Business Licensing to Support Business Activity (PB-UMKU) across more than 18 ministries/agencies.
[45] We use the coefficient of variance as the measure of variance, which is the ratio of the standard deviation to the mean. Since larger firms have more complex transactions and consequently longer wait times, we normalize the variance of wait times by dividing by the average wait time for each transaction. This allows us to compare variances across different types of firms.
[46] These are obtaining electricity and water connections, clearing exports and imports through customs, obtaining construction permits, and operating and import licenses.

Figure B.12: Efficiency vs uncertainty in regulatory compliance

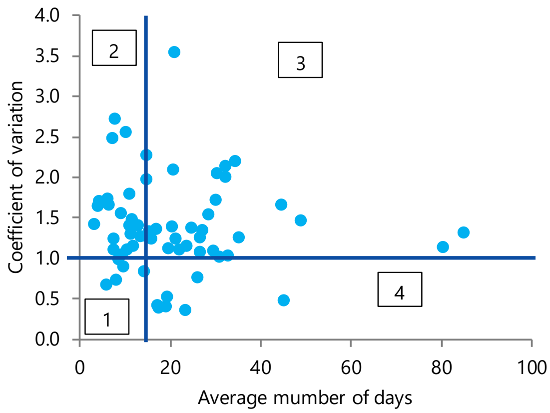
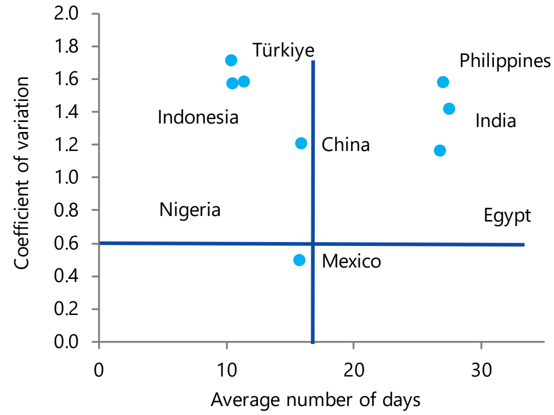
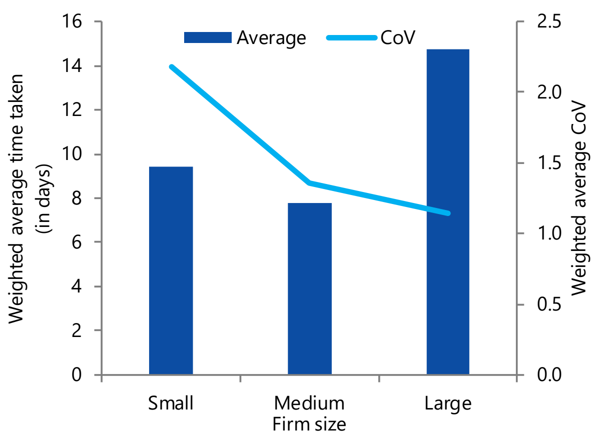


Figure B.13: Average efficiency and discretion across regulatory compliance regimes: Indonesia and comparator countries



Source: World Bank Enterprise Survey data

Figure B.14: Indonesia: Regulatory efficiency and discretion across firm sizes in 2023

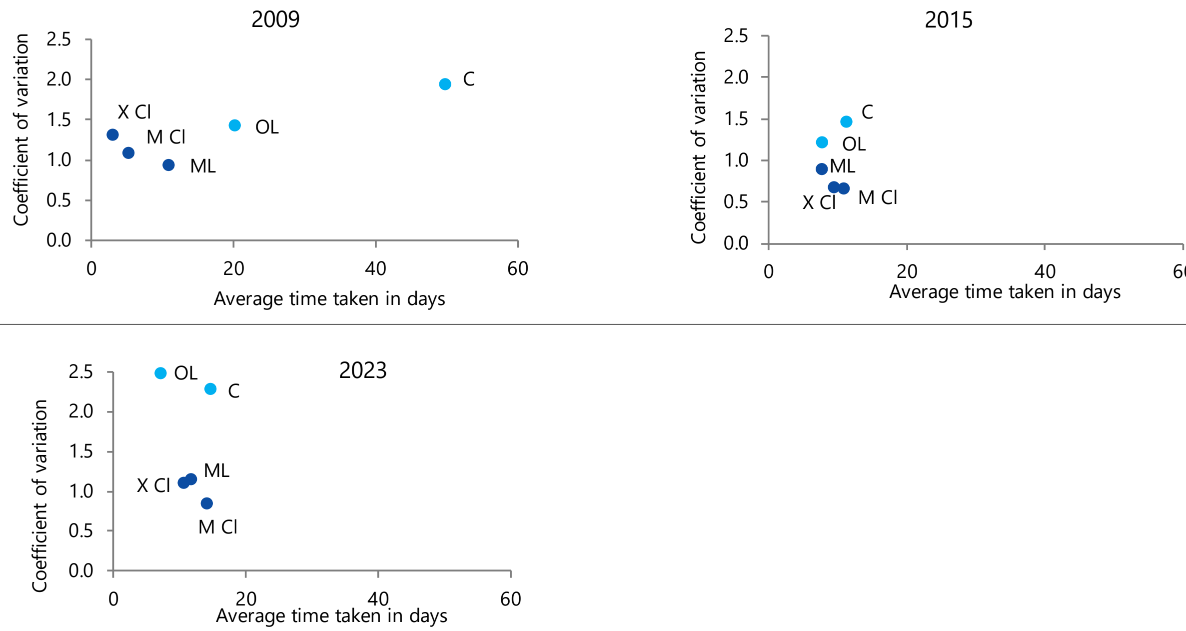


Source: World Bank Enterprise Survey data

Regulatory efficiency and uncertainty have improved. In 2009, there was wide variation in efficiency across different regulatory interfaces. The time taken to complete a regulatory procedure ranged from three days to obtain an export clearance to 50 days to obtain a construction permit (Figure B.16; panel 1). Similarly, the degree of discretion, measured by the variation of time taken, varied from a low of 0.94 for import licenses to a high of 1.93 for obtaining a construction permit. Two of the five regulatory interfaces fell in the northeast quadrant, reflecting the worst of both worlds, i.e., low efficiency and high discretion. All these areas relate to starting a business, i.e., construction permits and operating licenses.

The situation improved considerably by 2015, but momentum slowed more recently. There was much less variation in performance across the regulatory interfaces (Figure B.16; panel 2). All regulatory areas fell in the two western quadrants, indicating a significant improvement in efficiency. For example, the average number of days to obtain a construction permit fell from 50 days in 2009 to 11 days, while that of obtaining an operating license from 20 days 8 five days. The variation ranged from 0.66 to 1.5. This trend is reversed in 2023 (Figure B.16; panel 3), but mainly in the degree of discretion. All regulatory interfaces, except import clearance, had variation above the threshold of 1.0, with a broader range than in 2015, i.e., from a low of 0.8 for import clearance to a high of 2.5 for obtaining an operating license.

Figure B.15: Indonesia: Regulatory efficiency and discretion over time



Source: World Bank Enterprise Survey
Note: C refers to the construction permit, OL refers to operating license, M CL refers to import clearance, X CL refers to export clearance, and ML refers importing license

4. Takeaways and Policy Recommendations

In the past ten years, Indonesia's private sector reforms have improved the business environment but have not translated into productivity gains. The narrative has evolved from basic infrastructure and regulatory harmonization to a more difficult need for market efficiency (quality of regulations, access to finance, trade, etc.), competition, and innovation. Access to finance, corruption, and time spent dealing with government regulations affect firms' productivity the most.

Indonesia's private sector is characterized by many smaller firms alongside few dominant players. While this structure offers some potential advantages, it also presents significant challenges for growth and development.

On the positive side, the scale of large firms grants them the ability to capitalize on economies of scale, potentially yielding lower production costs and consumer prices. Moreover, their substantial resources enable significant investments in research and development, propelling industry-wide innovation and technological progress. Established brand recognition and robust marketing capabilities extend their market reach, fostering stability and consumer trust. Additionally, the global footprint of large corporations can enhance a nation's export prowess, positioning it as an industry leader on the international stage.

However, there exist notable drawbacks. Such sizeable entities translate into market dominance; this can dampen competition, thereby diminishing incentives for innovation and growth. This top-heavy market structure may also disadvantage smaller enterprises since dethroning large firms will be a formidable challenge for up-and-coming firms that dare to enter a market dominated by large firms. Furthermore, market leaders may exploit their power, impose higher prices, and potentially wield undue influence over governmental policies to serve their interests. Moreover, limited consumer choice may ensue when a handful of major players control the market, curtailing variety in products and services.

The dominance of giant firms can operate in markets segmented from smaller firms. Such segmentation can impede growth, innovation, and global competitiveness. Notably, the dominance of large firms in Indonesia's manufacturing sector could impede opportunities for outsourcing or sourcing from local small-scale suppliers. Resource limitations make the small-scale suppliers unattractive partners for industry giants, disinclined to engage due to concerns about quality consistency and scalability amid intense competition for contracts. Such dynamic impacts knowledge transfer and technological innovation, hampering sector-wide competitiveness and growth potential.

Without links to larger firms, smaller firms may be more vulnerable to external shocks, such as economic downturns. With limited resources and poor financial resilience, this vulnerability poses significant risks, triggering cascading effects like job losses and economic downturns. Additionally, unequal revenue distribution within the sector exacerbates disparities, as concentrated profits among a few large firms limit government revenue, constraining crucial social spending and infrastructure development vital for citizen welfare and sustainable economic growth.

Lower labor productivity within the manufacturing sector explains some of its lackluster performance. A cursory look at Indonesia's manufacturing firms compared to cohorts in India, Mexico, the Philippines, and Türkiye reveals a substantial concentration of data towards the lower end of the productivity spectrum within Indonesia's distribution, depicted by a bell-shaped curve. This suggests that a significant workforce segment exhibits comparatively lower productivity levels than their counterparts in other economies.

Lower labor productivity results in diminished output per unit of labor input. Consequently, manufacturers may need help competing on price and quality in the global marketplace. This, in turn, can impede economic growth, as constrained output expansion within the manufacturing sector may stifle a nation's overall economic advancement.

The costs of complying with regulatory transactions are trending downward and are low, but regulatory uncertainty is still a burden. Regulatory uncertainty and other hassles of dealing with regulatory bodies are often due to poor quality of regulatory governance, making policy and regulations vulnerable to capture, privilege-seeking, and corruption. The government recognizes this, and in 2015, it issued the National Strategy for Regulatory Reform 2015-19, the first-ever initiative of this nature. Sixteen economic policy packages followed from this. Some focused primarily on regulatory reforms, such as Economic Package 12 and Economic Package 16, which aimed to accelerate streamlining licensing and permitting processes. Other economic packages also contained regulatory reform components.

4.1 Policy Recommendations

Addressing fragmentation between firms will create more and better jobs. Strengthening linkages among the various segments of the private sector—formal and informal, small and large—will mitigate the dual economy issue, where segments operate with little interaction. The government should adopt a comprehensive approach beyond local content and downstream initiatives to develop supplier quality, enhance technology transfers, and build resilience, fostering a robust and interconnected private sector. Supplier development programs will enable local businesses to benefit from investments to improve skills and the workforce sustainably. Enforcing contracts through streamlined court structures, transparent and standardized court proceedings and case management rules, and advanced court automation systems will increase trust among formal firms. Additionally, alternative dispute resolution (ADR) mechanisms can reduce the courts' burden, provide more efficient and effective means of resolving disputes, and promote greater access to justice for all stakeholders. These linkages can be partially strengthened by improving the design and implementation of existing regulations on partnership between MSMEs and large firms (Ministry of Investment Regulation No. 1 Year 2022) and innovation (Ministry of Finance Regulation No. 153/PMK.010/2020).

Addressing regulatory uncertainty will enhance investment quality and facilitate business operations. The government could conduct digital-inspection to assess the implementation gaps across regions. Business compliance with environmental and social standards remains a significant constraint. Hence, ensuring that risk-based licensing for medium and high-risk business activities can be completed online transparently and uniformly across the country is essential. This requires a comprehensive IT modernization across various ministries, departments, and agencies. Reviewing, re-classifying and re-purposing the volume of licenses, many of which are redundant or require overly frequent renewal, is a meaningful step. This reform would require support from various sectoral ministries to ensure the effectiveness of digital-based licensing and compliance with service level agreement. These cumulative improvements are expected to significantly facilitate investment realization and business operationalization, aligning the country with international best practices. Eliminating uncertainty will benefit small and large firms, stimulating enterprise dynamism and attracting much-needed investments.

Annex

Annex Table 1: Allocative efficiency: Relationship between capital and labor allocations and size (sales) and market concentration (HHI Index)

	Indonesia				Comparators			
	labor		capital		labor		capital	
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Missing reference category is 1st quartile in annual sales								
2nd quartile in annual sales (dummy=1)	0.5725**	0.6523**	0.0524	0.0507	0.4426***	0.4601***	0.3317***	0.3408***
	(0.288)	(0.292)	(0.459)	(0.459)	(0.114)	(0.113)	(0.110)	(0.110)
3rd quartile in annual sales (dummy=1)	0.6011**	0.6468***	-0.0627	-0.0623	1.1535***	1.1598***	0.4583***	0.4429***
	(0.236)	(0.235)	(0.488)	(0.489)	(0.138)	(0.138)	(0.133)	(0.133)
4th quartile in annual sales (dummy=1)	0.8192***	0.7691***	-0.5037	-0.5054	0.8866***	0.9018***	0.1640	0.1493
	(0.304)	(0.279)	(0.466)	(0.466)	(0.167)	(0.166)	(0.130)	(0.130)
Missing reference category is HHI Index=1								
HHI Index=2		2.0111***				0.2656		0.6302**
		(0.396)				(0.286)		(0.278)
HHI Index=3		1.7596***				0.4138		0.5843**
		(0.391)				(0.275)		(0.284)
Constant	-1.8060***	-3.6260***	-1.1014***	-1.0997***	-1.6382***	-2.0144***	-0.8989***	-1.4994***
	(0.153)	(0.406)	(0.365)	(0.366)	(0.071)	(0.286)	(0.060)	(0.287)
Observations	806	806	239	235	6,325	6,325	5,989	5,989
Standard errors in parentheses								
***** p<0.01, ** p<0.05, * p<0.1**								

This table provides the regression results on the relationship between the efficient allocation of labor and capital. It compares these allocations across different company sizes and market competitiveness levels. The unweighted estimates are based on the fixed effects of country, industry, and location. We are cautious about overinterpreting the results because of likely collinearity issues with one of the dependent variables (size based on sales) and the dependent variable (a derivative of industry-level market share). Also, when using the Herfindahl-Hirschman Index to measure market concentration, we dropped the industry dummy as market concentration is estimated at the industry level.

Columns (1) and (2) are the regression results for labor allocation for Indonesia. Columns (3) and (4), again for Indonesia, but the allocation results for capital allocation. Also, columns (5) and (6) are the regression results for labor allocation for comparator economies, while columns (7) and (8) are the regression results for capital allocation.

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