

INDONESIA
ECONOMIC
QUARTERLY

March 2018

Towards inclusive growth

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Preface

The Indonesia Economic Quarterly (IEQ) has two main aims. First, it reports on the key developments over the past three months in Indonesia's economy, and places these in a longer-term and global context. Based on these developments, and on policy changes over the period, the IEQ regularly updates the outlook for Indonesia's economy and social welfare. Second, the IEQ provides a more in-depth examination of selected economic and policy issues, and analysis of Indonesia's medium-term development challenges. It is intended for a wide audience, including policy makers, business leaders, financial market participants, and the community of analysts and professionals engaged in Indonesia's evolving economy.

The IEQ is a product of the World Bank's Jakarta office and receives editorial and strategic guidance from an editorial board chaired by Rodrigo A. Chaves, Country Director for Indonesia. The report is compiled by the Macroeconomics and Fiscal Management Global Practice team, under the guidance of Ndiame Diop (Practice Manager), and Frederico Gil Sander (Lead Economist). Led by Derek H. C. Chen (Senior Economist and lead author), the core project team comprises Arsianti, Dwi Endah Abriningrum, Indira Maulani Hapsari, Ahya Ihsan, Yus Medina, Alief Aulia Rezza, Jaffar Al-Rikabi, Dhruv Sharma, and Pui Shen Yoong. Administrative support is provided by Sylvia Njotomihardjo. Dissemination is organized by Nugroho Sunjoyo, Jerry Kurniawan, and GB Surya Ningnagara under guidance of Lestari Boediono Qureshi.

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Acronyms

AEOI	Automatic Exchange of Financial Account Information
Bappenas	Badan Perencanaan Pembangunan Nasional (Indonesian National Development Planning Agency)
BI	Bank Indonesia
BEPs	Base Erosion and Profit Shifting
BLUs	Badan Layanan Umum (Public Service Delivery Units)
BOP	Balance of Payments
BPK	Badan Pemeriksa Keuangan (Supreme Audit Agency)
BPKP	Badan Pengawasan Keuangan dan Pembangunan (Finance and Development Supervisory Agency)
BPNT	Bantuan Pangan Non Tunai
BPS	Badan Pusat Statistik (National Statistics Agency)
CEQ	Commitment to Equity
COTS	Commercial off-the-Shelf
CPI	Consumer Price Index
CPO	Crude Palm Oil
CRM	Compliance Risk-Management
DAK	Dana Alokasi Khusus (Specific Allocation Fund)
DAU	Dana Alokasi Umum (General Allocation Fund)
DGT	Directorate General of Taxation
DID	Dana Insentif Daerah (Village Incentive Fund)
ECED	Early Childhood Education and Development
EMCI	Emerging Market Currency Index
EMDE	Emerging Market and Developing Economies
ERM	Enterprise Risk-Management
ESDM	Ministry of Energy and Mineral Resources
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
IEA	International Energy Agency
IMF	International Monetary Fund
IETU	El Impuesto Empresarial a Tasa Única (a flat rate business tax)
JCI	Jakarta Composite Index
JKN-PBI	Jaminan Kesehatan Nasional-Penerima Bantuan Iuran
LFPR	Labor Force Participation Rate
LGST	Luxury Goods Sales Tax
LHS	Left Hand Side
LNG	Liquefied Natural Gas
MIC	Middle Income Countries
MoF	Ministry of Finance
MSME	Micro Small and Medium Enterprises
NPL	Non-Performing Loans
OECD	Organization for Economic Cooperation and Development
O&G	Oil and gas
OPEC	Organization of the Petroleum Exporting Countries
PIP	Program Indonesia Pintar
PISA	Programme for International Student Assessment
PKH	Program Keluarga Harapan
PLN	Perusahaan Listrik Negara (Indonesian government-owned electricity company)
PMI	Purchasing Managers Index
PTKP	Penghasilan Tidak Kena Pajak (Non-taxable income)
Rastra	Beras Sejahtera (Rice for the poor)
R&D	Research and Development
RHS	Right Hand Side

RISKESDAS	Riset Kesehatan Dasar (National Health Survey)
RPJMN	National Medium-Term Development Plan
SAKERNAS	Survei Angkatan Kerja Nasional (National labor force survey)
SOE	State Owned Enterprises
S&P	Standard and Poor's
STR	Student Teacher Ratio
SUN	Surat Utang Negara (Government Securities)
Susenas	Survei Sosial Ekonomi Nasional (National social-economic survey)
TA	Technical Assistance
TAP	Tax Amnesty Program
ToT	Terms of Trade
VAT	Value-Added Tax

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Executive summary: Towards inclusive growth



Indonesia's real GDP growth accelerated in Q4, led by stronger investment

Real GDP growth picked up to 5.2 percent yoy in Q4 from 5.1 percent in Q3, driven by higher domestic demand, in particular stronger investment. Private consumption growth also strengthened marginally, partly due to consumer price inflation easing in Q4. Export and import growth moderated from a peak in Q3 and remained robust due to a sustained recovery in global trade and commodity prices. Net exports, however, were a drag on growth in Q4, partly reflecting higher investment in machines and equipment and associated imports of capital goods. After significant destocking in Q3, inventories contributed positively to GDP growth. On the production side, growth in manufacturing accelerated, while construction and other services sectors saw the fastest growth.

Favorable global conditions contributed to stronger GDP growth in 2017

For 2017 as a whole, GDP growth rose to 5.1 percent from 5.0 percent in 2016, the highest in 4 years. The stronger outturn was partly due to stronger investment and net exports, in line with the continued recovery in commodity prices, strong global growth and trade flows, and still relatively supportive global financing conditions.

Firming commodity prices were a key driver in investment and exports in Q4

Higher commodity prices contributed to investment and exports growth in Q4. Despite slowing credit growth, investment growth rose to a near 5-year high of 7.3 percent in Q4 from 7.1 percent in Q3, led by a jump in import-intensive machine and equipment investment, a category that includes mining yellow goods¹. Nominal growth of import of capital goods in Q4 consequently remained in the double-digits. Despite slowing from Q3, export growth of the six key commodities remained at a robust average of 22.4 percent in Q4.

¹ Yellow goods are equipment or machines that are used for construction, earth moving and quarrying. Examples include tractors, excavators and fork lift trucks.

- The current account deficit widened in Q4, but the overall external position remained robust** The current account deficit widened to 2.2 percent of GDP in Q4, from 1.7 percent of GDP in Q3, driven primarily by a lower goods trade surplus as higher imports of capital goods for investment offset higher export prices. For 2017 as a whole, improved terms of trade and the recovery in global trade helped the current account deficit narrow to 1.7 percent of GDP, the lowest in 6 years. Meanwhile, the capital and financial account surplus shrank in 2017. This was despite gross capital inflows surging more than three times higher than in 2016 thanks to improved investor confidence due to the credit rating upgrades and a low base effect. Consequently, bond yields declined across all tenors. Foreign direct investment also rose to a seven-year high in 2017. Healthy external accounts contributed to the stability of the Rupiah in 2017, although the continued strength in imports in Q4 and the beginning of this year has led to a weakening in recent months.
- Inflation eased in Q4 as food price inflation declined to a 14-year low** Despite higher commodity prices, headline consumer price inflation eased to an average of 3.5 percent yoy in Q4 2017 from 3.8 percent in Q3, supporting private consumption. Food price inflation reached the lowest quarterly average in 14 years, despite picking up since December. Core inflation in Q4 remained unchanged from Q3, the lowest quarterly average on record, reflecting stable inflationary pressures as the economy operates at near full employment. In annual terms, headline inflation was 3.8 percent, higher than the 3.5 percent in 2016, predominantly due to increases in administered prices in the first half of the year. Muted inflationary pressures supported Bank Indonesia's easing of monetary policy in 2017, including two consecutive 25 bps cuts in Q3. As inflation stabilized and global volatility increased, BI has kept interest rates steady at 4.25 percent since September 2017.
- Public investments also supported growth, but fiscal policy was restrained as the deficit narrowed in 2017** Total government spending in 2017 grew at its fastest pace in 3 years, supported by higher capital, material, and social spending. Notably, capital expenditures reached a disbursement rate of 96.9 percent, and grew 18 percent in 2017, the highest in 8 years. While total tax revenues as share of GDP fell to less than 10 percent in 2017, the exclusion of fees from the one-time Tax Amnesty program actually yielded an increase in the tax ratio from 2016, reflecting ongoing tax reform efforts. Higher commodity prices helped revenue growth reach a six-year high and kept the fiscal deficit at 2.4 percent of GDP in 2017, the lowest in three years.
- Healthy growth has been accompanied by higher poverty reduction** The official poverty rate – calculated using Indonesia's national poverty line – stood at 10.1 percent in September 2017, 0.6 percentage points lower than in September 2016, the largest yoy decline since March 2013. While growth in employment and real earnings slowed between August 2016 and August 2017, job creation tilted towards formal, manufacturing work. The manufacturing sector created 1.5 million jobs in 2017, absorbing many workers from agriculture, which saw a sharp decline in its share of employment.

Outlook continues to be positive on continued strength in domestic demand

The economic outlook continues to be positive with GDP growth projected to reach an average of 5.3 percent in the period 2018-2020 (Table 1). Although the tailwinds from commodity prices are expected to wane and eventually turn to headwinds, the momentum in import-intensive investment growth is expected to continue in the near term.

Table 1: Real GDP growth is expected to rise to 5.3 percent in 2018

		2017	2018f
Real GDP	(Annual percent change)	5.1	5.3
Consumer price index	(Annual percent change)	3.8	3.5
Current account balance	(Percent of GDP)	-1.7	-1.9
Fiscal budget balance	(Percent of GDP)	-2.4	-2.3

Source: Bank Indonesia; Central Bureau of Statistics (BPS); Ministry of Finance; World Bank staff calculations

Note: 2017 actual outcome; f stands for World Bank forecast

In light of the strong domestic demand, contribution from net exports is expected to be muted as terms-of-trade decline and import growth strengthens. Imports will also be facilitated by the ongoing streamlining of import processes.

Low inflation, spending in the upcoming elections and stronger commodity prices are expected to boost consumption growth

Empirically, inflation and the Rupiah have been found to be structural drivers of consumption growth, with effects sometimes increasing after a number of quarters. The current low inflation but with a weakening exchange rate have therefore opposing effects, creating an overall ambiguous effect on private consumption growth going forward. However, spending in the upcoming elections and stronger commodity prices are expected to provide an independent boost, leading to a modest improvement in private consumption growth over the next two years.

The fiscal deficit is expected to narrow while the current account deficit is projected to widen

Headline inflation is expected to pick up from 2019 partly due to higher import costs associated with higher crude oil prices. The fiscal balance is expected to narrow modestly over the forecasting horizon, in line with the smaller deficit stipulated in the 2018 budget, high oil prices, and critical revenue enhancing reforms being implemented, boosting total collections. The current account deficit is expected to widen over the medium term, in line with stronger domestic demand and weaker terms of trade.

Risks to the outlook include slower global trade, volatility and slower private consumption

Risks to the economic growth outlook are tilted to the downside. On the external front, with global protectionism on the rise, there is a risk that the nascent recovery in international trade could stall, weighing on global growth and commodity prices. Although the normalization of U.S. monetary policy is proceeding in an orderly manner, unexpected monetary tightening could lead to abrupt capital outflows from emerging markets. While private consumption strengthened in Q4, there remains a risk that private consumption will be lackluster or even weaken in the medium-term. Given that it constitutes more than half of GDP, any slowdown in private consumption could have notable repercussions on total expenditures.

This edition includes a focus topic that discusses the importance of fiscal policy to fostering inclusive growth and how Indonesia can better use fiscal tools to reduce poverty, promote inclusion and reduce inequalities.

To achieve inclusive growth, Indonesia needs to spend better and spend more in

Decisions on government spending and revenue collections – the core of fiscal policy – play a key role in supporting economic growth, and help share the benefits of growth more widely across society. Effective policies that promote inclusive growth, such as investing in human capital or enhancing the connectivity of remote areas,

priority areas, and to collect more revenues in an efficient and growth-friendly manner

both reduce inequality and promote growth. Indonesia's experience of the past 15 years suggests that fiscal policy has contributed positively to economic growth, notably through macroeconomic stability. However, fiscal policy has been less successful in sharing the benefits of growth more widely: inequality of opportunity remains substantial, and estimates suggest that taxes and public expenditure reduce Indonesia's Gini coefficient by only 0.04 points, compared to 0.18 points in South Africa. In the past, the impact of revenue and expenditure policies on inclusive growth has been dampened by underspending in priority areas such as infrastructure, health and social assistance, and by ineffective spending in those and other critical areas, especially education. Spending on priority areas has recently increased due to the reallocation of expenditures from energy subsidies; however, low revenue collections continue to hinder a sustained increase in priority sector spending. To achieve faster and more inclusive growth, Indonesia needs to spend better and spend more in priority areas. This will require continuing to enhance the effectiveness of line ministry and subnational spending, further reallocating spending across and within sectors, and collecting more revenues in an efficient and growth-friendly manner. Relevant tax reforms include broadening of the tax base, simplifying the tax code, and significantly strengthening compliance management.

A. Economic and fiscal update



1. Stronger domestic demand lifted growth in Q4

The Indonesian economy grew 5.2 percent yoy in Q4, the highest growth in six quarters

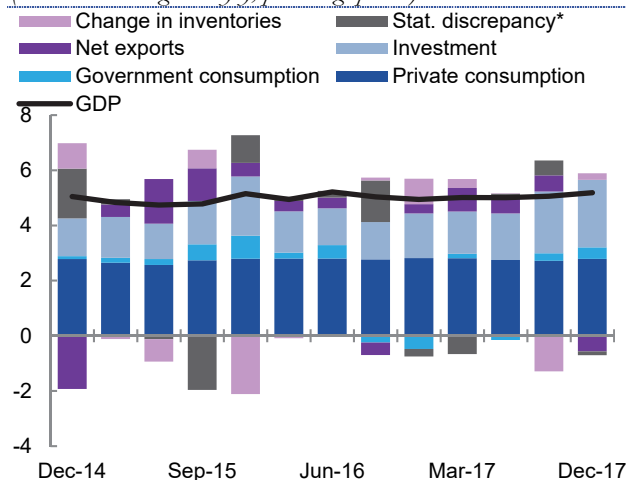
Indonesia's economy expanded 5.2 percent year-on-year (yoy) in Q4, the highest growth in six quarters. This was above the consensus forecasts for Q4 and growth in Q3, both at 5.1 percent. The uptick in GDP growth was driven by domestic demand, in particular stronger investment (Figure A.1). Export and import growth both slowed in Q4, but continued to be robust on the back of a sustained recovery in global trade and commodity prices. However, net exports dragged on growth in Q4, as imports grew faster than exports, partly reflecting higher investment in machines and equipment. Changes in inventories, which subtracted 1.3 percentage points (pp) from GDP growth in Q3, saw a turnaround in Q4, contributing 0.2 pp to GDP growth. On the production side, among the 9 production sectors, the manufacturing sector continued to contribute the most to growth, of 1.0 pp in Q4, but construction and other services sectors (public administration, defense, health, education, social work and others) saw the largest growth.

Real GDP growth rose to 5.1 percent in 2017, a four-year high, partly due to a stronger global economy

For 2017 as a whole, and in line with the World Bank forecast, annual real GDP growth accelerated to 5.1 percent from 5.0 percent in 2016, a four-year high (Figure A.2). The uptick in growth mainly driven by stronger investment growth and net exports, on account of the recovery in global commodity prices and stronger global economy and international trade flows (Box A.1).

Figure A.1: Stronger investment growth lifted GDP growth in Q4

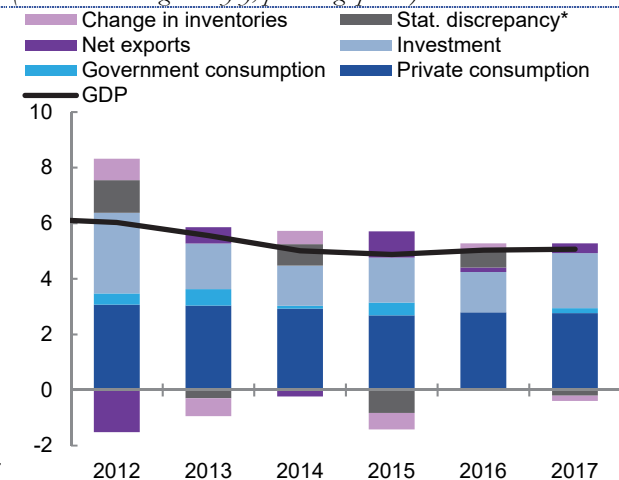
(contributions to growth yoy, percentage points)



Source: BPS; World Bank staff calculations

Figure A.2: Growth in 2017 reached the highest in four years

(contributions to growth yoy, percentage points)



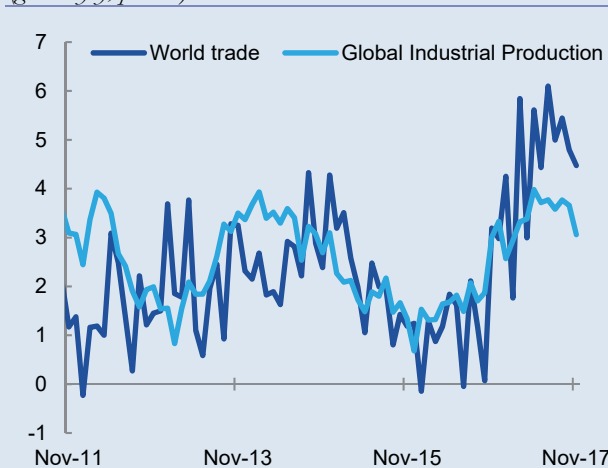
Source: BPS; World Bank staff calculations

Box A.1: The global economy ends 2017 on a strong note

The global economic recovery continued to be broad-based. Global growth remained sound in Q4 and throughout 2017. This was supported by strong global trade and investment¹, improved business confidence, and relatively supportive global monetary conditions². A sustained strengthening in global commodity prices, specifically energy commodity prices, also spurred growth of commodity exporting emerging economies. This continued upswing in the global economy has been supportive to the Indonesia economy.

Figure A.3: Global trade and industrial production growth in 2017 reached a six-year high

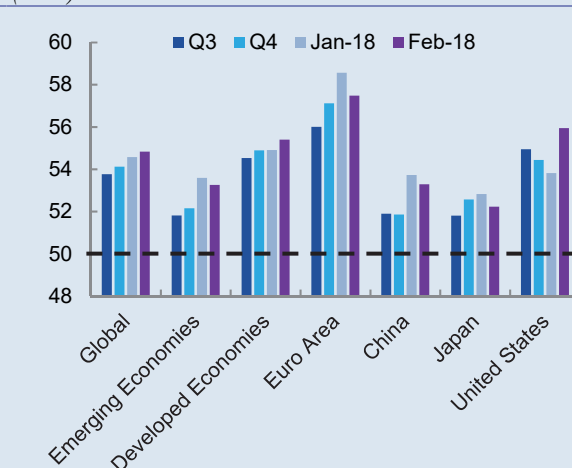
(growth yoy, percent)



Source: CBP World Trade Monitor, World Bank staff calculations

Figure A.4: Global Composite Purchasing Managers' Index recorded a near seven-year high outcomes

(index)



Source: Markit Economics, Haver Analytics; World Bank staff calculation

Note: Readings above 50 represent expansions and readings below 50 represent contractions.

Global economic activity continued to firm up throughout 2017, and high frequency indicators point to sustained in growth in Q1 2018. The steady pickup in global growth has been broad-based, coming from both advanced economies and emerging markets and developing economies (EMDEs)³. Growth in the major economies such as the Euro Area and the United States remained robust with the former growing 2.5 percent yoy in Q4, and the latter expanding 2.7 percent. Overall in 2017, the United States and Euro Area recorded growth at 2.3 percent⁴ and 2.5 percent (a 10-year high), respectively⁵. Meanwhile, growth in Japan accelerated to 2.0 percent yoy in Q4, bringing its

overall 2017 growth to 1.7 percent, almost doubling its 2016 growth of 0.9 percent⁶. Major emerging market and developing economies, such as Brazil and China also posted stronger growth in 2017 at 1.0 percent⁷ and 6.9 percent,⁸ the fastest since 2015, respectively.

Global trade also recorded a solid 2017 growth at 4.7 percent, the highest since 2011, despite a slight slowdown in Q4 to 4.9 percent yoy from 5.6 percent in Q3 2017⁹. Similarly, global industrial production growth slowed down from Q3 (Figure A.3), but still posted the highest growth in 6 years in 2017. Business sentiment also improved in Q4, signaled by the near seven-year high global composite Purchasing Managers' Index (PMI) of 54.1 in Q4¹⁰. This was partly supported by high growth in output and new orders (Figure A.4). In February 2018, the global composite PMI strengthened further to 54.8, led by a strong improvement in the United States, implying that the global upturn will likely be extended through Q1 2018.

¹ The growth rates of which both rose to six-year highs. (CPB, 2017).

² Global monetary conditions are still relatively accommodative, despite heightened expectations of a pickup in inflation in advanced economies, which would lead to faster than expected monetary tightening in the near future.

³ International Monetary Fund (2018). The World Economic Outlook also noted around 120 countries saw an acceleration in their economic growth in 2017, the broadest global growth pickup since 2010.

⁴ Compared to its 2016 growth at 1.5 percent yoy

⁵ Quarterly growth data was taken from OECD Quarterly GDP data, while annual growth data was taken from Eurostat and the US Commerce Department through Haver Analytics.

⁶ Cabinet Office of Japan through Haver Analytics. Data accessed on March 22, 2018.

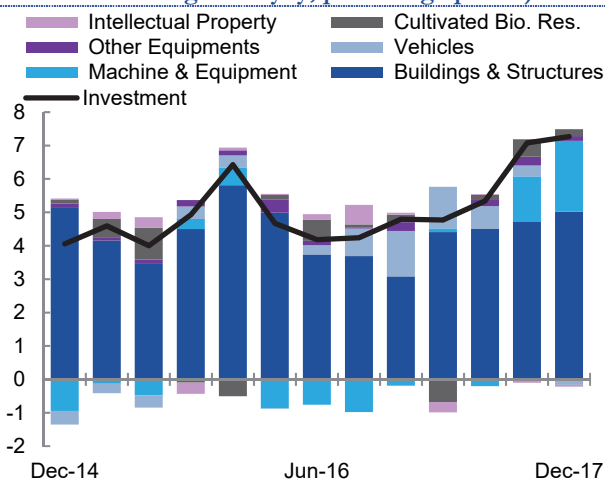
⁷ Consensus Forecast. Brazil recorded a strong turnaround in growth in 2017 compared to a contraction in the economy in 2016, registering a -3.5 percent yoy growth.

⁸ National Bureau of Statistics of China press release.

⁹ CPB World Trade Monitor, February 2018 – data only up to November 2017.

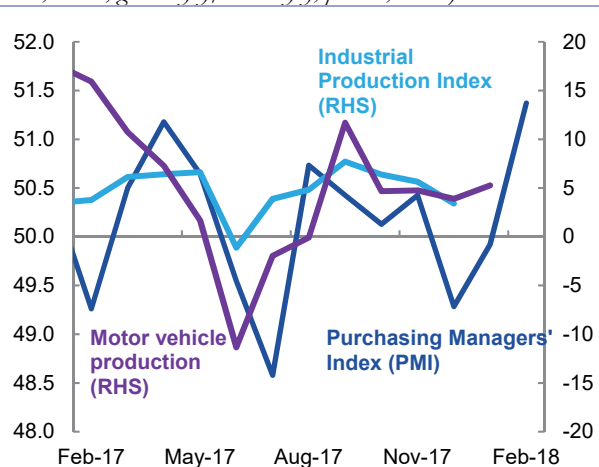
¹⁰ PMI readings above the 50 mark indicates expansion.

Figure A.5: Machinery and equipment investment continued to drive fixed capital formation (contributions to growth yoy, percentage points)



Source: BPS; World Bank staff calculations

Figure A.6: Industrial Production and Manufacturing Purchasing Managers' Index weakened (index, LHS; growth yoy/ 3mma yoy, percent, RHS)



Source: Nikkei/Markit; BPS; World Bank staff calculations

Note: IPI growth in yoy terms; motor vehicle production growth in 3-month moving average (mma) yoy terms. Manufacturing PMI above 50 points indicates expansionary territory.

Fixed investment growth continued to pick up and supported GDP growth in Q4

Gross fixed capital formation continued to be the economy's bright spot, with investment growth rising from 7.1 percent in Q3 to 7.3 percent in Q4, the highest in nearly five years (Figure A.5). Machine and equipment investment saw the fastest growth, rising from 15.2 percent in Q3 to 22.3 percent in Q4, in line with the sustained

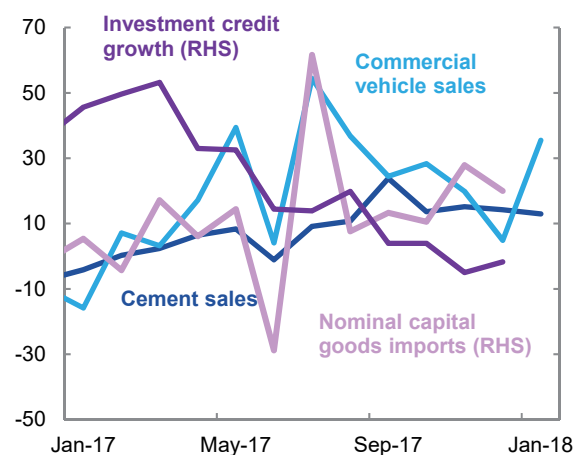
surge of nominal capital imports that remained in the double digits² in Q4. This, in turn, was partly driven by higher investments in the mining sector, in light of the higher global commodity prices. Buildings and structures investment remained the main contributor to overall investment growth in Q4, helped by an expansion in public investments. Nominal government capital expenditure leaped 43.0 percent in Q4, but partly due to the low-base effect in Q4 last year. Meanwhile, investment in vehicles slowed, mainly due to a high base effect in Q4 last year and consistent with the notable slowdown in commercial vehicle sales growth (Figure A.6). Also contributing to the strong investment growth, foreign direct investment saw double digit yoy growth in Q4, with the largest inflows going into the manufacturing sector.

Investment growth in 2017 reached a five-year high

Annual investment growth in 2017 rose to a five-year high of 6.2 percent from 4.5 percent in 2016. The gradual recovery of commodity prices, the continued low financing costs, stronger investor confidence due to the credit rating upgrades, and the jump in infrastructure investment and foreign direct investment, all contributed to the stronger investment growth.

Figure A.7: Commercial vehicle sales growth fell and investment credit growth continued to wane

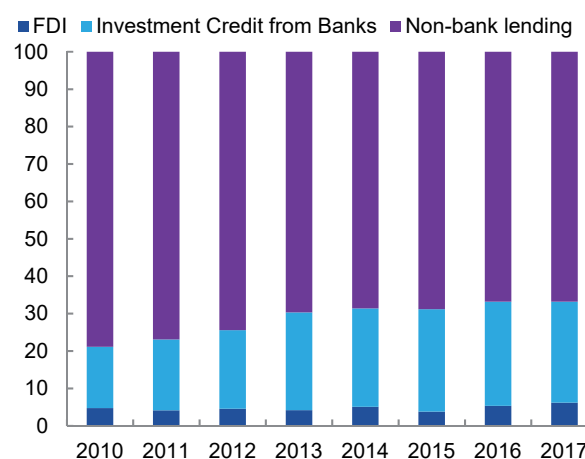
(3mma growth yoy, growth yoy, percent, LHS; growth yoy, percent, RHS)



Source: BI; BPS; World Bank staff calculations
 Note: Investment and nominal capital goods imports are measured in yoy terms. Cement and commercial vehicle sales are measured in 3-month moving average (mma) percent yoy terms.

Figure A.8: Only one third of investment is financed through FDI and bank lending

(share of total investment, percent)



Source: Bank Indonesia; BPS; World Bank staff calculations

However, monthly indicators for investment presented a weak picture

Meanwhile, Bank Indonesia’s series of policy interest rate cuts, amounting to a total reduction of 200 basis points over the last two years, did not strengthen credit growth to the private sector, as investment credit growth continued declining to 4.9 percent in Q4 from 6.3 percent in Q3³ (Figure A.7). However, it is noteworthy that both foreign direct investment (FDI) and investment credit from banks have historically constituted only around one third of total investment financing in Indonesia.

² Nominal capital goods import growth slowed but still registered a 19.6 percent yoy growth in Q4. Some of the components that recorded a slowdown were automatic data processing machines, commercial motor vehicle to transport goods, and building and structures machines (Bank Indonesia, 2018).

³ Strengthening investment growth together with declining credit growth suggests that investment was increasingly financed by non-bank lending.

Therefore, a large part of investment financing comes from non-bank lending such as equities, bonds, and retained earnings (Figure A.8).

Private consumption growth remained sluggish ...

Private consumption growth rose slightly to 5.0 percent yoy in Q4 from a revised 4.9 percent in Q3⁴. Private consumption growth has remained broadly flat since Q1 2016, sticking close to 5.0 percent. This is slower than the 2012-14 average of 5.4 percent, but only slightly below the 10-year average of 5.1 percent. For 2017 as a whole, private consumption expanded at 5.0 percent, unchanged from 2016.

Consumption on food and beverages was the largest contributor to private consumption growth with stronger growth in Q4⁵. The slight increase in consumption growth is consistent with the marginal uptick in consumption credit⁶, despite a significant reduction in consumption lending rate⁷, and lower inflation in Q4. Overall, muted private consumption growth is not a recent trend. In fact, private consumption growth has averaged at 5.0 since the second half of 2014, compared to an average of 5.5 percent in the period between 2012 to first half of 2014.

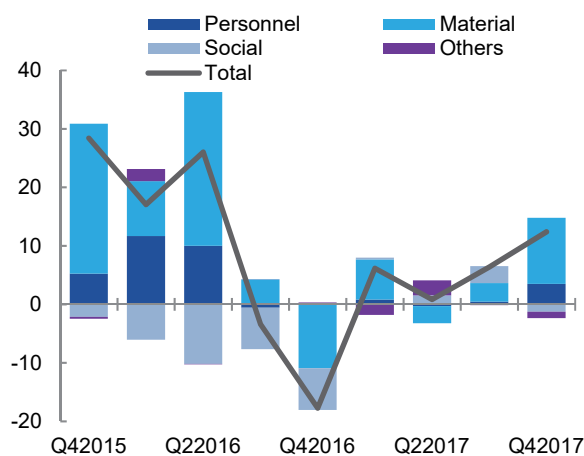
The pickup in Government consumption was sustained in Q4

Real government consumption continued to climb to 3.8 percent yoy from 3.5 percent in Q3.

The sustained pickup was partly due to a low base effect resulting from public expenditure cuts in Q4 2016, and a surge in nominal material spending⁸ (Figure A.9). Nominal growth in personnel spending also picked up⁹, while nominal social spending contracted¹⁰, unsurprising since most of the budgeted social spending had been disbursed by Q3. Overall for 2017, real government consumption saw a moderate rebound, growing 2.1 percent for the year after a 0.2 percent contraction in 2016.

Figure A.9: Government consumption continued to pick up, driven by nominal growth of material spending

(contributions to nominal growth, percentage points)



Source: Monthly budget realization data, Ministry of Finance, World Bank staff calculations

Note: Government consumption realization comprises Central Government spending on personnel, material, social, and others (grants and other) expenditure.

While export and import growth

In line with the slight easing in global activity in Q4, both export and import growth for Indonesia slowed from Q3; but with imports growing faster than exports, net

⁴ On a seasonally adjusted quarter-on-quarter annualized (qoq saar) basis, private consumption eased from 5.6 percent in Q3 to 4.5 percent in Q4. X12 seasonality adjustment was employed.

⁵ Contributing 1.9 pp to consumption growth, with growth strengthening to 5.4 percent yoy in Q4 from 5.1 percent in Q3.

⁶ 10.3 percent yoy in Q4 from 10.0 percent in Q3.

⁷ See detailed discussion in Section 4.

⁸ 22.0 percent in Q4 compared to 7.8 percent in Q3.

⁹ From Q3 growth of 0.9 percent to 9.7 percent in Q4.

¹⁰ Nominal social spending declined by 17.0 percent in Q4 from a growth of 36.9 percent in Q3.

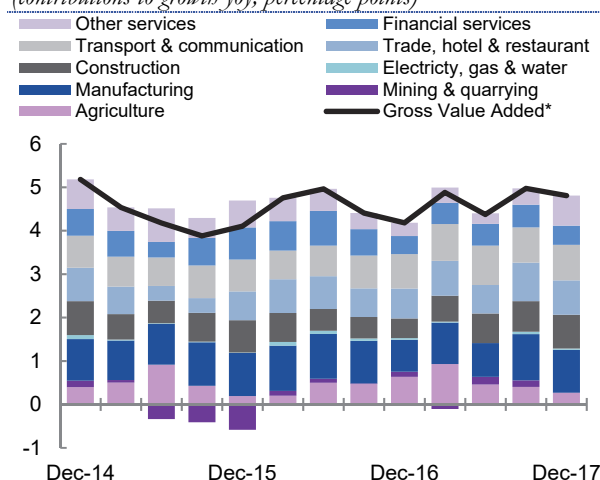
slowed in Q4, both expanded for the year 2017, the first time since 2014

exports were a drag on overall GDP growth. Export growth dropped to 8.5 percent in Q4, while import growth slowed to 11.8 percent. The moderation in export and import growth was partly due to base effects. In 2017, both real exports and imports saw a return to positive growth, the first time since 2014.

Construction and services sectors drove growth, consistent with the continued rebound in government spending

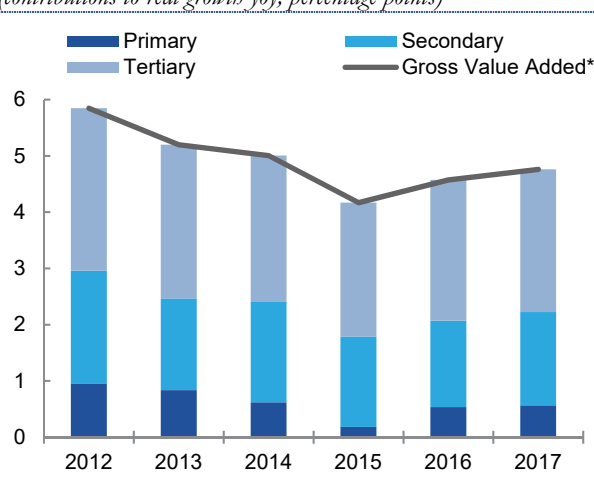
On the production side, the manufacturing sector remained the largest contributor to growth, across the 9 production sectors. Construction and other services sectors (public administration, defense, health, education, social work and others) saw the fastest growth rates¹¹, in line with the continued recovery in government spending (Figure A.10). Meanwhile, the mining and quarrying sector made the smallest contribution to overall GDP growth in Q4, recording a significant moderation in growth¹². This may be partly due to the long-running Contract of Work renegotiations between mining companies and the Ministry of Energy and Mineral Resources¹³. Meanwhile, the agriculture sector recorded the slowest sectoral growth for three consecutive quarters at 2.2 percent¹⁴, partly due to a pest and disease outbreak that caused harvest failures and hampered the production of agriculture commodities, causing supply shortages in certain commodities¹⁵. For 2017 as a whole, growth was broad-based across the three main sectors of the economy, with the secondary sector experiencing the most notable expansion (Figure A.11).

Figure A.10: On the production side, Q4 growth was driven by expansion in construction and services (contributions to growth yoy, percentage points)



Source: BPS; World Bank staff calculations
 Note: * Gross Value Added is derived as the sum of the value added in the agriculture, industry and services sectors. If the value added of these sectors is calculated at purchaser values, gross value added at factor cost is derived by subtracting net indirect taxes from GDP.

Figure A.11: Growth for 2017 as a whole was broad-based, driven by expansion of the secondary sector (contributions to real growth yoy, percentage points)



Source: BPS; World Bank staff calculations
 Note: Primary sector consists agriculture, mining and quarrying. Secondary sector includes manufacturing, utilities and construction; Tertiary sector consists of trade, hotel and restaurant, transport and communication, financial and other services.

¹¹ Growth of construction sector strengthened to 7.2 percent yoy in Q4 from 7.0 percent in Q3, while growth of other services sector strengthened to 6.8 percent from 4.0 percent.
¹² From 1.8 percent in Q3 to 0.1 percent in Q4.
¹³ Reuters (Februari 3, 2018).
¹⁴ Agriculture sector grew strongly in Q1 2017 at 7.1 percent yoy but moderated sharply to 3.2 percent in Q2 and 2.8 percent in Q3.
¹⁵ Tempo (2018). From the sub-categories of the agriculture sector, food farm crops recorded a contraction of 4.7 percent yoy in Q4, after a contraction 0.3 percent in Q3.

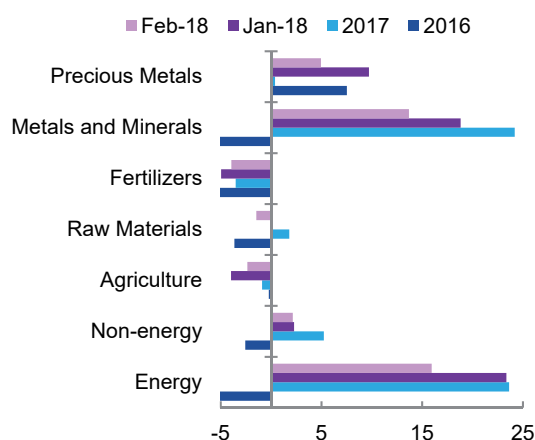
2. Higher commodity prices supported domestic demand

2017 also saw soaring global energy commodity prices

After dipping in the first half of 2017, global commodity prices surged in the second half of 2017, and remained buoyant entering into 2018. The World Bank energy price index soared in Q4 2017 and surged 23.6 percent yoy in 2017, driven mostly by strong coal and oil prices. The Brent oil price jumped 18.8 percent in December alone, due to tightening global supplies, partly from the extension of OPEC agreement to cut global oil production, as well as rising political uncertainty in the Middle East¹⁶. Meanwhile, the non-energy price index rose 5.2 percent in 2017, partly due to the metals and minerals price index leaping double digits. (Figure A.12).

Figure A.12: Global commodity prices recovered in 2017

(growth yoy, percent)



Source: World Bank Pink Sheet; World Bank staff calculations

The rally in commodity prices carried over into 2018. In January and February this year, commodity prices rose across-the-board, led by higher energy prices. Non-energy commodity prices also rose, partly due to higher metals and minerals prices, and precious metals prices.

Prices of Indonesia's key commodities on average rose in Q4

After predominantly shrinking during the first half of 2017, the prices for Indonesia's key export commodities that includes crude oil, crude palm oil (CPO), LNG, rubber, coal and base metals ended 2017 mostly on a positive note. Considerably higher prices of crude oil, coal and base metals in the second half of 2017 brought the average annual growth of the six commodities to 20.9 percent in 2017, contrary to the contraction of 4.4 percent in 2016 (Table A.1).

Energy and base metal prices continued to rally in Q4 on reduced supplies, while rubber and palm oil prices fell

After surging by 37.8 percent in Q3, coal prices jumped 5.9 percent yoy in Q4, reaching to a level not seen since 2012 on the back of supply tightness¹⁷. At the same time, crude oil prices jumped 20.0 percent to an average

Table A.1: Changes in commodity prices

(yoy, percentage)

	2016	2017	Q3-2017	Q4-2017
Coal (Australia)	14.6	34.2	37.8	5.9
Crude Oil (average)	(15.7)	23.4	12.3	19.6
Natural Gas (Japan)	(32.6)	16.2	23.3	12.3
Rubber	2.2	24.3	15.5	(15.6)
Crude Palm Oil	12.5	2.6	(3.9)	(6.6)
Base Metals	(7.2)	24.4	26.5	24.0

Source: World Bank (2017, 2018) and Macro Poverty Outlook 2018.

¹⁶ Economist Intelligence Unit (2018).

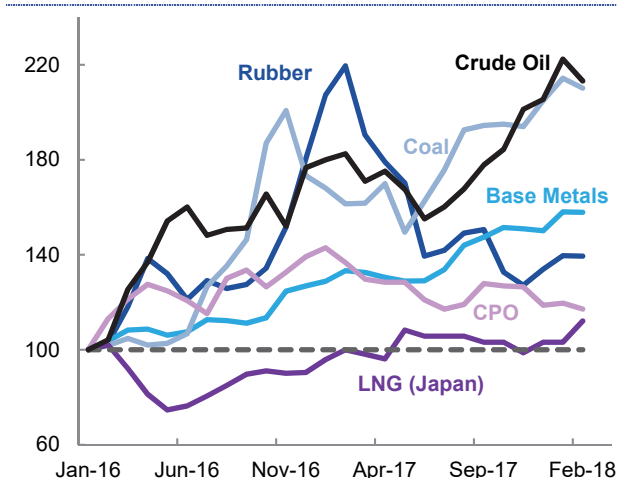
¹⁷ The rally in Q4 was mainly driven by supply disruption as one of the berths at Queensland's Dalrymple Bay Coal Terminal is undergoing a month-long scheduled maintenance, resulting in vessel queues swelling to a more than five-year high. See metalbulletin.com (December 27, 2017).

of USD 61.2 per barrel in Q4, stronger than 12.3 percent rise in Q3, on declining supply due to a substantial output fall in Venezuela and lower production from the North Sea (Figure A.13).

Prices of base metals gained 24.0 percent yoy in Q4, continuing 26.5 percent rise in Q3. The rally in industrial metals was driven by aluminum, copper, zinc, nickel and lead. The gains in aluminum and copper prices were mainly due to tighter supply, though the copper rally has intensified going into 2018 on expectations of higher demand on the back of faster growth around the world¹⁸.

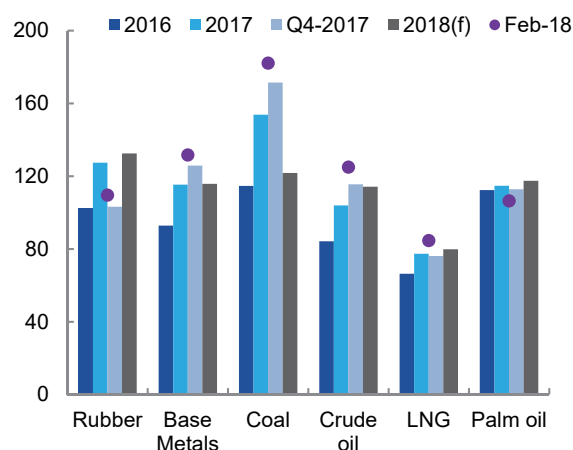
Palm oil and rubber prices, in contrast, finished 2017 lower. The former shrank 6.7 percent in Q4, faster than the decline at 3.9 percent seen in Q3, while the latter fell 15 percent in Q4, a complete turnaround from the 15 percent increase in Q3. Palm oil prices have been trending downwards since November following the decline in demand from India, after its government raised import taxes on edible oils to their highest in more than a decade. On the other hand, rubber prices have been weakening due to continuous oversupply over the year.¹⁹ Prices of these key commodities continued to strengthen in January and February 2018, with a number of them rising to multi-month and even multi-year highs. (Figure A.14).

Figure A.13: Global prices for most of Indonesia’s six key export commodities have been on the rise in Q4.
(index January 2016 = 100)



Source: World Bank Pink Sheet; CEIC; World Bank staff calculations
 Note: LNG stands for Liquefied Natural Gas and CPO stands for Crude Palm Oil. LNG prices are average of prices from 20 exporters of LNG to Japan. Data for January-2016 to December-2017 are actual historical, January-February 2018 are estimates. The figures differ from spot prices published by Japan’s Ministry of Economy, Trade and Industry.

Figure A.14: Prices of Coal, Crude Oil and Base Metals continued to strengthen in January and February 2018, rising to multi-month and multi-year highs
(index 2015=100)



Source: World Bank (2018); World Bank staff calculations
 Note: f stands for forecast

¹⁸ The price of copper is considered a good indicator of global economic health as it is used intensively in electrical equipment such as motors, wiring and electronic goods. Further discussion on the subject could be found in World Bank (2017d).

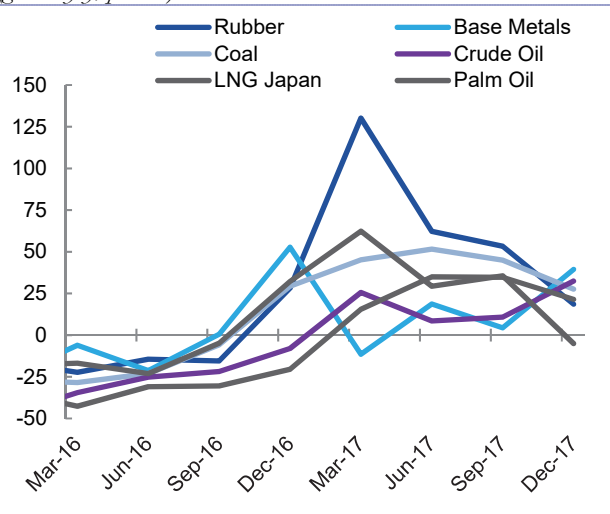
¹⁹ To tackle the concern of oversupply, Indonesia, Malaysia and Thailand have agreed to cut exports by 350,000 tons between Dec. 22 and March 31. The three countries have also actively provided loans at subsidies for farmers to encourage replanting and to increase productivity. The prices of rubber may be further supported by the beginning of the wintering season and the subsequent lower production levels.

Firmer commodity prices drove up exports of the six key commodities

Stronger global commodity prices have sparked the recovery of Indonesian commodity. Of the six key commodities, base metals were the best performer in Q4, with exports growing 39.4 percent. Exports of crude oil and coal also saw strong growth in Q4 (Figure A.15).

Exports of the six commodities saw strong growth in 2017 as a whole. Rubber exports grew at the fastest pace of 66.1 percent. In contrast, base metal exports saw the lowest growth over the year. By and large, 2017 was the turning point of the commodity sector. The average export growth of the six commodities was 33.0 percent in 2017, a marked recovery from the average contraction of 10.5 percent in 2016.

Figure A.15: Robust growth of Indonesia's key commodities export in 2017
(growth yoy, percent)



Source: BPS; World Bank staff calculations

3. The current account deficit widened

The current account deficit widened in Q4 on the back of a narrower trade surplus

The current account deficit widened to 2.2 percent of GDP in Q4, the largest in six quarters, from 1.7 percent of GDP in Q3, as a sharply narrower goods trade surplus, and a marginally wider services trade deficit, more than offset a slightly lower primary income deficit. On goods trade, both exports and imports grew slower than they did in Q3 with imports rising faster than exports. The services trade deficit widened slightly because of higher payments for freight services, which in turn were due to higher imports and lower revenue from tourism caused by the eruption of Mount Agung in Bali. The improvement in the primary account deficit, was influenced by lower interest payments of government's debt²⁰.

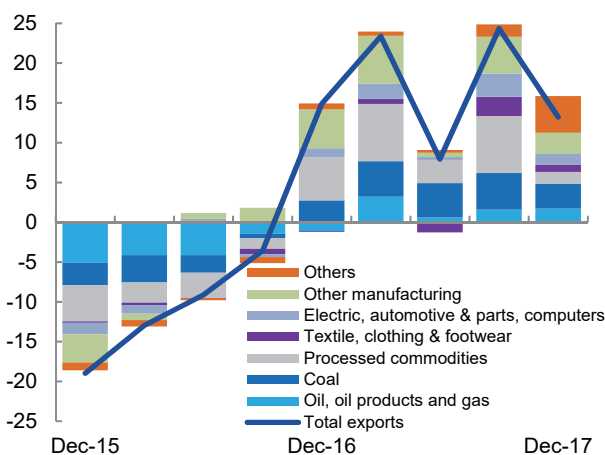
Goods trade remained in surplus, but narrower than in Q3 as higher prices of oil and oil products drove imports higher

In line with the easing of global trade in Q4, Indonesian goods exports and goods imports also slowed in Q4, causing the goods trade surplus to ease sharply to 1.2 percent of GDP in Q4 2017 from 2.0 percent in Q3.

Values of exported goods grew 13.2 percent yoy in Q4, slightly more than half of the 24.3 percent jump recorded in Q3, which was the highest in more than five years. Growth of goods imports values edged down to 21.5 percent, from 22.4 percent in Q3, which was also the highest in more than five years. The moderation in exports and imports growth was partly due to slowing global trade and the high base effect in Q3. Using deseasonalized data, qoq growth for both exports and imports still eased sharply in Q4 relative to Q3.

²⁰ The last sixteen quarters have shown that the peaks of interest payments were always seen in the third quarter before then declined considerably in the fourth quarter.

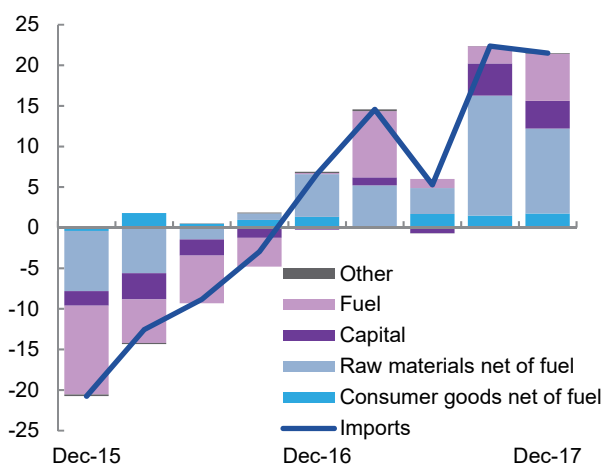
Figure A.16: Exports growth slowed down driven by lower non-oil and gas exports growth
(yoy growth, percent)



Source: CEIC and BI; World Bank staff calculations

Notes: The 'other manufacturing' category includes paper, paper materials, furniture, plastics, processed foods, chemicals and 'other'.

Figure A.17: Growth of imports remained strong as higher oil prices edged up values of fuel imports
(yoy growth, percent)



Source: CEIC and BI; World Bank staff calculations

Exports grew slower than in Q3

Compared to Q3, the yoy growth of goods export in Q4 slowed in almost every category. Exports of coal²¹, processed commodities, textiles, clothing and footwear, as well as electric and automotive parts, all saw softer growth²² (Figure A.16). The only exceptions were oil and gas exports²³, and exports of other mining²⁴. With the exception of exports destined for the Philippines, exports to the rest of the nine top destination countries recorded slower growth than in Q3. China, the United States, Japan, India and Singapore accounted for slightly more than 50 percent of Indonesia's exports in 2017, a tad more than their share in 2016²⁵.

Imports of fuel rose in Q4 with higher oil prices

Growth of goods imports eased in part due to slower growth of raw material imports and capital goods (Figure A.17). Import of capital goods, nevertheless, remained robust for capital goods in general, and also capital goods related to transport equipment²⁶. Imports of fuel surged, with both higher volumes and prices²⁷. Imports

²¹ Shipment of coal to China declined to 9.1 million tonnes in November, lower than in October (10.1 million tonnes) and September (9.6 million tonnes). The appetite for Indonesian coal in China has been partly dampened by the decreasing demand for lower-grade varieties of the coal. See Reuters (December 5, 2017).

²² Crude Palm Oil, both raw and processed ones, have been hit by oversupply in the market, the decision of the government of India to apply import tax for imported edible oils, and the resolution by the European Parliament in April 2017, aiming to reduce the indiscriminate clearing of rain forests for palm oil plantations.

²³ The increase in oil and gas export were driven by both volumes and prices. Both oil and gas exports were up in terms of volumes but the volume of the exported oil products declined. The increase in the volume of exported oil is in line with the surge in oil lifting that cyclically higher in Q4.

²⁴ Other mining category includes all the mining output except for coal, oil and gas, copper, nickel and bauxite.

²⁵ Other countries listed in the top ten export destinations are Malaysia, South Korea, Netherland and Thailand.

²⁶ The only component of import of capital goods that declined was passenger motor cars.

²⁷ The average of oil prices for Brent and WTI were USD 51.7 per barrel, and USD 48.1 per barrel during Q3 2017. They rose to USD 61.5 per barrel and USD 55.4 per barrel respectively during Q4 2017.

of consumption goods rose slightly compared to Q3, in line with the stronger private consumption growth²⁸. Imports from nearly all trading partners experienced a slow-down, except for imports from Thailand, the United States and India.

The financial account surplus narrowed in Q4, as both direct investment and portfolio inflows eased

The surplus recorded in the capital and financial account fell to 2.5 percent of GDP (USD 6.5 billion) from 4.1 percent in Q3, as both direct investment and portfolio inflows eased.

Portfolio flows plunged in Q4 to USD 1.9 billion – less than half of that in Q3, due mainly to foreign investors pulling out of Indonesian equities (Table A.2). Net foreign inflows into the Jakarta Composite Index (JCI) have been negative since June 2017. The sell-off in Q4, while the largest since Q2 2013, was a reflection of the broader perception of overvalued equity markets worldwide rather than a specific concern with the Indonesian equity market. Net foreign purchases of Ministry of Finance Surat Utang Negara (SUN) bonds in Q4 were also lower than that seen in Q3 mainly due to outflows in October. Foreign ownership of government bonds continues to remain stable at around 40 percent.

Net foreign direct investment was lower than in Q3 but still robust

Net foreign direct investment (FDI) was markedly lower than inflows recorded in Q3 which had been driven by high profile flows into large Indonesian startup firms. The Q4 outcome was also partly due to outflows in the mining sector as several oil and gas contracts expired²⁹. In contrast, the manufacturing sector again saw the largest positive inflows, with FDI inflows totaling around USD 3.3 billion – around 71 percent of total FDI in Q4 (Table A.2).

Table A.2: Indonesia's Balance of Payment (BOP)

(USD billion unless otherwise indicated)

	Q3-2017	Q4-2017	2016	2017
Overall Balance of Payments	5.4	1.0	12.1	11.6
<i>As percent of GDP</i>	2.0	0.4	1.3	1.1
Current Account	(4.3)	(5.8)	(17.0)	(17.3)
<i>As percent of GDP</i>	(1.7)	(2.2)	(1.8)	(1.7)
Goods trade balance	5.3	3.2	15.3	18.9
Services trade balance	(2.2)	(2.3)	(7.1)	(7.9)
Income	(7.4)	(6.6)	(25.2)	(28.3)
Capital and Financial Accounts	10.4	6.5	29.3	29.9
<i>As percent of GDP</i>	4.1	2.5	3.2	2.9
Direct Investment	8.1	4.6	16.1	20.2
Portfolio Investment	4.1	1.9	19.0	20.7
Other Investment	(1.4)	0	(5.8)	(10.9)

Source: BI; World Bank staff calculations

The BOP posted a seventh consecutive surplus in Q4 as a wider current account deficit was offset by surplus in the financial account

With the wider current account deficit and the narrow capital and financial account surplus, Indonesia recorded a USD 1 billion balance of payments surplus (0.4 percent of GDP) in Q4 2017, a surplus for the seventh straight quarter, but down from USD 5.4 billion surplus (2.0 percent of GDP) in Q3 (Table A.2). International reserves accordingly increased just USD 0.8 billion to reach USD 130.2 billion at the end of Q4, the highest in history, and sufficient to finance government external debt repayments and imports for 8.3 months.

²⁸ See section 1.

²⁹ The expired contracts include Attaka Block (operated partly by a Japanese company), Offshore North West Java Block (operated partly by a Singaporean company), and Mahakam Block (operate partly by a French company).

The current account deficit for 2017 was at a six-year low as export values grew faster than import values

For the whole 2017, the country's balance of payments recorded a surplus of USD 11.6 billion (1.1 percent of GDP), slightly lower than the USD 12.1 billion (1.3 percent of GDP) seen in 2016. The current account deficit stood at USD 17.3 billion or 1.7 percent of GDP, a six-year low, from the preceding year's deficit of 1.8 percent of GDP, driven by a surge in the trade balance (Figure A.18). The goods trade balance improved because export values accelerated more than import values, as oil import values were

contained as prices were relatively lower for most of 2017 before they jumped in Q4. The deficit in the services trade, on the other hand, widened as the surge of imports for consumption and investment drove up payments for freight services.

The capital and financial account surplus narrowed in 2017

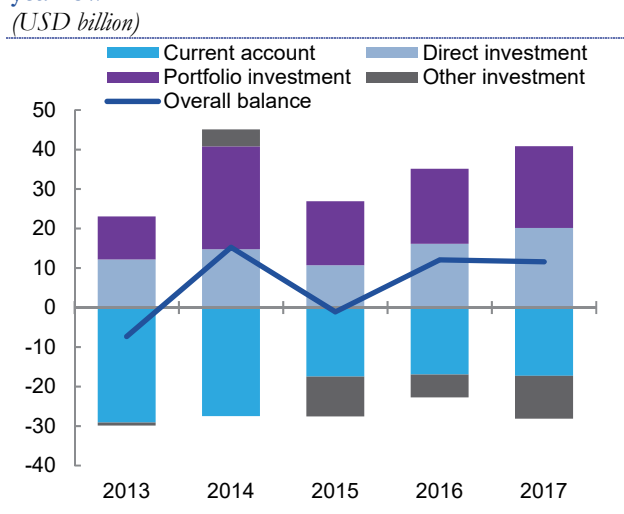
In annual terms, the financial account surplus in 2017 was 2.9 percent of GDP compared to 3.2 percent in 2016, despite rising direct and portfolio investments indicating still strong investor appetite for Indonesian financial assets.

Portfolio investments rose as foreign purchases of SUN bonds, at around USD 12.8 billion in 2017, reached the highest in at least 7 years (Figure A.19). In contrast, foreigners sold off Indonesian equities as part of the broader, global, trend which saw investors become increasingly wary of overvalued stock markets. The equity selloff of USD 3 billion in 2017 was the largest equity outflow in 7 years. Nevertheless, the JCI still recorded gains on the back of domestic investor purchases.

FDI rose to a seven-year high in 2017

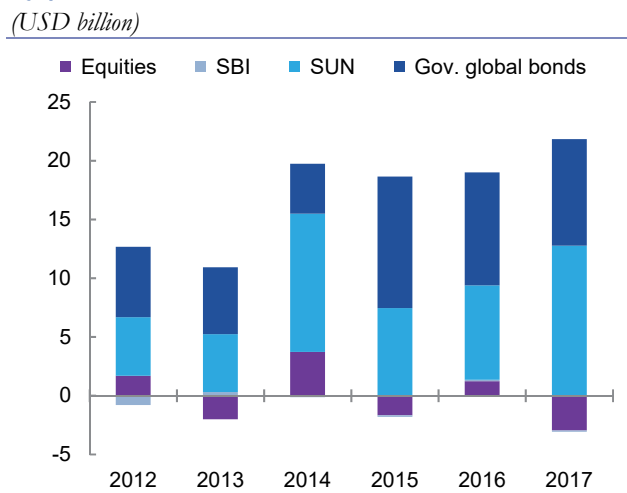
In annual terms, net FDI flows in 2017 were the largest in 7 years mainly due to the inflows in Q3 (Figure A.20). The strong 2017 outcome is in line with other positive

Figure A.18: The BOP continued to record a surplus in 2017, driven by strong flows of direct and portfolio investments. The current account deficit falling to a 6-year low



Source: BPS; World Bank staff calculations

Figure A.19: Investors sold off Indonesian equities in 2017



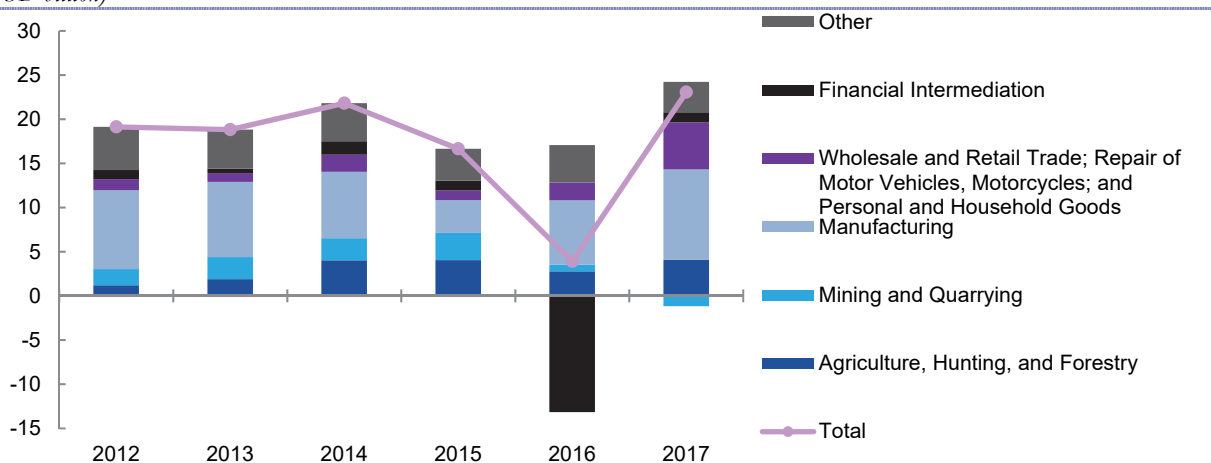
Source: Bank Indonesia, Jakarta Stock Exchange, Directorate General of Budget Financing and Risk Management; World Bank Staff calculations

Note: Sertifikat Bank Indonesia (SBI), Surat Utang Negara (SUN)

economic indicators, such as declining bond yields and upgrades by three major credit rating agencies over the past 12 months that point to Indonesia being a sound investment option. Manufacturing and wholesale and retail trade drove much of the FDI increase, while the mining sector saw direct investment outflows.

Figure A.20: FDI inflows were the strongest in recent history

(USD billion)



Source: CEIC and BI; World Bank staff calculations

The Rupiah depreciated marginally in Q4, but less than in Q3 and ended 2017 with a modest depreciation compared to 2016...

The Rupiah was broadly flat in Q4, depreciating against the U.S. Dollar by around 0.4 percent to 13,548, compared to a depreciation of 1.3 percent in Q3. These movements led to an overall annual depreciation of 0.5 percent in 2017, compared to an appreciation of 3.3 percent in 2016. Apart from the modest depreciation³⁰, the Rupiah's performance in 2017 was also characterized by higher volatility in H2 after considerable stability in H1. The currency reached a peak of 13,154 in September 2017 and fell to a low of 13,630 at the end of October, a swing of more than 3 percent over a period of these two months.

...and had decoupled from other emerging market currencies

2017 also saw the decoupling of the Rupiah, from currencies of other emerging market economies (Figure A.21). Historically the Rupiah has tended to loosely follow exchange rate movements of emerging market economies, as represented by JP Morgan's Emerging Markets Currency Index (EMCI). Movements in foreign reserves indicate that along with underlying robustness, currency market intervention by Bank Indonesia played some role in supporting stability.

The Rupiah has begun 2018 with relatively higher volatility

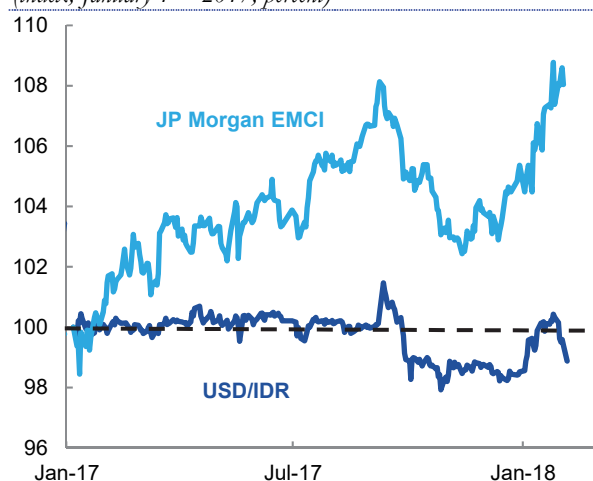
In real terms, the Rupiah depreciated by 5.2 percent in 2017, the most among regional peers, which will provide a competitiveness boost to Indonesia's exports. This is a complete reversal of the situation in 2016, where the Rupiah appreciated 3.9 percent, more than all its major regional peers except Japan (Figure A.22). Over the past 4 years, the Rupiah has appreciated 9.1 percent in real terms, more than any other currency except for the Indian Rupee. This suggests that any boost in competitiveness has only come about in the past year or so.

³⁰ The Rupiah depreciated in H2 2017 due to global economic developments such as the announcement by the U.S. Federal Reserve that it would begin to shrink its balance sheets, as well as domestic economic developments with Bank Indonesia cutting its policy rate twice in Q3.

Thus far in Q1 2018, the Rupiah has been relatively volatile compared to 2017³¹ – appreciating just under 2 percent in mid-January before losing all gains at the beginning of February. The increased volatility has attracted Bank Indonesia's attention such that, while it is not a matter of concern yet, the central bank remains ready to intervene to ensure stability, if required³².

Figure A.21: The Rupiah decoupled from other emerging market currencies and recorded a modest depreciation

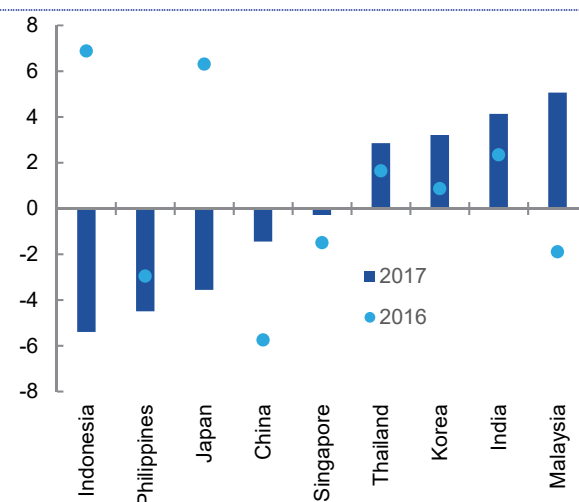
(index, January 1 = 2017, percent)



Source: JP Morgan; World Bank staff calculations
Note: Downward movement represents a depreciation.

Figure A.22: In real terms the Rupiah depreciated more than most regional peers

(year-to-date percentage change)



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

4. The fiscal stance improved in 2017, with higher spending and a low deficit

2017 saw improvements in tax collection and spending execution, and a low fiscal deficit

Due to a combination of higher global oil prices and efforts to improve tax compliance, Indonesia's revenues grew at the fastest pace in the last six years excluding revenues from the Tax Amnesty Program (TAP). Higher revenues supported the fastest nominal growth in total government spending in the last three years, driven by capital, material, and social spending. Overall, the fiscal deficit stood at 2.4 percent of GDP³³ in 2017, lower than the 2016 deficit of 2.5 percent. Total public debt stood at 29 percent of GDP by end-2017, well below the legal threshold of 60 percent of GDP, a slight increase from 28.3 percent in 2016.

Compared to 2016, 2017 saw a small increase in the tax-to-GDP ratio when

The tax-to-GDP ratio³⁴ declined from 10.4 percent of GDP in 2016 to 9.9 percent of GDP in 2017, continuing the downward trend seen since 2012. However, if redemption fees from the TAP are excluded from 2016 and 2017 numbers, the ratio improved to 9.8 percent from 9.5 percent in 2016 (Figure A.23). This small increase

³¹ Recent Indonesia Economic Quarterly reports have referred to the stability of the Rupiah past 18 months. The relative volatility referred to above is in reference to the aforementioned stability. For a floating currency, movements of 1 or 2 percent are not anything to be concerned about.

³² Netralnews.com (February 3, 2018).

³³ All figures in this section refer to preliminary realization figures from the Ministry of Finance, received February 9, 2018, unless otherwise stated.

³⁴ Tax revenues is defined as the sum of domestic and international taxes collected by the central government. This accounts for about 92 percent of total tax revenues in Indonesia.

excluding Tax Amnesty revenues

in the tax ratio points to the impact of higher oil prices³⁵ and some early results from the Government’s efforts to ease the burden of paying taxes and enhance compliance management. Excluding TAP, overall revenue growth stood at 13.5 percent, with value-added tax (VAT) contributed the most with 4.7 percentage points, mainly supported by import VAT (Figure A.24)³⁶. Higher oil prices also meant oil and gas (O&G) related revenues played a substantial role, contributing 3.6 percentage points to total revenue growth excluding TAP.³⁷ The contribution from excise revenue was small but positive, demonstrating gains from tobacco excise reforms³⁸.

Commodity-related revenues and VAT continued to drive revenue collection in the first two months of 2018

Preliminary monthly realization data indicate that commodity-related revenues and VAT continue to drive revenue collections in early 2018. Total revenue realizations by end-February grew 17.7 percent yoy in nominal terms, faster than the 8.9 percent over the same period in 2017³⁹. Similarly, tax revenues grew 14.1 percent during the first two months of this year. Other revenue sources such as import duties, other non-tax revenues, and revenues from public service delivery units (*Badan Layanan Umum* or BLUs) also grew after experiencing nominal declines in 2017.

Figure A.23: Tax-to-GDP ratio excluding tax collections from TA program picked up in 2017
(change yoy, percent)

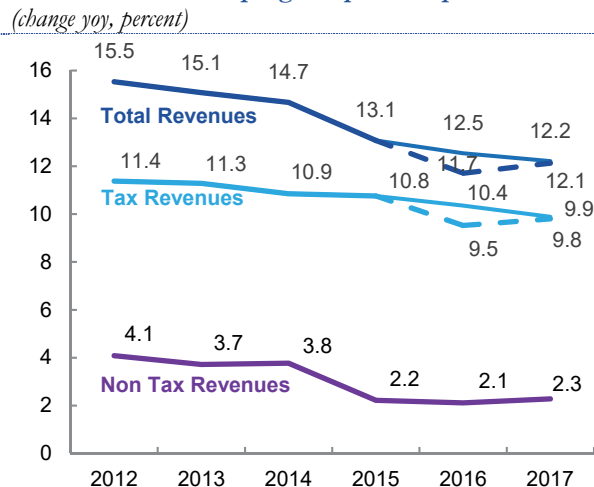
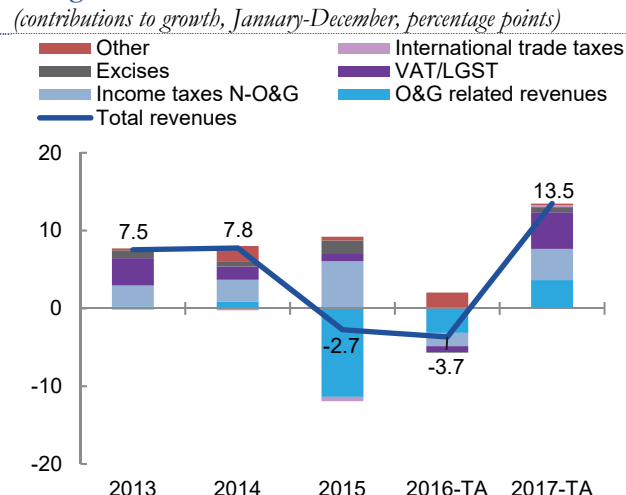


Figure A.24: VAT and O&G related revenues drove strong 2017 collections
(contributions to growth, January-December, percentage points)



Source: Ministry of Finance; World Bank staff calculations.

Note: 2012-2016 are actual audited figures, 2017 are preliminary actual figures as of February 9, 2018.

Expenditures grew at the fastest pace in the last three years, partly due to a low base effect in 2016

In 2017, total expenditures grew by 6.5 percent yoy in nominal terms, the highest rate in the last 3 years (Figure A.25). Capital spending particularly drove this growth, rebounding sharply from negative 21.3 percent in 2016 to 17.9 percent in 2017, though remains lower than 2015 in nominal level terms. The strong growth rate of total spending was partially due to a low base effect, given budget cuts to capital and material expenditures in Q4 2016. Social spending also partially recovered, growing at 10.9 percent from over a year ago.

³⁵ Oil prices averaged USD 51 per barrel, higher than the 2017 Budget assumption of USD 48 per barrel.

³⁶ Import and domestic VAT contributed 3.1 and 1.6 percentage points, respectively to the nominal non-TAP revenue growth in 2017.

³⁷ See Section 4 on commodities.

³⁸ See Part B for more discussion.

³⁹ 2018 is the first time January-February monthly outturns grew by double digits since 2014, when they grew by 16.3 percent.

Figure A.25: Higher capital and social spending drove overall spending growth in 2017
(annual actual expenditure growth yoy, percent)

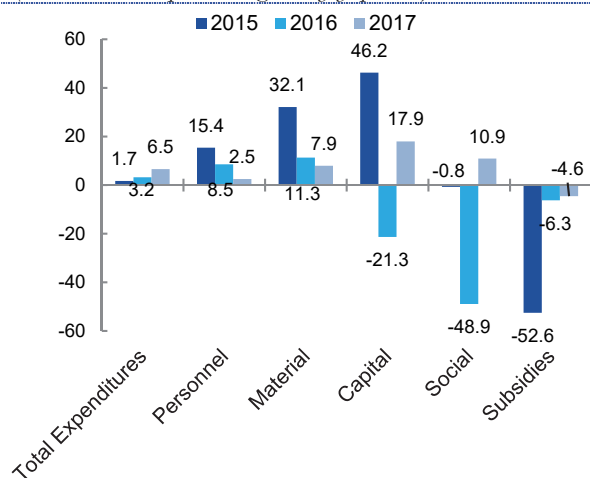
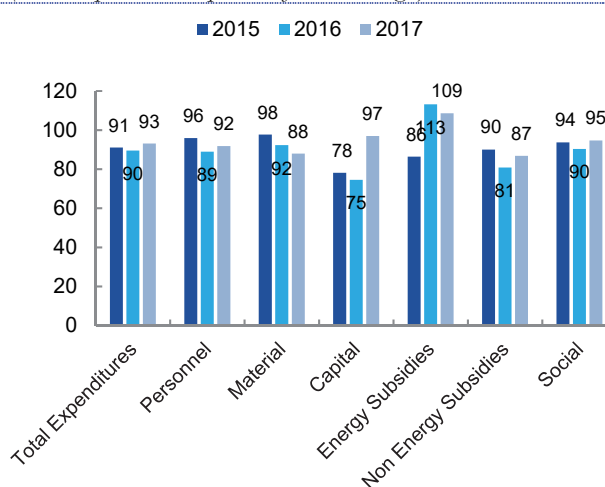


Figure A.26: Disbursements improved overall, especially for capital and social spending...
(actual expenditure as percent of revised budget)



Source: Ministry of Finance, World Bank staff calculations

Note: Some social expenditures were reclassified into material spending in 2015. 2015-2016 are actual audited figures. 2017 are preliminary figures as of February 9, 2018.

Disbursements of capital and social budgets improved

By the end of 2017, IDR 1,986 trillion or 93.1 percent of the total government expenditure in the 2017 Revised Budget was disbursed, the highest in 3 years (Figure A.26). This reflects improvements in expenditure budget executions, with disbursement of capital expenditures improving from 74.5 percent in 2016 to 96.9 percent in 2017, the highest in 8 years. Disbursement of social spending also improved to 94.7 percent of the Revised Budget, but the disbursement of non-energy subsidies remained low due to persistent administrative issues. The Government exceeded its budget on energy subsidies due to higher than expected oil prices⁴⁰ and some arrears payments from 2016.⁴¹

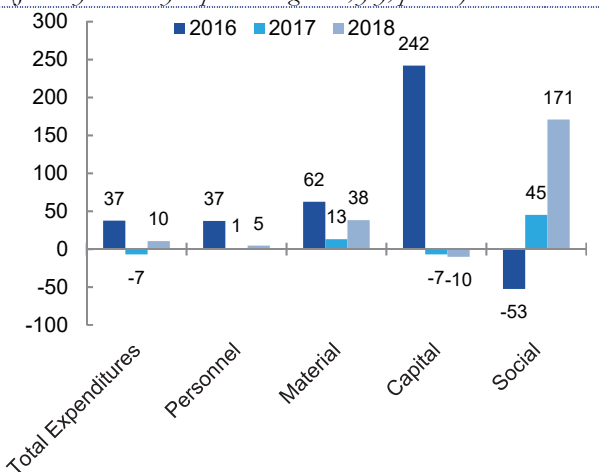
⁴⁰ Average crude oil prices came in at USD 51 per barrel in 2017, compared to the assumption of USD 48/barrel in the 2017 Revised Budget.

⁴¹ The Government paid IDR 5 trillion in arrears to PLN in 2017. <http://republika.co.id/berita/ekonomi/keuangan/18/01/15/p2lvax383-kurang-bayar-anggaran-subsidi-energi-membengkak-pada-2017>

Expenditure outturns in February 2018 indicate sustained momentum in social spending

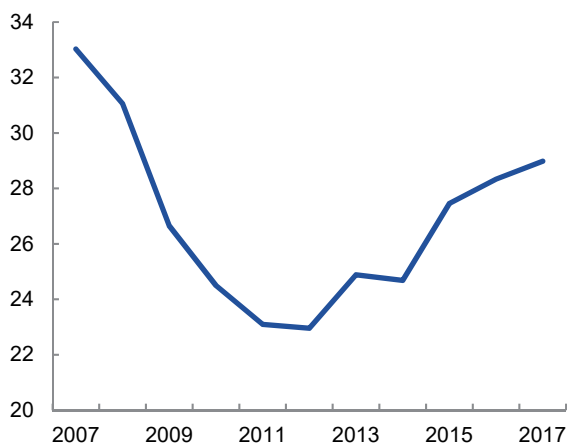
As of end-February 2018, the Government had disbursed 11.3 percent of the total approved 2018 budget, 0.5 percentage points higher than the disbursement rate over the same period last year. Social expenditure disbursements were particularly strong, growing 170.8 percent yoy in nominal terms. This was due to better beneficiary data management in the Family Hope Program (Program Keluarga Harapan or PKH) and the Subsidized Health Premium (Penerima Bantuan Iuran or PBI) Program.⁴²

Figure A.27: January-February 2018 realizations reflected a strong increase in social spending
(January-February expenditure growth, yoy, percent)



Source: Ministry of Finance, World Bank staff calculations

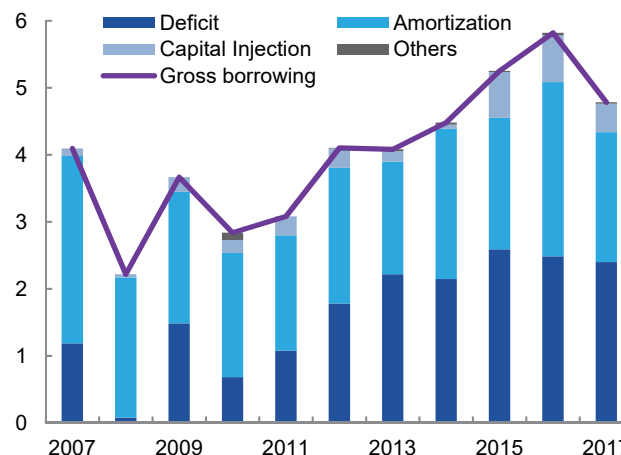
Figure A.28: Debt-to-GDP slightly increased in 2017, but remains well below the legal threshold
(Central government outstanding debt; percent of GDP)



Source: CEIC; Ministry of Finance; World Bank staff calculations.

Note: In Figure 41, 'others' consists of other government below the line expenditure such as guarantee obligations

Figure A.29: Gross borrowing in 2017 was double the size of the fiscal deficit
(percent of GDP)



The debt ratio remains well below the legal threshold

As of end-2017, Central Government debt inched up from 28.3 percent of GDP in 2016 to 29.0 percent of GDP⁴³, remaining well below the legal threshold of 60 percent (Figure A.28)⁴⁴. Most of 2017 debt was still dominated by government bonds issuance in domestic currency⁴⁵. Gross borrowing in 2017 was at 4.8 percent of GDP, a slight decline relative to 2016. Capital injections into SOEs and BLUs has contributed more

⁴² Kemenkeu (February 2018).

⁴³ Includes an additional USD 4.0 billion of 2018 Budget pre-financing. See DJPPR (2017).

⁴⁴ Article 12 of Law No 17/2003 on State Finance.

⁴⁵ Rupiah denominated bonds do not bear exchange rate risks to Indonesia, unlike bonds denominated in foreign currencies.

to higher gross borrowing in recent years, accounting for 8.8 percent of total (Figure A.29)⁴⁶.

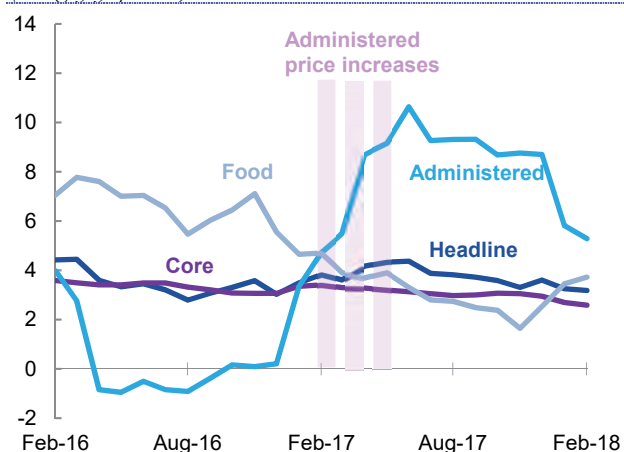
5. Headline inflation eased in Q4 as food price inflation remained subdued

Inflationary pressures eased further in Q4 largely on the back of lower food prices

Headline consumer price inflation eased to an average of 3.5 percent yoy in Q4 2017, the lowest since Q4 2016, from 3.8 percent in Q3. The lower inflation in Q4 was largely due to muted food price inflation, 0.5 percent in Q4, the lowest quarterly average for 14 years. In the first two months of 2018, headline inflation continued to ease. In fact, in February 2018, inflation was at its lowest since December 2016. This was despite an uptick in food price growth due to supply problems with staple products such as rice.

Figure A.30: Headline inflation eased in Q4 due to subdued food price inflation

(change yoy, percent)



Source: BPS; World Bank staff calculations

Note: Food prices are a weighted average of the raw and processed food price components of CPI

In terms of the major components of headline inflation, core inflation in Q4 remained unchanged from Q3's average of 3.0 percent yoy, the lowest quarterly average on record, as the economy continues to operate at close to potential. Core inflation has continued to ease during the first two months of this year, reaching its lowest reading on record of 2.6 percent yoy in February. Similarly, largely due to low food price inflation, volatile good inflation averaged 0.9 percent in Q4, unchanged from Q3, also the lowest quarterly average on record. After rising an average of 8.7 percent in Q4, down from 9.3 percent in Q3, administered price growth fell below 6 percent for the first time since March 2017.

In annual terms, headline inflation was 3.8 percent, a little higher than the 3.5 percent recorded in 2016, predominantly due to the higher administered prices resulting from the electricity tariff hikes in H1 2017 (Figure A.30).

Trends in food price inflation may be reversing

2017 was largely characterized by easing food price inflation. This was in part due to favorable weather conditions as well as direct Government efforts to stabilize food prices and reduce volatility through the introduction of price ceilings and improving distribution with assistance from line ministries and institutions as such Bulog, the state logistics agency⁴⁷. However, due to a surge in prices of cereal, cassava and related products, food prices in January and February 2018 have edged up, reversing the

⁴⁶ Capital injections are for State-Owned Enterprises (Badan Usaha Milik Negara or BUMN) and Public Service Units (Badan Layanan Umum or BLU).

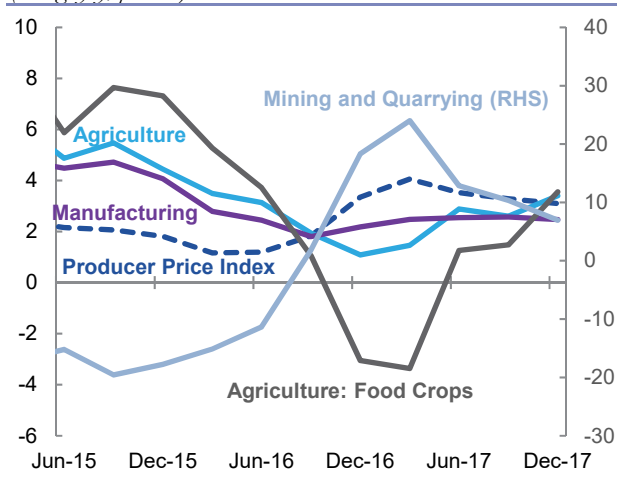
⁴⁷ For further information, please see World Bank (2017b).

downward trend in food price inflation saw in most of 2017. Rice prices also rose sharply in December 2017 and the first two months of 2018, contributing to the increase in food price inflation and prompting the Government to allow an increased amount of rice imports to alleviate upward price pressures caused by falling domestic stockpiles⁴⁸.

Producer price growth eased in Q4 due to subdued growth of mining and quarrying prices

On the production side, headline producer price inflation in Q4 eased to an average of 3.1 percent yoy compared to 3.3 percent in Q3. This was the slowest pace of growth since Q3 2016, largely driven by a significant slowdown in the mining and quarrying price increases to the lowest since Q3 2016 (Figure A.31). Almost all other categories remained stable with the exception of food crop prices which saw price growth pick up to rates last seen in Q2 2016. Pestilence affecting crops also contributed to an increase in food prices and this will likely to place some upward pressure on prices for several months until new crops are harvested.

Figure A.31: Producer prices were also subdued in Q4
(change yoy, percent)



Source: BPS; World Bank staff calculations

6. Macrofinancial conditions were stable, with credit growth remaining sluggish

Bond yields continued to fall in Q4, amid strong investor appetite for Indonesian sovereign bonds

As noted earlier, capital flows into Indonesia in 2017 were strong – a reflection of strong investor appetite for Indonesian financial assets. In Q4, domestic bond yields continued the overall downward trend seen throughout 2017 (Figure A.32). However, the trajectory flattened a little and 10-year yields fell by 15 basis points, compared to 30 basis points in Q3. For the year, yields fell, on average and across all tenors, by around 150 basis points. The spread between the Indonesian 10-year bond yield and the U.S. 10-year

Figure A.32: The spread between Indonesian bond yields and U.S. bond yields has narrowed considerably
(percent)



Source: CEIC

⁴⁸ The Jakarta Post (January 22, 2018).

yield narrowed to almost a 4-year low in Q4 as yields in the United States began to rise in line with continued monetary policy normalization actions by the U.S. Federal Reserve.

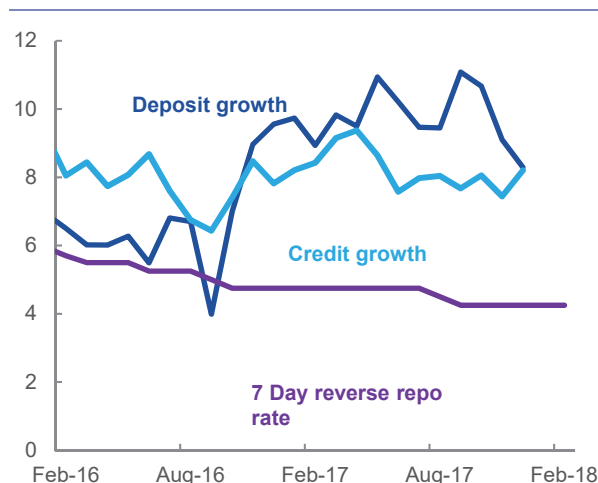
The start of 2018 has seen Indonesian bond yields increase – largely a reflection of the broader volatility in global financial markets. Notwithstanding the narrowing in spread between the U.S. and Indonesian yields and given that the fundamentals of the Indonesian economy remain strong, Indonesian yields are likely to continue to attract investors.

Bank Indonesia held benchmark interest rates steady in Q4

After the two surprise rate cuts in Q3, Bank Indonesia (BI) held its benchmark policy rate steady at 4.25 percent in Q4. BI cited improved global economic conditions and the easing in Q3 as reasons for holding the benchmark rate steady⁴⁹. Despite the cumulative 200 bps worth of monetary policy easing over the past 2 years, credit and deposit growth continued to disappoint, with the former not increasing substantially and the latter not falling significantly (Figure A.33).

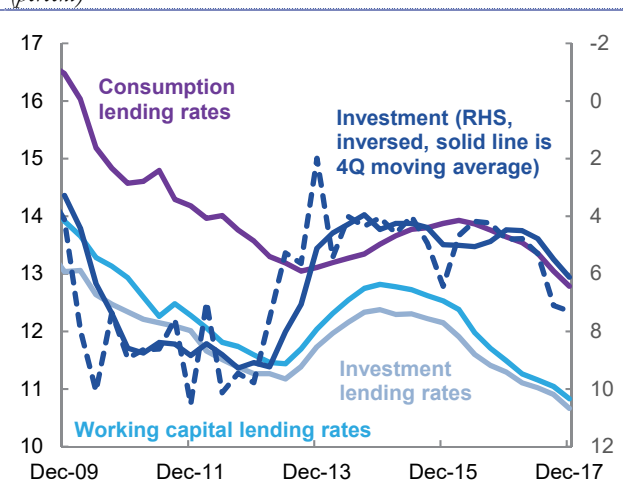
Credit growth averaged 8.2 percent in 2017 – a tick higher than the 7.9 percent recorded in 2016. Due to the tepid growth, BI’s credit growth target range in 2017 was revised down from 10 – 12 percent to 8 – 10 percent in November 2017. However, investment growth has sustained its upward trajectory in Q4 which suggests that investment is, at least partially, being financed by non-bank lending. (Figure A.34).

Figure A.33: Monetary policy easing cycle halted in Q4
(percent)



Source: CEIC; Bank Indonesia; World Bank staff calculations

Figure A.34: Monetary policy appears to be contributing to a pickup in investment growth
(percent)



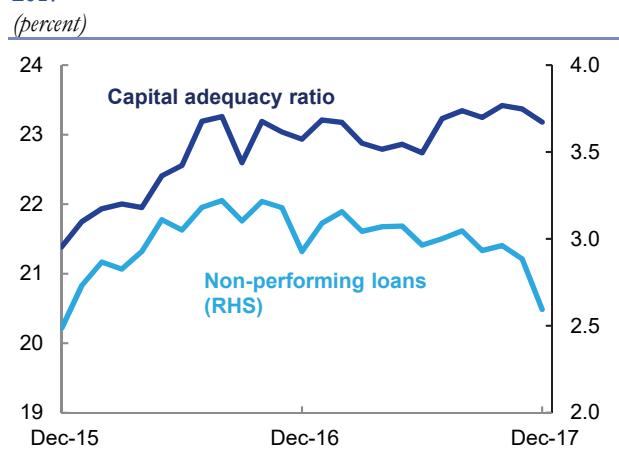
Source: CEIC; Bank Indonesia; World Bank staff calculations

⁴⁹ Bank Indonesia (2017).

The banking sector remains healthy, with NPLs ticking downwards

Non-performing loans in Q4 2017 fell to ratios last seen in Q4 2015 (Figure A.35). This outcome was in line with the overall downward trend in 2017 and signals that lending quality concerns continued to be abated. The capital adequacy ratio remained stable in Q4, hovering around 23 percent, pointing to a well-capitalized banking system. Both these metrics are typically associated with a reasonably healthy banking system.

Figure A.35: NPL ratio has started to tick downwards on the back of balance sheet consolidation by banks in 2017



Source: CEIC; World Bank staff calculations

7. The employment rate continued to climb, but earnings growth has fallen sharply

The employment rate rose to 63.0 percent in August 2017 as employment growth outpaced labor force growth

Indonesia's overall employment rate rose to 63.0 percent in August 2017, up from 62.6 percent in August 2016.⁵⁰ There were 121.0 million employed individuals in Indonesia in August 2017, with the number of workers having grown by 2.2 percent over the preceding year.⁵¹ This represents a notable slowdown in job creation compared with the year to August 2016, when the number of workers grew by 3.1 percent. Nevertheless, employment growth continued to outpace growth in the broad labor force – which grew by 2.1 percent – and growth in the working age population – which grew by 1.6 percent – between August 2016 and August 2017 (Figure A.36).⁵²

The year to August 2017 also witnessed a small decline in the broad unemployment rate, which fell from 5.6 percent to 5.5 percent, but the core unemployment rate showed a slight uptick, rising from 4.3 percent to 4.4 percent (Figure A.37).⁵³ Taken together, these results suggest that the tightening of the labor market observed in 2016 and early 2017 continues, but likely at a slower pace.

⁵⁰ The employment rate is the number of employed workers divided by the total working-age population. Its recorded value tends to be higher in the February Sakernas than the August Sakernas.

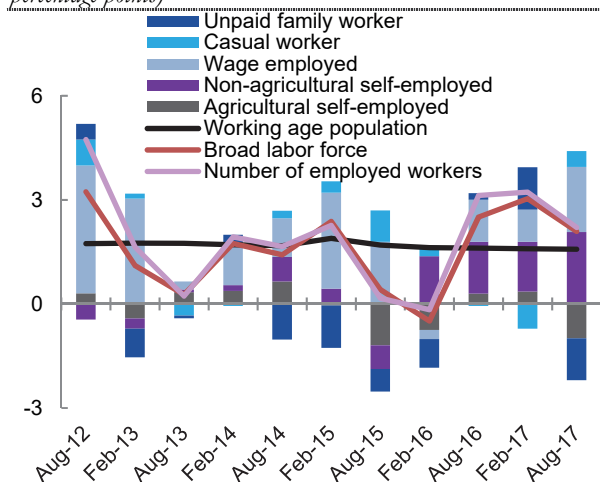
⁵¹ According to latest data from Statistics Indonesia (*Badan Pusat Statistik*, BPS).

⁵² In accordance with BPS convention, 'working age' is defined as anyone aged 15 years or more.

⁵³ Under the 'core' definition, the unemployed are those individuals who do not work, but who are actively looking for work. The 'broad' definition includes the core unemployed, as well as discouraged workers, those who are establishing a new business, and those who have a future job arranged. The core and broad unemployment rates moved in different directions because, while there were nearly 260,000 new job seekers added to the labor force in the year to August 2017, the number of discouraged workers – who are counted in the calculation of broad but not core unemployment – fell by around 380,000.

Figure A.36: Employment growth slowed, but shifted away from unpaid family work and agricultural self-employment towards wage-employment and non-agricultural self-employment

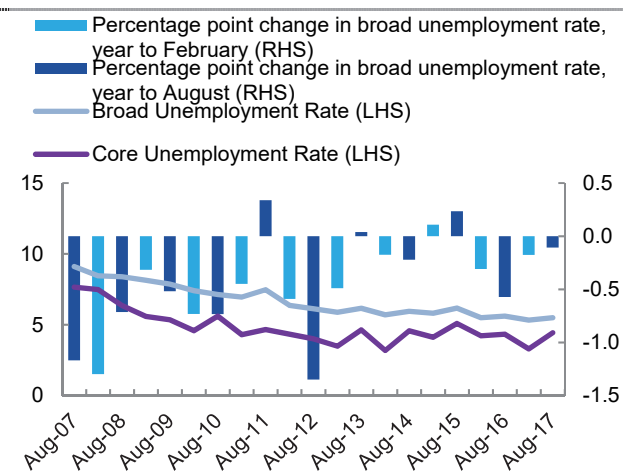
(growth in employment, labor force, and working age population, percentage points)



Source: National Labor Force Survey (Survei Angkatan Kerja Nasional, Sakernas)

Figure A.37: Broad unemployment continued to fall, but the core unemployment rate picked up slightly

(unemployment rate, percent, LHS; change in unemployment rate, percentage points, RHS)



Source: National Labor Force Survey (Survei Angkatan Kerja Nasional, Sakernas)

Gender differences in the labor force participation and employment rates widened

The narrowing of the large gender gap in employment rates seen in the previous year was partially reversed in the year to August 2017. The employment rate for women moved from 48.0 percent to 48.1 percent, while the employment rate for men moved from 77.3 percent to 77.9 percent. The gender gap in terms of the broad labor force participation rate (LFPR) also increased in the year to August 2017. The overall broad LFPR was 66.7 percent in August 2017, up from 66.3 percent in August 2016. While the broad LFPR for women rose slightly from 50.8 percent to 50.9 percent, the broad LFPR for men rose more, moving from 82.0 percent to 82.5 percent.

Employment growth shifted towards wage-employment and non-agricultural self-employment

The wage-employed comprised 39.7 percent of all workers in August 2017, with wage employment growing by 4.8 percent over the preceding year. This was significantly faster than in the year to August 2016, when the number of wage workers grew by 3.1 percent. The year to August 2017 also saw non-agricultural self-employment grow by 9.7 percent – up from 7.3 percent the year before – with the proportion of such workers reaching 22.9 percent, the highest level since 2011. At the same time, the proportion of unpaid family workers and agricultural self-employed individuals reached their lowest ever levels,⁵⁴ with the numbers of such workers falling by 8.8 percent and 6.3 percent, respectively. The renewed growth of wage jobs and the decline of unpaid family work and agricultural self-employed partially signals a return to the high formality of job creation witnessed between 2010 and 2015, although this has been somewhat offset by the rising importance of non-agricultural self-employment.

Manufacturing created 1.5 million jobs, while the transition out of

In August 2017, 48.1 percent of workers were employed in the service sector, up from 46.7 percent a year earlier (Figure A.38). Over the same period, the proportion of workers in industry increased for the first time since 2015, rising from 21.4 percent to 22.3 percent. This was largely attributable to the creation of 1.5 million jobs in

⁵⁴ In August 2017, unpaid family workers and agricultural self-employed workers comprised 12.3 percent and 14.3 percent of all employed individuals respectively.

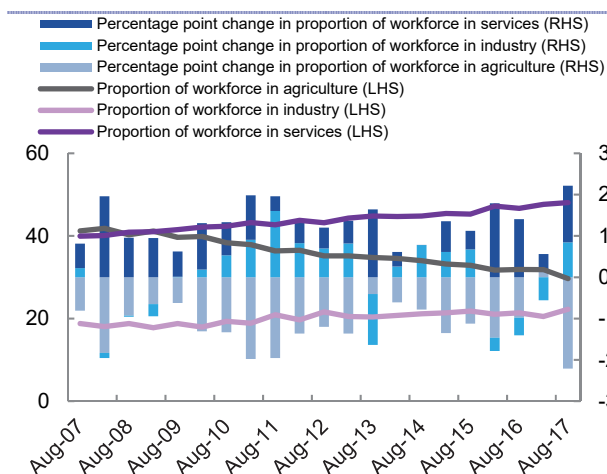
agriculture accelerated

manufacturing. To accommodate this, the proportion of workers in agriculture experienced its largest year-on-year decline since 2004, dropping from 31.9 percent to 29.7 percent. This reflects an acceleration in the Indonesian workforce’s transition out of agriculture towards services and industry, although it remains to be seen whether this apparent uptick in the pace of structural transformation will be sustained.⁵⁵

Real earnings growth remained positive, but declined substantially compared with the previous year

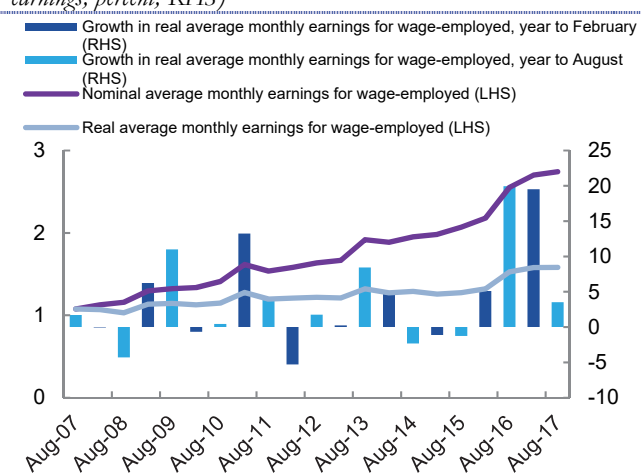
Mean earnings for the wage-employed increased by 3.5 percent in real terms and 7.4 percent in nominal terms in the year to August 2017, heralding an end to the double-digit wage growth observed in earlier Sakernas surveys in August 2016 and February 2017 (Figure A.39). Median earnings for the wage-employed also rose by 4.3 percent and 5.0 percent in real and nominal terms respectively, indicating that wage growth has fallen across the distribution.⁵⁶ This provides additional evidence that the tightening of the labor market seen over 2016 and early 2017 may now be easing off.⁵⁷

Figure A.38: Workers switched from agriculture into both services and industry
(proportion of employed workers, percent, LHS; yoy percentage point change in the proportion of employed workers, percent, RHS)



Source: National Labor Force Survey (Survei Angkatan Kerja Nasional, Sakernas)

Figure A.39: Growth in mean real earnings for the wage-employed decreased sharply in the year to August 2017
(earnings, billions IDR, LHS; yoy percentage growth in mean monthly earnings, percent, RHS)



Source: National Labor Force Survey (Survei Angkatan Kerja Nasional, Sakernas)

⁵⁵ Between August 2007 and August 2016, the proportion of workers in services and industry increased, on average, by 0.9 and 0.3 percentage points per year respectively, while the proportion of workers in agriculture dropped by 1.2 percentage points per year. Thus, the changes observed in the year to August 2017 – when the proportion of workers in services and industry grew by 1.4 and 0.8 percentage points respectively and the proportion of workers in agriculture fell by 2.2 percentage points – far exceed the trends witnessed over the last decade.

⁵⁶ If the earnings of own account workers and casual workers – the only other workers whose earnings are captured by the Sakernas – are included, the growth in mean earnings was 2.5 percent in real terms and 6.4 percent in nominal terms. Growth in median earnings for this expanded sample was 2.7 percent in real and 12.0 percent in nominal terms. The difference between growth in median real earnings and growth in median nominal earnings does not necessarily correspond to average Consumer Price Index (CPI) inflation because the earnings data are deflated using city CPIs, which can reorder observations within the same year.

⁵⁷ The methodological changes to the Sakernas surveys, described in the October 2017 IEQ, should still be borne in mind when making intertemporal comparisons of earnings. The new formulation of the earnings questions introduced for the February 2017 Sakernas has been retained for the August 2017 Sakernas.

Earnings growth was stronger in the industrial sector than in services or agriculture

Despite the slowdown, earnings growth was strongest in the industry, where mean earnings for the wage-employed increased by 6.0 percent in real terms in the year to August 2017, providing one potential reason for the growth in industrial sector employment described above. Over the same period, mean real earnings for the wage-employed in agriculture and services grew by 2.4 percent and 2.5 percent respectively.⁵⁸ Relatedly, the year to August 2017 saw a flattening of the growth incidence curve for real earnings compared with the year to August 2016, meaning that earnings growth fell more for low-income groups than high-income groups. As such, the drop in earnings growth has not been felt evenly across the Indonesian economy.

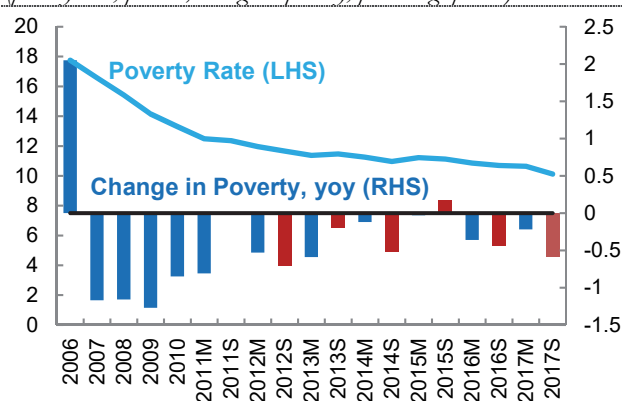
8. The poverty rate declined the most in four years

Poverty dropped substantially in September 2017

The official poverty rate released by Statistics Indonesia (*Badan Pusat Statistik, BPS*) for September 2017 was 10.1 percent, or down 0.6 percentage points from September 2016 (Figure A.40). This is a substantial drop in the poverty rate, the largest yoy decline since March 2013. However, this rate of poverty reduction is still slower than what Indonesia achieved between 2007 and 2011, where the poverty rate dropped an average of 1.1 percentage points annually. In absolute terms, there were 26.6 million poor people in September 2017, or 1.2 million fewer than the year before.

Figure A.40: The September 2017 poverty rate saw the largest reduction since March 2013

(poverty rate, percent; change in poverty, percentage points)



Source: National Socio-Economic Survey (*Survei Sosial Ekonomi Nasional, Susenas*)

Poverty fell despite a larger increase in the poverty line

This substantial reduction in poverty happened despite a relatively larger increase in the poverty line. The poverty line increase for September 2016 – September 2017 was 7 percent, from IDR 361,990 to IDR 387,160. This is larger than the increases seen for March 2016 – March 2017 (5.7 percent) and September 2015 – September 2016 (5 percent). This increase was driven slightly more by the food component of the poverty line (7.2 percent) than by the non-food component (6.3 percent)⁵⁹.

Methodological changes may have

The September 2017 round of the National Socio-Economic Survey (*Survei Sosial Ekonomi Nasional, Susenas*), which was used to produce the September 2017 poverty

⁵⁸ In the year to August 2016, growth in mean real earnings for the wage-employed was 20.3 percent in agriculture, 21.3 percent in industry, and 18.1 percent in services.

⁵⁹ This is seemingly at odds with the fact that food price inflation between October 2016 and September 2017 was the lowest of these three periods. However, this can be explained by the differences in the goods basket used to measure CPI inflation and the basket used to measure consumption for the poverty rate, as well as the changes that occur in the poverty basket from period to period. Indonesia’s poverty measurement uses a reference population that is 20 percent above the poverty line in the previous period, so the poverty basket will always change based on what the “not-so-poor” are consuming.

impacted the magnitude of poverty reduction

rates, underwent a methodological change compared to past rounds. Specifically, the number of food commodities included in the consumption module was reduced from 222 to 174. Prior to this change, the Susenas consumption module questionnaire had already been changed twice in the past few years. In March 2015, the questionnaire went from 215 food items and 108 non-food items to 112 food items and 116 non-food items⁶⁰. In September 2016, there was a further adjustment to 222 food items and 116 non-food items. Over these periods, the methodological changes may have affected the calculations for the poverty line and for per capita expenditures used to assess household poverty status, including the large increase to the poverty line mentioned previously. However, the full extent of that impact is not yet known.

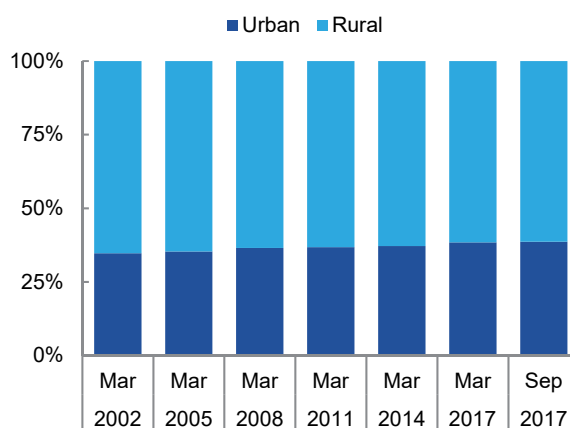
Urban and rural poverty fell in similar magnitudes

The poverty rates in urban and rural areas dropped by a similar magnitude, with both urban and rural poverty falling 0.5 percentage points between September 2016 and 2017. However, in headcount terms, urban poverty only dropped by 220,000 people, while the rural poverty headcount dropped by 970,000 people. This happened because during that time period, the total rural population shrank by 2.7 million people, while the urban population grew by 5.8 million. This continues the observation made in World Bank (2017b) that increasing urbanization is changing the face of poverty in Indonesia.

Over the past 15 years, poverty has slowly become a more urban phenomenon

A closer look at longer term trends in poverty shows a slow crawl towards the “urbanization of poverty”. In March 2002, 34.7 percent of poor people lived in urban areas. As of September 2017, that share has grown to 38.6 percent (Figure A.41). This is in large part due to the broader global trend of rural-to-urban migration, which has occurred as people sought better work opportunities and better access to jobs in urban areas. Going forward, Government efforts to reduce poverty must consider its increasingly urban nature.

Figure A.41: Poverty has slowly become more “urbanized” in the past 15 years
(percentage of poor people living in urban and rural areas)



Source: Susenas

⁶⁰ See World Bank (2015b).

The Gini coefficient has also dropped slightly, largely driven by the growth of the Middle 40 rather than the Bottom 40

The Gini coefficient for September 2017 was 39.1, which is a minor drop of 0.3 points compared to September 2016. Over the past year, the Bottom 40 and Middle 40 population groups experienced a mild strengthening in their proportions of total national consumption

(Table A.3). However, as in previous periods, inequality reduction has been largely driven by the growth of the Middle 40 rather than the Bottom 40. This is not only a problem for Indonesia: aggregate inequality rates for the East Asia and Pacific region increased between 1998 and 2012, in large part due to a stagnant “Bottom 40” in the region⁶¹. Thus, much work remains on sharing prosperity more broadly with Indonesia’s poor and vulnerable households.

Table A.3: Mild strengthening of the consumption shares of the Bottom 40 and Middle 40 led to a slight drop in the Gini coefficient

(share of national consumption, percent)

Period	Bottom 40	Middle 40	Top 20
Sep 2015	17.45	34.70	47.85
Sep 2016	17.11	36.33	46.56
Sep 2017	17.22	36.66	46.12
Δ 2015-2016	-0.34	+1.63	-1.29
Δ 2016-2017	+0.11	+0.33	-0.44
Δ 2015-2017	-0.23	+1.96	-1.73

Source: Susenas

9. Economic outlook and risks

Real GDP growth is forecast to reach an average of 5.3 percent in the medium term

The economic outlook continues to be positive with the Indonesian economy projected to expand at an average of 5.3 percent annually for the years 2018-2020, on strengthening domestic demand lifted by the upcoming elections and still relatively easy global and domestic financing conditions (Table A.4). Net exports, however, will drag on economic growth as import-intensive investment growth remains robust, also thanks to the ongoing streamlining of import processes (Box A.2).

Table A.4: Key economic indicators

(growth yoy, percent, unless otherwise indicated)

	Annual Growth			Revisions from
	2017	2018f	2019f	December 2017 IEQ
1. Main economic indicators				
Gross Domestic Product (GDP)	5.1	5.3	5.3	0.0
Private consumption expenditure	5.0	5.1	5.2	0.0
Government consumption	2.1	4.0	4.5	0.5
Gross fixed capital formation	6.2	6.0	5.7	-0.1
Exports of goods and services	9.1	7.0	6.0	1.0
Imports of goods and services	8.1	7.0	6.0	1.4
2. Other economic indicators				
Consumer price index	3.8	3.5	3.7	0.0
Current account balance (% of GDP)	-1.7	-1.9	-2.1	-0.1
3. Economic Assumptions				
Exchange rate (IDR/USD)	13381	13550	13750	50
Indonesian crude price (USD/bl)	51	56	57	-0

Source: BPS; BI; CEIC; World Bank staff projections

Note: 2017 figures are actual outcomes. F stands for forecast. Statistical discrepancies and change in inventories are not presented in this table. All GDP components are based on the latest GDP data. Exchange rate and crude oil price assumptions are average annual data. Revisions are relative to projections in the December 2017 IEQ.

Private consumption is projected to

Empirically, inflation and the Rupiah have been found to be structural drivers of consumption growth, with effects sometimes increasing after a number of quarters.

⁶¹ World Bank (2018a).

gradually strengthen on low inflation and a robust labor market

The current low inflation but with a weakening exchange rate have therefore opposing effects, creating an overall ambiguous effect on private consumption growth going forward. However, spending in the upcoming elections and stronger commodity prices are expected to provide an independent boost, leading to a modest improvement in private consumption growth over the next two years. Meanwhile, the current robust labor market conditions along with continued structural transformation of a shrinking employment share in agriculture, and the expansion of various government programs⁶², are also all expected to contribute to stronger private consumption.

Investment growth is forecast to remain robust on strong infrastructure investment and FDI

Despite the projected marginal easing, as some potential investors adopt a wait-and-see approach in light of the upcoming elections, growth of gross fixed capital formation is expected to remain strong, consistent with its performance in recent quarters. Supportive factors include the gradually improving global commodity prices, the continued low financing costs at least in the short-term, recovering business sentiment, the persistent push on infrastructure investment and surging foreign direct investment.

Box A.2: Recent changes in trade policy

The Indonesian government has implemented a number of significant trade reforms over the past quarter.

Shifting to post-border audits to accelerate the customs clearance process

In an attempt to facilitate the processing of imports and exports, the government has moved the inspection of documents required for the import of a number of products from the border to post-border audits. This measure has been so far applied to over 2,000 products included in the list of prohibited and restricted goods, so-called “Lartas”, mainly through a series of new Ministry of Trade regulations. This list comprises 5,229 products (almost half of all possible products according to the 2017 HS 8-digit classification), which are subject to the most stringent importation requirements.

The reform – which had already been announced last June through the economic policy package nr. XV⁶³ - should facilitate the importation process as it would speed up the customs clearance process, which would become automatic. Given the burdensome documentary requirements associated with the import of many “Lartas” products, the potential gains in terms of costs and time savings are particularly large. At the same time, this new approach presents considerable implementation challenges.

First, it requires the harmonization of regulations across multiple ministries and agencies responsible for issuing permits and licenses to import these products, so that the checks of these documents are moved to post-border audits. At the time of writing, this process is still in progress and several goods whose inspections have been shifted to post-border audits by one Ministry were still subject to verification at the border by other ministries.

Second, there is a need to develop post-border audit capacity within the Ministries which are responsible for the inspection of the relevant import permits and licenses at the factory premises. This is a new potentially burdensome task for Ministries, which in the past have been delegating the necessary inspections to DG Customs at the border, and would eventually have to dispatch their own personnel across the archipelago to perform time-consuming inspections in factories and other commercial premises. Some form of risk management techniques – which are new to these ministries - would likely have to be employed to focus these audits on the riskiest cases. In addition, such audits – which can occur up to 3 years after the importation of the goods – can be opportunities for corruption if the auditors are not provided with an adequate system of incentives to counter that risk.

⁶² Examples of such government programs include the expansion of Program Keluarga Harapan (PKH) welfare beneficiaries from 6 to 10 million households, the non-cash food assistance program (Bantuan Pangan Non-Tunai, or BPNT), and the labor-intensive construction programs implemented by the Public Works and Housing Ministry and the Transport Ministry.

⁶³ The Jakarta Post (June 15, 2017).

Streamlining documentary requirements for imports

In a closely related reform, the government has also sought to simplify and rationalize the documentary requirements for imports on several Lartas goods in two ways. First, the Ministry of Trade has abolished some of the import licenses for certain products, such as cement and related products, and has reduced the number of supporting documents required to obtain the import approval, such as the Deed of Establishment on corn imports, the technical recommendation by line Ministries for importing products such as tires, corn, iron, steel and related products. Second, the government has reduced the existing duplications among various ministries and agencies that require the same supporting documents for issuing permits and licenses to import the same good.

Mandatory use of domestic shipping carriers and insurance companies

Apart from the above reforms, which promise to substantially facilitate trade if appropriately implemented, the government has implemented a trade reform that is more controversial. The Ministry of Trade issued a regulation which from April 2018 will force exporters of crude palm oil (CPO) and coal as well as importers of rice and government procured goods to use Indonesian-flagged vessels and to insure their traded products with Indonesian companies. The ostensive objective is to promote the domestic shipping and insurance industries and reducing the large trade deficit, particularly in transport services. While the impact on domestic insurance companies and shipping lines is unclear, when the latter are already operating at full- or near-full capacity, this move could substantially raise import and export costs of these goods as the supply of shipping services for these products would shrink. This in turn could raise the prices of these services while reducing their quality due to lower competition. There is indeed a concern among commodity exporters that Indonesian fleets are unable to accommodate the current volume of exports of coal and CPO.

- Risks to the outlook include slower global trade,...** Risks to the economic growth outlook at tilted to the downside. On the external front, with protectionism on the rise, there is a risk that the nascent recovery in global trade could stall, weighing on Indonesian exports and hence growth.
- ... financial volatility** Although the normalization of U.S. monetary policy is proceeding in an orderly manner, faster than expected inflation could trigger unexpected monetary tightening, leading to volatile capital outflows from emerging markets. In addition, a number of equity markets are currently perceived to be overvalued, and valuation corrections, such as the one seen with the U.S. stock market earlier this year, remain plausible in the immediate future. There is a risk that such valuation corrections could lead to financial volatility and jumps in bond yields, and abruptly raising financing costs for emerging economies.
- ...and slowing private consumption** While private consumption strengthened in Q4, there remains a risk that private consumption remains lackluster or even weaken in the medium-term. Given that it constitutes more than half of GDP, any slowdown in private consumption could notable repercussions on total expenditures.

Headline inflation is expected to average 3.5 percent in 2018, but risks to the outlook remain heavily tilted to the upside

Despite the increases in food price inflation at the end of 2017 and start of 2018, headline inflation is expected to average 3.5 percent in 2018, lower than that in 2017, and therefore supporting private consumption and creating further space for a stable monetary policy. (Figure A.42). The baseline forecast assumes increases in crude oil prices and some inflationary effects of regional elections this year and in 2019. Risks to the inflation outlook continue to remain on the upside especially given the trajectory of international oil prices and some uncertainty about whether rice supply shortages can be alleviated completely through increased imports.

Indonesia's key commodities' ToT end 2017 at a considerably higher level than 2016, but is forecast to decline in 2018

The World Bank projects that prices of rubber, crude oil, LNG, palm oil, and base metals will rise in 2018 and 2019, while coal prices are expected to ease⁶⁴ (Table A.5). Oil prices are forecast to rise to USD 58/bbl in 2018 from USD 53/bbl in 2017, on strong demand and continued restraint in OPEC and non-OPEC production.⁶⁵ Coal prices are expected to retreat to USD 70/mt in 2018 from USD 85/mt in 2017, as demand slows, especially from China where an environmentally-friendly initiative is underway to reduce coal consumption^{66,67} (Figure A.43).

⁶⁴ World Bank (2017d).

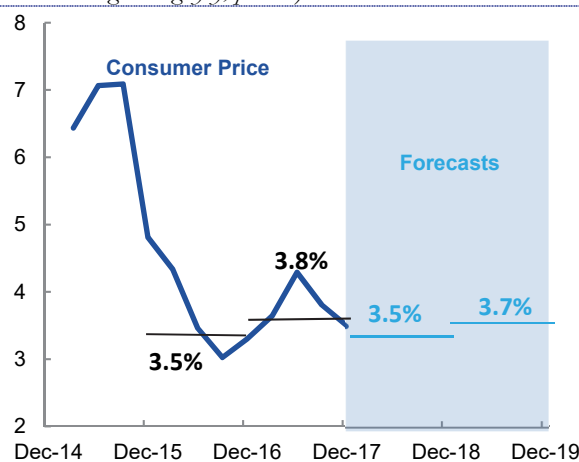
⁶⁵ The oil market is tightening as OECD crude stocks fell by an average of 630 kb/d in the three consecutive quarters 2Q17-4Q17. Such condition has happened only few times in the modern history, including in 1999 (prices doubled), 2009 (prices increased by nearly USD 20/bbl), and 2013 (prices increased by USD 6/bbl). On the other hand, OPEC reported a strong compliance to the agreed OPEC cuts over 129 percent in their monthly reports, driven by the decline in Venezuela's oil production.

⁶⁶ According to International Energy Agency (IEA), coal's share in the global energy mix is forecast to decline from 27 percent in 2016 to 26 percent in 2022 on sluggish demand growth relative to other fuels. As the largest coal consumer in the world, prices of coal will continue to depend largely on China. Accordingly, the structural reform of the Chinese coal industry is key to the evolution in coal prices. Readers interested more on the issue shall refer to IEA (2018).

⁶⁷ Further upside and downside risk are discussed in detail and can be found in the latest World Bank Commodity Market Outlook, available at <http://www.worldbank.org/en/research/commodity-markets>. Readers could also refer to the 2017 World Energy Outlook (IEA, 2017) for scenarios of energy demand and supply in the future.

Consumer price inflation is expected to be muted

Figure A.42: Anticipated food price volatility is not yet expected to weigh on forecasts
(annual average change yoy, percent)



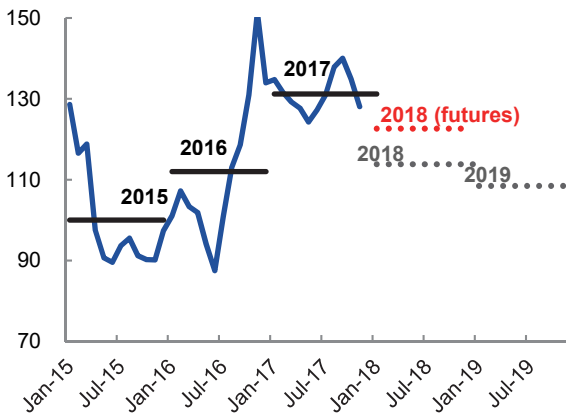
Source: BPS; World Bank staff calculations

Terms-of-trade is forecast to weaken and the current account deficit to widen modestly

As Indonesia is a net exporter of coal and a net importer of oil, the expected movements of coal and oil prices imply a significant swing in the country’s terms-of-trade (ToT)⁶⁸. Given the 2017 average prices of the six commodities are higher than those in 2016, the Net-Trade Weighted Price Index for 2017 is considerably higher than the 2016 level. However, in line with price forecasts, the 2018 Index projected to be lower than the 2017, albeit still slightly higher than the 2016 level. The decline of the 2018 is still prominently observable even if the average of prices of futures in 2018 are used instead of the forecast prices from the World Bank (2017)⁶⁹ (Figure A.43)⁷⁰.

Figure A.43: The net trade-weighted price index – historical and forecast until 2020

(index 2015=100)



Source: BPS; World Bank; World Bank staff calculations
 Note: Net trade-weighted price index is constructed over Indonesia’s six major export commodities (rubber, base metals, coal, oil, LNG, and palm oil)

Table A.5: Average commodity prices in 2016, 2017 and forecasts for 2018, 2019

	2016	2017	2018f	2019f
Coal (Australia)	65.9	88.4	70.0	60.0
Crude Oil (average)	42.8	52.8	58.0	59.0
Natural Gas (Japan)	6.9	8.1	8.3	8.5
Rubber	1.6	2.0	2.1	2.1
Crude Palm Oil	700.0	715.0	732.5	745.1
Base Metals	68.3	83.8	85.2	86.0

Source: World Bank (2017, 2018)

⁶⁸ Terms of trade (TOT) refers to the relative price of imports in terms of exports and is defined as the ratio of export prices to import prices. It can be interpreted as the amount of import goods an economy can purchase per unit of export goods.

⁶⁹ The futures prices used are those for oil (average 2018 prices for WTI, Dubai and Brent is USD 60.1), crude palm oil (USD 629.4) and coal (USD 93.8). Futures prices were extracted on 09 February 2018.

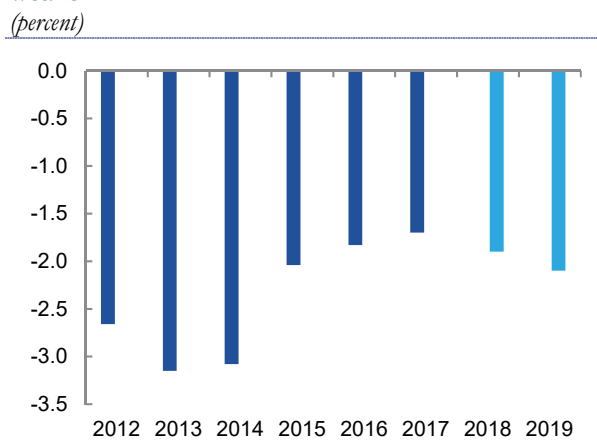
⁷⁰ The Net Trade-Commodity Price Index (NTI) is defined as: $NTI_t = \frac{Weight_{i,p} \times Price_{i,t}}{Price_{i,t}}$ where

$Weight_{i,p} = \frac{(E_{i,t}) - (I_{i,t})}{\sum (E_{N,t}) - \sum (I_{N,t})}$ and i= commodity type; t= month; p=period cycle (ex. 5 year average); N = number of commodities; T= base year; E=value of export; I=value of import

The current account deficit is expected to widen in 2018, in line with the decline in terms of trade and strong investment growth

Indonesia's terms-of-trade may have peaked in 2017 and projected to trend downward in 2018. Owing to stronger domestic demand, strong investment growth and slightly weaker projected growth for Indonesia's major trading partners, the current account deficit is expected to widen modestly to 1.9 percent of GDP in 2018 and to 2.1 percent of GDP in 2019 (Figure A.44).

Figure A.44: The current account is expected to widen in 2018 and 2019 as import-intensive investment remains strong and terms-of-trade weaken

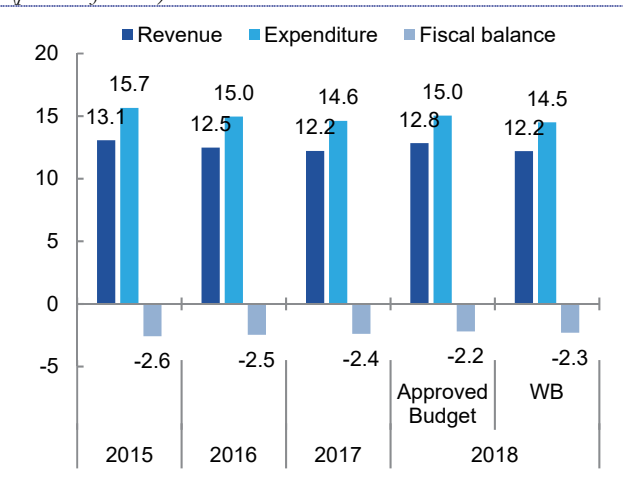


Source: CEIC and BI; World Bank Staff Calculations
Note: 2018 and 2019 are forecasts

The fiscal deficit is expected at 2.3 percent of GDP in 2018

The fiscal balance is expected to narrow modestly over the forecasting horizon (Figure A.45). This narrowing in line with the smaller deficit stipulated in the 2018 budget, as high oil prices persist and critical revenue enhancing reforms are implemented, boosting total collections.

Figure A.45: World Bank projects a fiscal deficit of 2.3 percent of GDP in 2018



Source: Ministry of Finance, World Bank staff calculations
Note: 2012-2016 are actual audited figures; 2017 are preliminary actual figures as of February 9, 2018.

Consistent with the macroeconomic outlook for 2018 and continued tax administration reforms, total central government revenues are projected to grow 8.0 percent yoy in nominal terms, driven largely by projected increases in collections from income taxes⁷¹. Meanwhile, total government expenditures are forecast to increase 7.5 percent from 2017 in nominal terms, driven by projected increases in goods and materials

⁷¹ The World Bank's revenue projection is 5.4 percent lower than the 2018 Budget.

Upward and downward risks remain in 2018 outlook

spending⁷². Overall, the World Bank projects a fiscal deficit of 2.3 percent of GDP, wider than the 2018 Budget projection of 2.2 percent (Table A.6)⁷³.

A significant share of revenues in 2018 will remain closely correlated⁷⁴ with global oil price, exposing the Government to upside and downside risks from oil price fluctuations. Without continuing the reforms that broaden the tax base and tax the existing base more efficiently and equitably, the Government's medium-term fiscal position will be compromised, along with fiscal expenditures critical to the country's progress towards inclusive growth (See Part B). On the spending side, the government has announced that it will keep the regulated fuel and electricity prices unchanged⁷⁵ until the end of 2019 amid higher global fuel prices. This policy increases fiscal risks from potential losses by Pertamina and higher expenditure through payments on arrears to Pertamina and PLN⁷⁶, leading to even higher energy subsidy outlays. In addition, there could be some risks stemming from contingent liabilities associated with the financing of infrastructure projects. If downside risks from revenue collections materialize and expenditures are maintained, a wider fiscal deficit could emerge in 2018. Overall, sustaining the reform momentum in revenue administration, tax policy, and quality of spending, will potentially be more challenging given upcoming regional and Presidential elections in 2018-2019.

⁷² The World Bank's expenditure projection is 3.9 percent lower than the 2018 Budget.

⁷³ The Government recently announced that it would seek to increase the allocation towards energy subsidies, in response to higher than expected crude oil prices. This reallocation is currently expected to have a limited impact on the fiscal deficit.

⁷⁴ Volatility of major tax revenues streams, such as VAT and income taxes, to global oil prices were also discussed in IEQ December, October, June 2017.

⁷⁵ Regulated fuels refer to RON 88 and diesel. See Jakarta Globe (November 30, 2017).

⁷⁶ The regulated fuel prices have not been changed since April 1 2016 when Brent crude oil price was in the range of USD 35-40/barrel. Meanwhile, the average Brent crude oil price from January 1 2018 till March 19 2018 was USD 66.6/barrel. However, by February 25 Pertamina increases prices of non-subsidized fuels, where Pertamina (Ron 92) prices is up by IDR 300/liter (to IDR8,900/liter), Pertamina Turbo is up by IDR 500 (to IDR10,100/liter), and keeps Peralite unchanged, which may indicate further cross-subsidization to manage the pressures on Pertamina's balance sheet from higher fuel prices.

Table A.6: The World Bank projects lower revenue and expenditure than in the 2018 Budget
(IDR trillion, unless otherwise indicated)

	2016 Actual Audited	2017 Budget	2017 Revised Budget	2017 Preliminary	2018 Budget	2018 World Bank
A. Revenues	1,556	1,750	1,736	1,660	1,895	1,793
(% of GDP)	12.5	12.5	12.8	12.2	12.8	12.2
1. Tax revenues	1,285	1,499	1,473	1,343	1,618	1,498
(% of GDP)	10.4	10.9	10.8	9.9	10.9	10.2
Income taxes	666	788	784	647	855	753
Oil & Gas	36	36	42	50	38	47
Non-Oil & Gas	630	752	742	597	817	706
VAT/LGST	412	494	475	481	542	512
Property taxes	19	17	15	17	17	17
Excises	144	157	153	153	155	167
International trade taxes	35	34	36	39	39	41
Import duties	32	34	33	35	36	37
Export duties	3	0	3	4	3	4
Other taxes	8	9	9	7	10	7
2. Non-tax revenues	262	250	260	310	275	294
(% of GDP)	2.1	1.8	1.9	2.3	1.9	2.0
Natural resources revenues	65	87	96	112	104	123
Oil & Gas	44	64	72	83	80	99
Non-Oil & Gas	21	23	23	29	23	23
Other non-tax revenues	197	163	165	198	172	172
3. Grants	9	1	3	6	1	1
B. Expenditures	1,860	2,080	2,133	1,986	2,221	2,134
(% of GDP)	15.0	15.2	15.7	14.6	15.0	14.5
1. Central government	1,149	1,316	1,367	1,244	1,455	1,391
(% of GDP)	9.3	9.6	10.0	9.2	9.8	9.4
Personnel	305	345	340	313	366	332
Material	260	270	319	280	340	353
Capital	169	221	206	200	204	204
Interest payments	183	221	219	217	239	234
Subsidies	174	160	169	166	156	171
Energy	107	77	90	98	95	119
Fuel	44	32	44	50	47	59
Electricity	63	45	45	47	48	60
Non-energy	67	83	79	69	62	51
Grants	7	2	6	5	1	3
Social	50	56	58	55	81	80
Other	6	41	50	9	67	14
2. Transfers to regions	710	710	766	742	766	743
(% of GDP)	5.7	5.5	5.6	5.5	5.2	5.0
Overall Balance	-308	-308	-397	-326	-326	-341
(% of GDP)	-2.5	-2.4	-2.9	-2.4	-2.2	-2.31
<i>Assumptions</i>						
Real GDP growth rate (%)	5.0	5.1	5.2	5.1	5.4	5.3
CPI (%)	3.5	4.0	4.3	3.8	3.5	3.5
Exchange rate (IDR/USD)	13,300	13,300	13,400	13,381	13,400	13,550
Crude-oil price (USD/barrel)	51	45	48		48	58

Source: Ministry of Finance

B. Collecting more and spending better for inclusive growth



Decisions on government spending and revenue collections – the core of fiscal policy – play a key role in supporting economic growth, and help share the benefits of growth more widely across society. Effective policies that promote inclusive growth, such as investing in human capital or enhancing the connectivity of remote areas, both reduce inequality and promote growth. Indonesia's experience of the past 15 years suggests that fiscal policy has contributed positively to economic growth, notably through macroeconomic stability. However, fiscal policy has been less successful in sharing the benefits of growth more widely: inequality of opportunity remains substantial, and estimates suggest that taxes and public expenditure reduce Indonesia's Gini coefficient by only 0.04 point compared to 0.18 points in South Africa. In the past, the impact of revenue and expenditure policies on inclusive growth has been dampened by underspending in priority areas such as infrastructure, health and social assistance, and by ineffective spending in those and other critical areas, especially education. Spending on priority areas has recently increased due to the reallocation of expenditures from energy subsidies; however, low revenue collections continue to hinder a sustained increase in priority sector spending. To achieve faster and more inclusive growth, Indonesia needs to spend better and spend more in priority areas. This will require continuing to enhance the effectiveness of line ministry and subnational spending, further reallocating spending across and within sectors, and collecting more revenues in an efficient and growth-friendly manner. Relevant tax reforms include broadening of the tax base, simplifying the tax code, and significantly strengthening compliance management.

1. Indonesia needs to collect more and spend better to promote inclusive growth

Ensuring economic growth is both robust and inclusive is the right thing to

Inclusive growth – economic growth that disproportionately benefits the bottom of the income distribution⁷⁷ – has been an objective of successive governments in Indonesia. The pursuit of narrowing disparities embedded in the concept of inclusive growth is commendable in its own right, but it is also smart economics, as high

⁷⁷ There are many definitions of inclusive growth. World Bank (2018a) defines inclusive growth as growth that reduces poverty and ensures economic security for all classes. The OECD defines inclusive growth as economic growth that creates opportunity for all segments of the population and distributes the dividends of increased prosperity, both in monetary and non-monetary terms, fairly across society. In this report, inclusive growth refers to economic growth that benefits the bottom of the income distribution disproportionately and therefore is accompanied by stable or lower inequality.

do – and smart economics

inequality can harm both the pace and duration of growth spells⁷⁸. This is because inequality (i) limits progress in health and education, reducing human capital accumulation, (ii) dampens aggregate entrepreneurship and risk-taking as large numbers of households are credit-constrained⁷⁹; and (iii) can provoke political and social instability⁸⁰. Decreases in inequality are therefore associated with most transitions from middle-income to high-income economies⁸¹.

Spending and revenue policies are key tools to make growth more robust...

While monetary and structural policies, such the legal and regulatory framework, also have a major impact on both growth and equity, this Part of the IEQ focuses on the role of fiscal policy, particularly Government policies for revenue mobilization and public expenditure.⁸² Public expenditure supports economic growth largely through investments in infrastructure and human capital. Infrastructure connects skilled labor to firms, and firms to markets, contributing to the creation of better, more productive jobs⁸³. In Indonesia, higher annual growth of physical infrastructure stock over 2001-2012 of 5.0 percent, instead of the actual average of 3.0 percent, would have led to higher GDP growth over the period, with a cumulative gain of 0.5 percentage points.⁸⁴

...and more inclusive, by redistributing resources...

Expenditure and revenue policies also influence the current and future distribution of disposable incomes and consumption levels. In any given period, fiscal policy redistributes resources from taxpayers to consumers of public goods and services. For example, when a poor family that pays no taxes sends their children to free public schools, it can enjoy a higher level of consumption than if it had to pay private school fees. Meanwhile, a wealthy family that pays the taxes used to fund public education ends up with less disposable income. Overall, the likely effect is a smaller difference in consumption levels between the wealthy and poor families. In Indonesia, estimates suggest that taxes and public expenditure contribute to a slight reduction of inequality, accounting for a decline of 0.04 points in the Gini coefficient.

...and by equalizing opportunities and promoting job-creating growth

Beyond the contemporaneous effect described above, public spending and revenue policies can help reduce *future* inequality by creating more equal opportunities. For example, spending on education allows the children of both wealthy and poor families to acquire more similar skills. More equal opportunities in education over time therefore lead to narrower gaps in capabilities, and ultimately lower inequality in disposable incomes. The example of education also illustrates how the same policy can have both contemporaneous and lagged effects on inequality, as well as a positive effect on economic growth. In Indonesia, one-third of current levels of inequality is due to inequality of opportunities,⁸⁵ i.e. circumstances that are beyond the control of an individual, such as gender, ethnicity, birthplace or family background.

⁷⁸ See Ostry et al. (2014); Berg and Ostry (2011).

⁷⁹ See Banerjee and Newman (1993); Banerjee and Duflo (2007); Aghion and Bolton (1997); Kray and McKenzie (2014)

⁸⁰ Alesina and Perotti (1996).

⁸¹ Bulman et al. (2016).

⁸² Fiscal policy also includes decisions on the level of the deficit and resulting debt levels (“fiscal management”), which also affect growth. Indonesia’s track record of compliance with a 3 percent ceiling for the deficit of the general government have underpinned macroeconomic stability and supported growth. Given the moderate level of debt and credible commitment to the fiscal rule, this article focuses on reforms to spending and taxation policies.

⁸³ See for example, Fan and Rao (2003; Mitchell (2005); and Dao (2012);

⁸⁴ World Bank (2015a).

⁸⁵ For more on the concept and measurement of inequality of opportunity, see Roemer (1993), Van Der Gaer (1993), Barros et al., (2010) and World Bank (2006). For more on inequality of opportunity in Indonesia, see World Bank (2015a).

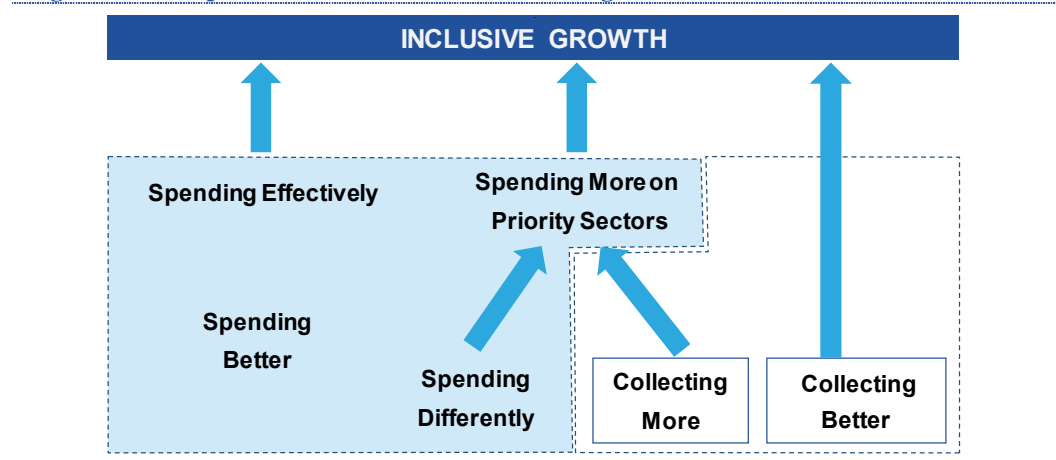
To achieve inclusive growth, Indonesia needs to spend more effectively – and spend more on priority sectors...

To advance in its quest towards inclusive growth, Indonesia needs to spend more and more effectively in priority sectors, which are those that support both growth and inclusion. These include education, but also infrastructure, health and social assistance. Spending effectively means getting the most out of each *Rupiah* of public expenditures. For example, it means achieving a lower rate of maternal mortality with the same resources. In many priority areas – particularly infrastructure, health, and social assistance – Indonesia needs to spend not only more effectively but also to increase the level of spending to catch up to other emerging economies, both in terms of spending levels and inclusive growth.

...by spending differently and collecting more in an efficient, equitable manner

Indonesia prioritizes prudent fiscal management and a commitment to containing deficit financing. Thus, in order to spend more in priority areas, the Government needs to pursue a combination of reallocating spending away from lower priority areas (“spending differently”), and collecting more revenues through taxation. To maximize growth, collecting more needs to be pursued in a way that is efficient and equitable (“collecting better”). In summary, Indonesia needs to collect more (and better) and spend better (Figure B.1).

Figure B.1: To spend more and better for inclusive growth, Indonesia needs to collect more



2. Fiscal policy has supported growth and poverty reduction, but inequality remains high

Prudent fiscal management has supported macroeconomic stability and growth in Indonesia...

Indonesia has enjoyed solid growth since the 1997-1998 Asian Financial Crisis (Figure B.2). Over 2003-2016, real GDP growth averaged 5.5 percent – slower than the pre-crisis average of 7.0 percent, but more sustainable, as reflected by Indonesia's ability to weather the Global Financial Crisis reasonably well. Prudent fiscal management was a key contributor to macroeconomic stability⁸⁶: since 2003, Indonesia has adhered to limits on the fiscal deficit and the general government and public debt level, at 3 percent and 60 percent of GDP respectively.⁸⁷

⁸⁶ The variance of GDP growth declined from 14.4 percent over 1993-2003 excluding the crisis years (1997-1999) to 5.7 percent over 2004-2016.

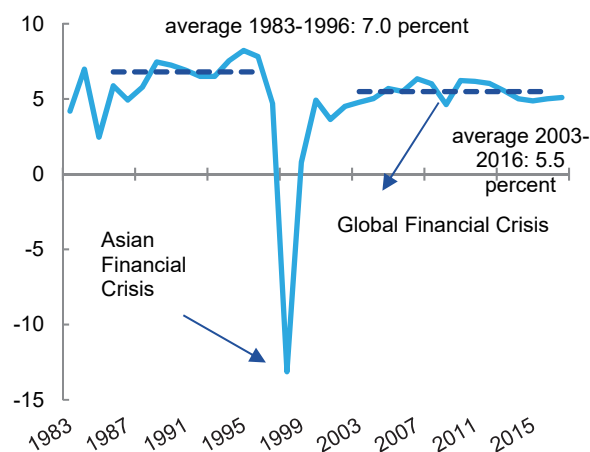
⁸⁷ Fiscal deficits averaged 1.4 percent of GDP from 2000-2016 and the public debt-to-GDP ratio declined from 92.3 percent to 27.9 percent over the period.

...leading to large advances in poverty reduction...

Broad macroeconomic stability, commodity-driven growth and structural transformation led poverty rates to halve to 10.9 percent over 2000-2016. Over 30 million service and industrial jobs were created over this period, replacing less productive agricultural jobs and raising incomes for millions of Indonesians. As real per capita incomes doubled to nearly USD4,000, an additional 32 million people joined the middle class between 2006 and 2016.⁸⁸

Figure B.2: Prudent fiscal policy has supported more stable economic growth...

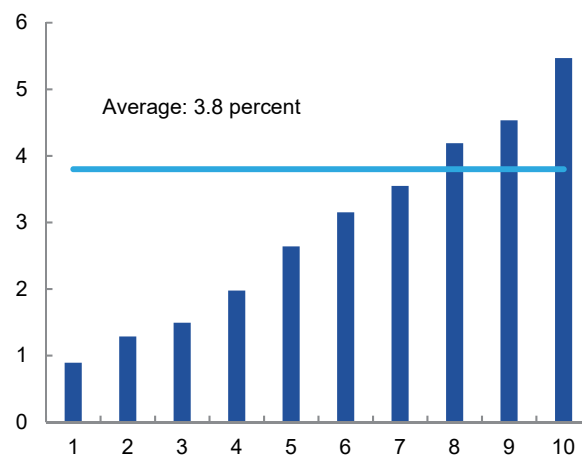
(Y-axis: real growth of Gross Domestic Product, x-axis: year)



Source: World Development Indicators (WDI), World Bank staff calculations

Figure B.3: ...but growth has not been very inclusive

(Y-axis: average annualized growth of per capita consumption from 2006-2016, percent; X-axis: household consumption decile)



Source: Susenas household surveys, World Bank staff calculations
Note: There are breaks in the sampling strategy between 2010-2011 and 2014-2015.

However, consumption inequality has increased...

Notwithstanding these achievements, the benefits associated with growth have not been shared widely. Real consumption of the poorest 40 percent of households grew by 1.5 percent per annum between 2006-2016, compared to 5.1 percent per annum for the richest 20 percent of households (Figure B.3). Inequality has risen substantially: the Gini coefficient⁸⁹ on consumption rose from 30 points in 2000 to 41 points in 2013⁹⁰.

... while the contemporaneous effect of fiscal policy on inequality is limited

Compared to advanced and other emerging economies, the contemporaneous effect of fiscal policy in Indonesia on inequality of disposable incomes is very small. In 2012, Indonesia's Gini coefficient, a measure of inequality, barely changed after accounting for taxes and transfers⁹¹ (Figure B.4). Meanwhile, in South Africa, highly progressive direct taxes and social spending reduced the Gini coefficient by 0.08 points. Accounting for other elements of fiscal policy such as indirect taxes, indirect subsidies and in-kind transfers in health and education, fiscal policy reduced the Gini coefficient in South Africa by 0.18 points in total⁹². In Argentina and Brazil, conditional cash transfers and other fiscal policy instruments also played an important role in reducing

⁸⁸ World Bank staff calculations using Susenas data.

⁸⁹ Measures the extent to which the distribution of income or consumption among individuals/households deviates from a perfectly equal distribution (Gini coefficient of 1.0).

⁹⁰ Actual levels of inequality are likely even higher, as surveys tend to exclude the richest households and account for only 45 percent of consumption in national accounts.

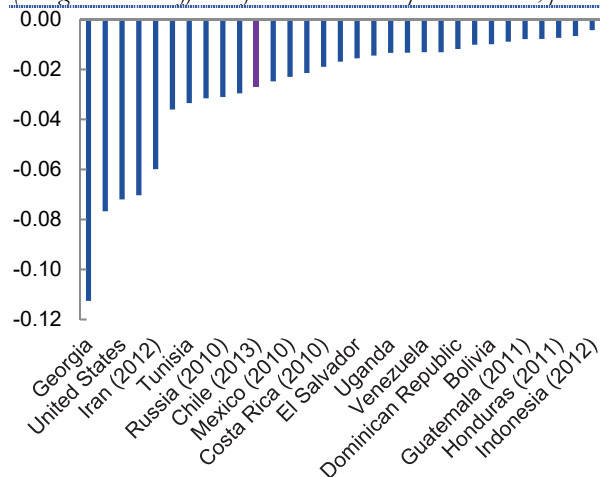
⁹¹ The effect of fiscal policy on inequality can be estimated using the Commitment to Equity methodology, which compares pre-fiscal policy and post-fiscal policy income. More details are available in Annex 1.

⁹² Not shown in Figure B.4, which only accounts for taxes, social security contributions, and transfers.

inequality as measured by the Gini coefficient, by 0.07 and 0.03 points respectively. Fiscal policy plays an even larger role in OECD countries, where progressive taxation and social safety nets reduce inequality by 0.14 points on average (Figure B.5).

Figure B.4: Decisions on Government spending and revenue collections substantially reduce inequality in other emerging economies

(change in Gini coefficient from market to disposable income, points)

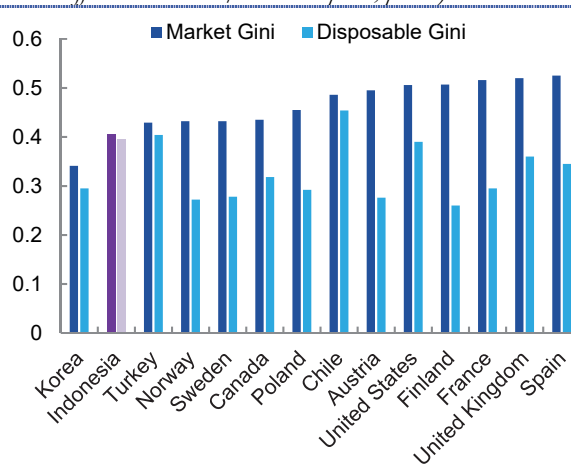


Source: Commitment to Equity (CEQ) Standard Indicators, web version (November 30, 2017); World Bank staff calculations
Note:

1. Data for Indonesia, Ghana, Ethiopia, Jordan and Tanzania refer to Gini coefficient on consumption; data for other countries refers to Gini coefficient on income.
2. Market income refers to wages, salaries, or other private income before accounting for government taxes (which subtract from income), social security contributions and transfers (which add to income). Disposable income refers to income after accounting for these taxes and transfers. For more information, see Annex 1.

Figure B.5: Indonesia’s pre-fiscal policy Gini is not very different from OECD countries, but fiscal policy has a greater redistributive impact in OECD countries

(Gini coefficient on income / on consumption, points)



Source: OECD Statistics, Tiwari et al (2018), World Bank staff calculations
Note:

1. All data refer to 2015 unless otherwise stated. Data for Indonesia refers to Gini coefficient on consumption; data for other countries refers to Gini coefficient on income.
2. Market income refers to wages, salaries, or other private income before accounting for government taxes (which subtract from income), social security contributions and transfers (which add to income). Disposable income refers to income after accounting for these taxes and transfers. For more information, see Annex 1.

Inequality of opportunity remains a major challenge.

Significant disparity in Indonesians’ access to basic services persists across the archipelago. Although average access to basic services improved from 48.8 percent in 2001 to 70.9 percent in 2015, many districts still lag national averages⁹³. Less than 30 percent of households in some districts in Papua and Kalimantan have access to safe water, compared to over 70 percent in about half of all districts. The quality of education is also uneven: the coefficient of variation for high school test scores rose from 0.09 in 2006 to 0.15 in 2015, indicating widening disparity in learning outcomes⁹⁴.

3. Limited effectiveness and low levels of spending in priority areas held back both growth and equity

Indonesia has not spent enough in some areas crucial to inclusive growth...

There are several reasons why decisions on Government spending and revenue collections have not resulted in a significant impact on inclusive growth in Indonesia. First, Indonesia is not spending enough on certain areas that are critical for inclusive growth: infrastructure, health and social assistance. Years of underinvestment in

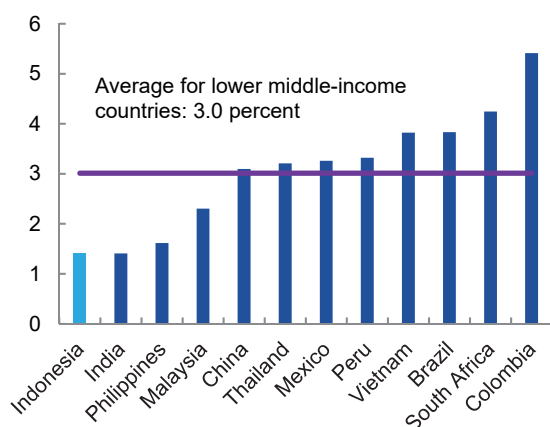
⁹³ World Bank staff calculations using Susenas data. Refers to the simple average of net enrollment rates in junior and senior high school, access to safe water, access to safe sanitation, and proportion of births attended by a skilled health worker. See World Bank (2017e).

⁹⁴ World Bank (2017e).

infrastructure has led to a large deficit estimated at USD 1.5 trillion⁹⁵. Between 2000-2013, Indonesia spent an average of 3.6 percent of GDP in public investments and Public Private Partnerships in infrastructure per year, compared to 17.7 percent in China, 11.3 percent in Malaysia and 6.3 percent in Thailand⁹⁶. In health, Indonesia spends 1.4 percent of GDP or a third of the global average (Figure B.6). This contributes to poorer health outcomes: life expectancy at birth is 69 years for Indonesians, five years lower than the average East Asia & Pacific resident⁹⁷. In social assistance, Indonesia also spends less as a share of GDP than the average lower middle-income country (Figure B.7).

Figure B.6: Indonesia is one of the countries that spends the least on health in the world...

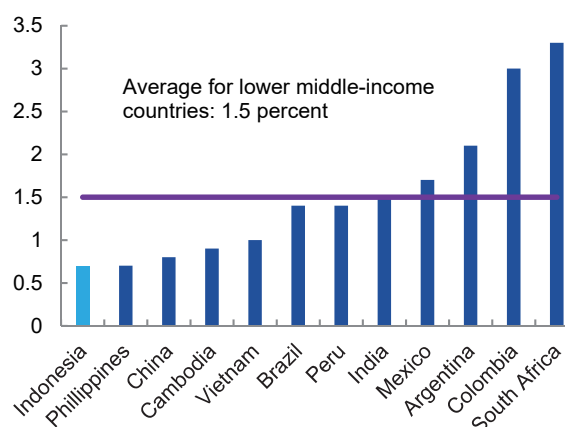
(general government spending on health, percent of GDP)



Source: WDI, Ministry of Finance, World Bank staff calculations
Note: Data for Indonesia refer to 2016 and includes subnational spending. Data for other countries refer to 2014.

Figure B.7: ...and it also underspends on social assistance compared to other emerging economies

(public spending on social assistance programs, percent of GDP)



Source: World Bank ASPIRE, World Bank staff calculations
Note: Data for Philippines refer to 2013-14, China (2014), India (2016), Indonesia and other countries (2015).

...in part because of high spending on regressive energy subsidies in the past...

Until 2015, a large share of the revenue raised during the commodity boom was spent on regressive energy subsidies. In 2012, the Government spent a fifth of its budget or 4.0 percent of GDP on energy subsidies, about four times the amount spent on social assistance. Subsidies do not contribute meaningfully to growth, and are poorly targeted, with only about 35 percent reaching poor and vulnerable households (Figure B.8). By comparison, direct social assistance transfers such as PKH and BLSM⁹⁸ are much more progressive, with about 60 percent and 40 percent respectively reaching poor and vulnerable households (Figure B.9). However, such transfers only accounted for about 5 percent of total expenditures or 0.9 percent of GDP in the same year.

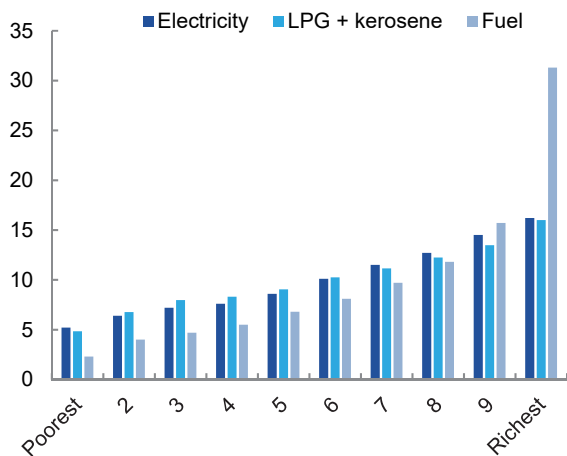
⁹⁵ For more details on the methodology, see World Bank (2017b).

⁹⁶ World Bank staff calculations using the IMF Investment and Capital Stock Dataset (2017).

⁹⁷ Excluding high-income countries in East Asia and the Pacific.

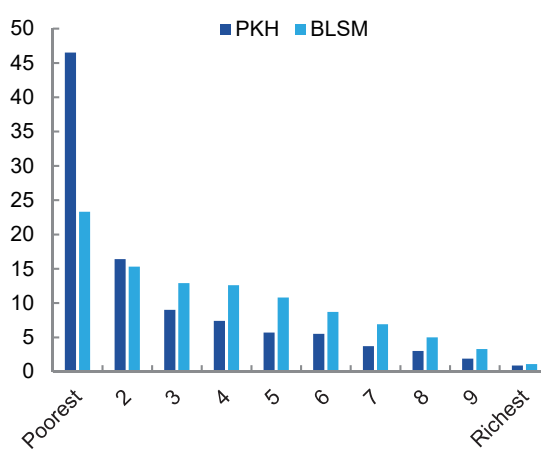
⁹⁸ *Bantuan Langsung Sementara Masyarakat* is a temporary, just-in-time cash transfer that is distributed to the poor in response to price shocks such as energy subsidy cuts.

Figure B.8: Up until recently, about a fifth of the budget was spent on regressive energy subsidies...
(share of benefits received by consumption decile)



Source: Susenas 2015, World Bank staff calculations

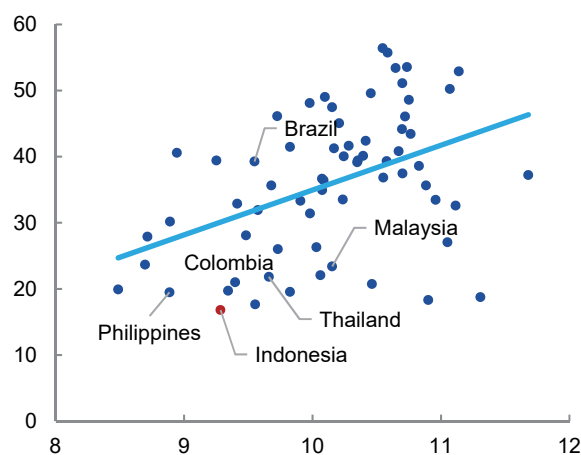
Figure B.9: ...rather than on progressive direct transfers for social assistance
(share of benefits received by consumption decile)



Source: Susenas 2015, World Bank staff calculations

Figure B.10: Indonesia's level of public expenditure is relatively low

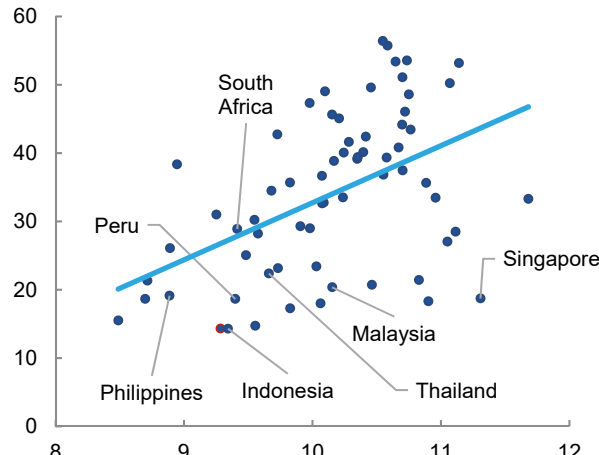
(Y-axis: General government spending, percent of GDP, 2016; X-axis: log GDP per capita in 2011 PPP)



Source: IMF Fiscal Monitor, World Bank staff calculations

Figure B.11: ...primarily due to its low revenue to GDP ratio

(Y-axis: General government revenue, percent of GDP, 2016; X-axis: log GDP per capita in 2011 PPP)



Source: IMF Fiscal Monitor, World Bank staff calculations

...but also because of weak revenue collection, which constrains the overall resource envelope

At 14.6 percent of GDP in 2017, Indonesia's level of expenditure is less than half the average of other emerging markets⁹⁹, making Indonesia a small spender in comparison with its peers (Figure B.10). Even during the commodity boom, total national public spending only reached 20 percent of GDP. Low revenue collections are a major cause of the low level of spending in priority areas that matter for inclusive growth. Indonesia's revenue-to-GDP ratio is low: 12.2 percent in 2017, compared to the emerging economy average of 27.8 percent (Figure B.11)¹⁰⁰. Spending is also constrained in part by the fiscal deficit limit of 3.0 percent of GDP. However, given the importance of prudent fiscal management to sustaining growth, rather than

⁹⁹ The average general government expenditure-to-GDP ratio for 39 emerging markets excluding Indonesia was 35.4 percent in 2016. See IMF (2017b).

¹⁰⁰ Same set of countries and source of data as above.

running higher deficits, Indonesia needs to finance higher expenditures by collecting more.

The effectiveness of spending in areas that would enhance inclusive growth have been limited – for example in infrastructure...

A second set of reasons why Government spending has had a limited impact on inclusive growth is because spending does not necessarily lead to better outcomes. Although Central Government spending on national roads increased sixfold in real terms between 2005-2015, it did not lead to a concurrent increase in the quantity and quality of roads. Road development stayed relatively constant at 2,000-3,000 kilometers per year and only 60 percent of the national road network can be considered in good condition. This is partly due to costlier road treatments from higher design standards and the growing use of concrete pavement in trunk corridors, but also insufficient spending on maintenance. Similarly, despite a seven-fold increase in real terms in central government spending in the water supply sector since 2005-2013, usage of piped water for drinking purposes has fallen by almost one third and usage for cleaning purposes has remained broadly flat.

Another form of inefficient spending in infrastructure is in the use of public funds for projects that could be delivered by the private sector. The private sector can deliver infrastructure more efficiently and at better value for money than traditional government procurement. However, private investment in infrastructure has declined from 19 percent on average during 2006-2010 to 9 percent on average between 2011-2015¹⁰¹. One challenge in attracting the private sector is the lack of a systematic mechanism to allocate projects between state-owned enterprises (SOEs) and the private sector. Government Contracting Authorities (GCAs) determine whether projects are publicly or privately funded at a very early stage of project development, with no clear criteria to determine which projects should be competitively tendered and which should be assigned to an SOE. As a result, many viable projects are assigned to SOEs, reducing the overall size of the ‘pie’ of infrastructure that can be developed within a given budget envelope.

... and education

In education, increased spending¹⁰² has not led to meaningful improvements in human capital, especially in terms of quality. Although education spending increased almost elevenfold in nominal terms over 2001-2016 to 3.6 percent of GDP, with more teachers hired to lower the student-teacher ratio¹⁰³ and teachers’ salaries doubled, student performance as measured by national test scores have barely moved.¹⁰⁴ This is in part because Indonesia did not systematically link increased pay to observed teaching performance. Although Vietnam and Indonesia both allocate a fifth of their budgets to education, Vietnam¹⁰⁵ is one of the top 10 achievers in the PISA test, whereas Indonesia remains towards the bottom of the rankings, despite some improvements in scores from earlier years (Figure B.12).

¹⁰¹ See World Bank (2017b).

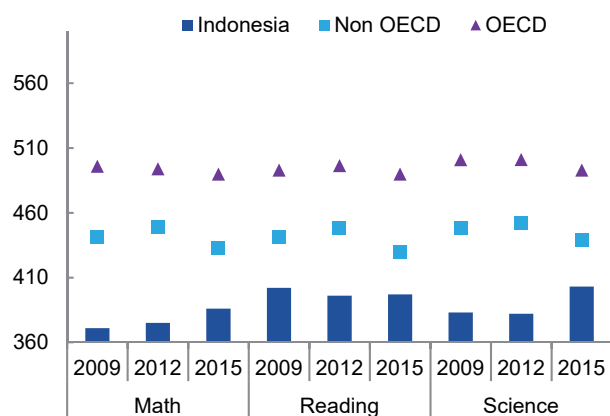
¹⁰² Since the passage of a constitutional amendment in 2002, the Government is required to allocate at least 20 percent of the total budget to spending on education. The rule’s mandate was fully met for the first time in 2009. Today, government spending on education in Indonesia is comparable to peers and not far from the OECD average of 5.3 percent of GDP.

¹⁰³ In 2014, Indonesia’s STR for elementary school was 1:17, compared to 1:14 for high-income economies on average and 1:29 in lower middle-income countries.

¹⁰⁴ See World Bank (2018d) and De Ree et al. (2017).

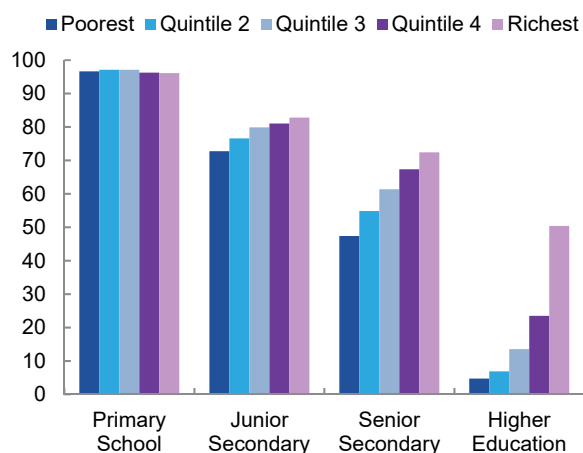
¹⁰⁵ Parandekar and Sedmik (2016) suggest that Vietnam outperforms its peers on the PISA due to higher levels of access to pre-school, investment in school infrastructure, and cultural factors.

Figure B.12: Despite high spending on education, student performance on the PISA test has not significantly improved
(PISA score, points)



Source: OECD, World Bank staff calculations

Figure B.13: Poor children are still much less likely to get a high school and university education...
(school enrollment rate by level of education)



Source: Susenas 2015, World Bank staff calculations

Within education, spending is not always allocated to interventions with the highest impact...

Moreover, within the education sector, spending is not necessarily allocated towards interventions with the largest potential impact on inclusive growth. Despite the proven benefits of investments in early childhood education and development (ECED)¹⁰⁶, resources spent for ECED are low. This especially affects the cognitive development of poorer children: a four-year-old child born in the poorest 20 percent of households only has a 16 percent chance of enrolling in ECED services, while a four-year old from the richest 20 percent of households has a 40 percent chance of doing so¹⁰⁷.

... while poorly targeted financial support for schooling absorbs scarce resources and leave many behind

Existing social assistance schemes do not adequately address these inequalities of opportunity in education. Despite the expansion of *Program Indonesia Pintar* (PIP), a cash transfer given to enrolled students or school-age children from the poorest 25 percent of households, nearly half of eligible children from the poorest 20 percent of households were not attending senior secondary school in 2016. This is largely because a large gap remains between the cost of attendance and the value of the PIP transfer, especially at the senior secondary school level¹⁰⁸. Although the program is progressive, it is poorly targeted: 36 percent of those who are non-poor benefitted from PIP in 2016¹⁰⁹. Poorer children are thus still less likely to obtain higher levels of education, and more likely to drop out of school: about a third of children in the poorest families who are enrolled in junior secondary school do not progress to the senior secondary level, compared to 17 percent of children in the richest families (Figure B.13).

¹⁰⁶ Every dollar invested in high-quality early childhood education programs can yield between USD 6-17 in return. See Engle et al. (2011).

¹⁰⁷ See World Bank (2017a) for further discussion.

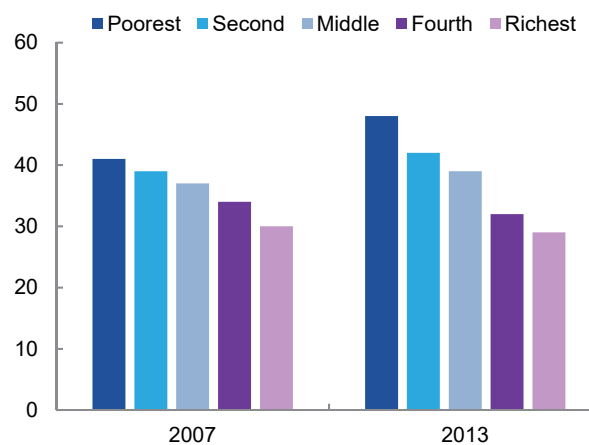
¹⁰⁸ See World Bank (2017f).

¹⁰⁹ World Bank Education Global Practice staff calculations using Susenas (2016) data.

Ineffective spending in health and social assistance also constrained the impact of public spending on the quality of human capital...

The effectiveness of health spending, particularly at the subnational level remain sub-optimal, partly result in large regional and income-related inequalities in health outcomes across the country. The maternal mortality ratio (MMR) remains high in Indonesia at 126/100,000 live births, far above the 2030 SDG target of less than 70 per 100,000 live births. At the same time, 37 percent of under-five children are stunted, disproportionately affects poorer children (Figure B.14)¹¹⁰.

Figure B.14: Stunting disproportionately affects poorer children
(percent of children under-5 experiencing stunting, by income decile)



Source: Riskesdas 2007 and 2013, World Bank staff calculations

Effectiveness is constrained by the lack of mechanisms to incentivize delivery at local levels, and by a disproportional allocation of spending toward curative interventions, while the more cost-effective promotive and preventive interventions receive significantly low allocation (less than 1 percent of total health expenditure). Similarly, in social assistance, the most effective programs in reducing poverty received the lowest amount of public spending and vice versa. Although every rupiah spent on *Program Keluarga Harapan* (PKH) reduces inequality¹¹¹ by 10 times more than every rupiah spent on the rice subsidy, *Rastra*, the latter's budget was more than 2.5 times higher in 2016.¹¹²

Intergovernmental transfers do not adequately address regional inequality, nor incentivize performance

Subnational governments are important players delivering services in the priority areas discussed above. The central government has limited mechanisms to influence or incentivize the generation of outputs and outcomes from the use of resources at the subnational level. Moreover, fiscal transfers from the Central Government to districts and villages do not adequately address regional inequality. The distribution of main transfers, such as the General Allocation Fund (*Dana Alokasi Umum*, DAU) and the Village Fund (*Dana Desa*) prioritizes a 'basic allocation' that is equal across districts and villages regardless of the population size and development needs of each region, rather than a 'per capita' distribution that takes these factors into account¹¹³. As a result, those who live in more populated districts receive 8 times less revenue per capita than citizens in the least populated districts. This constrains the availability of resources for infrastructure and other development needs in larger urban areas.

¹¹⁰ See World Bank (2016b) for a more detailed discussion

¹¹¹ According to analysis by the Fiscal Policy Agency (2018), every 1 trillion IDR spent on PKH can reduce poverty and inequality by 0.08 percentage points and 0.03 Gini points respectively.

¹¹² See World Bank (2017f) for a more detailed discussion.

¹¹³ 77 percent of *Dana Desa* funds are allocated according to basic allocation (equal allocation per village); 3 percent are allocated to disadvantaged regions, and the remaining 20 percent is allocated according to a formula that covers population size, number of poor people, village land area, and geographic difficulty.

4. The quality of spending has improved in recent years, but further progress is possible

a. Indonesia has improved the quality of spending through reallocations towards priority areas ...

The quality of spending has improved in recent years, with some impact on inclusive growth

Recent efforts by the Government have slightly improved the impact of fiscal policy on reducing inequality. After accounting for various instruments of fiscal policy – taxes, transfers, indirect taxes and subsidies, and in-kind transfers¹¹⁴ such as health and education, the Gini coefficient declined from 0.41 to 0.37 in 2015 (Figure B.15). This is an improvement from 2012. Similarly, accounting for taxes, transfers, and indirect taxes and subsidies, the poverty rate declined by 2.6 percentage points from 14.3 percent to 11.7 percent – an improvement from 2012 when the poverty rate declined by 1.0 percentage point (Figure B.16). Nonetheless, these magnitudes remain small when compared to other emerging and advanced economies as shown earlier.

Figure B.15: Fiscal policy reduced inequality by slightly more in 2015 compared to 2012...

(Gini points)

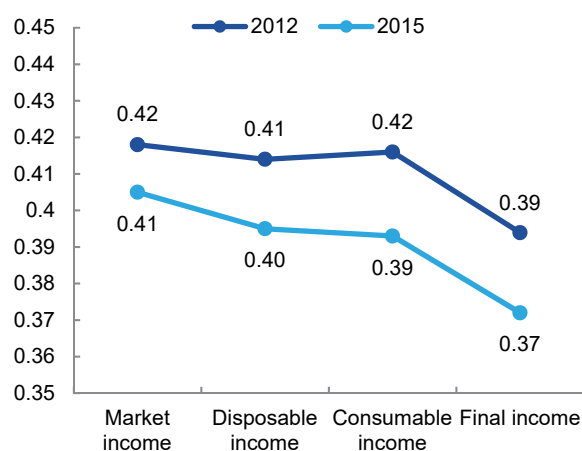
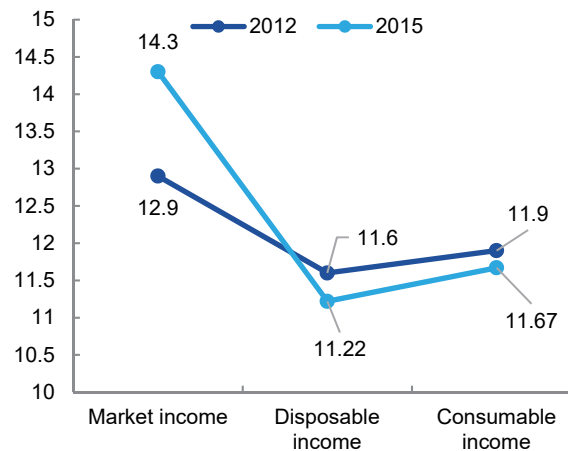


Figure B.16: ...and had a larger effect on poverty in 2015 compared to 2012

(Poverty rate, percent of population)



Source: Tiwari et al (2018) and Jellema et al (2017) based on Susenas data from 2012 and 2015

Note: *Market income* refers to wages, salaries and other private income before paying taxes or receiving transfers. *Disposable income* takes into account the effects of taxes, which subtract from income, and transfers, which add to income. *Consumable income* further adjusts for indirect taxes/subsidies. *Final income* further considers the welfare-enhancing effects of subsidized public services such as health and education.

The Government has reallocated spending to priority areas for inclusive growth...

The Government has recently spent more in areas that matter for inclusive growth. In 2015, the Government removed gasoline subsidies, sparking a critical shift in expenditures away from regressive energy subsidies towards higher investment in human and physical capital. Total spending on energy subsidies fell from 3.7 percent of GDP in 2014 to 1.4 percent of GDP in 2016¹¹⁵, while spending on infrastructure

¹¹⁴ The effects of fiscal policy on inequality can be estimated using incidence analysis. Market income refers to wages, salaries and other private income before paying taxes or receiving transfers. Disposable income takes into account taxes and transfers; consumable income further adjusts for indirect taxes/subsidies, and final income also takes into account the inequality-reducing effects of subsidized public services such as health and education. This information is not available on OECD countries, hence Figure B.4 only compares market and disposable income. See Annex 1 for more information.

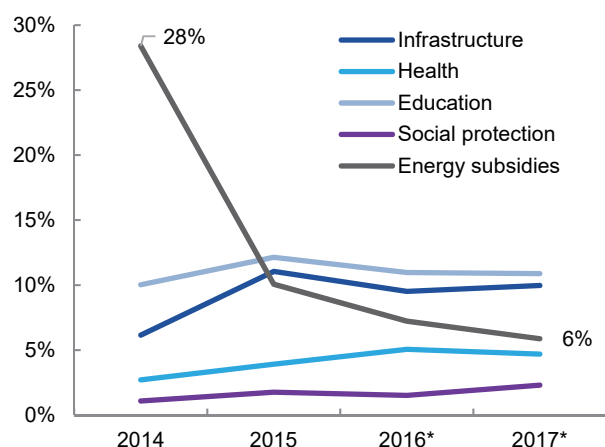
¹¹⁵ In 2017, spending on energy subsidies (electricity, diesel and LPG) amounted to about IDR 90 trillion.

and health increased to 1.9 percent of GDP and 1.4 percent of GDP, respectively (Figure B.17)¹¹⁶. In 2017, the government also improved the targeting of electricity subsidies by moving the non-poor and non-vulnerable 900 VA household customers under a non-subsidized tariff. The amount allocated under the Specific Allocation Fund (*Dana Alokasi Khusus*, DAK), designed to boost local infrastructure, has increased at a compound annual growth rate of 30 percent in nominal terms from 2008 to 2016. Although overall spending on social assistance remains low at 0.4 percent of GDP, spending on PKH, the most pro-poor welfare program¹¹⁷, has increased in absolute terms to over IDR 8 trillion, in line with the expansion from 3.2 million households to 6 million households in 2017. In 2018, the Government plans to further scale up the program to 10 million households; as a result, the allocated budget for social assistance is almost double that of 2016-2017.

...and slightly improved the distribution of Village Fund allocation

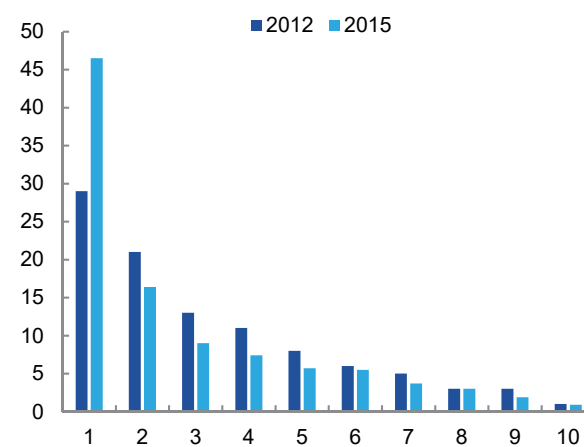
In 2015, the Government also began to distribute the Village Fund (*Dana Desa*) to 75,000 villages, amounting to IDR 60 trillion or 0.4 percent of GDP in 2018. While the overall design of the fiscal transfer system still prioritizes an equal distribution of funds across subnational units regardless of development need, there have been recent improvements in the distribution of *Dana Desa*. In 2018, 20 percent of the funds will be distributed according to the per capita formula that takes population size and village need into account, compared to 10 percent previously.¹¹⁸

Figure B.17: Spending on regressive energy subsidies has been redirected towards infrastructure...
(percent of Central Government spending excluding transfers to subnational governments)



Source: Ministry of Finance, World Bank staff calculations
Note: 2014-2015 refer to actual spending, 2016 and 2017 are budgeted. Infrastructure only includes line ministry spending and does not include below the line capital injections to SOEs.

Figure B.18: ...and spending on PKH has become more pro-poor
(Y-axis: share of benefits of PKH, X-axis: household consumption decile)



Source: Tiwari et al (2018) and Jellema et al (2017) based on Susenas data from 2012 and 2015

The Government is trying to spend better by making social assistance

Some social assistance programs have become more pro-poor: in 2015, 60 percent of PKH benefits went to the bottom 20 percent, compared to 50 percent in 2012 (Figure B.18). The Government is also trying to improve the delivery of other social assistance programs: in 2017, the Government began a trial with 5 million households to improve the distribution of food subsidies by integrating *Rastra* into a more

¹¹⁶ Compared to 1.4 percent and 1.1 percent of GDP, respectively in 2014.

¹¹⁷ See detailed discussion in World Bank (2017f).

¹¹⁸ See Ministry of Finance (2018).

programs more pro-poor...

accountable e-voucher delivery system under the BPNT (*Bantuan Pangan Non-Tunai*) or non-cash food aid program. This is expected to reduce the leakage of such assistance to non-targeted households and to support financial inclusion. The Government plans to phase out *Rastra* completely in 2018 by scaling up the BPNT to the remaining 10 million households, although problems with distributing the e-vouchers and communicating these changes to beneficiaries¹¹⁹ may delay these plans.

...and has some plans for further energy subsidy rationalization

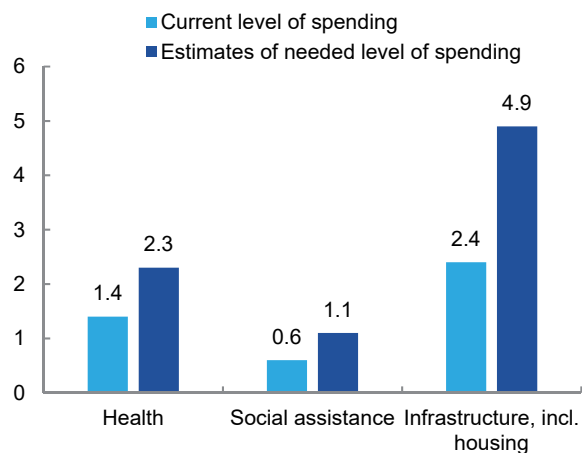
The Government also has expressed its intentions to improve the targeting of remaining energy subsidies to poor and vulnerable households. Among the plans outlined for 2018 are: (i) developing a city gas network to optimize the distribution of LPG¹²⁰ and improve the targeting of LPG subsidies to poor households; and (ii) limiting electricity subsidies only for customers of 450 volt-ampere (VA) and 900VA supplies who are registered as welfare beneficiaries.¹²¹

b. ...but spending better remains a challenge in many areas

Indonesia needs to spend more in priority areas for inclusive growth...

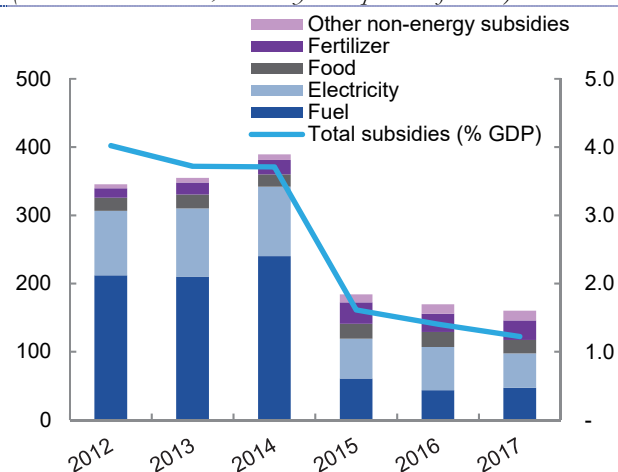
To achieve Indonesia's development targets, as stated in the National Medium-Term Development Plan (RPJMN), the required total *net additional* annual Government spending is estimated at around 4 percent of GDP by 2020 (Figure B.19). While spending in these areas have increased recently, as discussed in the previous section, the level of spending remains low compared to the Government's targets and Indonesia's needs. In infrastructure, achieving the Government's target of USD500 billion in additional investments by 2020 would require increasing public investment to 4.9 percent of GDP per year. In health, fully implementing the universal healthcare coverage program requires public health spending (excluding spending on the National Social Security System) to increase to around 2.3 percent of GDP a year. In social assistance, spending should double to 1.1 percent of GDP by 2020 to enable the expansion of programs for the poor and vulnerable.

Figure B.19: Indonesia needs to spend more on infrastructure, health, and social assistance...
(percent of GDP)



Source: Ministry of Finance, World Bank staff calculations
Note: Only refers to Government spending.

Figure B.20: ...and create the fiscal space to do so by further reducing subsidies
(Y-axis: IDR trillions, secondary axis: percent of GDP)



Source: Ministry of Finance, World Bank staff calculations
Note: Data for 2017 refer to preliminary realization data, all other years refer to audited realization data.

¹¹⁹ Metro TV News (February 07, 2018).

¹²⁰ See Financial Note 2018 and The Jakarta Post (February 11, 2018).

¹²¹ Fiscal Policy Agency, Ministry of Finance (2018).

...by further reallocating expenditures away from poorly targeted subsidies...

Increasing funding for priority sectors can be achieved by further reallocating spending away from unproductive expenditures. Despite recent reforms, spending on poorly targeted and regressive energy subsidies still accounted for 0.7 percent of GDP or 7.4 percent of the total budget in 2017¹²². While protecting poor and vulnerable households from higher energy prices is a laudable goal, alternative mechanisms, notably direct social assistance transfers, would be more effective and efficient compared to providing energy subsidies¹²³. In addition, further rationalization of non-energy subsidies can improve spending efficiency. The fertilizer subsidy, *Rastra*, and the credit interest program subsidy are the three largest nonenergy subsidy programs (Figure B.20), accounting for 0.4 percent of GDP or 4.1 percent of the budget in 2017.

...and by leveraging private sector participation in priority areas

In priority areas such as infrastructure, appropriately detailed proposals for all infrastructure projects need to be prepared, whether they are ultimately publicly or privately financed. These proposals must provide sufficient data to make a calculated, if preliminary, decision on delivery method, prior to the state budgeting process. Government contracting agencies (GCAs) should be required under the State Budget Law to demonstrate that a project is not able to mobilize private capital before seeking funding through the state budget. Furthermore, GCAs should only assign projects to SOEs where private investment and commercial financing are not otherwise available. Finally, GCAs should only pursue government support to the extent it is absolutely required to make the project bankable.

Indonesia should continue to improve the effectiveness of spending at the central and subnational levels...

To ensure that higher spending translates into better outcomes, more meaningful improvements are also required at the sectoral level and at the subnational level, the latter of which accounts for half of public spending. As mentioned, improving the quality of spending is especially important as a third of the reduction in inequality due to fiscal policy in advanced economies originates from expenditure, rather than taxation policies¹²⁴. Given Indonesia's limited resources, it is essential that every *Rupiah* of taxpayer resources translates into better outputs and outcomes across all areas of public expenditure at the central and subnational levels, but particularly those that have the greatest potential to reduce inequality and boost growth: infrastructure, education, health, and social assistance.

...through better integration of social assistance programs...

Currently, due to differences in targeting and implementation, few poor and vulnerable households receive a 'complete' package of welfare benefits: in 2014, only over 2 percent of poor households received all four main social assistance programs (*Rastra*, JKN-PBI, PIP, and PKH). Better integration across programs would enable households to consume more and better respond to shocks, potentially insulating individuals and households from longer-term negative impacts. Simulations suggest that integrating these programs into a single benefit would provide eligible households with a significant boost to consumption expenditure equivalent to about 14 to 21 percent of an average targeted household's budget¹²⁵. Doing so is also expected to lead to larger reductions in poverty, vulnerability, and inequality than the current scenario.

¹²² Preliminary data from the Ministry of Finance, February 2018.

¹²³ Energy subsidies tend to be regressive, whereas direct transfers mostly benefit the poor and vulnerable. See Figure B.8 and Figure B.9 earlier.

¹²⁴ IMF (2014).

¹²⁵ See World Bank (2017f) for a more detailed discussion of the benefits of integrating these programs.

...and by reallocating spending within some sectors, especially in education, to help reduce inequality of opportunity

Redirecting resources towards interventions that specifically address inequalities of opportunity is also key. In education, for example, allocating more funds towards early childhood education and development would promote long term learning gains and contribute to further reductions in stunting. Reallocating resources towards progressive direct transfers in education, for example by increasing the benefit levels and further improving the targeting of the *Program Indonesia Pintar* scholarship, would also help to increase enrollment rates among the poor. In addition, more directly linking teacher professional allowances to performance and commencing a rigorous teacher re-certification mechanism may help the Government to address the disconnect between high spending on teacher salaries and allowances and poor learning outcomes.

... and more effective spending in health, in addition to higher level of spending...

In the health sector, reallocating expenditures towards promotive and preventative interventions, rather than curative interventions, would be more cost effective in achieving better health outcomes. Further, accelerating and improving the health facility accreditation process to ensure supply-side readiness and quality of services across health facility will improve health outcomes, especially in remote areas. The Central government can use existing intergovernmental fiscal transfer systems such as the DAK and health insurance capitation payments (JKN) to incentivize health facilities to achieve accreditation. Better incentives and programs to help address health worker shortages in remote areas is also critical.

...and improving the effectiveness of transfers to subnational governments

Incentivizing and equipping districts and villages with the resources required to provide basic services is also key in making sure no region is left behind. In line with most countries which normalize measures of expenditure needs and fiscal capacity as per capita amounts, Indonesia should move to a per capita formula in its intergovernmental transfers, rather than the current design. For DAU, the Government could reduce the basic allocation portion of the formula, which assumes the need for and funds the entire subnational civil service wage bill. Similarly, for *Dana Desa*, the Government should allocate an even greater proportion of the formula on a per capita basis¹²⁶. This notwithstanding, there is a valid case for providing special transfer for the lagging regions, many of them are remote and sparsely populated, to reduce inter regional inequalities in access to services. However, this would be better done through a special transfer, such as DAK, that include a clear, time-bound, results framework. Further, the Government should specify clear purposes and rules for each type of DAK to ensure that these reflect national priorities and address the infrastructure deficit.

5. Indonesia needs to raise more revenues to spend more

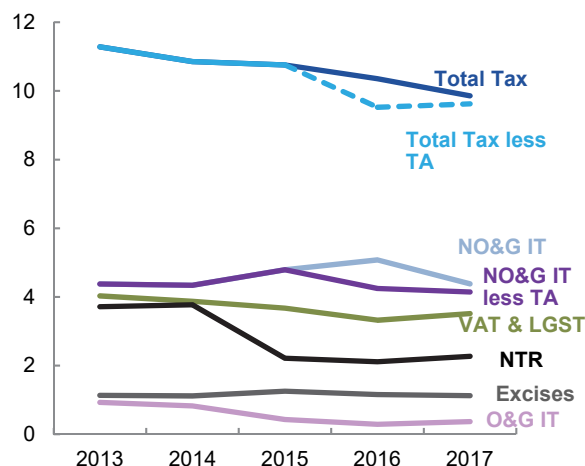
a. Indonesia collects too little, often ineffectively

Indonesia has low tax collection, which has declined as a share of GDP in recent years

Given the importance of maintaining a prudent fiscal stance, it would not be feasible for Indonesia to spend more in areas that matter for inclusive growth without collecting more. Low revenues are driven by low tax collection, which, in turn, is explained by different factors over the years, including: cyclical; structural; administration capacity; and tax policy (Box B.1). Worryingly, the tax ratio has been on a declining trend since 2013 (Figure B.21).

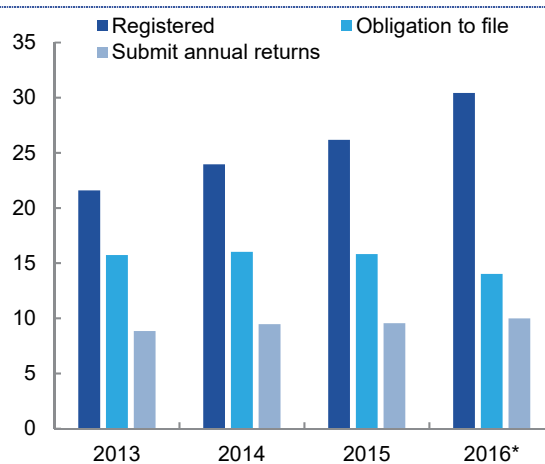
¹²⁶ In 2018, a greater share of the formula will be allocated on a per capita basis (20 percent, as opposed to 10 percent in previous years). See Ministry of Finance (2018).

Figure B.21: Tax revenues have been declining since 2013, but signs of recovery appeared in 2017
(percent of GDP)



Source: MOF data, World Bank staff calculations
Notes: 2017 is based on preliminary realization data; TA stands for tax amnesty program; NO&G for non-oil and gas; IT for income tax; VAT for value-added-tax; LGST for luxury-goods sales taxes; NTR for non-tax revenues

Figure B.22: Indonesia’s tax base is too narrow
(number as a share of total employed workers, percent)



Source: Directorate General of Taxes, World Bank Analysis
Notes: 2016 is an estimate and has yet to be verified in official figures

Low tax ratios are in part due to a narrow tax base

Indonesia’s current tax base is too narrow. Less than 10 percent of Indonesia’s population have an obligation to file annual income tax returns, or approximately 15 percent of the number of employed workers (Figure B.22). This compares to rates of 50 percent or higher in many advanced economies¹²⁷.

The ‘quality’ of tax collection is also low

Indonesia currently ranks lower on the ease of paying taxes compared to its peers on the World Bank’s Doing Business indicators (Figure B.24). Moreover, current complexity and unequal treatment in the tax code increases the inefficiency of the tax system, with negative impacts on inclusive growth. For example, extensive VAT exemptions generates a “cascading effect” whereby some sectors and/or taxpayers bear a higher burden of the tax than would otherwise have been the case if the VAT was implemented broadly and free of exemptions¹²⁸. This undermines the equity of the VAT, and hurts the growth of those sectors and taxpayers bearing a higher tax burden¹²⁹.

¹²⁷ In the UK, for example, 56.2 percent of the adult population (that is, both workers and non-workers) paid tax in 2015-2016. See Institute of Fiscal Studies (2016).

¹²⁸ For an explanation of the cascading problem and how it relates to the design of the VAT, see Le (2003).

¹²⁹ Moreover, the “deadweight loss” associated with the tax increases with increased inefficiencies such as those generated by the cascading problem.

Box B.1: Why is Indonesia's tax-to-GDP ratio so low?

Different factors have interacted over the years to result in a low tax-to-GDP ratio for Indonesia. The challenges Indonesia has faced can be organized around four themes: 1) cyclical; 2) structural; 3) administration capacity; and 4) tax policy.

(1) Cyclical factors. A significant share of Indonesia's revenues has traditionally been linked to commodity prices¹. As a result, total revenues fell by approximately 1.6 percentage points of GDP from 2014-2015 due to the oil price collapse. Despite a partial rebound in oil prices in 2017, non-tax revenues have yet to recover: accounting for approximately 2.3 percent of GDP compared to 3.8 percent in 2014. Tax revenues have a broader cyclical component: since the bases for taxes are the main components of economic activity (consumption, investment, etc.), cyclical shocks to these components result in cyclical shocks to related tax revenues. For example, the impact of the global recession in 2008 was reflected in a sharp reduction in non-oil and gas income tax, which fell from 1.6 percent of GDP in 2008 to 0.9 percent of GDP in 2009.

(2) Economic structure. The magnitude of the commodity price cyclical component is directly linked to the fact that Indonesia's economy remains reliant on resource-extraction sectors such as plantations and mining, particularly in exports. A lack of diversification from resource revenues represents one structural constraint to Indonesia's revenue collections². Another factor is the size of the informal economy, which represents an estimated 57 percent of the Indonesian workforce³. Informal activity tends to be of lower productivity and thus less able to bear the burden of taxation. Moreover, the lack of digitization or paper trail involved in a lot of informal transactions makes them more difficult and expensive to tax⁴.

(3) Revenue Administration Capacity. Indonesia's tax revenue agency, the Directorate General of Taxes (DGT) faces severe capacity constraints and organizational shortcomings⁵. IT and staff capacity are two areas that face particularly significant challenges. The DGT's IT systems are outdated and limited in capacity.

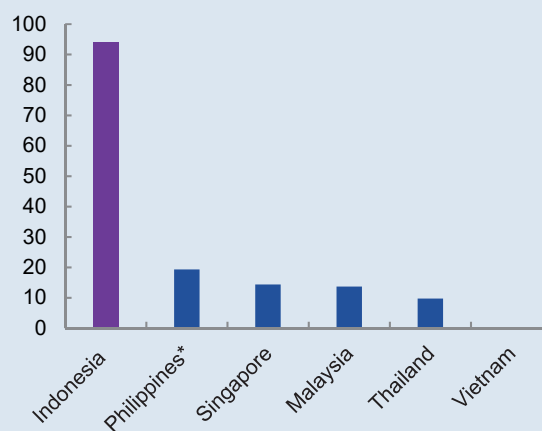
Moreover, a large share of DGT staff are under-skilled in fulfilling functions such as risk-management or auditing. Staff are not helped by inefficient business processes, and by having to implement tax policies and regulations that are overly-complex and at times uncertain and unclear. Weak revenue administration capacity contributes to Indonesia's narrow tax base (limited taxpayer registration capacity), and more seriously, to the low tax compliance ratios amongst its existing tax base⁶.

(4) Tax policy. Indonesia's low tax ratio is also a product of tax policy design decisions. Sub-optimal policies include: a) extensive VAT exemptions; b) a high VAT registration threshold level (Figure B.23); c) distortive preferential regimes; d) a high non-taxable income threshold for personal income tax; and e) underutilization of externality-correcting taxation such as tobacco taxation and green taxes. Many of these policies were designed with different intentions. Ultimately, however, they have resulted in aggregate in a narrowing of the tax base, a reduction in the tax burden on some sectors, types of taxpayers and types of economic activity, greater inefficiencies, and greater space for tax avoidance and evasion⁷.

The issues highlighted above are well-known to technical staff and policymakers grappling with designing and implementing Indonesia's ambitious tax reform program.

Figure B.23: Indonesia's VAT registration threshold as a share of real per capita GDP is the highest in the world

(VAT Threshold as a share of GDP per capita)



Source: Information on VAT thresholds from vatlive.com; data on GDP from World Bank

Notes: GDP per capita is 2016 PPP; Philippines ratio is calculated using the threshold of PHP 3 million, which only came in effect in January 2018; previous threshold was PHP 1.9 million; Vietnam has no minimum VAT threshold

¹ For example, in 2014, 20 percent of revenues were directly related to oil and gas sector, and 30 percent of revenues were positively correlated with it. See Box 4 in World Bank (2017e) for discussion of the link between revenue and oil and gas prices.

² According to data from Bank Indonesia, more than a third of Indonesia's 2017 exports came from the following commodity-related categories: palm oil, oil products, liquified petroleum gas and mining products such as coal and natural gas.

³ Estimates for the size of the rural segment of society from Susenas household survey.

⁴ See for instance Joshi et al. (2014).

⁵ For more on the challenges of administration and reform steps the Government is undertaking, see World Bank (2017c). Reforms are key to lowering the costs of compliance, and to tackling problems such as corruption. Finance Minister Sri Mulyani has spoken openly about corruption cases as part of an effort to eradicate the problem; see for example: Yoga Sukmana, "Sri Mulyani Jengkel dengan Petugas Pajak yang Ditangkap KPK," *Kompas.com* (November 11, 2016). The new Director General of DGT, Robert Pakpahan, who assumed the role end of November 2017, has also gone on public record to emphasize how a key objective behind organizational reform currently being implemented is to prevent corruption; see, for example, "New Director General of Taxes Committed to Combat Corruption," *Netral News* (December 6, 2017)

⁶ For example, Sugana and Hidayat estimate that compliance in VAT is approximately 56.6 percent. See Sugana and Hidayat (2014).

⁷ For discussion of how VAT exemptions and a high VAT registration threshold level erode the base, see Le (2003). For more on the link between tax exemptions and deductions and tax evasion, see Alm (2001) and Feust and Riedel (2009).

Complexity of the tax system is seen in other areas too. For example, in addition to the standard corporate income tax rate, Indonesia has a discount to the corporate rate for publicly listed companies, a different discount for companies with turnover less than IDR 50 billion, different tax incentives, and a presumptive tax regime for the construction sector and one for micro, small and medium enterprises (MSMEs) whereby companies are taxed on their gross turnover as

opposed to their taxable income. As a result of these different provisions, the corporate income tax regime is complex and difficult for taxpayers to understand, and the effective tax rate for different corporate taxpayers varies, undermining the horizontal equity of the tax and impacting on inclusive growth.

b. The Government has endeavored to improve tax collections...

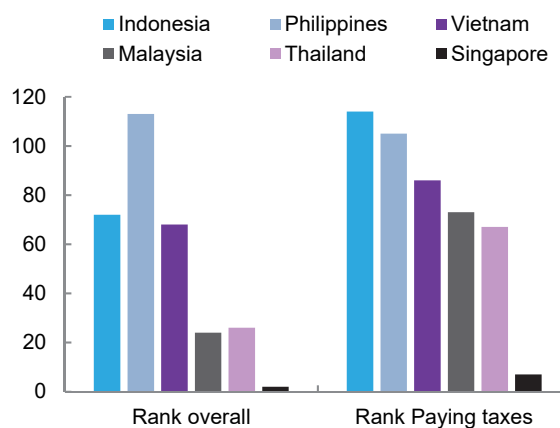
The Government has intensified efforts to collect more

Tax reform in Indonesia is a challenging process: legislation is complex and requires balancing multiple political and business interests so that it can be passed through cabinet and parliament. The Ministry of Finance is preparing major tax law changes, which it is discussing with other ministries and relevant stakeholders, as well as preparing a medium-to-long term tax reform strategy to guide the reform process for the next few years¹³⁰.

¹³⁰ Revisions to the General Taxation (KUP) Law have already been tabled to parliament and is part of its legislative agenda for 2018. The other major tax laws being revised are the Income Tax (PPh) Law, the VAT (PPN) Law, the Stamp Duty Law and the Land and Building Tax Laws. Preparation of the medium-to-long term revenue strategy is being led by the Fiscal Policy Agency, and has benefited from technical assistance from international organizations and tax experts. See for example, IMF (2017a)

Figure B.24: Indonesia ranks lower than its peers on ease of paying taxes in the 2018 Doing Business Indicators

(country rank, where a higher score means the country is ranked lower compared to peers)



Source: Doing Business Indicators, World Bank

Despite the slow progress on passing tax laws through parliament, the Government has tried to collect more through short-term actions and through Presidential-level and Ministerial-level regulations. A Tax Amnesty Program (TAP) launched in 2016 raised taxes and fees equivalent to 10.4 percent of average tax revenues in 2013-15, and led to declarations of total assets worth IDR 4,882 trillion, 39.3 percent of 2016 GDP¹³¹. TAP success was driven in part by the ability of the Government to persuade high net worth individuals to participate¹³². Efforts to collect more at the upper end of the tax bracket also took the shape of proactive involvement in the OECD-led Inclusive Framework to tackle base erosion and profit shifting (BEPS), which Indonesia adopted in July 2016¹³³. In June 2017, Indonesia became one of the signatories of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI)¹³⁴, and by September 2018, Indonesia is set to undertake the first information exchange as part of the automatic exchange of financial account information (AEOI). Through regulations issued annually, the Government has also revised the tobacco excise, increasing the minimum regulated price and raising tariffs (Box B.3).

...and is trying to collect better, by targeting improvements in the ease of paying taxes...

The Government is also trying to collect better, by facilitating the payment of taxes so that the burden on complying taxpayers is reduced. In July 2015, for instance, the Government launched an electronic VAT invoice online application that enables systematic submission of detailed information on taxable goods and services by taxpayers, as part of a policy of mandating VAT for businesses that came into effect in 2016-17. Electronic e-filing systems are also being developed and rolled out, with the Directorate General of Taxes (DGT) seeking to gradually enforce e-filing of corporate income taxes and of withholding taxes from employees' payrolls. Implementing such reforms widely and effectively is important if Indonesia is to improve its ease of paying taxes, with the country currently ranking lower compared to its peers in this areas on the World Bank's Doing Business indicators. International experience points to revenue and economy-wide gains when such policies are implemented successfully. Enhancing the efficiency and transparency of tax filing and payments reduces the burden on taxpayers, encourages higher levels of voluntary compliance, and frees up time and resources for productive economic activity.¹³⁵

c. ...but the need and scope for additional tax reforms remains large

Reforms have yielded some gains, but the room for improvement remains large

Tax policy and administration reforms have yielded some limited gains to date. As discussed in Part A, Section 4 of this report, nominal revenue collections grew in 2017, in large part because of a boost in commodity prices, but also because of gains from reforms. This growth meant that, once revenues from the TAP are excluded, the yoy decline in the tax ratio that began in 2013 was finally arrested in 2017 (Figure B.21)¹³⁶. But with an additional 4 percent of GDP needed to spend on priority areas

¹³¹ See Box 2 in World Bank (2017a).

¹³² See for example, Doebele (2016); Hutton (November 30, 2016); and Indonesia-Investments (September 3, 2016).

¹³³ See OECD (2017a).

¹³⁴ See OECD (2017b).

¹³⁵ See for example, Institute of Chartered Accountants in England and Wales (2016) and Microsoft and PricewaterhouseCoopers (PwC) (2017).

¹³⁶ For more on 2017 analysis, please see Part A of this report. Revenues from redemption fees collected in the TAP can be excluded as they are treated as a one-off; other more medium-term gains from the TAP (e.g. the new taxpayers it attracted into the tax net) are treated as part of broader reforms to broaden the base and improve compliance.

key for inclusive growth, a substantial increase in tax collection is still very much required. However, it is important that tax policy and administrative reforms raise the needed additional revenues in a manner that is efficient, equitable and transparent (Box B.2).

To collect more, the Government should prioritize reforms that broaden the tax base for existing taxes...

Given Indonesia's current narrow tax base, the Government should prioritize base broadening policies as part of its efforts to collect more. Broadening should particularly include comprehensive coverage of Indonesia's current and emerging middle classes who stand to benefit from additional health, education and infrastructure spending, and who, with continued GDP growth, will enjoy higher incomes and thus have higher capacity to pay tax in the future. Many plausible policy measures are possible, and are currently being studied by the Government, including: lowering the VAT registration threshold; lowering the gross turnover threshold by which MSMEs are defined; and replacing the non-taxable income tax threshold (PTKP) with tax credits for taxpayers of a certain low-income threshold¹³⁷.

...as well as consider introducing new taxes, or raising the rates of existing ones

Collecting more could also be partly achieved through introducing new taxes, or by raising the rates on existing taxes. There is a strong case for introducing new taxes that address current market failures with respect to the impact of economic activity on the environment. So-called "green taxes", including on carbon emissions and on use of harmful substances like non-biodegradable plastics and tobacco, have the benefit of both generating government revenues and supporting sustainable economic growth. Box B.3 makes the case for how raising Indonesia's tobacco excise, reforming its tax on vehicles, and introducing a new plastics bag excise can contribute to these goals.

To collect better, the Government should simplify taxes further...

Simplifications in the tax code are much needed to tackle existing complexity that creates inefficiencies and opportunities for tax evasion. Reducing VAT exemptions as discussed above is one way of simplifying the tax regime. Simplifying the corporate income tax code is yet another reform that is worth considering. Such measures should aim to increase the ease of paying taxes, increase the horizontal equity of the tax system, and reduce the inefficiencies it generates.

...and improve compliance through better enforcement...

As mentioned in Box B.1, estimates for compliance rates across most of Indonesia's major taxes are around the 50 to 60 percent mark¹³⁸. Increasing compliance requires substantial strengthening of the DGT. For example, DGT's existing IT systems are out of date and much of the revenue administration remains reliant on paper. To address this, the Government plans to procure a commercial off-the-shelf (COTS) IT system, as part of a broader transformation of business processes and organizational reform. International experience demonstrates that shifting the organizational culture and ways of working to a focus on enterprise and compliance risk-management (ERM and CRM) is a critical enabler for success¹³⁹. Equally important is a shift that entails treating taxpayers as consumers and setting targets on regular improvements in the ease of paying taxes for citizens. Efforts to shift behavior of citizens through 'nudges' – small changes in how governments operate – will help, as evidence from other

¹³⁷ For more discussion of the policy reform agenda, see World Bank (2017e)

¹³⁸ See Sugana and Hidayat, *Ibid*.

¹³⁹ See Khwaja, Awasthi and Loepnick (2011).

countries show¹⁴⁰. Ultimately, the most effective revenue administration systems are those that facilitate a high degree of voluntary compliance¹⁴¹.

Box B.2: Guiding principles for Indonesia's tax reforms

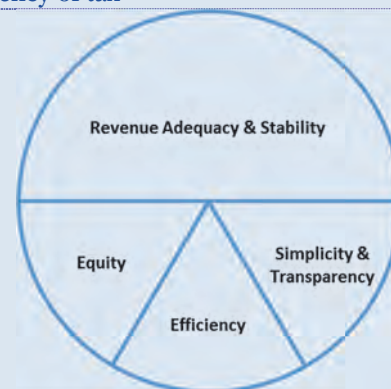
Indonesia's policy reforms should aim to raise revenues that Government needs to execute its spending plans in a manner that is efficient, equitable and transparent¹ (Figure B.25):

1. **Revenue adequacy and stability.** The raison d'être of tax policy is to raise the revenues that enable Government to reliably meet its spending needs over the medium-to-long term. Once spending needs are identified, and revenues based on the existing policies projected, a gap between spending needs and revenue projections may be deduced. Part of such a 'gap' is met through additional debt that the Government may be willing to take on; while the other part serves to motivate a revenue-raising objective for tax reform. Often, the target is expressed in shares of GDP. Setting out to "increase Indonesia's tax ratio by 3 percent in five years" would be an example of a medium-term revenue target. Given Indonesia's low-tax-ratio and high spending needs, improving the revenue adequacy of tax revenues should be the most important guiding principle for its tax reform agenda.
2. **Efficiency.** Tax policies invariably result in distortions in the economy, but if effectively designed, inefficiency can be minimized. Moreover, some policies may enhance economic efficiency if they are able to address market failures (Box B.3).
3. **Equity.** Two elements of equity are important for tax policy. "Vertical equity" refers to maintaining the principle that tax should be borne by those with greatest capacity to pay. This principle motivates the progressive element of taxation: for instance, in the personal income tax code, income falling under different brackets faces different rates. "Horizontal equity" is the second element, and speaks to the principle that similar tax objects should face comparable treatment: for example, two companies generating similar levels of gross income should face the same effective tax rate.
4. **Simplicity and transparency.** Governments should set out to reduce the compliance burden on taxpayers by simplifying the tax code and making all its provisions transparent. Transparency, moreover, can be enhanced through publishing annually a tax expenditure statement that lists all the tax expenditures in the tax system, and ideally quantifies their impact². Government Simplicity and transparency make the job of the revenue administration easier, enabling more effective and less costly enhanced compliance management.

¹ These principles are commonplace in the tax literature. For more, see for example, Le, Jensens, Biletska and Shukla (June 2016).

² For more on tax expenditures, see: Brixi, Valenduc, and Swift (Ed.) (2004).

Figure B.25: Reforms should enhance revenue adequacy, efficiency, equity, simplicity and transparency of tax



Successful tax policy reform juggles trade-offs, and is implemented in a

Targeting a raise in tax revenues over the short-to-medium term needs to balance other objectives, particularly the impacts on growth and equity. Trade-offs are inevitable. One approach is to design package reforms so that different measures could address different objectives and so that support for the reform could be

¹⁴⁰ For more on the impact of behavioral initiatives on improving tax compliance, see Kettle, Hernandez, Ruda and Sanders (June 2016).

¹⁴¹ It is recommended that a comprehensive compliance improvement plan be designed that includes all these features. For more on this, see Russell (2010).

manner that eases compliance for the taxpayer, and implementation for the revenue administration

broadened by appealing to different groups. Current reform efforts in the Philippines have adopted such a strategy (Table B.1). Well-designed policy measures need to also carefully assess how *implementation* of the tax changes can be conducted in a way to mitigate negative impacts on industry and business, and to lower the costs of compliance. A good example here is of Switzerland's tax on volatile organic compound (VOC) emissions. The policy was introduced in 1997 as part of 'greening' Swiss taxes, but the legislation came with a two-year implementation window both so industry had an opening to innovate its designs and adjust its processes, and so that the revenue administration can build the required institutional capacity to manage the new tax¹⁴². Wide socialization of proposed reforms is also a critical success factor: if citizens do not understand tax changes, this will foster confusion, or worse, distrust in the system, reducing the intended goal of improved compliance. Socialization of Denmark's 2010 tax reforms is one good example, with its Tax Commission broadcasting live its recommendations on tax reform as part of the process of preparing the legislation¹⁴³. The success and shortcomings of recent reforms in other countries provide Indonesia some lessons and points of reflection. Two recent reform cases that resulted in higher tax collections are briefly reviewed in Table B.1.

Table B.1: Recent international tax reform experience

Country	Year	Tax Reform Scope	Unique Features	Impact
Philippines	2017-Present	Comprehensive including VAT, PIT/CIT, Excises	Reforms balancing trade-offs designed in packages. 1st package of 5 provided for personal income tax cuts, lowered the estate tax, reduced VAT exemptions, but raised threshold; it increased excise taxes, including on automobiles, fuels and sweet-beverage drinks. Administration reforms included mandatory e-invoicing for large taxpayers and exporters, and mandatory fuel marking and metering.	Expected to be revenue-positive, with an additional 0.5 percentage of GDP improvement in tax ratio from package 1 in 2018. Equity of tax system expected to reduce. Government targeting improvement in overall progressivity of fiscal policy through spending side
Mexico	2013-2014	Broad, focusing on reform of income taxes and on excises	Flat rate business tax (IETU) and tax on cash deposits removed, replaced with a tax on dividends. Introduced 'sin' taxes on sweet beverage drinks and on carbon emissions	Revenue-positive reform, with tax ratio increasing from 13.8 in 2013 to 17.2 in 2016. Improved horizontal equity through removing preferential treatment on primary sector activities. But tax reform has been criticized by some analysts as having negative impact on growth, at least in short-term

Sources: On the Philippines, see "A Guide to T.R.A.I.N.," Office of the Presidential Spokesman (January 2018) and "Tax Reform for Acceleration and Inclusion – Package 1", PricewaterhouseCoopers, Tax Alert No. 34. On Mexico's tax reforms, see: "Mexico's tax reform is signed by President and published," Ernst & Young, Global Tax Alert (December 13, 2013); Gutierrez, Boyle and Graham, Reuters (November 1, 2013); and Alvarez-Estrada (2013). For more on tax policy reform stories, see OECD (2010).

¹⁴² OECD (2011).

¹⁴³ See OECD (2010) and the Danish Ministry of Taxation (2009).

Box B.3: Excise taxes to address externalities

Excise taxes are a popular fiscal policy instrument that governments use both to raise revenues and to correct for externalities that hold back inclusive growth. For example, Indonesia can raise its tobacco excises, streamline and raise taxes on vehicles, and introduce a plastics bag excise as part of its efforts to address negative externalities on health and the environment.

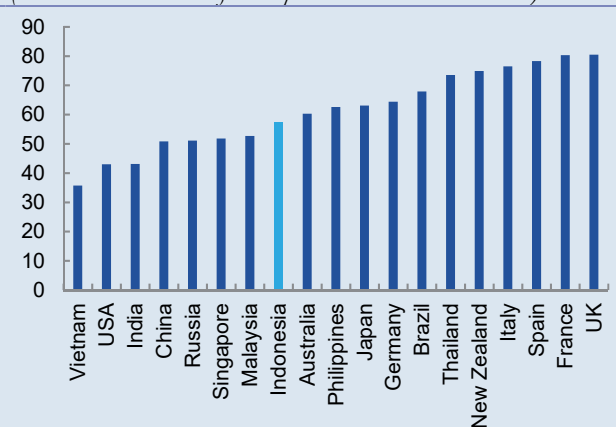
Indonesia can raise tobacco excises to address health issues and raise revenues

Tobacco excises are the most prevalent type of excise, given the negative health impacts of tobacco consumption and the costs to the economy of fighting these impacts¹. Indonesia is estimated to have the eighth highest level of tobacco consumption per capita in the world (Table B.2). Taxes on tobacco in Indonesia have historically been low, but have been increased in annual regulations from 2015-2018. Presently, Indonesia’s total taxes on tobacco are higher than some of its regional peers, but still lower than some emerging economies and lower still than most advanced economies (Figure B.26). Moreover, most of Indonesia’s taxes on tobacco come from its excise tax, which suffers from the complexity of having multiple tiers. Thus, while the rate on the most sold brand in 2016 was 44.3 percent, lower priced products produced by small-cigarette firms faced taxes of half those rates or lower. The rationale for the multiple-tier structure is that firms that produce lower-tier products account for more than half of the total factories in the tobacco industry and are responsible for employing a significant share of the workers in tobacco manufacturing (44 percent). Yet, a forthcoming study by the World Bank finds that both farmers and manufacturing workers are only partially dependent on tobacco income, and that tobacco cultivation was not profitable for most farmers². Thus, encouraging tobacco farmers to shift to farming other products could bring economic gains for these farmers, as well as contribute to reducing production of tobacco in Indonesia. Higher tobacco excises would induce such an effect through reducing demand for cigarettes.

Table B.2: Indonesia has one of the highest cigarette consumption levels in the world

Country	Consumption per capita rank	Total Consumption (billion)
Russia	1	321.4
China	2	2,568.1
South Korea	3	87.7
Japan	4	189.3
Germany	5	106.4
Turkey	6	89.6
Vietnam	7	87.1
Indonesia	8	239.2
United States	9	281.3

Figure B.26: Indonesia’s tobacco taxes are lower than some emerging economies and many advanced ones (total taxes as a share of retail price on the most sold brand)



Source: Cigarette consumption data from Euromonitor International, 2014, cited in tobaccoatlas.org; 2014 population figures from World Bank

Source: World Health Organization (2017), World Bank staff calculations.

Notes: Total Consumption figures are the number of sticks of cigarettes sold at retail including roll-your-own (RYO) equivalents

Indonesia can streamline and raise its taxes on motor vehicles

Indonesia collects an average of 0.2 percentage of GDP on luxury goods sales tax (LGST), 90 percent of which is estimated to come from LGST on motor vehicles. The existing LGST on motor vehicles is an ad valorem tax on the factory price of the vehicle with different rates for different types of vehicles (ranging from 0 to 75 percent of the factory price). The ad valorem system creates significant risk for transfer pricing³ between manufacturers and dealers where the reported (for tax purposes) factory price is lower than the real factory price. The current tax code also discriminates against some categories of cars and is not consistent with environmental considerations; for example, pick-up/trucks are zero rated, even though they cause more environmental damage than other vehicles.

This tax can be reformed in two ways to increase its revenue potential, improve its efficiency and equity, and tackle negative externalities related to the environment. Firstly, the Government can change the existing LGST ad valorem tax

into a specific excise tax, which should reduce the compliance gap by reducing the revenue impact from transfer pricing practices. Second, the Government can adjust the tax rates to make the system fairer (by removing discrimination and preferential treatment) and to make it more consistent with addressing negative externalities (higher tax for vehicles that have larger negative environmental impact). According to joint analysis conducted by the Ministry of Finance and the World Bank, these proposed changes to the tax on motor vehicles can generate an additional 0.64 percent of GDP, a significant increase to the existing tax ratio (9.9 percent in 2017).

Indonesia can introduce a plastic bag excise to help address environmental issues

Indonesia is estimated to have the second highest percentage of mismanaged plastic waste amongst 192 coastal countries in the world, producing 0.48-1.29 million metric tons of plastic marine debris every year⁴. Plastic waste, particularly in marine environments, is of increasing concern because of its persistence and effects on oceans, wildlife, and humans.

The Government of Indonesia has committed to slashing its marine litter by 70 percent by 2025⁵. In June 2016, the Government launched a national program to reduce plastic waste by imposing a plastic bag charge. After three months of the program, plastic bags use fell by more than 25 percent, according to an estimate by the Ministry of Environment and Forestry. Despite its early success, the program was terminated after three months due to legal challenges around the basis of the charge and how to regulate revenues collected from it. The 2016 experience illustrates the positive potential impact of a tax on plastic bags. Adding a plastic bag excise as part of revisions to the Excise Law is currently being considered by the Government and would solve the legal challenges the 2016 policy faced. Experience from the United Kingdom is encouraging: a 5-penny levy on plastic bags resulted in sharp reductions in use, by more than 80 percent in different parts of the UK. Moreover, the policy proved a popular measure amongst the public, with one survey finding 80 percent support in Wales and 61 percent in England and Scotland⁶.

¹ Tobacco has been directly linked to non-communicable diseases (NCDs) including diseases of the circulatory system, various forms of cancers, chronic respiratory diseases and metabolic diseases (U.S. Department of Health and Human Services, 2014).

² World Bank (2018c, forthcoming)

³ Transfer pricing refers to the setting of the price at which goods or services are sold between different legal entities within an enterprise. It can be used for income tax avoidance

⁴ Jambeck et al. (2015).

⁵ "Feature: UN's mission to keep plastics out of oceans and marine life," UN News (22 April 2017).

⁶ See, for example, Zero Waste Scotland (2015), Smithers (2015) and Poortinga et al. (2016).

6. How can Indonesia collect more and spend better to boost inclusive growth?

Accelerating inequality reduction and growth requires continued efforts to collect more and spend better

Indonesia can improve fiscal policy's contribution to inclusive growth by spending better and collecting more.

The need to spend more in priority areas – infrastructure, health, and social assistance – is particularly pressing. This will be possible only if improvements in spending allocations continue. Across the board, however, and especially in education, Indonesia also needs to improve the effectiveness of public spending to support inclusive growth. Resources should be allocated to well-targeted programs that lead to improvements in intended outcomes and that promote equality of opportunity.

Ultimately, however, spending better will be significantly constrained if Government endeavors at collecting more and collecting better does not translate into implementation of meaningful tax reforms. Policy reforms should target broadening the base of existing taxes, increasing the rate on some taxes, and making the overall system more efficient. Administration reforms should focus on enhancing compliance management by making it easier to pay taxes and by strengthening DGT capacity.

Combined spending and revenue reforms will not only invigorate economic growth, but the fruits of this growth will also be shared more widely. Better and more spending on infrastructure will help connect more communities to one another and open greater market access for individuals and businesses. Better and more spending on health and education services will improve the life expectancy and life quality of Indonesian citizens, and enhance the human capital boosting future growth and reducing future inequality. In this way, fiscal reforms both on the revenue and expenditure will help Indonesia accelerate inequality reduction and sustain strong growth over the medium to long term.

Collecting more and spending better are important tools to enhance growth and reduce inequality. It is widely recognized that such policy reforms require political consensus, which currently could be even more difficult to achieve in view of the upcoming elections. However, because of its contribution to sustaining longer-term economic development, it is critical that Indonesia makes meaningful progress towards inclusive growth.

Annex 1

General Commitment to Equity methodology:

We begin with *market income* – all household income from non-government sources, including income from working (wages and salaries), income from savings and investments (rents, interest, dividends), transfers from other households or individuals (such as remittances).

From market income, some households will pay personal income taxes or contributions to public pension plans, which reduces market income down to *net market income*.¹⁴⁴ Some households can receive cash transfers (such as from social assistance programs like *Program Keluarga Harapan*, or PKH, Indonesia's conditional cash transfer), which will lead to a higher *disposable income*, available for consumption.¹⁴⁵

When households consume, they can buy goods that are subsidized by the Government, such as fuel or food. This has the effect of increasing their effective income, as they are not paying the full price and are indirectly receiving government spending. At the same time, they may be paying taxes on their consumption, through sales taxes, value-added taxes (VAT), or excise taxes such as on tobacco and alcohol. In this case the final price they pay is higher than the market price, and they are indirectly providing revenues to the Government. The *consumable or post-fiscal income* is a household's disposable income, adjusted for how much the household is indirectly receiving from and paying to the Government through its consumption (i.e. indirect taxes and indirect subsidies).

Finally, households can consume subsidized public services, such as health and education, which represent a transfer to the household in-kind (in a non-cash fashion). However, households may also pay some fees as part of receiving these services, which reduces the benefit to them. The *final income* takes into account both the cost of the in-kind services received and any payments the household makes.

Source: Lustig, Nora and Sean Higgins. 2013. *Commitment to Equity Assessment (CEQ): Estimating the Incidence of Social Spending, Subsidies and Taxes*. (Handbook). *CEQ Working Paper* No. 1, July 2011; revised January 2013. New Orleans: Tulane University.

Methodology for Indonesia:

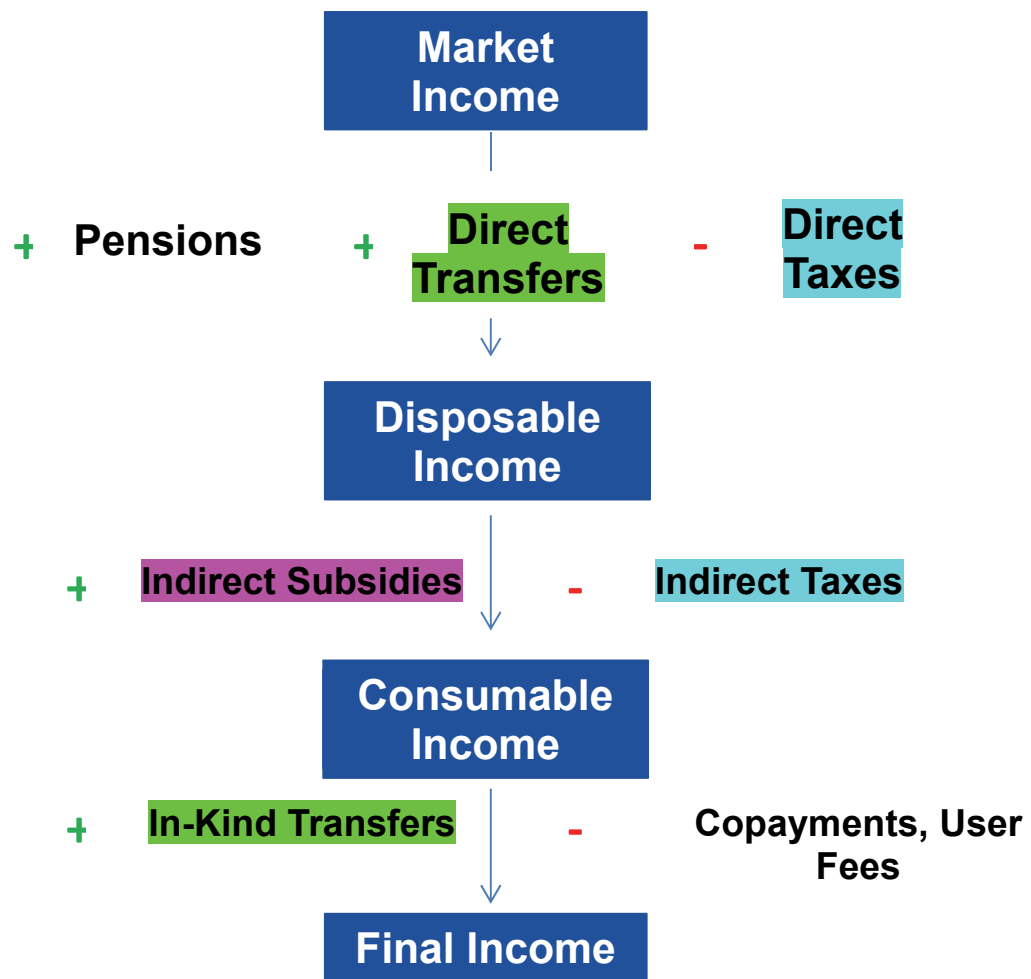
The National Socio-economic Survey (*Survei Sosial Ekonomi Nasional*, or Susenas) is used to figure out who is receiving the benefits. This household survey identifies which households receive cash or near-cash transfers (PKH, BSM, Raskin), how much households spend on subsidized energy (fuel and electricity), and how many children they have in school at which level, as well as the number of in-patient and out-patient health visits they have made. The survey also has information on how much each household spent on what items, which facilitates the calculation of VAT and tobacco excise.

This information is combined with information on tax and spending from Indonesia's national accounts and administrative fiscal data to determine how much of each spending a household benefits from. For example, if the Government spends on average USD 1,000 per primary school child, and USD 3,500 per junior secondary child, then a household with two primary children and one junior secondary child receives in-kind education spending benefits equal to USD 5,500. If each liter of fuel is subsidized by USD 0.50, then a household that consumes 100 liters per month receives a USD 50 subsidy benefit per month, or USD 600 per year.

Source: Jellema, J., M. Wai-Poi and R. Afkar. 2017. *The Distributional Impact of Fiscal Policy in Indonesia*. *Commitment to Equity Working Paper* No. 40, May 2017. New Orleans: Tulane University.

¹⁴⁴ The CEQ results for Indonesia that are reported here do not take personal income taxes into account.

¹⁴⁵ Only consumption is observed in the Indonesian data, which is taken to be the same as disposable income. In reality, some households, particularly richer ones, will save a part of their income.



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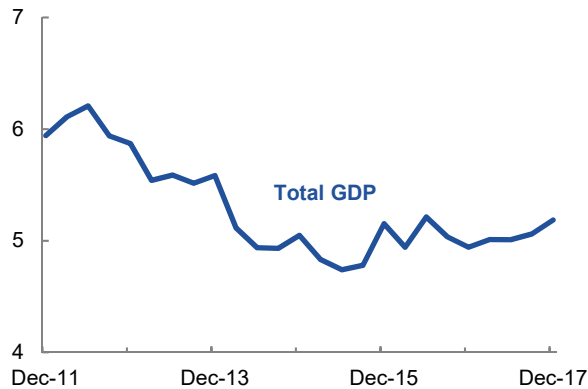
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APPENDIX: A SNAPSHOT OF INDONESIAN ECONOMIC INDICATORS

Appendix Figure 1: Real GDP growth

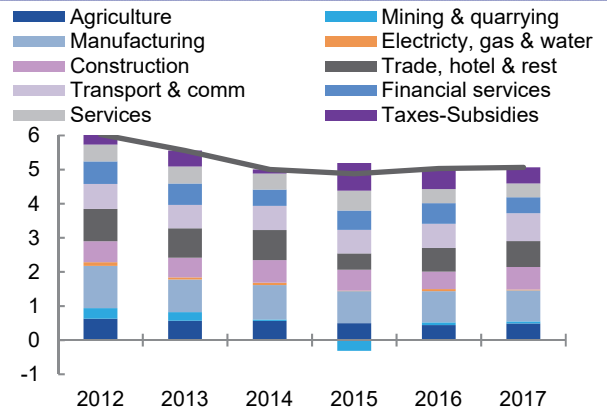
(growth quarterly yoy, percent)



Source: BPS; World Bank staff calculations

Appendix Figure 2: Contribution to GDP growth (production)

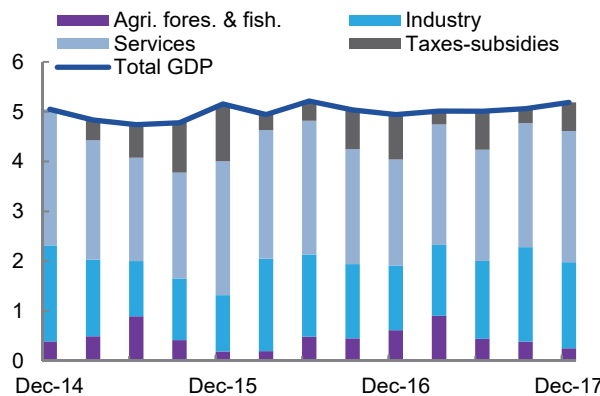
(contribution to real GDP growth yoy, percentage points)



Source: BPS; World Bank staff calculations

Appendix Figure 3: Contribution to GDP growth (production)

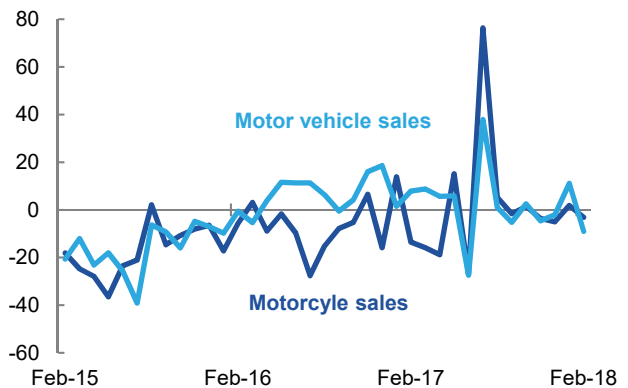
(contributions to real GDP growth yoy, percentage points)



Source: BPS; World Bank staff calculations

Appendix Figure 4: Motorcycle and motor vehicle sales

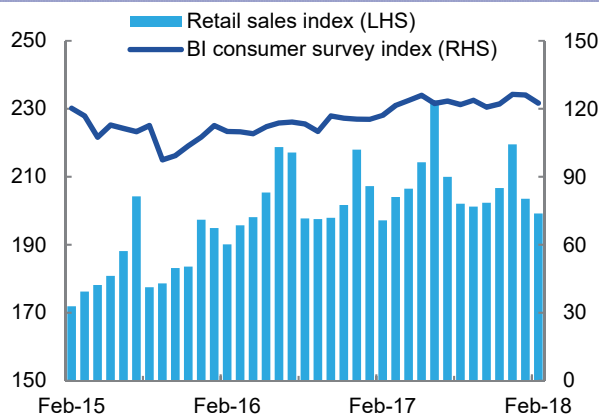
(growth yoy, percent)



Source: CEIC; World Bank staff calculations

Appendix Figure 5: Consumer indicators

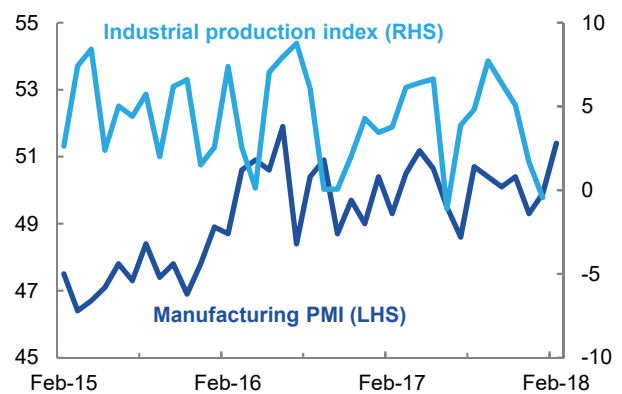
(retail sales index 2010=100)



Source: BI

Appendix Figure 6: Industrial production indicators and manufacturing PMI

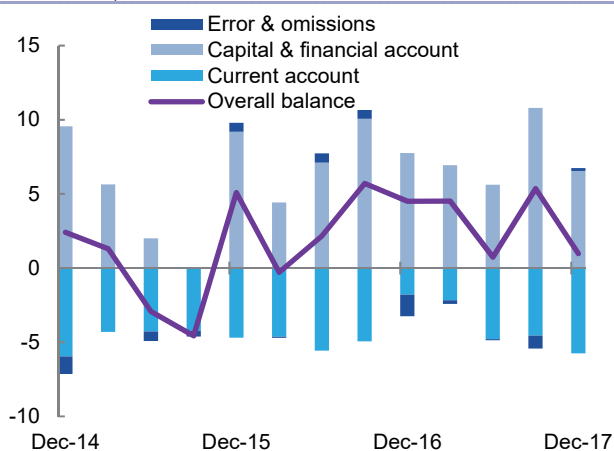
(PMI diffusion index; industrial production growth yoy, percent)



Source: BPS; Nikkei/Markit; World Bank staff calculations

Appendix Figure 7: Balance of payments

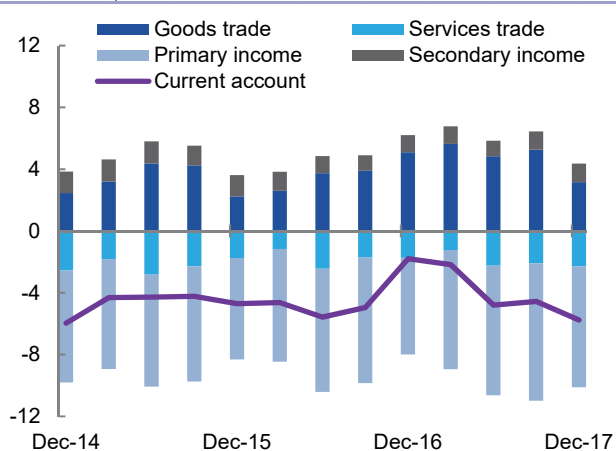
(USD billion)



Source: BI

Appendix Figure 8: Current account components

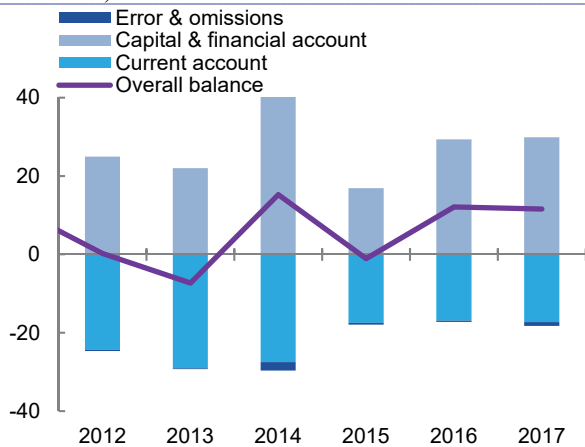
(USD billion)



Source: BI

Appendix Figure 9: Balance of payments

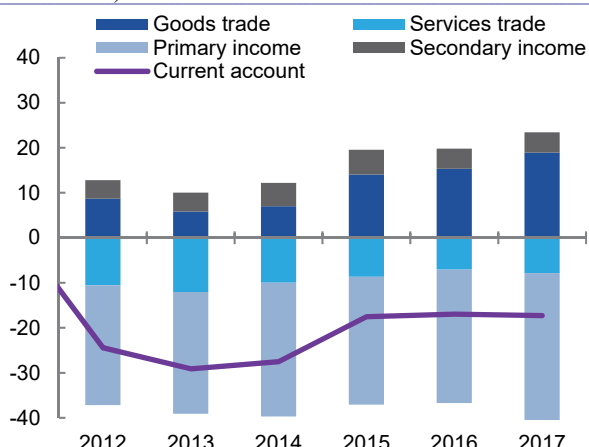
(USD billion)



Source: BI

Appendix Figure 10: Current account components

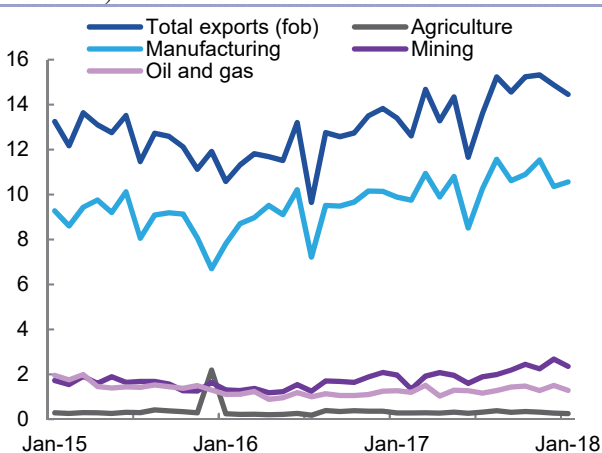
(USD billion)



Source: BI

Appendix Figure 11: Exports of goods

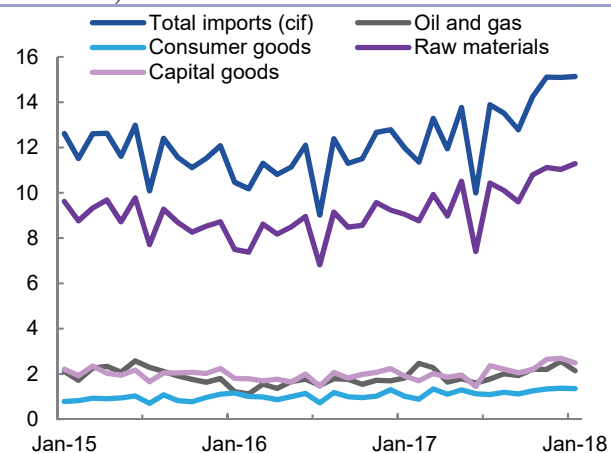
(USD billion)



Source: BPS

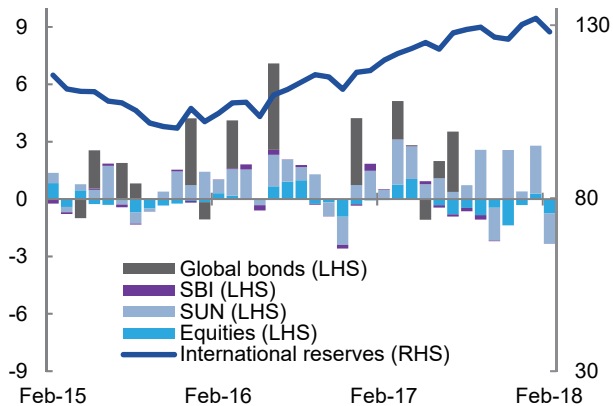
Appendix Figure 12: Imports of goods

(USD billion)



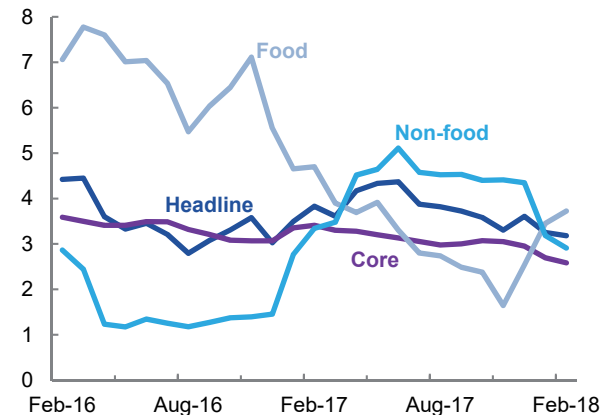
Source: BPS

Appendix Figure 13: Reserves and capital flows
(USD billion)



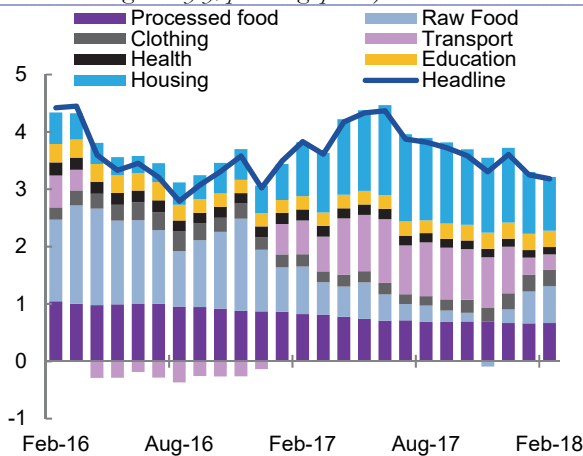
Source: BI; Ministry of Finance (MoF)
Note: SUN is government securities, SBI is BI certificates

Appendix Figure 14: Inflation
(growth yoy, percent)



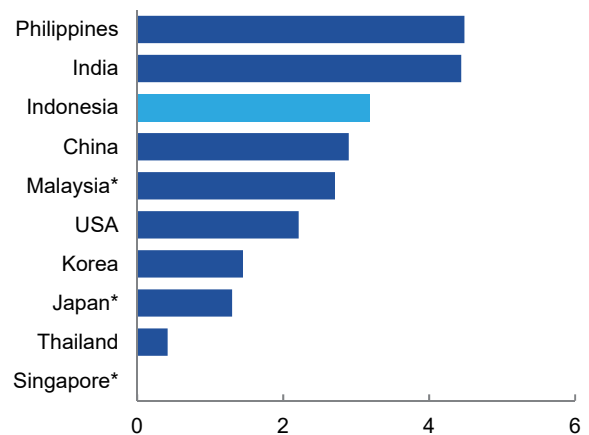
Source: BPS; BI; World Bank staff calculations

Appendix Figure 15: Monthly breakdown of CPI
(contribution to growth yoy, percentage points)



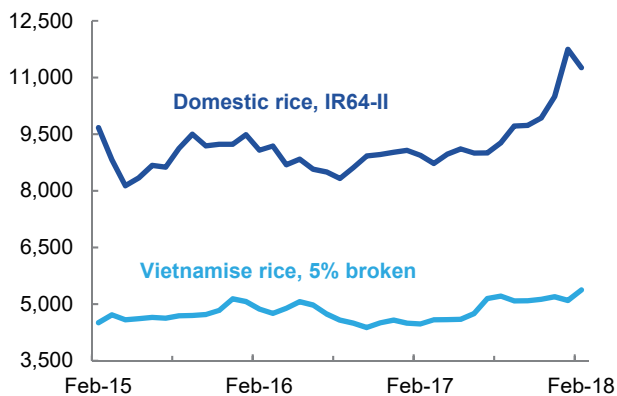
Source: BPS; World Bank staff calculations

Appendix Figure 16: Inflation comparison across countries
(growth yoy, percent)



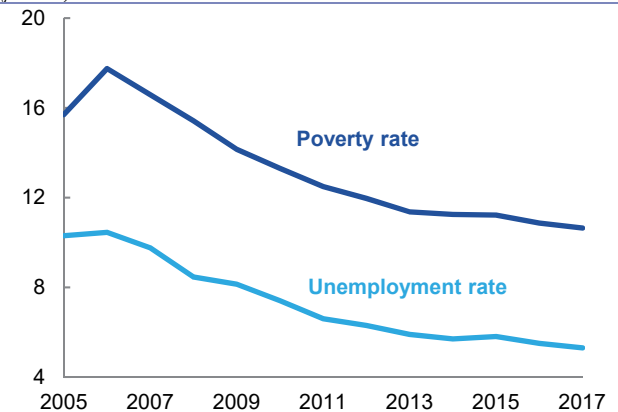
Source: BPS; CEIC; World Bank staff calculations
Note: February 2018 data; *January 2018 data.

Appendix Figure 17: Domestic & international rice prices
(wholesale price, in IDR per kg)



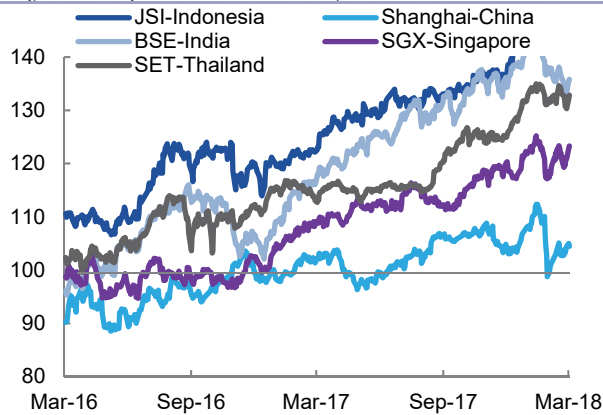
Source: Cipinang wholesale rice market; FAO
Note: "5% broken" refers to the quality of milled rice. 5 percent being the proportion of grains broken during the processing stage.

Appendix Figure 18: Poverty and unemployment rate
(percent)



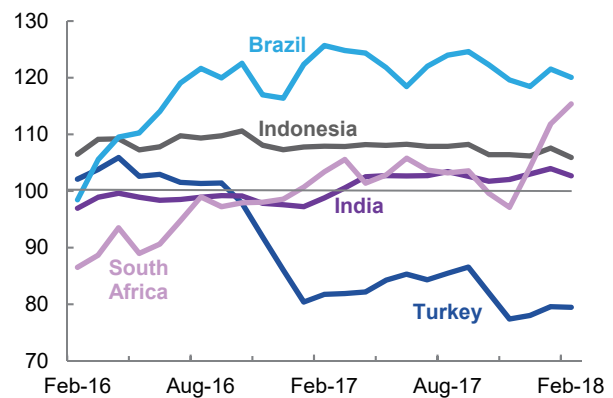
Source: BPS
Note: Poverty line based on national poverty line

Appendix Figure 19: Regional equity indices
(daily index, September 1, 2015=100)



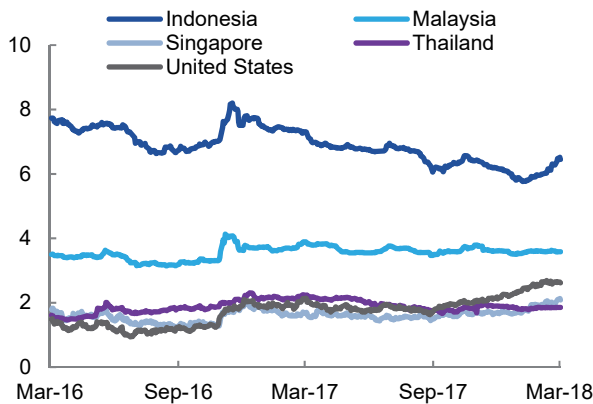
Source: CEIC; World Bank staff calculations

Appendix Figure 20: Selected currencies against USD
(monthly index, August 2015=100)



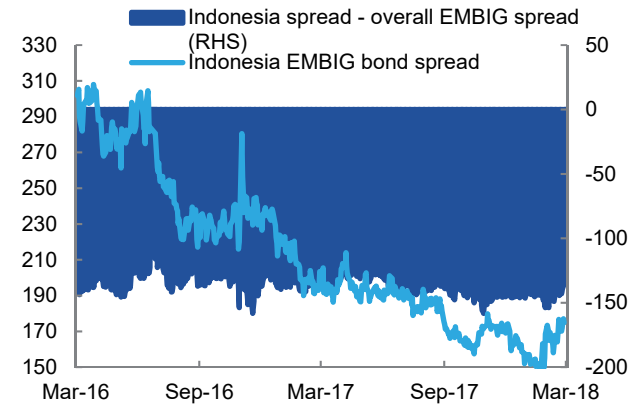
Source: CEIC; World Bank staff calculations

Appendix Figure 21: 5-year local currency government bond yields
(percent)



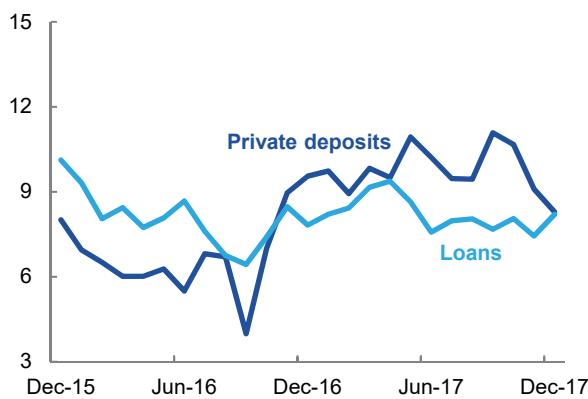
Source: CEIC

Appendix Figure 22: Sovereign USD bond EMBIG spread
(basis points)



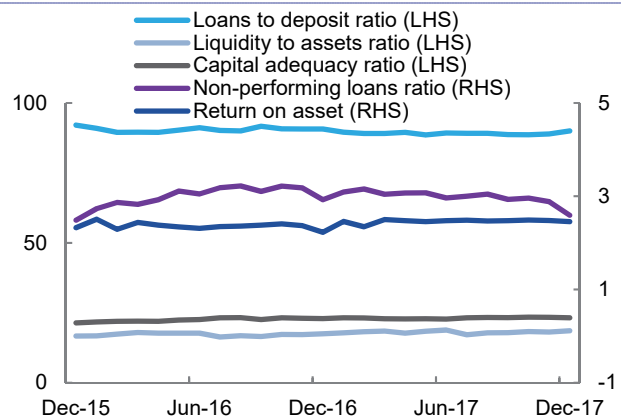
Source: JP Morgan

Appendix Figure 23: Commercial and rural credit and deposit growth
(growth yoy, percent)



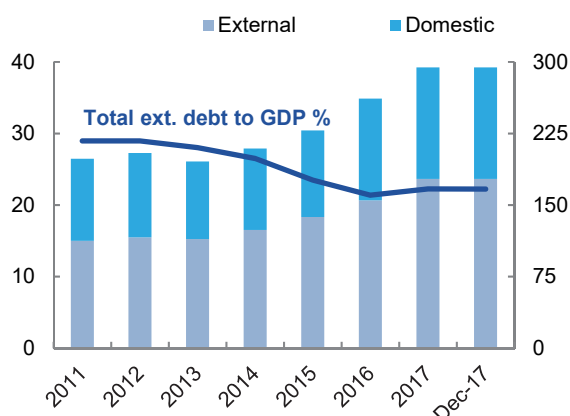
Source: BI; World Bank staff calculations

Appendix Figure 24: Banking sector indicators
(monthly, percent)



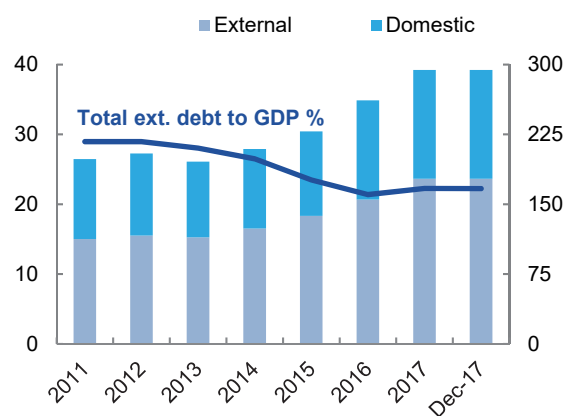
Source: BI; World Bank staff calculations

Appendix Figure 25: Government debt
(percent of GDP, LHS; USD billion, RHS)



Source: BI; MoF; World Bank staff calculations

Appendix Figure 26: External debt
(percent of GDP, LHS; USD billion, RHS)



Source: BI; World Bank staff calculations

Appendix Table 1: Budget outcomes and projections
(IDR trillion)

	2011	2012	2013	2014	2015	2016	2017
	Actual	Actual	Actual	Actual	Actual	Actual	Revised Budget
A. State revenue and grants	1,211	1,338	1,439	1,550	1,508	1,556	1,736
1. Tax revenue	874	981	1,077	1,147	1,240	1,285	1,473
2. Non-tax revenue	331	352	355	399	256	262	260
B. Expenditure	1,295	1,491	1,651	1,777	1,807	1,864	2,133
1. Central government	884	1,011	1,137	1,204	1,183	1,154	1,367
2. Transfers to the regions	411	481	513	574	623	710	766
C. Primary balance	9	-53	-99	-93	-142	-126	-178
D. SURPLUS / DEFICIT	-84	-153	-212	-227	-298	-308	-397
(percent of GDP)	-1.1	-1.9	-2.3	-2.2	-2.6	-2.5	-2.9

Source: MoF; World Bank staff calculations

Note: Budget balance as percentage of GDP uses the revised and rebased GDP

Appendix Table 2: Balance of payments
(USD billion)

	2014	2015	2016	2016			2017			
				Q2	Q3	Q4	Q1	Q2	Q3	Q4
Balance of payments	15.2	-1.1	12.1	2.2	5.7	4.5	4.5	0.7	5.4	1.0
Percent of GDP	1.7	-0.1	1.3	0.9	2.3	1.9	1.9	0.3	2.0	0.4
Current account	-27.5	-17.5	-17.0	-5.6	-5.0	-1.8	-2.2	-4.8	-4.6	-5.8
Percent of GDP	-3.1	-2.0	-1.8	-2.4	-2.0	-0.7	-0.9	-1.9	-1.7	-2.2
Trade balance	-3.0	5.4	8.2	1.3	2.2	3.4	4.4	2.6	3.2	0.9
Net income & current transfers	-24.5	-22.9	-25.2	-6.9	-7.1	-5.2	-6.6	-7.4	-7.7	-6.6
Capital & Financial Account	44.9	16.9	29.3	7.1	10.1	7.8	6.9	5.6	10.8	6.5
Percent of GDP	5.0	2.0	3.1	3.1	4.1	3.2	2.9	2.2	4.1	2.5
Direct investment	14.7	10.7	16.1	3.2	6.6	3.5	2.9	4.6	8.1	4.6
Portfolio investment	26.1	16.2	19.0	8.3	6.6	-0.3	6.6	8.1	4.1	1.9
Other investment	4.3	-10.1	-5.8	-4.4	-3.1	4.4	-2.5	-7.1	-1.4	0.1
Errors & omissions	-2.2	-0.4	-0.3	0.6	0.6	-1.5	-0.2	-0.1	-0.9	0.2
Foreign reserves*	111.9	105.9	116.4	109.8	115.7	116.4	121.8	123.1	129.4	130.2

Source: BI; BPS; World Bank staff calculations

Note: * Reserves at end-period

Appendix Table 3: Indonesia's historical macroeconomic indicators at a glance

	2000	2010	2011	2012	2013	2014	2015	2016
National Accounts (% change)¹								
Real GDP	4.9	6.2	6.2	6.0	5.6	5.0	4.9	5.0
Real investment	11.4	8.5	8.9	9.1	5.0	4.4	5.0	4.5
Real consumption	4.6	4.1	5.1	5.4	5.7	4.7	4.9	4.3
Private	3.7	4.8	5.1	5.5	5.5	5.3	4.8	5.0
Government	14.2	0.3	5.5	4.5	6.7	1.2	5.3	-0.1
Real exports, GNFS	30.6	15.3	14.8	1.6	4.2	1.1	-2.1	-1.7
Real imports, GNFS	26.6	17.3	15.0	8.0	1.9	2.1	-6.4	-2.3
Investment (% GDP)	20	31	31	33	5.0	4.4	5.0	4.5
Nominal GDP (USD billion)	165	755	893	918	915	891	861	933
GDP per capita (USD)	857	3,167	3,688	3,741	3,668	3,532	3,371	3,603
Central Government Budget (% GDP)²								
Revenue and grants	20.8	14.5	15.5	15.5	15.1	14.7	13.1	12.5
Non-tax revenue	9.0	3.9	4.2	4.1	3.7	3.8	2.2	2.1
Tax revenue	11.7	10.5	11.2	11.4	11.3	10.9	10.8	10.4
Expenditure	22.4	15.2	16.5	17.3	17.3	16.8	15.7	15.0
Consumption	4.0	3.6	3.8	3.9	4.1	4.0	4.5	4.6
Capital	2.6	1.2	1.5	1.7	1.9	1.4	1.9	1.4
Interest	5.1	1.3	1.2	1.2	1.2	1.3	1.4	1.5
Subsidies	6.3	2.8	3.8	4.0	3.7	3.7	1.6	1.4
Budget balance	-1.6	-0.7	-1.1	-1.8	-2.2	-2.1	-2.6	-2.5
Government debt	97.9	24.5	23.1	23.0	24.9	24.7	27.4	28.3
o/w external government debt	51.4	11.1	10.2	9.9	11.2	10.2	11.9	11.3
Total external debt (including private sector)	87.1	26.8	25.2	27.5	29.1	32.9	36.1	34.2
Balance of Payments (% GDP)³								
Overall balance of payments	..	4.0	1.3	0.0	-0.8	1.7	-0.1	1.3
Current account balance	4.8	0.7	0.2	-2.7	-3.2	-3.1	-2.0	-1.8
Exports GNFS	42.8	22.0	23.8	23.0	22.5	22.3	19.9	18.0
Imports GNFS	33.9	19.2	21.2	23.2	23.2	22.7	19.3	17.1
Trade balance	8.9	2.8	2.7	-0.2	-0.7	-0.3	0.6	0.9
Financial account balance	..	3.5	1.5	2.7	2.4	5.0	2.0	3.0
Direct investment	-2.8	1.5	1.3	1.5	1.3	1.7	1.2	1.7
Gross official reserves (USD billion)	29.4	96	110	113	99	112	106	116
Monetary (% change)³								
GDP deflator ¹	20.4	8.3	7.5	3.8	5.0	5.4	4.0	2.5
Bank Indonesia interest key rate (%)	..	6.9	6.5	4.7	6.0	7.9	7.6	7.2
Domestic credit (eop)	..	22.8	24.6	23.1	21.6	11.6	10.4	7.9
Nominal exchange rate (average, IDR/USD)	8,392	9,087	8,776	9,384	10,460	11,869	13,389	13,309
Prices (% change)¹								
Consumer price Index (eop)	9.4	7.0	3.8	3.7	8.1	8.4	3.4	3.0
Consumer price Index (average)	3.7	5.1	5.3	4.0	6.4	6.4	6.4	3.5
Indonesia crude oil price (USD per barrel, eop) ⁴	28	79	112	113	107	60	36	51

Source: ¹ BPS and World Bank staff calculations, using revised and 2010 rebased figures. ² MoF and World Bank staff calculations, ³ BI, ⁴ CEIC

Appendix Table 4: Indonesia's development indicators at a glance

	2000	2010	2011	2012	2013	2014	2015	2016
Demographics¹								
Population (million)	213	242	245	248	251	254	258	261
Population growth rate (%)	1.3	1.3	1.3	1.3	1.3	1.3	1.2	1.1
Urban population (% of total)	42	50	51	51	52	53	53.7	55
Dependency ratio (% of working-age population)	55	51	51	50	50	49	49.0	49
Labor Force²								
Labor force, total (million)	98	117	117	120	120	122	122	125
Male	60	72	73	75	75	76	77	77
Female	38	45	44	46	45	46	46	48
Agriculture share of employment (%)	45	38	36	35	35	34	33	32
Industry share of employment (%)	17	19	21	22	20	21	22	21
Services share of employment (%)	37	42	43	43	45	45	45	47
Unemployment, total (% of labor force)	8.1	7.1	7.4	6.1	6.2	5.9	6.2	5.6
Poverty and Income Distribution³								
Median household consumption (IDR 000 per month)	104	374	421	446	487	548	623	697
National poverty line (IDR 000 per month)	73	212	234	249	272	303	331	354
Population below national poverty line (million)	38	31	30	29	28	28	29	28
Poverty (% of population below national poverty line)	19.1	13.3	12.5	12.0	11.4	11.3	11.2	10.9
Urban (% of population below urban poverty line)	14.6	9.9	9.2	8.8	8.4	8.3	8.3	7.8
Rural (% of population below rural poverty line)	22.4	16.6	15.7	15.1	14.3	14.2	14.2	14.1
Male-headed households	15.5	11.0	10.2	9.5	9.2	9.0	9.3	9.0
Female-headed households	12.6	9.5	9.7	8.8	8.6	8.6	11.1	9.8
Gini index	0.30	0.38	0.41	0.41	0.41	0.41	0.41	0.40
Percentage share of consumption: lowest 20%	9.6	7.9	7.4	7.5	7.4	7.5	7.2	7.1
Percentage share of consumption: highest 20%	38.6	40.6	46.5	46.7	47.3	46.8	47.3	46.2
Public expenditure on social security & welfare (% of GDP) ⁴	..	0.40	0.40	0.39	0.59	0.53	0.59	0.60
Health and Nutrition¹								
Physicians (per 1,000 people)	0.16	0.29	..	0.20	..	..	..	..
Under five mortality rate (per 1000 children under 5 years)	52	33	32	30	29	28	27	..
Neonatal mortality rate (per 1000 live births)	22	16	16	15	15	14	14	..
Infant mortality (per 1000 live births)	41	27	26	25	24	24	23	..
Maternal mortality ratio (modeled est., per 100,000 live births)	265	165	156	148	140	133	126	..
Measles vaccination (% of children under 2 years)	76	78	80	82	81	75	75	76
Total health expenditure (% of GDP)	2.0	2.9	2.7	2.9	2.9	2.8	..	..
Public health expenditure (% of GDP)	0.7	1.1	1.1	1.2	1.2	1.1	1.2	1.4
Education³								
Primary net enrollment rate (%)	..	92	92	93	92	93	97	97
Female (% of total net enrollment)	..	48	49	49	50	48	49	49
Secondary net enrollment rate (%)	..	61	60	60	61	65	66	66
Female (% of total net enrollment)	..	50	50	49	50	50	51	51
Tertiary net enrollment rate (%)	..	16	14	15	16	18	20	21
Female (% of total net enrollment)	..	53	50	54	54	55	56	55
Adult literacy rate (%)	..	91	91	92	93	93	95	95
Public spending on education (% of GDP) ⁵	..	3.5	3.6	3.8	3.8	3.6	3.5	3.0
Public spending on education (% of spending) ⁵	..	20.0	20.2	20.1	20.0	19.9	20.6	20.0
Water and Sanitation¹								
Access to an improved water source (% of population)	78	85	85	86	86	87	87	..
Urban (% of urban population)	91	93	93	94	94	94	94	..
Rural (% of rural population)	68	76	77	77	78	79	80	..
Access to improved sanitation facilities (% of population)	44	57	58	59	60	61	61	..
Urban (% of urban population)	64	70	71	71	72	72	72	..
Rural (% of rural population)	30	44	45	46	47	48	48	..
Others¹								
Disaster risk reduction progress score (1-5 scale; 5=best)	..	..	3.3	..	..	..	..	..
Proportion of seats held by women in national parliament (%) ⁶	8	18	18	19	19	17	17	17

Source: ¹ World Development Indicators; ² BPS (Sakernas); ³ BPS (Susenas) and World Bank; ⁴ MoF, Bappenas, and World Bank staff calculations, only includes spending on rice distribution for the poor (Raskin), health insurance for the poor, scholarships for the poor, and Family Hope Program (PKH) and actuals; ⁵ MoF; ⁶ Inter-Parliamentary Union



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