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OVERVIEW

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BASIC STATISTICS OF INDONESIA, 2019*

(Numbers in parentheses refer to the OECD average)**

LAND, PEOPLE AND ELECTORAL CYCLE					
Population (million)	270.2		Population density per km² (2018)	147.8	(38.0)
Under 15 (%)	26.2	(17.9)	Life expectancy at birth (years, 2018)	71.5	(80.1)
Over 65 (%)	6.1	(17.1)	Men (2018)	69.4	(77.5)
International migrant stock (% of population, 2015)	0.1	(9.7)	Women (2018)	73.7	(82.8)
Latest 5-year average growth (%)	1.2	(0.6)	Latest general election	April 2019	
ECONOMY					
Gross domestic product (GDP)			Value added shares (%)		
In current prices (billion USD)	1 118.9		Agriculture, forestry and fishing	13.3	(2.6)
In current prices (trillion IDR)	1 583.5		Industry including construction	40.6	(26.8)
Latest 5-year average real growth (%)	5.0	(2.2)	Services	46.1	(70.5)
Per capita (000 USD PPP)	12.3	(48.9)			
GENERAL GOVERNMENT Per cent of GDP					
Expenditure (2018, OECD: 2019)	18.2	(40.6)	Gross financial debt (2018)	33.7	(107.5)
Revenue (2018, OECD: 2019)	16.6	(37.5)	Net financial debt (2018, OECD: 2017)	6.6	(67.9)
EXTERNAL ACCOUNTS					
Exchange rate (IDR per USD)	14 149.9		Main exports (% of total merchandise exports)		
PPP exchange rate (USA = 1)	4 743.3		Mineral fuels, lubricants and related materials	20.2	
In per cent of GDP			Manufactured goods	15.8	
Exports of goods and services	18.4	(54.2)	Machinery and transport equipment	13.3	
Imports of goods and services	19.0	(50.6)	Main imports (% of total merchandise imports)		
Current account balance	-2.7	(0.4)	Machinery and transport equipment	32.5	
Net international investment position	-30.3		Manufactured goods	17.5	
			Chemicals and related products, n.e.s.	14.0	
LABOUR MARKET, SKILLS AND INNOVATION					
Employment rate (aged 15 and over, %)	65.7	(57.6)	Unemployment rate (aged 15 and over, %)	6.0	(5.4)
Men	79.3	(65.6)	Youth (aged 15-24, %)	13.5	(11.7)
Women	52.2	(50.0)	Long-term unemployed (1 year and over, %)	0.6	(1.4)
Participation rate (aged 15 and over, %)	67.5	(61.1)	Tertiary educational attainment (aged 25-64, %, 2017, OECD: 2019)	11.9	(38.0)
Mean weekly hours worked	38.2	(37.4)	Gross dom. spending on R&D (% of GDP, 2018)	0.2	(2.6)
ENVIRONMENT					
Total primary energy supply per capita (toe, 2017, OECD: 2018)	0.9	(4.0)	CO_2 emissions from fuel combustion per capita (tonnes, 2017, OECD: 2018)	1.9	(8.6)
Renewables (%, 2017, OECD: 2018)	33.2	(10.5)	Renewable internal freshwater resources per capita (1 000 m³, 2014)	7.9	
Exposure to air pollution (more than 10 μg/m³ of PM 2.5, % of population, 2017)	94.8	(58.7)			
SOCIETY					
Income inequality (Gini coefficient, 2018, OECD: 2017)	0.378	(0.332)	Education outcomes (PISA score, 2018)		
Poverty gap at USD 3.20 a day (2011 PPP, %, 2018)	5.1		Reading	371	(487)
Public and private spending (% of GDP)			Mathematics	379	(489)
Health care (2016, OECD: 2018)	3.1	(8.8)	Science	396	(489)
Education (% of GNI, 2018)	3.3	(4.5)	Share of women in parliament (%)	17.4	(30.7)

* The year is indicated in parenthesis if it deviates from the year in the main title of this table.
** Where the OECD aggregate is not provided in the source database, a simple OECD average of latest available data is calculated where data exist for at least 80% of member countries.
Source: Calculations based on data extracted from databases of the following organisations: OECD, International Energy Agency, International Labour Organization, International Monetary Fund, World Bank.

Executive summary

COVID-19 interrupted a long and stable growth journey, causing a recession

After two decades of sustained, steady growth, the pandemic triggered a "perfect storm". GDP contracted in 2020 and some of Indonesia's vulnerabilities have come to the fore, although unprecedented policy interventions have circumscribed the damage.

The 2020 recession was widespread. Most sectors were hit, while uncertainty over the evolution of the pandemic and depressed confidence held back investment and consumption, with few exceptions such as ICT and healthcare services. Subdued global demand weighed on commodities sectors, notwithstanding improvement in the second half. Construction was also affected, with delays in infrastructure projects.

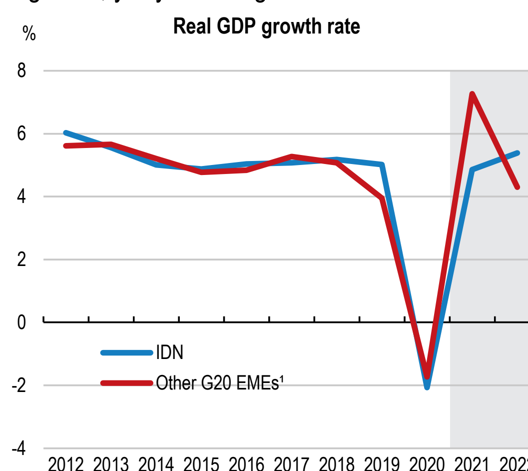
The social fallout is severe. Formal employment is shrinking, and the crisis is disproportionally hitting vulnerable groups such as informal workers, internal migrants, women and children. Government policies aim at reducing scarring effects and improving the skills of the population.

The healthcare system was put under stress but collapse was avoided. Extra efforts were made to deal with the COVID-19 outbreak and the system proved more resilient than expected, although the number of deaths for monitored patients, as well as among doctors and nurses, is high and the contract tracing system is still rudimentary. The migration of health professionals is also a cause of concern. Moving forward, it is important to continue the fight to eradicate other diseases like tuberculosis, dengue fever and malaria, which remain rampant.

The recovery will be gradual, with considerable downside risks. With no clear signals that the virus is receding, uncertainty surrounds the definitive withdrawal of all prevention and mitigation measures and the successful roll-out of the free vaccination programme. Despite the increasing reliance on e-commerce, private consumption will take time to return to pre-crisis levels due to income losses. Investment growth is set to remain soft, although the new Omnibus Bill for Job Creation is expected to improve the business climate. Sluggish global trade growth will also take its toll.

Figure 1. A sudden stop to a growth story

GDP growth, y-o-y % changes



1. Other G20 EMEs include Argentina, Brazil, China, India, Mexico, Russia, Saudi Arabia, South Africa, and Turkey.
Source: OECD Economic Outlook 108 database updated.

StatLink https://stat.link/jr1hzt

Table 1. The economy suffered a contraction

(annual growth rates, unless specified)	2019	2020	2021	2022
Gross domestic product (GDP)	5.0	- 2.1	4.9	5.4
Private consumption	5.2	- 2.7	3.6	7.1
Government consumption	3.3	1.9	- 0.3	1.0
Gross fixed capital formation	4.5	- 4.9	2.0	6.0
Exports of goods and services	- 0.9	- 7.7	2.0	3.9
Imports of goods and services	- 7.4	- 14.7	1.8	7.4
Unemployment rate (% of labour force)	5.3	8.0	6.8	5.8
Consumer price index	3.0	1.9	2.1	3.0
Fiscal balance (% of GDP)	- 2.2	- 6.5	- 5.7	- 4.1
Public debt (% of GDP)	26.3	27.0	35.0	38.6

Source: OECD Economic Outlook 108 database updated.

Fiscal policy has been expansive despite formal constraints. The ceiling on the deficit (3% of GDP) has been temporarily suspended. Slow disbursements limited the initial impact of the 4.3% of GDP fiscal stimulus in 2020 but the situation later improved with an acceleration of spending. The OECD projects the deficit-to-GDP ratio to recede from 6.5% in 2020 to 5.7% in 2021. Further support in the medium term will depend on maintaining easy access to financial markets and raising tax revenue above current levels, which are insufficient.

Monetary policy remains accommodative. Bank Indonesia cut its policy rate five times in 2020 and then again in February 2021, by 150 basis points in total, while quantitative easing and a range of macro-prudential measures were activated to increase liquidity. Inflation is projected to remain low and accommodative monetary policy, accompanied by forward guidance, should continue.

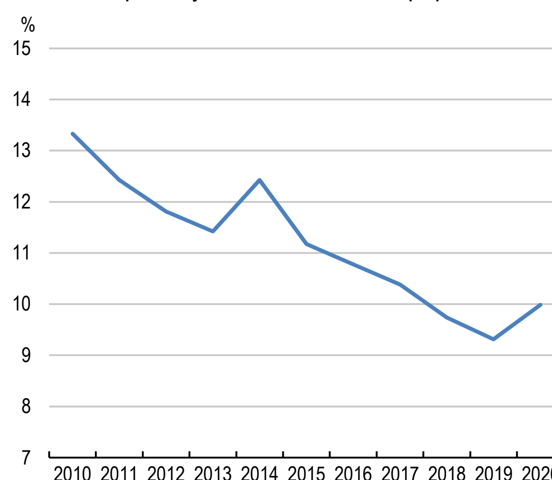
The central bank engaged in a "burden-sharing" scheme with the government. Bank Indonesia bought government bonds directly, bearing the interest cost. The action was consistent with the central bank's macroeconomic stabilisation mandate and appropriate safeguards were in place. Going forward, it will be important to maintain clarity regarding the boundaries between fiscal and monetary policy and preserve the independence of Bank Indonesia.

Some financial indicators warrant attention. Market stress was at its highest in March 2020. It has since receded but corporates' foreign currency debt is a risk to financial stability. Despite recent currency strengthening, the spreads over global benchmarks have yet to return to pre-crisis levels. The narrowing of the current account deficit is a positive signal insofar as reduces vulnerability, but investor sentiment towards emerging markets remains fickle and any sudden deterioration may trigger a vicious depreciation/inflation cycle and hinder market access.

Progress in reducing poverty is at risk. Poverty has declined since the turn of the century but started to edge up even before the pandemic hit (Figure 2). Consumption patterns, notably for durable goods, testify to the rise of the middle class. Nonetheless, only a third of Indonesians are economically secure and in urban areas three out of ten live in slums. Poverty remains widespread in rural areas and youth unemployment is the highest in Southeast Asia. Over 26 million people (9.8% of the population) were considered poor when the country started to suffer from the pandemic, which could push up to 10 million more individuals into poverty.

Figure 2. Poverty is on the rise again

Incidence of poverty as a share of total population



Source: BPS.

https://stat.link/pv2un4

Better performance of state-owned enterprises is key to unleash the benefits of globalisation

State-owned enterprises (SOEs) are assigned a central role in transforming Indonesia into a developed economy. SOEs enjoy favourable operational conditions, but their performance is uneven and their rising leverage represents a hidden fiscal risk.

Even short of large-scale privatisation, there is room for SOE reform. Corporate governance should be improved and boards and management shielded from government interference. The creation of holding companies at the sector level may bring benefits, provided operating companies are given a clear mandate and their financial reporting is transparent.

Trade intensity has diminished and exports remain concentrated in natural resources. Although commerce is increasingly with the rest of Emerging Asia, Indonesia only modestly participates in regional value chains and foreign investors are discouraged by high regulatory barriers and legal uncertainty.

Important and comprehensive agreements open new opportunities. The Regional Comprehensive Economic Partnership, the Indonesia-Australia Comprehensive Economic Partnership Agreement, and possible agreements with the European Union and EFTA will ease the flow of goods, services, investment and people

between Indonesia and some of its major partners. Preferential market access is a potential boon for exporters that must be complemented by progress in trade facilitation, product quality and other areas.

Despite progress in transport infrastructure, shortfalls in safety and logistics remain. Road and sea transport fatalities are among the highest in Asia and so are logistics costs. Filling infrastructure gaps to make the most of globalisation requires significant financial resources that should be increasingly sought from private investors, including from abroad. The new sovereign wealth fund can play a facilitating role.

Protecting the environment to the benefit of all

Achieving the Nationally Determined Contribution to the Paris Accord and the Sustainable Development Goals requires ambitious policies to mobilise additional financial and technological resources.

Land use and deforestation contribute to make Indonesia one of the world's largest emitters of greenhouse gases. The largest mitigation potential may come from extending the moratorium policy on the clearing and conversion of primary forest and peatlands and widening it to include secondary forests.

Decoupling greenhouse gas emissions from economic growth and fulfilling emission reduction targets for 2030 are tough challenges. They require investments in public transport and low-emission technologies and improvements in energy efficiency, to fight air pollution especially in Jakarta and its satellite cities. In many locations, inland and by the sea, pollution from plastic waste is a major challenge. In the post-crisis phase, government and business actions carry the potential to accelerate the green transition.

Building competencies for inclusive growth

Demography has been supportive but the window is about to close.

Indonesia has enjoyed a "demographic dividend", supporting the growth of GDP per capita. The share of the working age population is expected to peak in 2021, remain broadly stable for ten years, and then gradually decline.

Growth objectives for the next 25 years are particularly ambitious. Over the medium term, the 2020-24 Plan aims at achieving GDP growth between 5.4% and 6%, with the long-term goal of making Indonesia a developed country by 2045 – the centenary of Independence.

Educational attainment has improved considerably in the past two decades, but COVID-19 has increased the risk of absenteeism and drop-out. Improved public spending efficiency and starting school earlier could raise educational attainment and learning performance. Greater ICT investment would help reap the benefits of digitalisation.

Skills shortages are many and concern both current and future needs. The importance of securing adequate skills will increase as the economy becomes more knowledge-based. Vocational education and lifelong training should be further promoted to upskill and reskill the workforce, with an enhanced role for social partners.

Increasing employment is crucial to anticipate the end of the demographic dividend. Higher participation is needed from women, internal migrants, diaspora returnees, foreign workers, and disadvantaged groups.

Employment legislation reform aims at helping jobseekers. The recently-approved Omnibus Bill for Job Creation encourages hiring in the formal economy, diminishes firing costs and introduces a risk-based system for authorising environment-sensitive projects. Implementing regulation will be crucial to achieve desired outcomes and should be elaborated in consultation with relevant stakeholders.

Fostering competition, simplifying business regulations and modernising the financial sector would boost productivity. Many anti-competitive measures stymie entrepreneurship. There is scope to improve the regulatory framework, for instance by removing unnecessary restrictions on the entry of foreign multinationals.

Corruption remains a major issue. The overhaul of the national anti-corruption agency presents new challenges and its independence should be preserved. With considerable financial resources earmarked for the recovery, it is important to apply strict public procurement norms and practices.

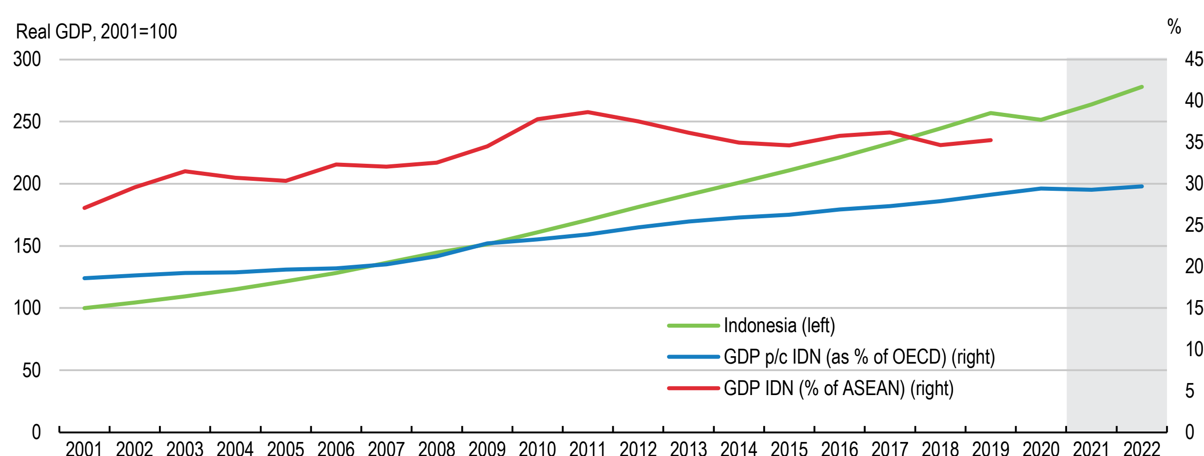
MAIN FINDINGS	KEY RECOMMENDATIONS
Moving from crisis management to achieving recovery	
A broad range of temporary measures has been adopted to succour vulnerable households and businesses.	Prolong measures directed at providing financial support to households and businesses to protect livelihoods and employment.
Disbursements in the context of the emergency fiscal package have been slow, but have accelerated in the latter part of 2020.	Improve inter-ministerial policy coordination and between government levels and ensure consistency between government accounting systems.
Past fiscal prudence has made room for fiscal expansion in the face of exceptional circumstances.	Authorities should plan for fiscal consolidation over the medium run but avoid a premature and abrupt removal of stimulus.
The economic crisis and the tax policy actions to mitigate its impact have further reduced tax revenue from already low levels.	Efforts to raise tax revenue should be stepped up, notably by: • improving compliance; • broadening the base; • increasing selected tax rates (e.g. on tobacco); • enhancing international cooperation; and • closing loopholes.
The "burden sharing" scheme is part of the unconventional apparatus, unlikely to generate inflationary pressures as long as demand stays compressed, and intended as temporary.	Phase out the "burden sharing" agreement, as envisaged.
The central bank has lowered the policy rate in steps during the crisis and inflation has drifted down to below target.	The monetary stance should remain accommodative as long as inflation is within target, with forward guidance on normalisation as conditions improve.
Central bank independence is key for the credibility of macroeconomic policy, especially in difficult times.	Bank Indonesia's independence should continue to be fostered.
Enhancing the effectiveness of government interventions	
SOEs' financial and operational performance has deteriorated during the crisis and some needed capital injections or restructuring.	Improve SOEs' corporate governance to align with global best practices.
A number of SOEs enjoy various competitive advantages and the lack of a level playing field may hamper private sector growth.	SOEs should always be subject to competition law and be held responsible when abusing their dominant market position.
Restrictions on FDI are amongst the highest in the G20.	Review existing restrictions, eliminate those that generate costs without producing benefits, and monitor the remaining ones.
Streamlined procedures and direct awards may be an efficient, but only temporary, solution for procuring specific goods, services and works in emergency situations like COVID-19.	Limit direct awards only to current, urgent and unforeseeable needs, when there really is only one qualified supplier, and terminate them as soon as possible.
The recent requirements to seek prior approval by the supervisory board before launching investigations and to turn staff into civil servants weaken the independence of the Corruption Eradication Commission (KPK).	Safeguard the independence and authority of the KPK to ensure the effective prevention, detection and investigation of corruption.
Accelerating the green transition	
Estimates suggest that the forest and peatland cover lost to burning rose during the pandemic.	Protect, rewet and restore peatlands and forests and increase the budget resources for environmental protection agencies.
Cost-reflective energy pricing is fundamental to reduce emissions.	Establish a carbon price on fossil fuels.
The share of renewables in the energy mix is still low.	Confirm plans to reform buy-in tariffs, to make cost recovery possible.
Jakarta and other metropolitan areas suffer from high pollution.	Accelerate investment in public transport and pursue inter-modal integration.
Expanding skills and well-being	
Early childhood education can reduce the impact of socio-economic backgrounds on education outcomes and encourage female labour participation. Enrolment is low, notably in rural areas.	Consider decreasing the starting age of compulsory education.
Median wages are below minimum wages in a third of provinces, incentivising informality. Different minimum wage settings are not explained by different levels of development.	Review the level of statutory minimum wages in each province to better align them with local characteristics.
There is a large gender gap in employment. Female educational attainment is converging towards men's but remains below. There is evidence of gender discrimination in the labour market.	Promote female employment through public campaigns. Target more women in lifelong training programmes. Support the construction of more childcare facilities. Enforce laws promoting gender equality.
The share of youth not in education, employment or training is relatively high.	Pilot lower levels of employment protection and discounted minimum wages for youth in special economic zones. If successful, extend them.
The recently-introduced unemployment insurance scheme provides dismissed workers with a lump sum.	Expand the unemployment insurance scheme together with business associations and trade unions.
Computers are only available in 40% and 67% of primary and upper-secondary schools, respectively.	Invest more in information and communication technology infra-structure for pedagogical purposes in primary and secondary schools.

1 Key policy insights

Indonesia is confronting the most severe challenges since the 1997 crisis

The COVID-19 pandemic is hitting the Indonesian people and economy hard, with GDP falling and poverty rising. The pandemic-driven recession in 2020 was a brutal interruption to a long spell of sustained economic expansion that saw GDP per capita rise from 19% of the OECD average in 2001 to 29% in 2019 and Indonesia's contribution to ASEAN GDP grow from 27% to 35% (Figure 1.1). During the 2001-19 period, the compound annual growth rate of GDP was 5.1%, the third-highest in the G20, and growth volatility was the lowest.

Figure 1.1. The pandemic interrupted a long spell of sustained growth



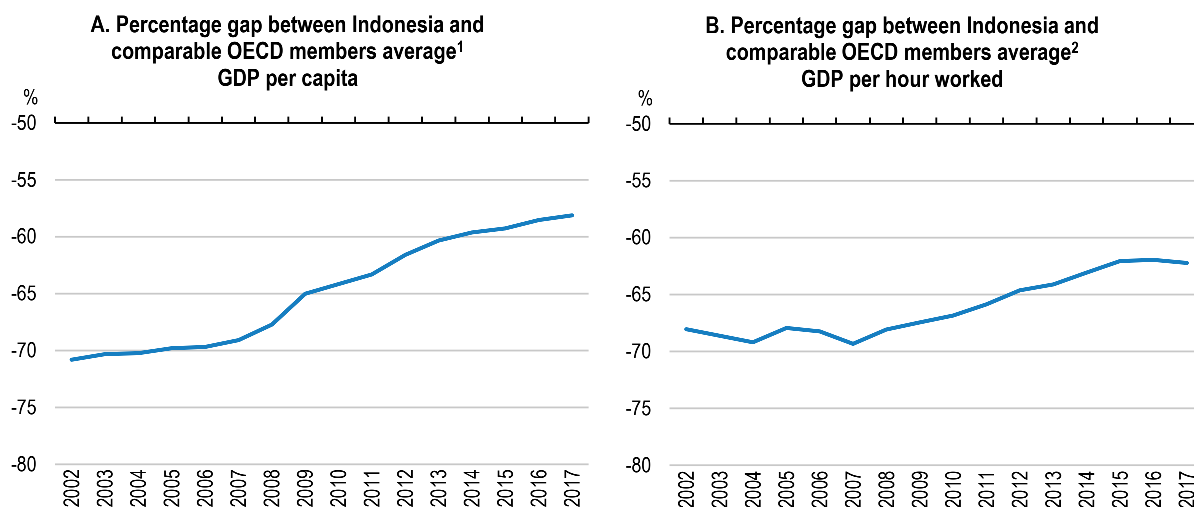
Note: Indonesia's GDP as a share of OECD and ASEAN GDP, computed at 2010 USD PPP. ASEAN GDP is the sum of Brunei Darussalam, Cambodia, Indonesia, Lao PDR, Malaysia, Myanmar, the Philippines, Singapore, Thailand and Vietnam.
Source: *OECD Economic Outlook*, No. 108 updated; World Bank, World Development Indicators.

StatLink https://stat.link/jbnd4i

The Indonesian economy has experienced considerable structural transformation over the period. Services have overtaken agriculture as the largest source of employment, the range of made-in-Indonesia products has become more sophisticated (in part also due to foreign direct investment), and the recent World Bank reclassification as an upper middle-income country testifies to Indonesia's rising global status. However, the pace of convergence in income per capita and productivity vis-à-vis the more comparable OECD countries has slowed in recent years (Figure 1.2), notably since the end of the commodities super-cycle in 2014. Moreover, low-value-added services and light manufacturing are still driving employment growth (Lewis, 2019a).

COVID-19 has triggered the first recession since the 13% contraction endured in 1998, with GDP shrinking by 2.1% in 2020, under the combined burden of the global recession and the domestic sanitary containment measures (Box 1.1).

Figure 1.2. Income and productivity convergence started decelerating around 2014



Note: 1. Panel A. OECD average refers to the population weighted average of 18 OECD member countries that have the lowest GDP per capita (in constant 2015 PPPs). 2. Panel B. OECD average refers to the population weighted average of 17 OECD member countries that have the lowest GDP per hour worked (in constant 2015 PPPs).
Source: OECD, National Accounts Database; APO Productivity database.

Box 1.1. Indonesia's strategy to contain the spread of the COVID-19 virus

With its first case confirmed on 2 March, Indonesia was hit by COVID-19 relatively late, after Thailand, the Philippines, Singapore, Cambodia, Vietnam and Malaysia in Southeast Asia. By 9 April, infections had spread to all 34 provinces and the daily number of new cases hit a record high on 30 January 2021. Subject to the caveat that COVID-19 underreporting is non-trivial (LaporCovid-19, 2020), as of 8 March, 1 386 556 cases and 37 547 deaths had been confirmed. Indonesia has a high number of deaths among patients under surveillance and persons under observations. The substantial number of deaths among health workers due to COVID-19 calls into question the efficacy of protective measures. International comparisons, however, are difficult to make given differences in data collection.

The following elements have featured in the containment strategy:

- Foreign entry controls: A ban on the entry of travellers coming from Hubei province was imposed in early February 2020, later extended to all visitors from China. Starting on 8 March, travel restrictions were expanded to include selected localities in Korea, Italy and Iran, and eventually all foreign countries. Authorised persons arriving in Indonesia are potentially subject to a 14-day quarantine.
- Large-scale social restrictions (Pembatasan Sosial Berskala Besar, abbreviated as PSBB): These include: closing public places (such as schools, offices, religious and cultural buildings), restricting public transport, limiting internal travel, and outlawing the annual post-Ramadan Idul Fitri mudik (exodus). A partial lockdown was imposed in major cities in mid-April and lasted until early June.

- Post-PSBB transition: In Jakarta, the first phase, with opening of commerce and restaurants, began on 5 June. This “New Normal” (later re-named “adapting to new habits”) approach, based on wearing masks, respecting physical distancing, washing hands regularly, and avoiding touching eyes, nose and mouth, was originally supposed to end on 2 July. With limited progress in curbing infection spread, the transitory phase was prolonged and PSBBs were re-imposed in Jakarta in mid-September and extended until 22 November. New public activity restrictions (PPKM), were introduced in January 2021 in response to the emergence of a new COVID-19 variant. The new measures would only be implemented in regions that meet one of four criteria: a death rate that exceeds the national average, a recovery rate that is below 82%, active COVID-19 cases surpassing the 14% national average, and a hospital bed occupancy rate higher than 70%. Most of Java and Bali enforced PPKM between 11-25 January, although enforcement was lacklustre.
- Testing: Polymerase chain reaction (PCR) testing is free for patients with symptoms at a government hospital, and the government has announced the formation of a group tasked with setting the price outside hospitals. There are long waiting lists due to limited human resources and lack of PCR reagents, extraction kits, viral transport media and consumables. Narrow testing limits the ability to detect asymptomatic and mild cases. The number of tests performed per million population has been the lowest among G20 members. GeNose, a COVID-19 detection system using a breath sample method created by Gadjah Mada University, obtained the distribution permit from the Ministry of Health on 24 December 2020.
- Tracing: In March 2020, the Communications and Information Ministry launched PeduliLindungi, a mobile app to trace and track confirmed or suspected cases, but uptake has been modest. Economic concerns, low trust, and stigmatisation fears are major obstacles.
- Treating: Extra fiscal resources, including tax relief, have been allocated to procure medical equipment such as test kits and ventilators, incentivise medical workers and subsidise social security premia. Existing facilities have been adjusted in response to the pandemic. In Jakarta, 4 053 isolation beds and 528 intensive care unit (ICU) beds in 67 referral hospitals have been designated for COVID-19 patients and the largest makeshift hospital has been built, with capacity of up to 2 000 patients. The occupancy rate was 83% for ICU beds and 77% for isolation beds in mid-September. At the end of 2020, the Ministry of Health announced plans to increase treatment room capacity by 30% and add new referral hospitals totalling 7 901 new health workers and 740 new ICU beds.
- Vaccination: The government has adopted a roadmap, following the WHO and Indonesian Technical Advisory Group on Immunization (ITAGI) standards, which identifies medical workers, the police, the armed forces and public servants as priority groups. Indonesia is expected to benefit from the Asia Pacific Vaccine Access Facility (APVAX) of the Asian Development Bank that will provide support for procurement and transportation of vaccines, as well as investments in distribution systems, like cold-chain storage and processing facilities. Indonesia has secured more than 600 million doses, from several vaccine producers. On 11 January, the Food and Drug Monitoring Agency (BPOM) issued an emergency use authorisation for Sinovac Biotech's CoronaVac vaccine after interim results of its late-stage trials showed an efficacy rate of 65%. This made Indonesia the first country outside China to approve the vaccine. The efficacy rate is lower than the 91% and 78%, respectively, reported in Turkey and Brazil. The free vaccination programme aims at covering 181.5 million citizens (⅔ of the official population) to achieve herd immunity. Rollout began on 13 January 2021 when President Joko "Jokowi" Widodo received the first shot. By end-February, more than 1.5 million people had been vaccinated, with more than 900 000 people receiving their second jab. Also in late February, one of the world’s first private vaccination schemes was authorised, to allow companies to buy vaccines and inoculate

staff and their families for free at privately-run health centres with vaccines distributed by state-owned Bio Farma.

Source: OECD, UN-OCHA and WHO.

Indonesia has achieved a remarkable growth journey over the past two decades, but its structural frailties have been laid bare by the crisis: widespread informality, insufficient human capital, persisting inequalities, insufficient tax revenues, slow budget execution, cumbersome market regulations and opacity in the allocation of public monies. Against this background, the main messages of this *Survey* are:

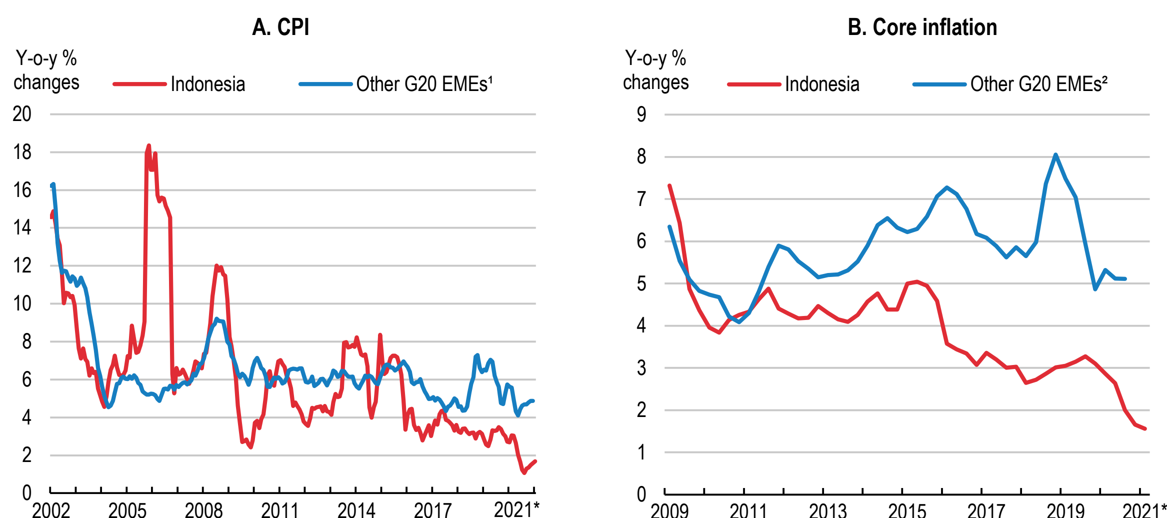
- The recovery from the 2020 recession will be gradual and subject to the evolution of the health situation. This will make it necessary to maintain government support to vulnerable households and businesses. The temporary suspension of the Constitutional limit on the fiscal deficit should be accompanied by structural reforms (such as the Omnibus Bills) that induce growth-enhancing investments. The inflation rate is low and monetary policy should remain accommodative, while the duration of the debt monetisation programme should be minimal and forward guidance provided.
- The demographic dividend that has assisted in the 2000s catch-up will soon dissipate, making it crucial to enhance human capital accumulation. Tackling pervasive informality and skills deficiencies should be a priority, through horizontal policies that simplify the business environment and sectoral policies that improve educational outcomes and the quality of vocational training. Additional efforts should be directed at promoting early childhood education, exploiting the learning opportunities of digitalisation and improving tertiary education.
- Exiting the recession, Indonesia faces the risk of experiencing a growth slowdown while still a middle-income country. State-Owned Enterprises (SOEs) play an important economic role and are meant to spearhead Indonesia's structural transformation from a low-wage to a knowledge-based economy, which is key to avoiding the middle-income trap. High standards of governance, integrity, transparency and responsible business conduct should therefore be adopted and respected. Competition should be promoted, including through regulatory simplification and regulatory certainty should be pursued to entice private and foreign investors. The fight against corruption requires the preservation of the independence of the anti-corruption commission (Komisi Pemberantasan Korupsi, KPK).

A deep contraction and a gradual recovery amid considerable uncertainty

The pandemic officially reached Indonesia on 2 March 2020, but the economic impact was felt earlier in the year, as commodity prices softened, international tourism slumped and financial markets gyrated. The introduction of containment measures brought activity to a near halt, with only one third of manufacturing firms operational in April, major investment projects suspended, household consumption in stand-by and the labour market hurting (see Chapter 2). The slow return to normalcy in the third quarter saw a timid rebound in industry and momentum built in the fourth, with the manufacturing Purchasing Managers Index recording in December the second-fastest rise in output in survey's history. Nonetheless, consumers remained very cautious and commercial activities modest. Mobility trends at transit stations proxy confidence levels: in late April 2020 they were 68% below baseline; by end-January 2021 they stood at -44% (Google LLC, 2021).

Against this backdrop, headline consumer price inflation has been exceptionally low, hitting 1.3% in August 2020 before rebounding to 1.6% in January 2021 (Figure 1.3, Panel A). The core measure of inflation, which excludes volatile foods and administered prices, has also declined over the past few years, falling well below 2%, to 1.6% in January. In both cases, the readings are lower than the average of the G20 emerging market economies.

Figure 1.3. Consumer price inflation is low



Note: 1. Other G20 Emerging Market Economies include Brazil, China, India, Mexico, Russia, South Africa and Turkey: data available up to December 2020. 2. Other G20 Emerging Market Economies include Brazil, Mexico, South Africa and Turkey: data available up to 2020 Q3. Data for Indonesia in both panels refer to January 2021.
Source: OECD Monthly Economic Indicators database.

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The recovery will be gradual (Table 1.1), with employment and income losses holding back consumption, uncertainty weighing on investment, and tourism depressed. The budget deficit more than doubled in 2020, and is expected to start falling in 2021. Bank Indonesia will maintain its accommodative stance, since inflation is under control. Forward guidance on normalisation as economic conditions improve would help. Resistance from public opinion may slow progress in social and regulatory reforms, underscoring the advantages of engaging the public at an early stage of the policy cycle. The socio-economic consequences of the recession will be dire, notably for lower middle-class groups. By end-2021 GDP is projected to be roughly 10% below its pre-crisis trend level.

Measures of financial market stress indicate a significant increase in March as panic spread through global financial markets, followed by rapid normalisation, which occurred as fast in Indonesia as in the rest of Asia and faster than in Latin America (Groen et al., 2020). However, various macroeconomic vulnerabilities have resurfaced in recent months, in particular the debt exposure of non-financial corporations (Figure 1.4). While general government gross debt, at 30% of 2019 GDP, is low relative to other emerging economies (IMF, 2020a), the share of foreign-currency-denominated debt means that when the rupiah weakens, financing costs rise. Other indicators are better oriented. The rupiah has remained stable against the US dollar in 2020 (-0.3%), but at year-end it had appreciated more than 18% with respect to the 23 March minima. Official reserve assets stood at USD 138 billion in January 2021 – slightly lower than the all-time high recorded in September, but still equivalent to 10 months of imports. The trade balance recorded a USD 2 billion surplus in 2020, reflecting compressed domestic demand and better terms of trade, while current account swung to a surplus of 0.4% of GDP in the third quarter, the widest since the first quarter of 2011. There are unexpected and/or uncontrollable events, however, which may worsen the economic outlook (Table 1.2).

Table 1.1. Macroeconomic indicators and projections

	2017	2018	2019	2020	2021	2022
	Current prices (IDR trillion)	Percentage changes, volume (2010 prices)				
Gross domestic product (GDP)	13 589.8	5.2	5.0	- 2.1	4.9	5.4
Private consumption	7 783.7	5.1	5.2	- 2.7	3.6	7.1
Government consumption	1 239.5	4.8	3.3	1.9	- 0.3	1.0
Gross fixed capital formation	4 370.6	6.7	4.5	- 4.9	2.0	6.0
Stockbuilding[1]	60.4	0.8	- 0.9	- 0.3	2.1	0.0
Total domestic demand	13 454.0	6.3	3.7	- 3.3	4.8	6.0
Exports of goods and services	2 742.1	6.5	- 0.9	- 7.7	2.0	3.9
Imports of goods and services	2 606.3	12.1	- 7.4	- 14.7	1.8	7.4
Net exports[1]	135.8	- 1.0	1.4	1.1	0.1	- 0.4
Other indicators (growth rates, unless specified)						
GDP deflator	_	3.8	1.6	- 0.5	2.0	3.0
Consumer price index	_	3.2	3.0	1.9	2.1	3.0
Current account balance (% of GDP)	_	- 3.0	- 2.7	- 0.4	0.9	0.3
General government financial balance (% of GDP)	_	- 1.6	- 2.2	- 6.5	- 5.7	- 4.1
Three-month money market rate, average	_	6.1	6.7	5.7	5.2	5.2
Ten-year government bond yield, average	_	7.4	7.5	7.0	6.3	6.3

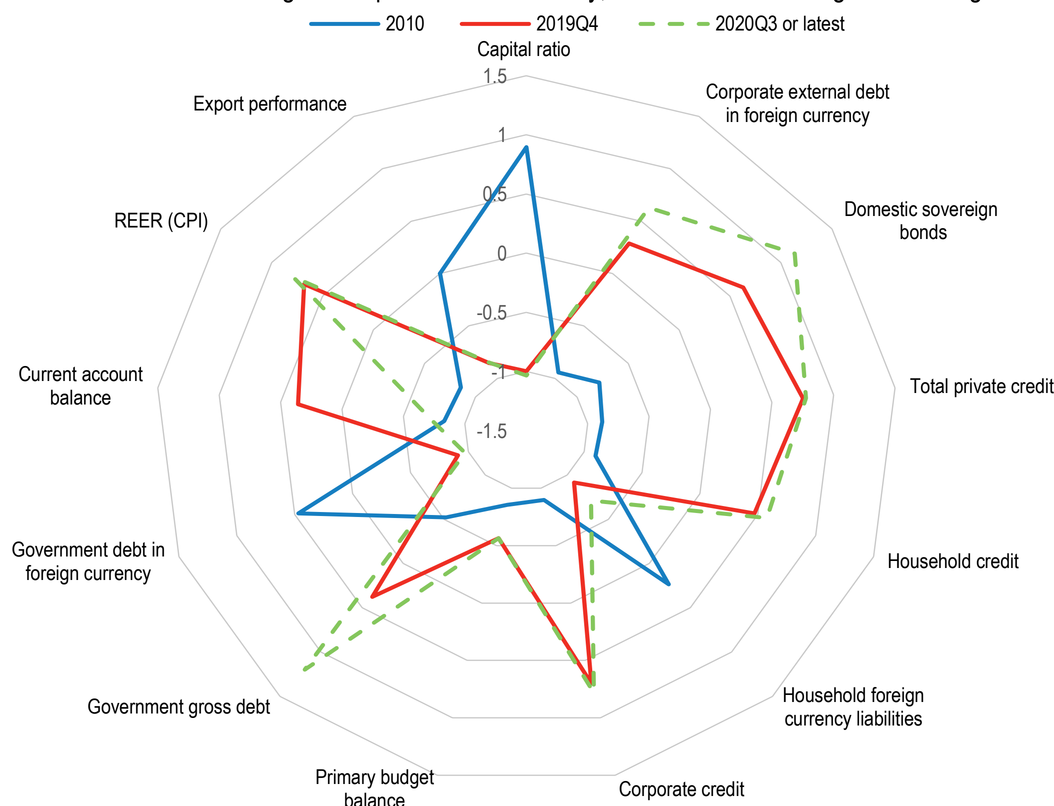
1. Contribution to changes in real GDP.
Source: OECD (2021), *OECD Economic Outlook*, No. 108 updated: Statistics and Projections (database).

Table 1.2. Events that could lead to major changes in the outlook

Shock	Possible impact
Further infectious disease outbreaks	Emerging market economies with a sizeable informal sector like Indonesia have found it difficult to cope with COVID-19 infections. A failure to curb the pandemic would put further strain on both vulnerable social groups and the health system, while a nationwide lockdown would further depress domestic demand and international tourism.
Heightened global trade and geopolitical tensions	Indonesia is integrated in Asia-Pacific supply chains through exports of raw materials and would be severely affected by a further and more pronounced slowdown in global trade. Geopolitical tensions would further exacerbate these difficulties.
International financial turmoil	Sudden capital outflows could lead to sharp currency depreciation and a tightening of monetary policy to contain inflation risks. Increases in financing costs could negatively impact consumer credit and business investment and complicate debt-servicing for firms and households. The Indonesian banking sector remains exposed to external shocks as shown in 2013 and 2018, when the price of bank shares plummeted due to a weakening currency.
Natural disasters	Indonesia is prone to natural disasters such as extreme weather, volcanic activity and earthquakes that can cause enormous economic, fiscal, ecological and humanitarian impacts. The same holds for man-made disasters, such as the 2015 forest fires.

Figure 1.4. A number of macroeconomic vulnerabilities have resurfaced

Index scale of -1 to 1 from lowest to greatest potential vulnerability, where 0 refers to long-term average



Note: Indicators are normalised to range between -1 and 1, where -1 to 0 represents deviations from long-term average resulting in less vulnerability, 0 refers to long-term average and 0 to 1 to deviations from long-term average resulting in more vulnerability. Long-term averages are calculated since 1995 or the latest year available. The indicators include: capital ratio (regulatory capital to risk-weighted assets) (inverted), debt to non-financial enterprises denominated in foreign currency (as a % of total debt), domestic rating bonds (% of total assets), total private credit (% of GDP), household credit (% of GDP), household foreign currency denominated liabilities (% of GDP), corporate credit (% of GDP), primary budget balance (% of GDP) (inverted), government gross debt (% of GDP), government debt denominated in foreign currency (% of gross government debt), current account balance (% of GDP) (inverted), real effective exchange rate (based on consumer prices), and export performance (exports of goods and services relative to export market for goods and services) (inverted).
Source: OECD calculations based on OECD Resilience database; OECD National Accounts database; Bank Indonesia; and CEIC.

Macroeconomic policy action has been stepped up in the face of the pandemic

Faced with the economic shock imparted by the global pandemic and the sanitary measures taken to address it, the reaction of the central bank and the government has been swift and credible. In the process, authorities pushed out the boundaries of macroeconomic policymaking, using new monetary instruments and suspending some Constitutional fiscal rules on account of the exceptional circumstances. Looking further ahead, safeguarding fiscal sustainability will require enhancing the revenue base and adopting a medium-term consolidation framework, as well as promoting more efficient public spending.

Monetary and financial policy levers have been activated

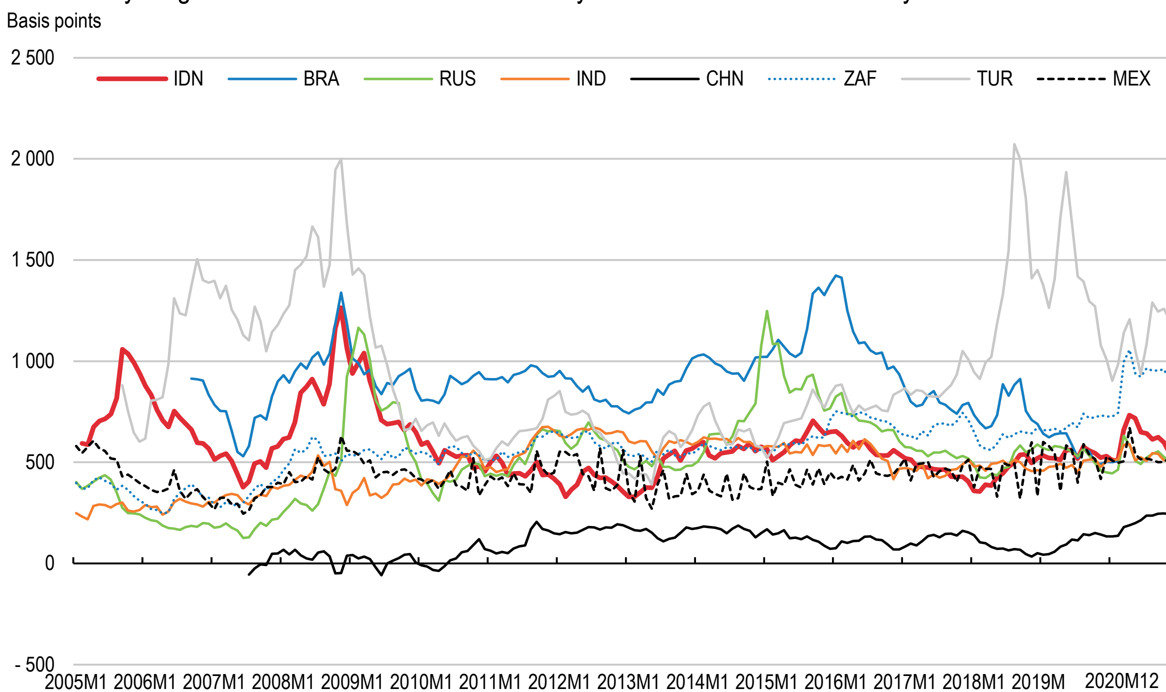
The goal of Bank Indonesia (BI), independent since 1999, is to achieve and maintain the stability of the rupiah. This, in turn, is defined as price stability and led in 2005 to the adoption of an inflation target, set for 2020 as 3% annual consumer price inflation, with a tolerance of ±1 percentage point (Perry and Solikin, 2019). BI started acting in response to the 2019 growth deceleration and then more massively to counter

the economic damage of COVID-19. BI cut the main interest rate (7-day reverse repo rate) in ten 25-basis-point steps, from 6% in June 2019 to a new record low of 3.50% in February 2021. In addition, it began quantitative easing in May 2019, providing banks and corporates a term-repo mechanism, and cut the minimum reserve requirements for both conventional and Sharia commercial banks. Liquidity is also regulated through changes in technical definitions, such as broadening the macroprudential intermediation ratio, which regulates banks' loan-to-deposit ratio. Another tool is the macroprudential liquidity buffer, which can be used as collateral for repo transactions with Bank Indonesia in the event that the bank requires additional liquidity. In addition, BI has maintained the supportive loan-to-value (LTV) regulation introduced in 2019 and eased LTV terms for environmental-friendly vehicles. Mandatory hedging requirements mitigate risks for corporations holding foreign debt. Lastly, OJK introduced credit restructuring measures to mitigate the impact of the pandemic on the banking industry, which it has extended until March 2022.

Indonesia also benefited from international cooperation at the height of the global financial turmoil in March-April 2020, signing or renewing bilateral currency swap arrangements with the People's Bank of China (CNY 200 billion, equivalent to USD 30 billion), the Bank of Japan (USD 22.8 billion), the Reserve Bank of Australia (USD 10 billion), the Monetary Authority of Singapore (USD 10 billion), and the Bank of Korea (KRW 10.7 trillion, equivalent to USD 8.2 billion). In addition, BI agreed on a repo-line with the US Federal Reserve (USD 60 billion), International borrowing costs remain high compared with other G20 emerging economies (Figure 1.5), but have receded since March and rating agencies have confirmed the country's lower-medium investment grade. In April, Indonesia placed a USD 4.3 billion 'pandemic bond' with a 50-year tranche, the longest-dated dollar debt ever issued by an Asian nation. By end-2020, Indonesia had raised up to USD 15.5 billion in the first round of funding for the Nusantara Investment Authority, its new sovereign wealth fund (Box 1.4), and was ready to launch a second round. Indonesia would seed the entity with up to USD 6 billion, while the US International Development Finance Corporation and the Japan Bank for International Cooperation would invest USD 2 billion and USD 4 billion, respectively.

Figure 1.5. The sovereign risk premium has decreased since March 2020 but remains high

Spread of 10-year government USD-denominated bond yields vis-à-vis the US Treasury instrument



Source: OECD Main Economic Indicators database.

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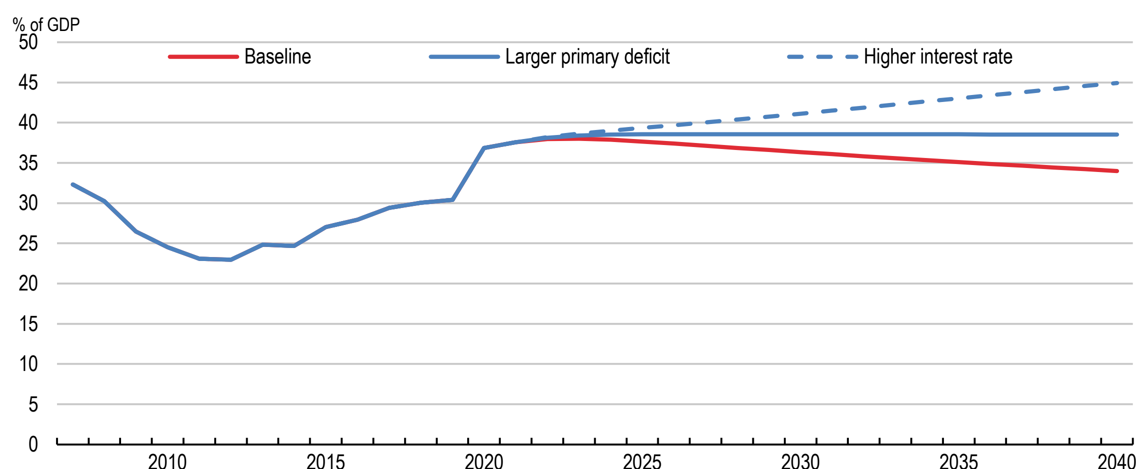
In the context of the National Economic Recovery programme (PEN), BI has been authorised to directly buy tradable government securities (SBN) at primary auctions, in addition to purchases on the secondary market. The central bank pledged to buy IDR 397.5 trillion in bonds at a coupon rate corresponding to its benchmark interest rate and then return the yield to the government in full on the day it is paid. Four principles guide BI's purchases of government bonds in the primary market: prioritising market mechanisms, buying tradable and marketable securities, taking into account measurable impacts on inflation, and intervening as a non-competitive bidder and "as a last resort". BI holdings of government bonds grew 150% between February and July 2020, its share of total outstanding SBN more than doubling from 4% to 9% and then declining. This action to monetise government debt is similar to actions taken by other independent central banks during the crisis. However, it could lead to higher inflation in the future and makes it crucial to preserve BI independence. Against this backdrop, a parliamentary proposal to allow cabinet members to vote at the Bank's monthly meetings to set interest rates and to set up a monetary policy council with government participation raised concerns. The proposal was eventually dropped from the list of 2021 priority legislation, but the experience of countries where central bank independence has been challenged, such as Argentina and Lebanon, shows the importance of managing communication on sensitive institutional issues.

The 2020-21 fiscal expansion pushes up the public debt ratio but, assuming the deficit reverts gradually to its pre-crisis levels by 2023, as mandated by the May 2020 law, the debt ratio would peak at 38% of GDP in 2023 (Figure 1.6). Thereafter, the public debt ratio would slowly return to the pre-crisis level, provided that the deficit remains under control and the interest rate is stable.

Figure 1.6. Debt will rise in the aftermath of COVID-19, but remain sustainable

General government debt



Note: In all scenarios, GDP growth and inflation are in line with OECD Economic Outlook projections to 2021. The baseline scenario assumes constant GDP growth of 5.1% and inflation (in the GDP deflator) of 3% from 2022. The primary budget deficit is 0.5% from 2022. The effective interest rate is converging to 6% from 2022. The "larger primary deficit" is an alternative scenario that assumes a primary deficit of 0.8% of GDP from 2022 onwards. In the "higher interest rate" scenario, the effective interest rate is assumed to rise by 150 basis points by 2023.
Source: *OECD Economic Outlook*, No. 108; IMF, *World Economic Outlook database*; and OECD calculations.

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Banks' soundness indicators, such as capital adequacy, liquidity and profitability levels, have remained stable in the first half of 2020 (Figure 1.7). Another metric, the gross share of non-performing loans, inched up from 2.3% at 2018 to 3.2% in November 2020. Stress tests carried out by the Indonesia Deposit Insurance Corporation (LPS) in April 2020 produced reassuring results, despite a still-sizeable share of

foreign-denominated debt in portfolios (LPS, 2020). The authorities rightly encourage bank consolidation, notably by easing the "single-presence" policy, whereby a single investor cannot have a controlling interest in more than one bank, and enabling a larger bank to acquire a controlling interest in a smaller bank, with no obligation to buy out minority investors. In order to ensure financial system stability is maintained through both macro- and microprudential supervision, Bank Indonesia and OJK (the Financial Services Authority) have established the integrated banking supervision forum (now expanded to include LPS).

Figure 1.7. The financial sector is profitable and the authorities consider it well capitalised

2020-Q3 or latest

A. Regulatory capital-to-risk-weighted assets

%

Indonesia | Other G20 EMEs[1] | Rest of ASEAN[2]

B. Return to assets

%

Indonesia | Other G20 EMEs[1] | Rest of ASEAN[2]

C. Liquid assets ratio

%

Indonesia | Other G20 EMEs[1] | Rest of ASEAN[2]

D. NPLs to total gross loans

%

Indonesia | Other G20 EMEs[1] | Rest of ASEAN[2]

Note: 1. Values for other G20 EMEs refer simple average of Argentina, Brazil, China, India, Mexico, Russia, Saudi Arabia, South Africa and Turkey in all panels. 2. Values for rest of ASEAN refer to simple average of Brunei Darussalam, Cambodia, Malaysia, Myanmar, Philippines, Singapore, Thailand and Viet Nam in all panels.
Source: IMF Financial Soundness Indicators.

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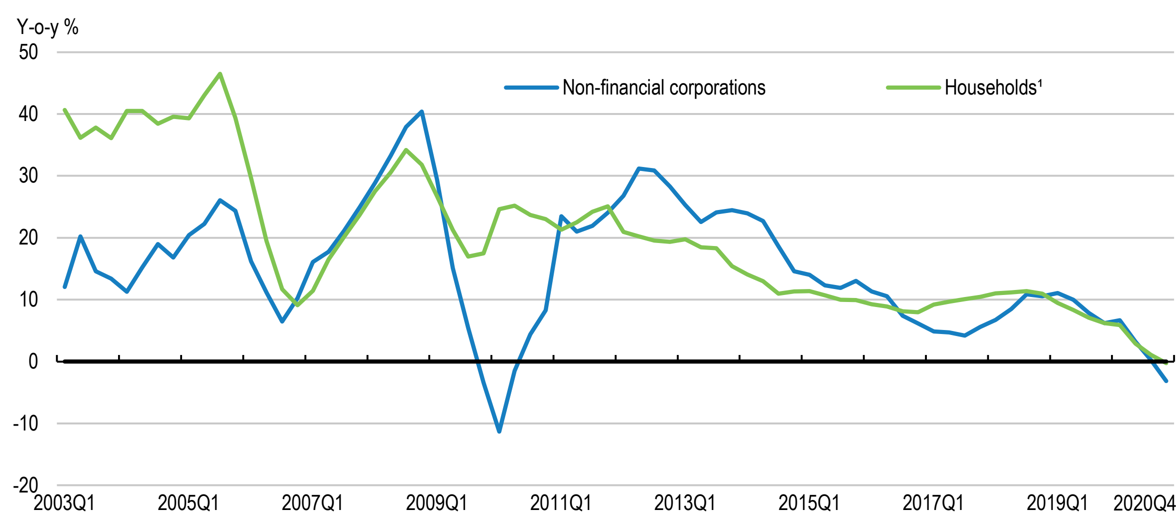
Despite looser monetary policy, bank credit expansion almost halved in 2019 (Figure 1.8), signalling a persistently suboptimal transmission from money market to bank interest rates (OECD, 2018). The COVID-19 recession is further slowing credit growth, as lenders increasingly worry about borrowers' risk profile

(Bank Indonesia, 2020a and 2020b). In the medium term, greater availability of consumer credit bureau information would facilitate the resumption of lending.

Figure 1.8. Credit growth to the real sector has weakened from very high levels



Note: 1. Household credit refers to consumption loans in the CEIC database.
Source: CEIC.

Financial inclusion remains challenging. Comparable global data show that less than half of the adult population has a bank account, versus around 70% in Malaysia and Thailand (World Bank, 2018c), although a survey by the Indonesian National Council for Financial Inclusion suggests a dramatic increase from 35% in 2016 to 56% in 2018. Fintech offers the opportunity to reach customers via mobile phones – indeed, having a mobile money account is the single indicator where Indonesia leads the rest of the region, although penetration remains as low as 3.1%. A different model is *Laku Pandai* (or 'Smart Practice'), launched by OJK in 2015 to promote branchless banking throughout rural Indonesia. It relies on existing bank customers, offline retail merchants, or kiosks to offer basic financial products. By mid-2020, 31 banks and financial institutions were participating, the number of agents exceeded 1 million, and the number of accounts was more than 27 million. There have been some downsides to fintech development, as predatory online money lenders have emerged (ADB, 2020). Full realisation of the promises of technology for financial inclusion requires promoting financial literacy and protecting consumers (OECD, 2020g). In the most recent PISA assessment of financial literacy, Indonesia trails well behind other emerging economies (OECD, 2020h). The National Strategy for Economic and Financial Inclusion rests on three pillars: economic empowerment, finance access and literacy, and policy harmonisation. The Indian experience shows how the institutional and educational framework has been adapted in a similar context to make progress on this front (Box 1.2).

Box 1.2. Implementing effective financial literacy policies: the case of India

India has sought to improve financial sector soundness, making it more competitive and inclusive while supporting business investment. Non-banking financial companies (NBFCs) have played an increasing role while public banks' market share in total credit has declined by about 10 percentage points from 2012-18. NBFCs tend to serve borrowers often excluded from the formal banking sector in the form of

small personal loans or innovative financial services to small enterprises. They are also competing with banks in some areas, including financing infrastructure and housing projects.

Financial literacy is a significant challenge, as only 24% of the adult population is financially literate, the lowest incidence among major emerging economies. Inter-state disparities are also wide, with rates ranging between 36% in Kerala and 4% in Chhattisgarh. Under the aegis of the Prime Minister's People Money Scheme, launched in 2014, financial inclusion efforts involve incentivising and regulating financial services providers to sell financial services responsibly, reducing the number of scams and promoting financial literacy. In particular, members of self-help groups, who are mostly women, face a risk of over-borrowing and should first learn about budgeting and planning, as a way of focusing on the longer term and learning how to repay their loans.

The Reserve Bank of India (RBI) acknowledges the key role of financial education in supporting the demand side of its financial inclusion strategy and the need for effective implementation of financial education policies in the context of the changing socio-economic and technological landscape. The RBI started developing financial education material in the early 2010s and currently develops the content, translates it into local languages and trains the trainers on the basis of the OECD/INFE core competencies for adults.

Other government bodies are also contributing. The Securities and Exchange Board of India (SEBI) implements initiatives such mass media education on Ponzi schemes, and activities training for resource persons including retired teachers. Tailor-made financial literacy programmes for farmers have also been initiated. The Pension Fund Regulatory & Development Authority (PFRDA) and the Insurance Regulatory and Development Authority (IRDA) are also active, including a two-year IRDA pilot project in the state of Tripura to create awareness programmes. The involvement of IRDA and PFRDA is particularly important insofar as few people in India are aware of the need for risk protection and pensions are not a priority.

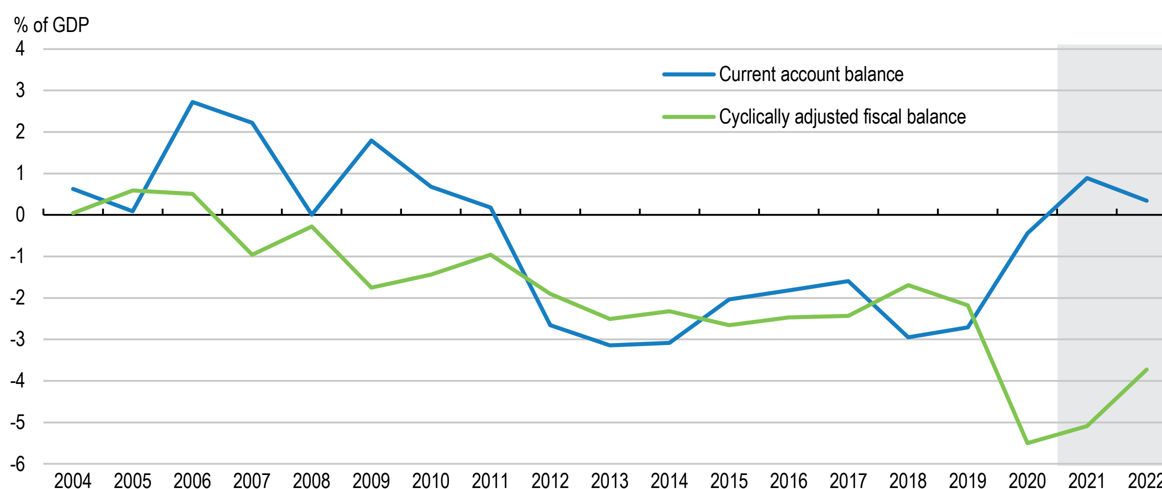
RBI, SEBI, IRDA and PFRDA have jointly set up the National Centre for Financial Education (NCFE) and work in close co-ordination, thus making it easier to identify and share best practices to deliver financial education in a cost-effective way. One is the benefit, in a complex country like India, of relying on regulated providers for implementation and of identifying key target groups, such as farmers, MSMEs, self-help groups (which are mainly composed of women), school children and the elderly. Digital channels are also proving crucial in teaching basic financial notions, creating materials in an icon-based way, which does not require high levels of literacy, and conducting awareness and education campaigns across the country.

Source: *Summary Record of the OECD-RBI High-level Global Symposium Implementing effective financial literacy policies in a changing financial landscape*, New Delhi, 8-9 November 2017; and OECD (2019d).

In the face of various risks, fiscal policy settings have long been prudent

Since 2002, fiscal policy has been run within the space of constitutionally-mandated caps on the deficit (3% of GDP) and public debt (60% of GDP). Fiscal policy loosened somewhat in the mid-to-late 2010s, but overall prudence has prevailed (Figure 1.9). Indonesia's credibility in international markets has improved, notwithstanding a persistent current account deficit funded mainly by debt, rather than more stable FDI.

Figure 1.9. Fiscal and current account deficits



Source: *OECD Economic Outlook*, No. 108 updated; IMF, World Economic Outlook database.

The COVID-19 shock prompted fiscal intervention, with disbursements gathering momentum

The government has prioritised strengthening the health system, widening the social safety net and succouring business. Interventions have come in steps (Annex Table 1), notably Perppu (Government Regulation in Lieu of Law) 1/2020 (31 March), Law 2/2020 (16 May) and Perpres (Presidential Regulation) 72 (24 June), the first increasing the 2020 deficit to 5.1% of GDP and the third raising it further to 6.3%. Like many other governments, Indonesian authorities reckon that the virus will continue spreading until a vaccine is found and distributed or an effective treatment is developed.

The overall package – amounting to 4.3% of GDP, including quasi-fiscal measures – was relatively small compared to other G20 members (Table 1.3). Interventions to improve the health system focus on expanding testing, quarantine and treatment capacity and health protocols. Resources are directed at purchasing medicine, meeting equipment needs, and hiring additional doctors and paramedics. A second axis of emergency intervention is to support livelihoods, notably through additional resources for existing programmes (conditional cash transfer, basic food, social assistance), labour-intensive public works, wage subsidies for low-income workers, free loans for laid-off workers, and accelerated deployment of the pre-employment card. Struggling firms are helped through different instruments depending on size. Medium-, small- and micro-sized enterprises may benefit from interest subsidies and credit guarantees, as well as tax deferrals and reductions. Among the support interventions for larger firms, the most notable is the availability of fresh capital for SOEs.

Fiscal execution has initially lagged. There have been delays in aligning emergency resources with spending plans and administrative bottlenecks. To accelerate disbursement and execution, an ad hoc Policymaking Committee was set up in July. The President of Indonesia publicly and forcefully summoned Ministers to act and this resulted in tangible improvements. By January 2021, the disbursed share of PEN stimulus spending was 83% for the total allocated budget, with sectoral ratios ranging between 47% for business incentives and 100% for corporate financing. In the longer run, it is important to improve budget execution through meaningful structural interventions, such as, in particular, better data that minimises the risk of mis-targeting beneficiaries.

The 2021 budget deficit, following supplementary spending measures announced in January 2021, is expected to be 5.7% of GDP, based on government projections of GDP growth returning to its medium-term trajectory, the exchange rate strengthening and oil prices increasing. Spending is set to increase on infrastructure (by nearly 50% compared with 2020, to resume work on projects interrupted because of the coronavirus) and defence (16%, with additional procurement outlays intended to reinforce the manufacturing sector through offset agreements with vendors). After the exceptional efforts made in 2020, the allocation for health-care in the 2021 budget remains considerable, as extra resources are set aside to facilitate vaccine procurement and run the mass free vaccination campaign (see Box 1.1).

Table 1.3. Main economic stimulus measures in 2020

Area	Budget (IDR trillion)	Description
Healthcare	88	Prioritisation of procurement of medical equipment such as test kits and ventilators.
		Incentives for medical workers including doctors and nurses.
		Subsidy of Social Security Agency (BPJS Kesehatan) premium.
Social protection	204	Assistance to households in the Family Hope and Staple Food programmes.
		Doubling of the budget for the pre-employment card programme (from the initial IDR 10 trillion).
		Free electricity for 24 million customers using 450 KVa and 7 million customers using 900 KVa.
		Support for low-cost housing (IDR 1.5 trillion).
		Basic logistical support and basic needs (IDR 25 trillion).
Tax Incentives and Credit for Business	121	Income tax exemption for six months to workers in the manufacturing sector with incomes below IDR 200 million per year.
		Import tax payment deferral for six months (later extended to nine) in 19 manufacturing sectors.
		Acceleration of VAT refunds in 19 manufacturing sectors.
		Reduction of corporate income tax rate from 25% to 22%.
		Suspension of debt reimbursement for six months for micro businesses affected by COVID-19.
Stimulus for SMEs	123	Interest subsidies for microcredit (KUR), MSME financing, guarantees, and placement of funds in banks.
Stimulus for SOEs	54	Capital injections.
Support for Ministries & regional administration	106	Support for tourism sector, food security and fisheries, industrial estates, ICT development.

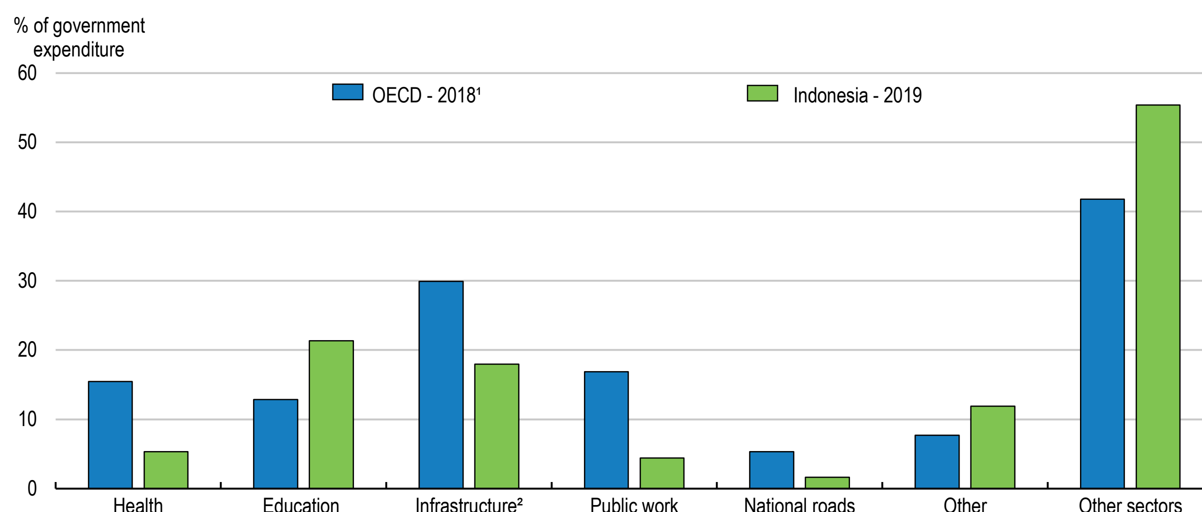
Source: Ministry of Finance.

The composition of public expenditures could be improved

General government expenditure as a share of GDP was the lowest among G20 countries in 2019. Based on budget commitments, the share of health and infrastructure therein is below the OECD average (Figure 1.10), while the opposite holds for education – though with caveats as to efficiency and equity (see below). The central government’s leeway is limited by the obligation to allocate given shares of non-discretionary spending to education, health, and regional transfers, including the Village Fund and the Special Autonomy Funds for Aceh and Papua. While the priority sectors are justifiably selected for their multiplier effects, greater flexibility would allow fine-tuning of the budget and greater responsiveness to changing priorities.

Figure 1.10. Composition of budgeted public spending

Share of government expenditure



Note: 1. OECD average refers to simple average of 2018 or the most recent values of OECD countries. 2. Infrastructure in the OECD case includes economic affairs, general public services, housing and community amenities and transport.
The values per territorial category do not sum up to 100% as Public work, National roads and Other are components of Infrastructure.
Data for OECD countries refer to disbursed expenditures and follow COFOG standards, while for Indonesia data are from CEIC, refer to budgeted outlays, and have been re-classified by the OECD Secretariat.
Source: OECD Government Expenditure by Function (COFOG); and CEIC.

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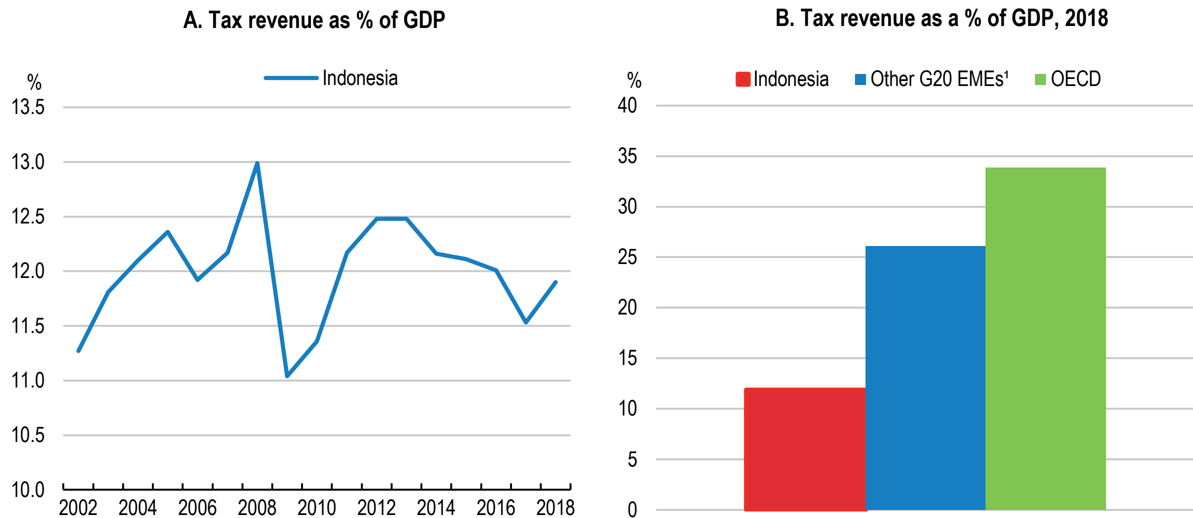
Ensuring high-quality public spending is a challenge due to several systemic constraints, including inconsistency between political directives, planning documents, and budget execution; poor data availability; weak intra-governmental organisational and information and communication technology synergies; and insufficient monitoring of outputs and outcomes. The Finance Ministry has improved the accuracy and flexibility of planning and budgeting and implemented performance-based budgeting on the basis of more comprehensive and informative documents. Looking ahead, it is crucial to reduce deviations between the Strategic Plan (*Renstra*) of the planning authority (Bappenas) and the line ministries' medium-term strategies, to improve data collection, harmonisation and standardisation, and to synchronise different financial application systems for spending units such as Bappenas' SAKTI and the Ministry of Finance's KRISNA.

A larger and more predictable revenue base is needed

Fiscal space, as well as the provision of public goods and redistribution, are limited by low tax revenues, due to low taxation levels and weak tax compliance (Figure 1.11), as documented in the 2018 *OECD Economic Survey* (OECD, 2018). Indonesia's tax-to-GDP ratio was 11.9% in 2018, far below the 34.3% OECD average (OECD, 2020a), and half as high as in G20 emerging economies. In 2018, taxes on businesses (corporate income, production, and trade) accounted for 66% of total revenue, more than twice as much as in the OECD (30%) (Figure 1.12). Property taxes contribute a meagre 2%, versus 6% OECD-wide. The government estimates that tax revenue fell 20% in 2020. Once the economy is out of recession, raising more revenue from recurrent taxes on immovable property would create relatively few distortions, address high levels of wealth inequality, and contribute to the budget of local governments (Lewis, 2019b). This requires speeding up land registration, which covers only 35% of the country, and completing it by 2025 (as per the government target). Other measures would include broadening the VAT base (by

removing exemptions and lowering the threshold for VAT registration) and increasing excise taxes (in particular on tobacco products and sugar-sweetened beverages) (*OECD Economic Survey of Indonesia*, 2018).

Figure 1.11. Tax revenue is low by OECD and G20 standards



Note: 1. Value for other G20 emerging market economies is computed as a simple average of Argentina, Brazil, Mexico, South Africa, and Turkey.
Source: OECD Global Revenue Statistics database.

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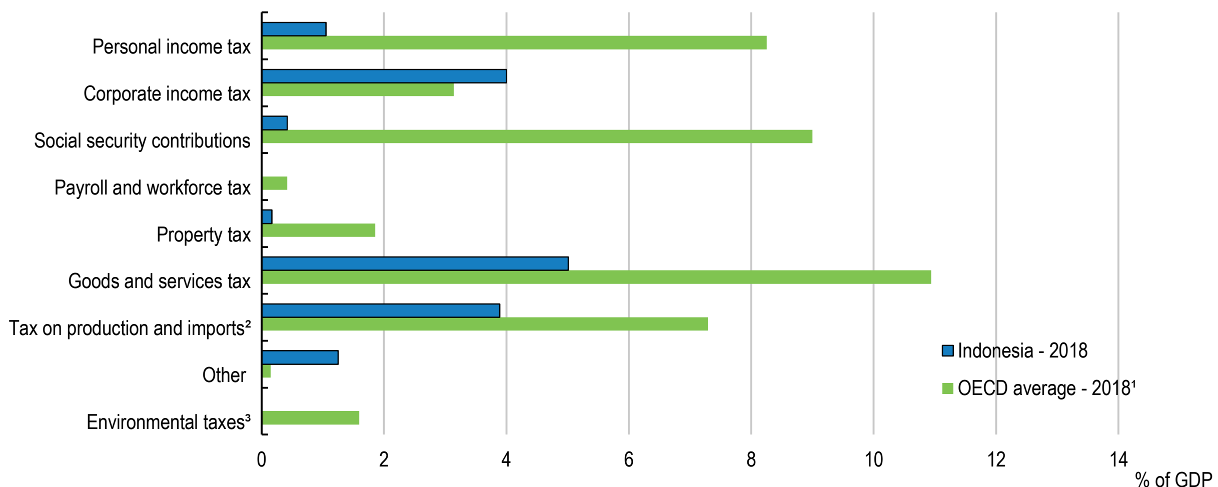
Figure 1.12. Composition of tax revenue

Tax revenue subcategories as a share of GDP



Note: 1. OECD average represents unweighted average of the OECD member countries that are available in the database. 2. Tax on production and imports represents a subcategory of Goods and services tax. 3. Environmental taxes cut across the classifications, and it shall not be considered as an exclusive, or belonging to any specific classification. https://www.oecd-ilibrary.org/taxation/revenue-statistics-2019_0bbc27da-en.
Source: OECD Tax Revenue Statistics, and OECD Green Growth Indicators.

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"Paying Taxes" is the World Bank's *Doing Business* sub-category where Indonesia has improved most between 2018 and 2019, gaining 31 positions in the global ranking (from 112th to 81st). The total yearly number of tax payments has decreased from 43 to 26 and it now takes 191 hours to complete the process, down from 208. Various actions have been taken since 2019 that match OECD recommendations (Table 1.4). An Omnibus Law – which amends the General Tax Provisions and Procedures Law, the Income Tax Law, the VAT Law, and the Regional Tax and Retribution Law – was presented in early 2020 and later integrated in the one on Job Creation. Various measures have been enacted : the cut in corporate income tax (CIT) rates, in particular, was passed as part of the PEN programme (Box 1.3). A 10% VAT is levied on digital or electronic purchases starting July 2020. The 2021 budget target is for total tax revenue to grow by 2.6%, but this amount would still be 7.7% lower than in 2019.

Box 1.3. Major tax reforms since 2019

Indirect taxes

- The range of services subject to 0% VAT has been expanded as of 1 April 2019.
- The excise tax on tobacco products was increased by an average of 23% in 2020 and 12.5% in 2021.
- The e-commerce purchase of foreign intangible goods and services is subject to a VAT rate of 10% as from 1 July 2020.
- A tax on plastic bags less than 75 microns thick was introduced in 2020 (IDR 30 000 per kg or IDR 200 per sheet).

Personal income taxes

- No significant changes have occurred since the enactment of the 2009 Income Tax Law other than the regular update on non-taxable income in 2012 and 2016 to accommodate inflation.

Corporate income taxes

- A flat CIT rate of 25% applied to net taxable income until fiscal year 2019. For fiscal years 2020 and 2021, the rate is set at 22%. From fiscal year 2022 onwards, the rate is set at 20%.
- From fiscal year 2020, newly-listed companies are entitled to a 3% rebate (previously 5%) off the standard CIT rate, provided they have a minimum floating of 40% of capital.

Source: OECD and PwC.

Tax efficiency in Indonesia is lower than in many G20 and ASEAN countries, due to low compliance, generous tax exemptions and widespread reduced rates. Relatively few individuals (around 7.6 million in 2019, up from 5.1 million in 2015) are subject to the personal income tax. VAT collection has declined as a share of tax revenue (from 36% in 1997 to 29% in 2018) due to exemptions and non-compliance. Improving tax collection is challenging given informality, as well as resource constraints of the Directorate General of Taxes (OECD, 2019b).

Reform options include reducing the scope of VAT exemptions, establishing a systematic approach in data collection and analysis to closely monitor taxpayer behaviour, and improving audit effectiveness by building trust between the tax authority and taxpayers (Iswahyudi, 2018). Of some success has been the experience with Medium Taxpayer Offices (MTOs), which in each region service large corporations (just 4% of corporate taxpayers), replacing a central Large Taxpayer Office in Jakarta. Assignment to an MTO more than doubled tax revenues, at a small cost (less than 1% of the increase in revenues) (Basri et al., 2019). In the case of import tax evasion, customs enforcement should be reinforced and penalties imposed also on consumers, so as to increase the risk of purchasing smuggled goods (Yubiwini and Patunru, 2018). Countries that have succeeded in enhancing trade tax collection have *inter alia* strengthened controls on

integrity, simplified customs procedures to increase effectiveness and reduce opportunities for rent-seeking, and promoted effective whistle-blower communication channels to enhance internal audits (OECD, 2017).

Table 1.4. Past recommendations related to raising revenue

Recommendations in previous *Surveys*	Action taken since the 2018 *Survey*
Tax administration and registration	
Increase investment in tax administration, particularly staff, electronic services and databases.	The Ministry of Finance (DG Taxes and DG Fiscal Balance) has signed a cooperation agreement with seven local governments in 2019 and 78 local governments in 2020 in order to optimize the collection of central and local taxes.
Establish standard procedures for public consultations on tax legislation before implementation.	The Indonesian Chamber of Commerce and Industry (Kadin) was involved in the process of preparation and public consultation of the Omnibus Bills, through a joint task force with central and regional governments, as well as academics.
Make greater use of information technology to strengthen monitoring and facilitate tax compliance. Increase use of risk-based assessment for conducting audits of all taxes.	The filing-and-paying process has been simplified through the adoption of the Online Single Submission (OSS) in 2019.
Continue to expand and improve tax expenditure estimates and publish them annually, as planned.	The 2019 Tax Expenditure Report (published in 2020) includes additional tax coverage, a new policy evaluation chapter, a chapter on incentives that are not included in the definition of tax expenditure, and improved technical calculations. The number of incentives/regulations whose cost is estimated is also higher than in the 2016-2017 Tax Expenditure Report.
Build tax capacity at sub-national government level through training and sharing of best practices.	Since 2018, DG Taxes has provided technical guidance on regional tax audits, collection of local taxes, and assessment of property tax (PBB-P2) to 2 113 local government officials.
Income taxes	
Freeze the basic tax allowance for individuals to broaden the tax base. Gradually lower thresholds for paying the top two rates of personal income tax.	The authorities consider the 2016 revision to the basic tax allowance (PTKP) appropriate under current conditions.
Include fringe benefits and employer allowances in taxable income. Reduce differences in the tax treatment of personal savings across sources.	Recent changes to the personal income tax base aim at catching income on a broader range of assets.
Shift from tax holidays towards cost-based tax incentives. Impose sunset clauses on all new tax incentives to ensure regular reviews.	To stimulate the development of large-scale infrastructure projects, the tax holiday and tax allowance incentives have been made more attractive for investors and easier to secure. A number of recent changes accelerate deductions or otherwise alleviate tax to incentivise investment.
Tighten eligibility for the turnover tax to very small firms and link registration to access to additional non-financial benefits.	Due to the pandemic, the decision of adjusting the threshold has been delayed and discussions continue with stakeholders.
Goods and services taxes	
Broaden the VAT base by removing most exemptions, especially for intermediate goods, replacing local sales tax with VAT, and lowering the threshold for compulsory registration. Compensate sub-national governments for lost sales tax revenue. Over the medium term, raise the VAT rate.	Indonesia has now moved to impose VAT on cross-border e-commerce purchase of taxable intangible goods and/or services.
Increase and harmonise tobacco excise across products	Cigarette excise taxes increased in 2020 by an average of 23%, while differences remain across products (10.9% for clove cigarettes, 13.5% for tobacco cigarettes and 7.3% for handmade cigarettes).
Link the level of motor vehicle taxes to their carbon emissions. Continue to phase out energy subsidies, then increase taxation of energy. Introduce a simple carbon tax at a low rate.	Since 2019, vehicle taxes are no longer based on engine capacity, but on fuel consumption and CO_2 emissions. Implementation will start in October 2021.
Non-tax revenues	
Finalise the One Map Initiative, and step up the fight against illegal resource extraction at all levels of government.	Completion of One Map is expected by December 2020.

Non-tax revenue includes royalties from the oil and gas sector (7.4% of 2018 revenue) (NRGI and PWYP, 2019). Indonesia has removed the USD 250 million upper limit on the value of signature bonuses when awarding a new production-sharing contract (PSC) and is now moving towards a gross split PSC model, whereby the government's share of production from a project derives from its gross revenue, rather than profits. This increases the importance of the disclosure and transparency commitments made by Indonesia as an EITI (Extractive Industry Transparency Initiative) implementing country.

The government has stepped up the fight against tax evasion and assets concealment. Indonesia has implemented the OECD's Common Reporting Standard for the automatic exchange of financial account information and now receives information on the foreign accounts held by its residents from more than 40 countries. Maximising the use of this information to enhance compliance, particularly in respect of high-net worth individuals, should be a priority. In 2017, Indonesia signed the Multilateral Instrument to implement certain tax treaty-related measures to help prevent Base Erosion and Profit Shifting (BEPS), which entered into force on 1 August 2020. Another important milestone has been the ratification in July 2020 of the Indonesia-Swiss Treaty on Mutual Legal Assistance in Criminal Matters. Further investment is required, for instance in specialised intelligence to cross-check information between the tax office and other national and foreign government agencies, to trace funds through complex financial systems, and to connect the assets discovered with the actual criminal activity. The "unexplained wealth order", which requires an individual or organisation to prove that the source of wealth is legitimate, could be introduced. Assistance from the UN/World Bank Stolen Asset Recovery Initiative would also help develop the legal framework and institutional expertise to recover assets stolen from the state.

Indonesia could gain more from globalisation

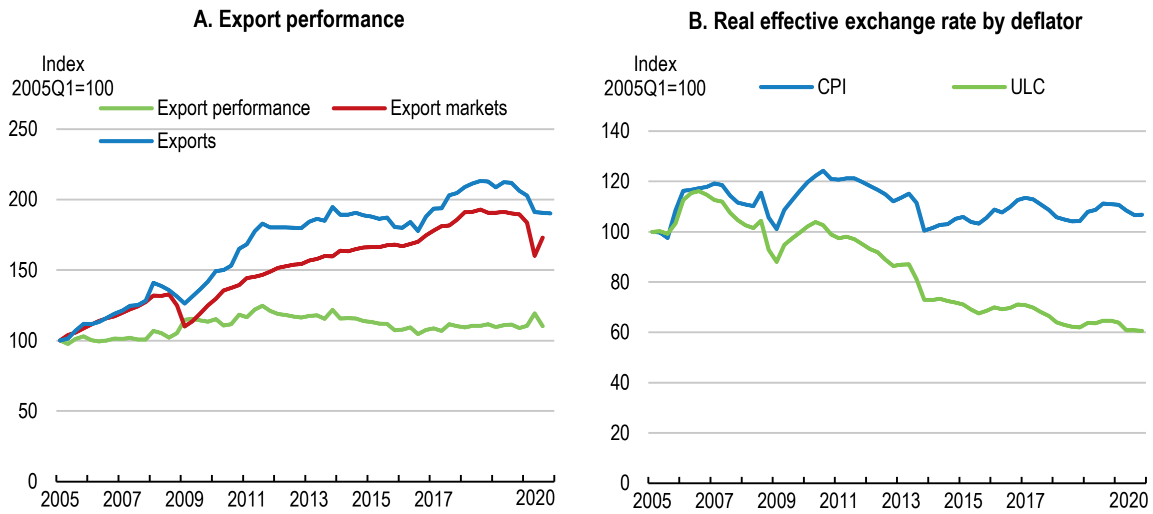
Emerging economies have by and large benefited from globalisation (Baldwin, 2016), but have not been exempted from the discussions about its limits. COVID-19 is now raising additional challenges. Commodity prices and trade volumes have fallen, while global trade and investment tensions remain high. The pandemic has highlighted the risk of single-sourcing critical components and goods, especially from China, and is leading multinationals to reassess the geography of their global production facilities (OECD, 2020e). More generally, as the resilience of value chains is tested, shortening the distance between suppliers and customers is becoming a significant competitiveness factor.

Exports are relatively low and concentrated in natural resources

Like some other large and rapidly growing emerging economies, Indonesia's trade openness (defined as the sum of exports and imports over GDP) has declined, from 59% of GDP in 2002 to 43% in 2018. Since 2005, Indonesia's export performance has mildly improved (Figure 1.13, Panel A) and its share of world merchandise exports has gone from 0.83% to 0.93% in 2018 (WTO, various years). Integration in global value chains is relatively weak and declining (ADB and IsDB, 2019), partly due to burdensome regulations, well-illustrated by the clothing industry: while competitors heavily rely on imported fabrics, raw material import restrictions apply in Indonesia.

In 2019, around 30% of Indonesia's exports and 41% of imports were with Northeast Asia (China, Japan, and Korea) (Figure 1.14, Panels A and B). China, in particular, has become the main trading partner of Indonesia and relations have been strengthening also in investment and finance. In terms of the export basket, Indonesia specialises in natural resources and labour-intensive, low-technology sectors (textile, footwear, tourism), with a slow upgrading toward medium-technology sectors (automotive, machinery, electronic equipment, information and communication services and high-end tourism) (Figure 1.14, Panels C and D). The only noticeable discontinuity between 2000 and 2016 is that coal and palm oil have replaced oil and gas as the top two export products (Breuer et al., 2018).

Figure 1.13. Export performance has been rather modest



Note: Panel A. Indicators of export performance are calculated by comparing the growth of a country's export volumes with that of its export market. This shows whether the country's exports grow faster or slower than its market, i.e. if over time it is experiencing market share gains or losses. Data for "Export performance" and "Export markets" are available until 2020 Q3.
Source: OECD National Accounts database; and OECD Monthly Economic Indicators database.

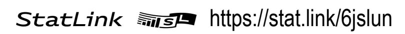


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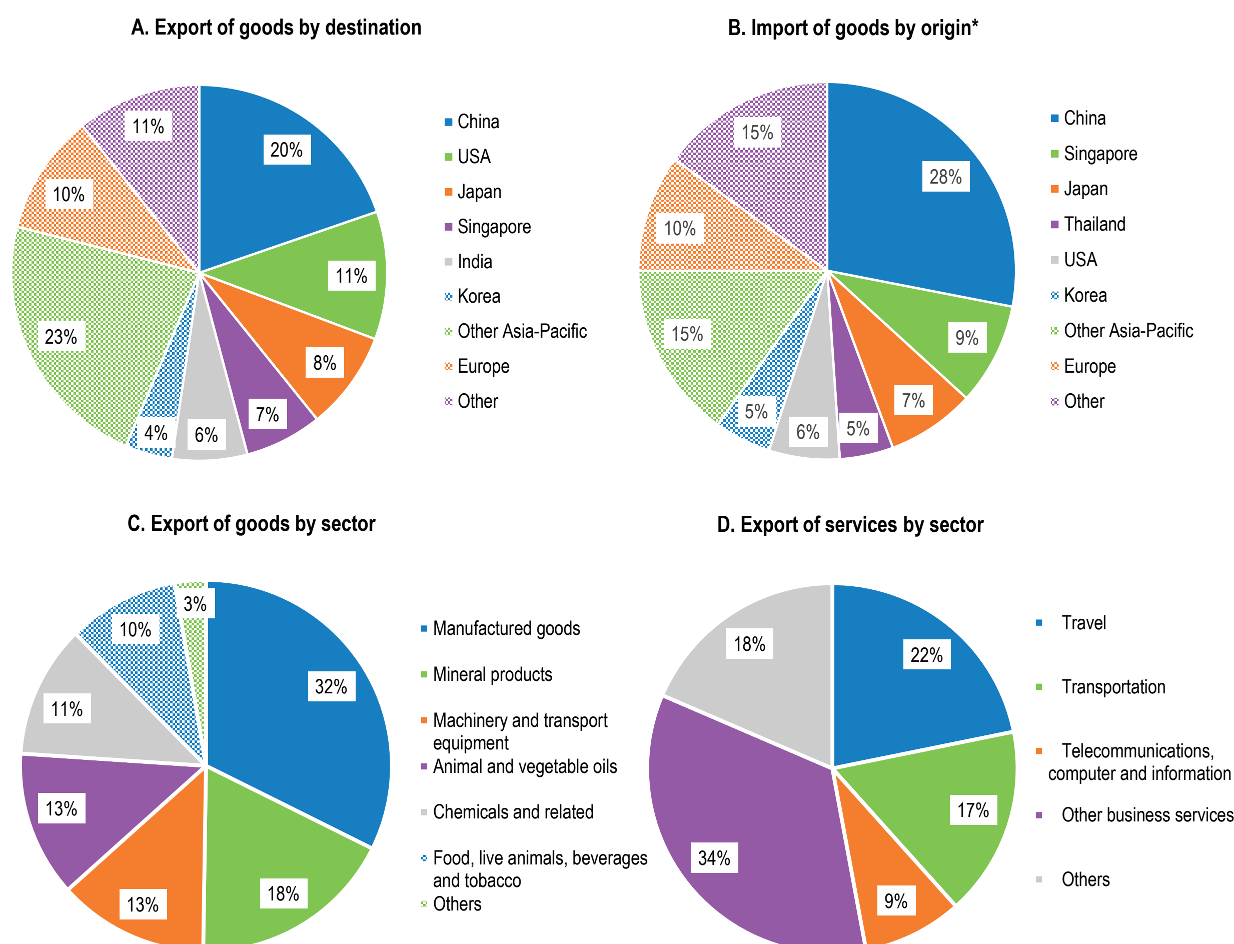
Figure 1.14. Northeast Asia is Indonesia's main trading partner

2019



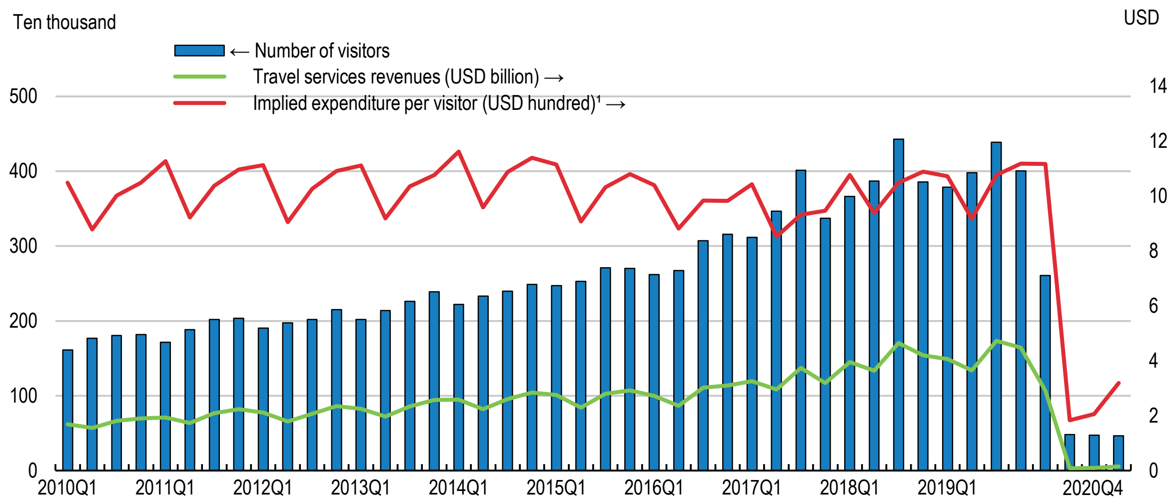
Note: Panel B: Data do not include shipments to the Batam free trade area. Panel C: Other include Miscellaneous Manufactures Articles; Optical, Photographic, Musical Instruments; Works of Art, Antiques Special Provisions; Arms and Ammunition; Parts & Accessories. Panel D: Other business services include Government Goods & Services; Construction; Financial Services; Manufacturing; Maintenance & Repair; Personal, Cultural and Recreational Services; Intellectual Property; Insurance and Pension Services.
Source: CEIC; IMF Balance of Payments database.

Tourism is deeply in crisis due to COVID-19

The pandemic was dramatic for the tourism industry, which in Indonesia contributes to around 4% to GDP. Tourist arrivals in January-October 2020 were 72% lower than during the same period a year earlier; with most international visitors coming from neighbouring countries (Timor Leste and Malaysia) on day trips and spending little in Indonesia, receipts were down 75% through September (UNWTO 2020). Travel corridor arrangements have been concluded with the United Arab Emirates, Korea, and Singapore. Domestic travel restrictions have been progressively eased since May, but those on international visitors have been extended (until February at the time of writing). Quarterly revenues, which in 2019 were on average around USD 4.2 billion, plunged to USD 88 million in the second quarter of 2020. Average spending per international visitor also nose-dived (Figure 1.15). The official target of increasing revenues from USD 16.9 billion in 2019 to USD 30 billion in 2024 was revised to around USD 22 billion. The sector

was among the first beneficiaries of aid, in the form of subsidies, tax cuts and accelerated cash-transfer and unemployment benefit programmes in major destinations. A second support package was announced in October. The first-order priority is to restore the international appeal of the country's traditional destinations, such as Bali and Lombok, even if this means slowing down the ambitious 10-New-Balis project. But even in this post-crisis context, past recommendations to upgrade the tourism offer and enhance the sector's development impact remain relevant (Table 1.5).

Figure 1.15. Mobility restrictions are hitting tourism hard



Note: 1. Implied expenditure per visitor is computed by dividing the travel services revenues on the number of visitors in the same time interval.
Source: Bank Indonesia; CEIC.

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Table 1.5. Past recommendations related to tourism

Recommendations in previous *Surveys*	Action taken since the 2018 *Survey*
Government planning	
Give more prominence to revenue-based targets for tourism in future plans.	Presidential Regulation No, 18/2020 on Medium-term National Development Planning 2020-24 shifts the focus of tourism development from mass to quality tourism and sets foreign exchange receipts as the main operational target for the next five years.
Better interconnect government plans across sectors, in particular ensuring coherence between tourism, transport and environment policy.	Bappenas and other ministries are preparing the Integrated Tourism Master Plan (ITMP) for six priority destinations (Lake Toba, Borobudur, Lombok, Labuan Bajo, Wakatobi, and Bromo-Tengger-Semeru). The Ministry of Tourism and the Creative Economy (MoTCE) is preparing the ITMP for Manado-Likupang, Bangka Belitung, Raja Ampat, and Morotai. Implementation will involve 17 line ministries/government agencies, SOEs, tourism authorities, local government, and the private sector. ITMPs include protocols on Environment and Social Management Framework and capacity-building activities for local government.
Incorporate expected tourism growth in all government planning, notably in the expansion of waste and water infrastructure and of broadband Internet.	Tourism nowadays is considered a priority sector for national development and all stakeholders are expected to contribute, including through implementation of the CHSE (cleanliness, health, safety, and environment) campaign.
Develop destination management plans, and establish destination management organisations in all strategic tourist areas. Adjust the size of destination areas covered by management plans to better balance management costs and local tourism linkages.	No action.
Local areas	
Incorporate needed infrastructure in forthcoming destination management plans to ensure sustainable development of tourism.	The Tourism Development Program is outlined in the Integrated Infrastructure Development for National Tourism Strategic Areas (Indonesia Tourism Development Project, ITDP). MoTCE collaborates with the World Bank to implements ITDPs in Toba Lake, Borobudur, and Lombok.
Create a small tourist tax on accommodation nights to fund local governments.	Law No. 28/2009 concerning Regional Taxes and Levies is under revision and taxes on housing rentals for tourists might be collected by local governments.
Build tourist service centres to promote local businesses, provide trusted information for tourists and offer specific services like free internet and ATMs.	MoTCE has DAK activities, including the development of a TIC (tourist information centre). The number of recipient regions has gone from 302 in 2018 to 331 in 2019.
Expand technical support to local governments on how to prepare tourism projects.	ITDP provides a framework for technical assistance.
Finalise the tourism satellite account update, and collect more detailed information at the regional level.	No action.
Labour and entrepreneurship	
Expand vocational and on-the-job training to build tourism-related skills in the workforce, especially in areas with skills shortages.	Presidential Regulation No, 18/2020 on Medium-term National Development Planning 2020-24 includes tourism among priority sectors for vocational education and training (TVET) development.
Increase interaction between high-level institutions and employers to better monitor missing skills and design appropriate curricula.	FKLPI (Forum Komunikasi Lembaga Pelatihan dan Industri) has been established to facilitate interactions between government, business and training institutions.
Further ease access to finance for female entrepreneurs.	No action.
Increase capacity building for firms by developing online applications and training, to facilitate start-ups and help them tap into foreign markets	No action.
Environment	
Increase the coverage of protected areas, and consider opening more for tourism use, but with visitor controls including regulations, and appropriate user and concession fees.	The Ministry of Environment and Forestry and other government bodies are working together to use protected areas as tourist destinations.
Take social and environmental impacts into account when selecting tourism-related infrastructure projects.	The Directorate of Nature, Culture and Man-Made Tourism refers to the MoTCE Regulation No. 14/2018 in its planning activities.

Improvements are needed to seize the opportunities of foreign investment and trade agreements

Indonesia has stepped up its economic diplomacy to gain favourable access into important markets. It is part of the Regional Comprehensive Economic Partnership (RCEP), combining ASEAN, Australia, China, Japan, Korea, and New Zealand – an area that represents 30% of the world's population and GDP and a quarter of trade flows. The RCEP, concluded in late 2019, was signed in November 2020. Moreover, the Indonesia-Australia Comprehensive Economic Partnership Agreement (CEPA) has been effective since 5 July 2020 and the CEPA with Korea was signed in December 2020, while negotiations are underway with the European Union and EFTA (European Free Trade Association). These are promising developments for Indonesian exporters and indeed for the whole economy (Petri and Plummer, 2020), but must be accompanied by public-private efforts to improve product quality, certification, branding, logistics, and the payment system, among other things.

Indonesia has made some progress with regard to the quality of infrastructure, as evidenced by the Global Competitiveness Report (WEF, various years), its ranking going from 102nd in 2007 to 70th in 2019. However, for logistics more generally Indonesia marginally slid from 43rd to 46th in the Logistics Performance Index (World Bank, various years), while road traffic casualties and sea transport incidents are the highest in Southeast Asia (WHO, 2018c; IMO, 2020). In 2014-19, the focus of public investment was on extending the road network and completing more than 50 irrigation reservoirs, mostly in peripheral regions. A massive USD 412 billion infrastructure programme is to be executed by 2024, with private investors expected to contribute for 35% of the sum through public-private partnerships (PPP). This goal requires making the PPP bidding process more transparent, enhancing the bankability of projects, setting tariffs at realistic levels that allow cost recovery, factoring in any possible contingent liabilities, and streamlining land acquisition procedures.

Opportunities and obstacles to investing and operating in Indonesia are analysed in greater depth in the recent OECD *Investment Policy Review of Indonesia* (OECD, 2020b). Restrictions on FDI remain among the highest in the G20 (Figure 1.16). Many of them could be removed without limiting policy space or jeopardising national security. The business environment is challenging and makes foreign investors cautious, depriving Indonesia of the many benefits of FDI, such as modern technologies and organisation practices, access to world markets, and better working and environment conditions. The Omnibus Bill on Job Creation, approved by Parliament in October (see Box 1.3), may improve the situation, in particular insofar as it provides for replacing the so-called negative investment list with a new and much shorter list of six sectors closed to foreign investors (controlled drugs, gambling, catching endangered fishes, harvesting of corals, manufacturing chemical weapons and industrial chemicals). The concrete realisation of this intent is conditional upon the enactment of implementation rules that fully respect the spirit of the Omnibus Law. Overlapping and complicated regulations affect export-oriented industrial parks and prolong dependence on government subsidies. The private sector should be allowed to promote and operate such parks, as their involvement produces better results than the current model of SOEs-led development. The *Investment Policy Review* also suggests to promote and enable responsible business conduct (RBC), notably in light of the heavy social impact COVID-19 has had on Indonesia's manufacturing sector. RBC standards, such as the OECD Guidelines on Multinational Enterprises, are becoming a norm in the global markets and can provide a useful framework to help stakeholders avoid making harmful unilateral decisions.

Box 1.4. The omnibus laws

In Indonesian legal parlance, omnibus laws designate laws that aim at reforming multiple laws and regulations in broad policy areas. The Omnibus Bill on Job Creation was passed by Parliament on 9 October 2020 and signed into law on 3 November.

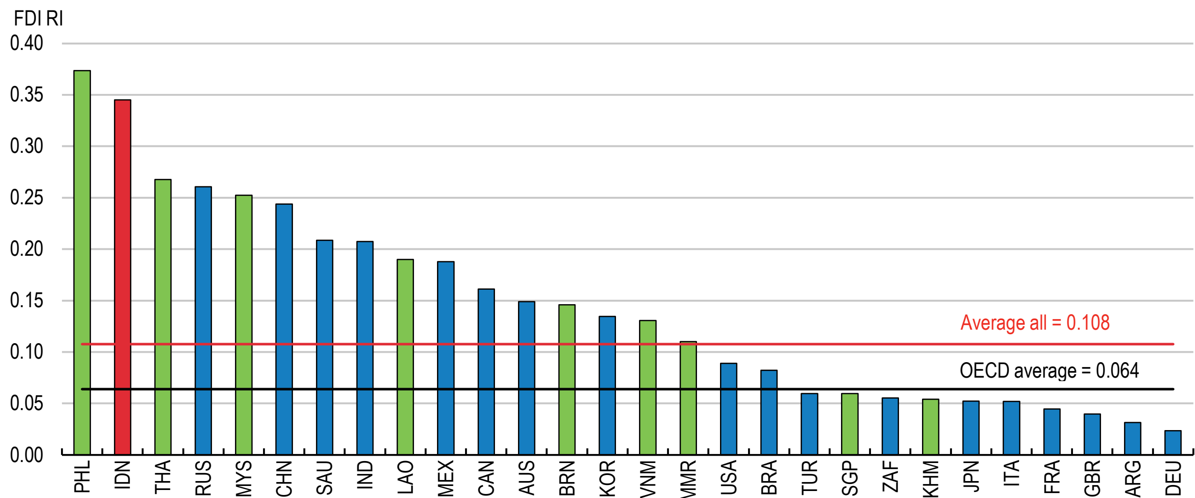
The Omnibus Bill on Job Creation, with 186 articles, amends 79 laws and eliminates thousands of regulations in ten main areas, including labour reform, ease of doing business, investment, tax, and land procurement. The main provisions include:

- Reduction of the severance payment liability to a maximum 19 months of salary (from 32);
- Addition of up to six months, covered by the government in the form of job loss insurance, that also includes access to training and job market/opportunities;
- Reformulation of the minimum wage to take into account variables such as GDP growth and/or inflation;
- Updated regulations on outsourcing and contract work;
- Establishment of a land bank that will ease management and redistribution land according to its rightful usage/owner;
- Simplification of business registration requirements to take into account the level of risk (in particular, only high-risk investments shall be subject to environmental impact studies);
- Clarification of the respective role of local (i.e. provinces and municipalities) and central governments in the processing of investment permits;
- Abolition of existing restrictions on foreign investment, except for a Negative List comprising six sectors (narcotics, gambling, chemical weapons, ozone-depleting substances, coral extraction and fishing activities for endangered species);
- Amendment of provisions of the Income Tax Law, the VAT Law and the Law on General Provisions and Guidelines on Tax.
- Creation of a sovereign wealth fund, with a view to draw in foreign entities as co-investors in infrastructure projects.

The implementing regulations are being drafted. In particular, Presidential Regulation No. 10/2021 stipulates the industries included in the priority investment list and the six prohibited sectors. Government Regulation No. 7/2021 obliges government and regional administrations to allocate 40% of their procurement budget for small businesses. Government Regulation No. 34/2021 provides easier terms regarding the employment of foreign workers.

Figure 1.16. Pervasive statutory restrictions discourage foreign direct investment

OECD FDI Regulatory Restrictiveness Index, 2019 (open = 0; closed = 1)



Note: The FDI Regulatory Restrictiveness Index (FDI Index) measures statutory restrictions on foreign direct investment in 22 economic sectors across 69 countries, including all OECD and G20 countries. Countries in blue are G20; countries in green are ASEAN.
Source: OECD the FDI Regulatory Restrictiveness Index https://www.oecd.org/investment/fdiindex.htm.

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The fruits of growth should be shared

The government is committed to reach the "No One Left Behind" goal (Box 1.5). The overall thrust of policy actions is solidly anchored in the pursuit of the Sustainable Development Goals (SDGs). Indeed, Indonesia is one of the few countries that presented twice its Voluntary National Review, a country-driven monitoring of the SDGs (Republic of Indonesia, 2019a). This inclusive policy approach has been confirmed in the COVID-19 context.

Box 1.5. Indonesia's government key goals and policy priorities

In his October 2019 inauguration speech for his second term, President Jokowi set out a number of objectives to be reached by 2045, when Indonesia will celebrate a century of independence. They include:

- Increase GDP to reach USD 7 trillion (in 2011 PPP).
- Become one of the world's five largest economies.
- Eradicate poverty.
- Escape the middle-income trap and become an advanced country.

The 2019-23 medium-term priorities include:

- Building a workforce that is hard-working, dynamic, skilled, with a mastery in science and technology.
- Continuing infrastructure construction.
- Simplifying, cutting down on and trimming all forms of obstructive regulation.
- Improving the bureaucracy and reducing drastically the number of bureaucracy echelons.

- Achieving economic transformation.

Two interrelated and interdependent development policy documents frame the process:

- The National Long-Term Development Plan 2005-25 spelling out the vision and mission for the country.
- The National Medium-Term Development Plan, with four five-year periods, starting with 2020-24 and issued through Perpres No. 18/2020.

Source: Bappenas and Sekretariat Kabinet Republik Indonesia.

Progress in poverty reduction is challenged by the recession

Different indicators show the progress made in reducing poverty. The share of the population living below the national poverty line declined from 13.3% in 2010 to 9.3% in September 2019 (Figure 1.17, Panel A). Based on the international poverty line, 5.7% of the population lived in extreme poverty (below USD 1.90 per day in 2011 PPP) in 2019 and 27.3% lived in moderate poverty (below USD 3.2) (World Bank, 2020a). Nonetheless, the pace of poverty reduction on the international metric in 2011-18 (0.3 percentage points per year) was half as high of what was achieved between 2003 and 2010 (0.6 p.p. per year). The Multi-Dimensional Poverty Index, which also takes into account non-monetary dimensions of poverty (Alkire et al., 2019), shows a quick decline in both the headcount (from more than 34 million people in 2015 to 21.5 million in 2018) and the share of the population (from 13.5% to 8.2%) in multidimensional poverty (Aidha et al., 2020). This positive result was mostly due to improvements in living standards, rather than income gains, although major gaps persist in indicators such as access to water and sanitation or reliance on cooking fuel.

The COVID-19 crisis is exposing the fragility of recent advances. A fifth of the population, their income marginally hovering above the national poverty line, is considered highly vulnerable to shocks. They mostly work in the informal sector (which accounts for three-quarters of total employment, see Chapter 2), have scant savings and assets to weather adverse economic circumstances, and are not always reached by existing social programmes. In the early phase of economic slowdown, around 1.6 million Indonesians fell into poverty in the six months to March 2020 and the poverty rate (on the domestic measure) rose to 9.8%, with the biggest increase in Java (BPS, 2000 and World Bank, 2020a). Social containment measures, the recession, labour shedding, and the freezing of most tourism activities is pushing 1 to 10 million people back into poverty in 2020 (Yusuf, 2020). Hunger and malnutrition, that were already hitting about 22 million people in 2018 (ADB and IFPRI, 2019), have further increased (World Bank, 2020b).

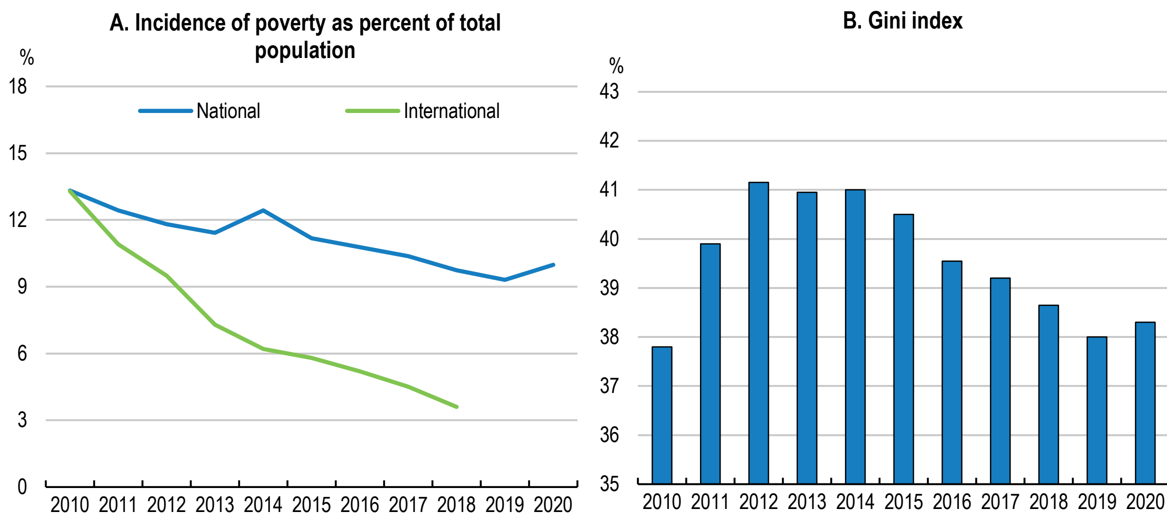
In response to the humanitarian crisis, Indonesia received official support from the Asian Development Bank (USD 2 billion) and the World Bank (USD 950 million for three projects, to some of which the Asian Infrastructure Investment Bank has been associated). Australia will provide an AUD 1.5 billion (USD 1.1 billion) loan, repayable over 15 years, to support the ADB-led COVID-19 Active Response and Expenditure Support Programme. Recognizing the crucial role that communities play in mitigating the socio-economic impacts of major shocks like the COVID-19 pandemic, the World Bank is implementing the Institutional Strengthening for Improved Village Service Delivery project, a community-driven development (CDD) operation that draws from a strong track record of moving funds quickly and flexibly in response to crises, such as the 2004 tsunami. Communities have indeed played an important role in organising the immediate response to the pandemic (Djalante et al., 2020), in some cases in parallel with group-based coping mechanisms such as the revival of seaweed farming in seaside destinations that saw tourists disappear (Al-Jaazira, 2020).

Income inequality declined since 2013 (Figure 1.17, Panel B), although it remains above the levels prevailing before the global financial crisis (World Bank, 2020a) and may well have increased again during the COVID-19 recession. While large-scale calamities historically cause labour shortages, which have a

"levelling effect" on income distribution (Scheidel, 2019), COVID-19 is likely to aggravate inequality. The pandemic has affected workers in the informal sector, increased unemployment, and depressed workers' remunerations (see Chapter 2). The crisis is also widening inequalities in access to education and health services, in particular in maternal and child health centres (*Pusyandu*).

The authorities have reacted to the social crisis, earmarking 29% of PEN resources to interventions such as basic food support, conditional cash transfers and the Village Fund. The coverage of the flagship Family Hope Programme (PKH, see OECD, 2019c) is being expanded from 6 million to 10 million families. It will be necessary to improve the programme's delivery systems and coordination with other initiatives such as the new Social Entrepreneurship programme that builds the business skills of former PHK beneficiaries.

Figure 1.17. Poverty and income inequality remain high



Note: Panel A. The national poverty line corresponds to the amount of money required to obtain 2 100 calories per day, along with a small amount for other basic non-food items. The international poverty lines is set at USD 1.90 in 2011 PPP on the basis of the poverty lines of the 15 poorest countries in 2005. Panel B. Inequality as measured by the Gini coefficient of the distribution of household consumption.
Source: BPS; World Bank, World Development Indicators.

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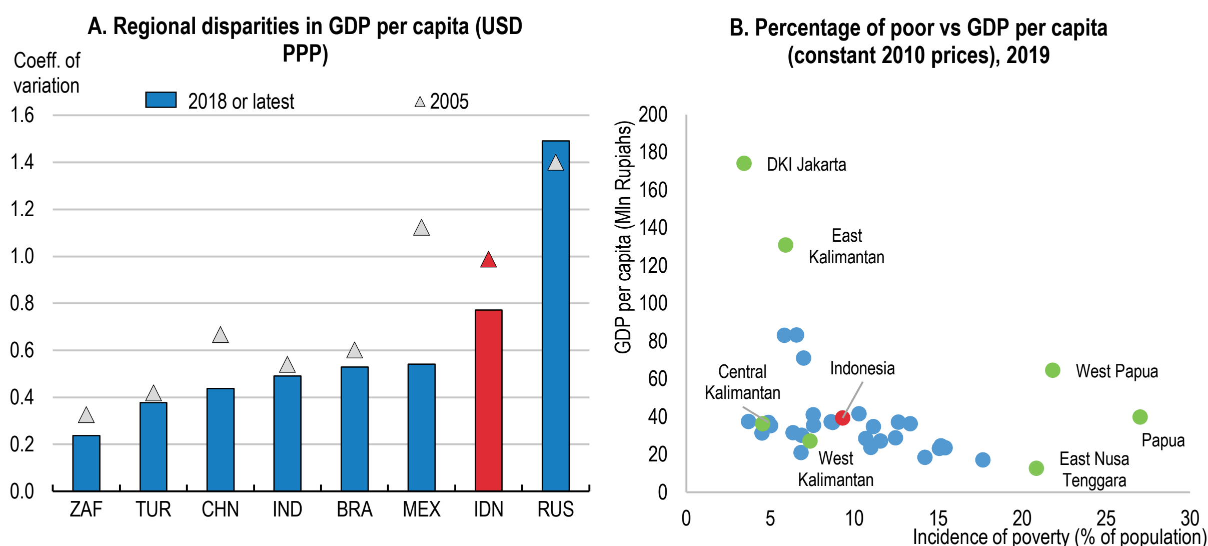
Regional disparities are considerable

Regional income disparities are higher than in most other G20 emerging market economies (Figure 1.18). The benefits of growth mostly accrue to urban areas, notably Jakarta, where GDP per capita is four times as high and the incidence of poverty five times as low as in the poorest province (East Nusa Tenggara). Inequality within locations has also increased, largely driven by disparities in human capital, insufficient housing and lack of spatial integration.

Figure 1.18. Regional disparities are high with pockets of deep poverty in the poorest provinces



Source: OECD Regional Economy database; and Statistics Indonesia.

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While metropolitan areas around the world have seen the fastest growth in the share of the middle class, in Indonesia urbanisation, compared to peer countries, has generated fewer benefits (Roberts et al., 2019). All urban areas in East Asia face heavy congestion costs, but in Indonesia the potential benefits of agglomeration in terms of productivity are not fully achieved due to low levels of infrastructure, competencies and skills.

Economic decentralisation is therefore an important policy goal, as indicated by the 26 August 2019 announcement by President Jokowi to build a new capital in Kalimantan “for the sake of realising an equitable and just economy”. The move is meant to address the problems building up in Jakarta over the years: declining air quality, sinking seawalls, polluted groundwater, and heavy congestion. The Government estimated the move to cost USD 34 billion, of which 55% provided by SOEs, and to occur in 2024. Pre-COVID, this timetable seemed optimistic in view of the global experience with transferring capital cities: in Korea, for instance, the new administrative capital, Sejong, was founded in 2007, five years after the proposal was first made, and the first ministries relocated there only in 2012. In any event, the Indonesian project has been put on hold as a consequence of the pandemic.

Selected well-being indicators point to tenuous improvements that will dissipate during the recession

Over the past two decades, well-being has improved on the whole with respect to health, housing and gender balance. However, major challenges remain and the pandemic recession is adding further pressure, notably on the poor and other groups.

Life expectancy at birth increased by more than five years and a half between 2000 and 2018, to 71.3 years; according to the WHO Global Burden of Disease project, years of healthy life lost due to communicable, maternal, neonatal, and nutritional causes decreased by 58.6% (Mboi et al., 2018). On the other hand, those lost from non-communicable diseases (like ischaemic heart disease, cerebrovascular disease and diabetes) rose. Nearly 70% of adult men smoke, one of the highest rates in the world, and tobacco is held responsible for one out of seven deaths (WHO, 2018b). Dietary risks are also rising: obesity grew at the fastest rate in Asia in 2000-16, from 2.6% to 6.9% of the population (FAO, UNICEF, WFP and WHO, 2019).

The COVID-19 emergency cannot hide the prevalence of other diseases such as tuberculosis (around 1 million cases per year), HIV/AIDS (transmission rate is at an all-time high), malaria (223 468 cases in 2018), and dengue (the incidence rate has increased almost every year since the first case was detected in 1968) (Harapan et al., 2019). It is important to maintain efforts to curb these diseases, which are disproportionally affecting the poor. The most effective way to fight the pandemic without sacrificing hard-won progress in other areas is to provide differentiated, patient-centred care. Access to healthcare should be made more responsive and efficient by telemedicine, drug delivery services, and remote drug dispensing systems as well as more investment in education and prevention.

More than 30% of urban Indonesians live in precarious housing conditions (World Development Indicators). Out of approximately 64 million housing units in Indonesia, around 20% are in poor condition (World Bank, 2017). In addition to the need of renovating low-quality housing, up to 1 million new units are needed each year to respond to pressure from population growth, new household formation and internal migration.

The 2011 housing law requires at least 20% of newly-built apartments to be affordable, whereas the *Satu Juta Rumah* (One Million Homes) programme was launched in 2015 to build 1 million houses per year. Unfortunately, vacancy rates are high, since subsidised housing is disproportionally found in rural areas, far from employment opportunities, and is of poor quality (van Doorn et al., 2020). Since August 2019, financial institutions can offer mortgages to first-time buyers without taking a down-payment. BI also eased the rule that forbade banks from lending to build houses for which construction had already begun. A combination of regulatory requirements and incentives could be used to promote the construction of higher-density, resource-efficient houses.

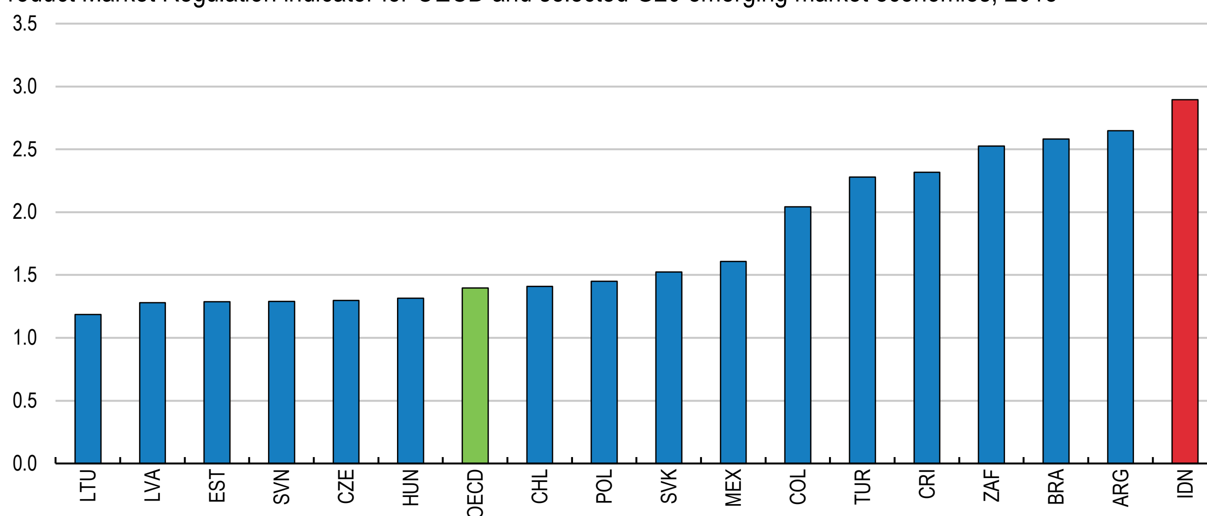
Indicators of gender balance point to strident gaps in opportunities and outcomes – Indonesia ranks 85th out of 153 countries in the *Global Gender Gap Report* (WEF, 2019). Women are disproportionally affected by the current crisis, with extra burden of unpaid work (including care-giving), massive layoffs in female-dominated service sectors, such as retail and tourism, and light manufacturing, such as clothing. When restrictions ease, female commuters are also more exposed to the risk of infection because they are more frequent users of public transports than men; in addition, poor women have less access to hospitals and are more likely to visit community health centres (Setyonaluri and Samudra, 2020). Better employment and career progression opportunities for women should be promoted, especially through actions that generate benefits that are not necessarily gender-specific such as enhancing childcare quality, supporting better work-life balance, and facilitating return to work after career breaks. During the COVID-19 confinement and the recession, an increase in reports of domestic violence has been recorded (Komnas Perempuan, 2020). Developing a culture of gender equality is important to fight abuse and efforts to move forward with the bill on sexual violence that has been in the making since 2015 should be stepped up.

Regulatory barriers are high and State-owned enterprises ought to lead by example

The 2018 OECD Product Market Regulation (PMR) indicators show that Indonesia maintains very high barriers to firm entry and competition (Figure 1.19). For most dimensions of state involvement and business operations, Indonesia is either the least competition-friendly country or close to it (Figure 1.20). In particular, retail price controls and command and control regulation (i.e. coercive rather than incentive-based regulation or reliance on markets) in both network and service sectors are used more extensively, while the public procurement framework is less competition-friendly. The exception is the administrative burden on start-ups – which is light and has supported the emergence of a vibrant business scene (World Bank and IFC, 2019), notably in ride-hailing. With no significant risk to consumers, it would be possible to shift the burden of proof from the regulated to the regulator – as in Korea, where around 2 000 regulations were found to be unnecessary (OECD, 2020d).

Figure 1.19. Indonesia has very strict regulations on product markets

Product Market Regulation indicator for OECD and selected G20 emerging market economies, 2018



Note: OECD average refers to the simple average of 37 OECD member countries.
Source: OECD Product Market Regulation database.

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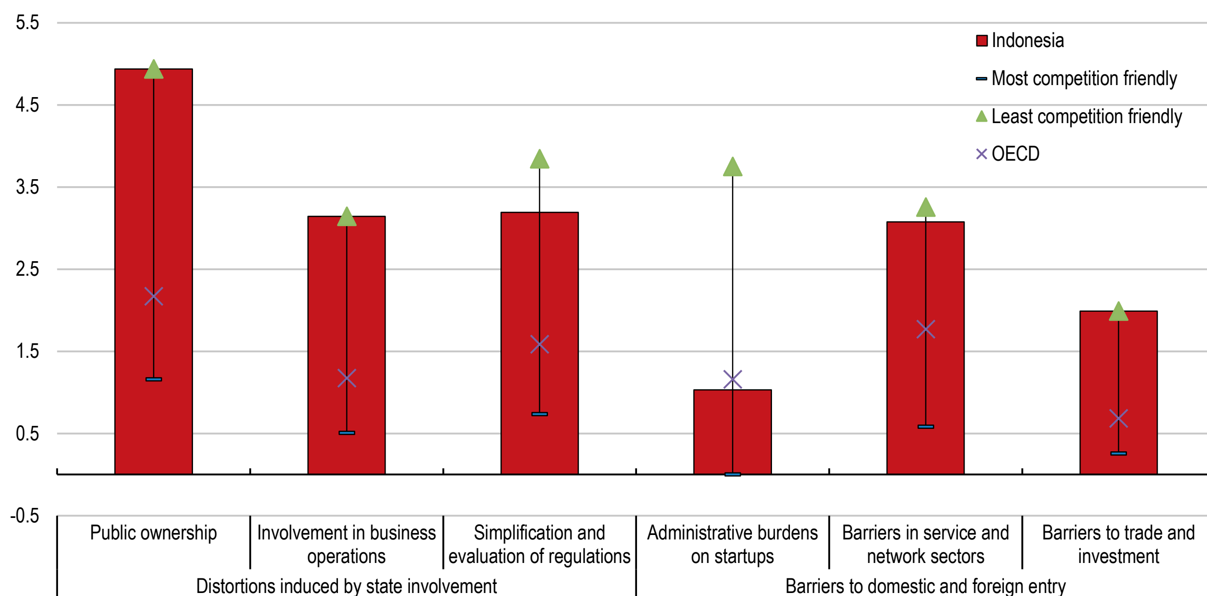
Figure 1.20. Indonesia's regulatory barriers to competition are very high

Index scale 0 to 6 from most to least competition-friendly regulation, 2018



Note: OECD average refers to the simple average of 36 OECD member countries, excluding USA; most and least competition-friendly among all countries for which data are available.
Source: OECD Product Market Regulation database.

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State-owned enterprises are omnipresent and powerful

The vast scope of activities performed by SOEs and the market power they exercise are captured in the PMR public ownership sub-index, which is almost twice as high as the OECD average. It reflects the wide presence of SOEs across the economy, the existence of special voting rights by the government in privately owned firms, the tight constraints on the sale of government stakes in publicly-controlled firms, and a comparatively high level of government involvement in network sectors through its control of incumbent firms.

In general, SOEs dominate the industry in which they operate, and it is not unusual for the main challengers to also be SOEs. For example, in the special fuel retail sector, Pertamina's market share was 96% in 2016 (Kim, 2018), while State-owned banks account for 40% of banking assets (IMF, 2020). In infrastructure like water, toll roads, ports and airports, SOE domination is absolute. Bio Farma is the only vaccine and serum manufacturer in Indonesia. SOEs are generally exempted from antitrust policies when their market power is connected to the pursuit of national development objectives (Siswanto and Janpieter Hutajulu, 2019). This exception weakens the principle of competitive neutrality under which private businesses manage to compete with SOEs, in particular in new markets such as logistics (OECD, 2020i). Moreover, tier I SOEs (i.e. directly controlled by the government) own a vast array of direct and indirect subsidiaries – 49 in the case of Telkom, while Pertamina has subsidiaries in air transport, property development and health care. It is in the public interest to subject SOEs to standard competition law and to require SOEs to justify the business logic of unrelated diversification.

Over the past two decades, SOE rationalisation has become an important policy objective, although progress has been limited by the provisions in the 1945 Constitution (art. 33) regarding government control. After the global financial crisis, the authorities announced the intention of “rightsizing” SOEs from 139 to 25. Yet, there were 114 central government SOEs at end-2019 (although the tally is higher, at 142 plus 782 provincial SOEs, according to World Bank and IFC, 2019). Most sell-offs in the 2000s were partial, leaving the state in control of companies that account for a quarter of stock market capitalisation and creating a lingering tension between the government’s emphasis on using SOEs to promote non-market, socio-economic objectives (and resorting to subsidies and soft loans to that effect) and private investors’ focus on financial metrics.

In general, SOEs have managed to pursue their plans despite minority shareholder dissatisfaction with the shift in corporate goals towards non-financial objectives (Kim, 2019). SOEs have been assigned a prominent role in infrastructure investment and are highly leveraged (ADB, 2018). The ensuing fiscal risks are not confined to government-guaranteed loans, but include the potential need for capital injections. Minority shareholders (often foreign institutional investors) can improve financial and accounting standards and governance practices, for example in demanding transparent criteria for recruiting top managers and board members. Still, the government has sometimes delayed compensating SOEs for performing public-service obligations (Fitch Ratings, 2020) and political interferences in corporate appointments remain (Apriliyanti et al., 2020). While some progress has been achieved in the past few years, in particular with respect to managerial appointments, stricter application of global standards such as the *OECD Guidelines on Corporate Governance of SOEs* would guarantee that public resources are always and solely used in the pursuit of public goals. Banking supervisors should be particularly vigilant regarding credit quality of new loans from public banks to SOEs.

Reform is all the more necessary because the financial and operational performance of SOEs has experienced a trend deterioration in recent years (Khatri and Ikhsan, 2020), which the current crisis is further aggravating. The gross combined debt of SOEs increased to 7.3% of GDP in March 2020 from 4.7% two years earlier (Fitch Ratings, 2020). In addition, several SOEs are operating with high debt-to-equity ratios, creating contingent fiscal risks that are not adequately covered. In the PEN programme, the government has allocated IDR 318 trillion (USD 21 billion) to public enterprises through capital injections, state guarantees and other support. An additional IDR 37.38 trillion (USD 2.5 billion) in capital injections

for SOEs has been budgeted for 2021, some of which will be used to resolve the investment mismanagement scandal involving state insurer PT Asuransi Jiwasraya. These intervention follows Krakatau Steel's debt restructuring in January 2020 and the default of Perumnas, a developer of affordable housing.

The SOE Ministry intends to continue consolidating SOEs and their odd 800 subsidiaries. Following the establishment of PTPN as the holding company of 14 national plantation firms, in mid-2020 consolidation in the pharmaceutical and insurance sectors reduced the number of SOEs to 107. Going forward, the government expects to group Pertamina's subsidiaries into specialised sub-holdings and list two of them (for upstream and marketing) by 2022. Plans have also been announced to rationalise SOEs in micro-lending and sharia banking and to list Telkom's tower subsidiary. Given the potential gains from consolidation – such as reinforcing and bringing together competencies on key matters, such as financial reporting or board nomination, or avoiding extreme competition among SOEs that operate under a soft budget constrain – the strategy could be extended to other sectors. But for such efficiency gains to materialise, it is indispensable that the financial situation of individual SOEs is presented in full transparency (OECD, 2018a). Progress on the recommendations made in previous *Surveys* has been uneven (Table 1.6).

Table 1.6. Past recommendations regarding SOEs

Recommendations	Actions taken
Develop an ownership policy to guide the process of listing more SOEs.	No action.
Give clear mandates to boards, with sufficient independence to achieve them, and appoint board members in transparent nomination processes with limited political interference.	The SOEs Ministry has reinforced application of Regulation No. PER-03/MBU/02/2015 that spells out qualification requirements and dismissal procedures for SOEs' directors.
Strengthen supervision by line ministries.	No action.
Pay greater attention given to the implicit risks stemming from SOE losses and rising debt.	The SOEs Ministry has encouraged asset securitization, debt reprofiling, and stronger risk management and governance practises.

Public procurement practices can be improved

Public procurement represents a third of the budget and is essential to kick-start the recovery, provided certain conditions apply regarding transparent contracting for goods and services, as well as licensing and budget allocations. In fact, full disclosure remains somewhat elusive (OGP, 2019) and cases under this rubric dominate investigations handled by the Corruption Eradication Commission (Komisi Pemberantasan Korupsi, KPK). The costs are huge, in terms of prices paid, delivery times and project quality. Moral hazard and adverse selection are additional concerns: in a corrupt public procurement system, good companies are discouraged from bidding.

The National Public Procurement Agency (LKPP) was established in 2008 and operates under Bappenas. Despite limited resources (OECD, 2016), its record in making tender and bidding processes more transparent is largely positive. The launch of an electronic procurement system in 2009 has lowered the risk of fraud and corruption by limiting one-to-one interactions between buyers and sellers (ADB, 2016). Nonetheless, procurement remains highly vulnerable to bribe solicitation, conflicts of interest, cronyism, trading in influence and insider information, and bid-rigging. Benefits would accrue from the introduction of a number of well-tested procedures, such as the opportunity to comment on procurement-related regulations and proposed tenders, notification to losing bidders and a description of why they lost, and an independent review mechanism (Transparency International-USA and Center for International Private Enterprise, 2011).

These issues acquire renewed relevance in the context of the PEN programme. Particular caution is needed in interpreting Article 27 of Perppu 1/2020, which stipulates that any emergency expenditures be considered "economic costs to save the economy from crisis" instead of state losses (which under the Anti-

Corruption Law is one of the key elements for an action to be deemed a corruption offence). The article also grants immunity to government officials as long as they act in “good faith and according to the law”. This legal concept is also used in other jurisdictions and it is generally agreed that it should be clearly and unambiguously defined.

Subsequent alleged cases of corruption by public officials responsible for COVID-19 emergency procurement have exacerbated these concerns. Procurement regulation provides for streamlined procedures, such as direct contracting and force account work, in emergency situations, which LKPP further elaborated during COVID-19 to emphasise the need for expediting urgent requests. While direct awards seem an efficient solution for procuring specific goods, services, and works, public procurement entities should take extra care: limit direct awards only to current, urgent and unforeseeable needs, ensure that there really is only one qualified supplier, and phase out emergency procedures and contracts as needs become foreseeable (OECD, 2020c).

The fight against corruption requires an independent KPK

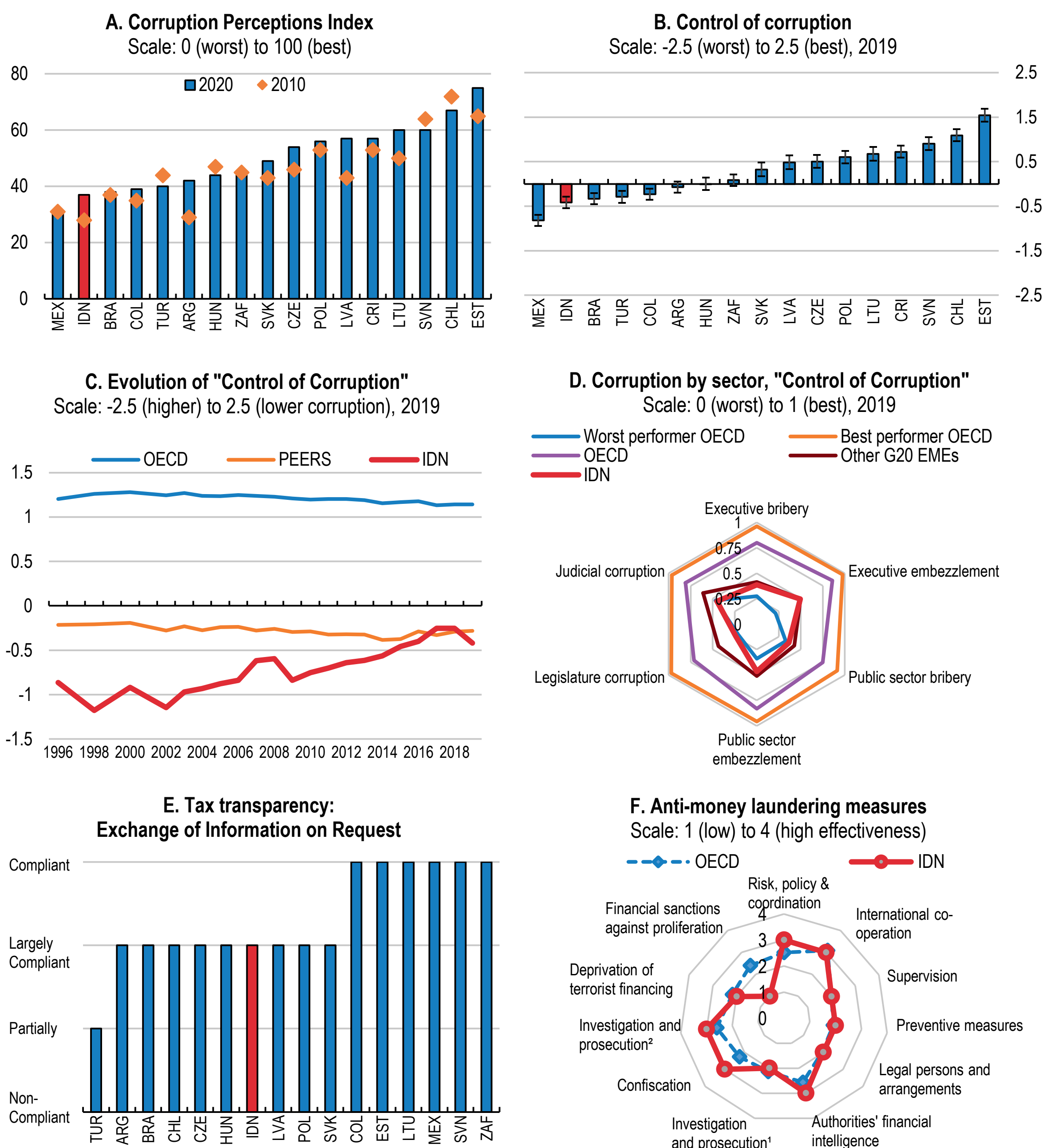
Corruption in the public sector is perceived to remain a major hurdle to development (Figure 1.21), it deters foreign investment and the COVID-19 emergency raises new challenges related to transparency and integrity (KPK, 2020). Recent governments have put great emphasis on fighting corruption and significant progress has indeed been made (Panel C). Recently, Presidential Decree No. 54/2018 outlines a national strategy to prevent corruption and some monetary incentives to report wrong-doing have been put in place by the Ministry of Law and Human Rights (Government regulation on public participation in the prevention and suppression of corruption, No. 43/2018).

The KPK was established in 2002 and has built a solid reputation after achieving an almost 100% conviction rate in its first 13 years of existence (Centre for Public Impact, 2016), before registering the first acquittal in July 2019. The entity reckons to have avoided IDR 63.8 trillion (USD 4.52 billion) in potential losses in 2016-19. At mid-2020, 274 national and regional parliamentarians, 28 Ministers, 21 Governors, and hundreds of high-ranking civil servants and managers had been successfully prosecuted. The KPK and the Anti-Corruption Court (ACC), established in 2003, have fought attempts to discredit and hobble them (Butt, 2011; OECD, 2016). A recurrent argument is that all state agencies need oversight, checks, and balances and that the KPK should be no exception.

In 2019, Parliament unanimously approved Law No. 19/2019 that transforms the KPK into an executive agency, rather than an independent authority, and places the Commission under the oversight of a supervisory board, which will authorise its most crucial activities, such as wire-tapping, searches and seizures. Subjecting the KPK to executive oversight and depriving it of law enforcement tools and prosecutorial power, as well as recruitment independence, has been criticised as a move to weaken its ability to investigate and prosecute graft. Furthermore, the establishment of 33 new ACCs, one in each provincial capital, has the potential to undermine their future efficacy (Butt, 2019). The new legislation appears to deviate from international standards (Buehler, 2019; Schütte, 2019; OECD, 2020j) and extreme care is needed to avoid making the Commission more vulnerable to pressure.

Indonesia, which ratified the UN Convention against Corruption (UNCAC) in 2006, should criminalise the bribery of foreign public officials and enact corporate liability for corruption offences as a Party to UNCAC and a G20 member. These legislative changes would address key criteria for accession to the OECD Convention on Combating the Bribery of Foreign Public Officials in International Business Transactions (the Anti-Bribery Convention). Policies and actions to raise awareness in SOEs on business ethics, conflicts of interest, bribery and lobbying should be extended to the private sector, in particular among SMEs.

Figure 1.21. Corruption is still perceived as high



Note: Panel B shows the point estimate and the margin of error. Panel D shows sector-based subcomponents of the "Control of Corruption" indicator. Panel E summarises the overall assessment on the exchange of information in practice from peer reviews by the Global Forum on Transparency and Exchange of Information for Tax Purposes. Peer reviews assess member jurisdictions' ability to ensure the transparency of their legal entities and arrangements and to co-operate with other tax administrations in accordance with the internationally agreed standard. The figure shows the results from the second round of peer reviews. Panel F shows ratings from the FATF peer reviews of each member to assess levels of implementation of the FATF Recommendations. The ratings reflect the extent to which a country's measures are effective against 11 immediate outcomes. "Investigation and prosecution[1]" refers to money laundering. "Investigation and prosecution[2]" refers to terrorist financing. In panels C and D, other G20 EMEs include Argentina, Brazil, China, India, Mexico, Russia, Saudi Arabia, South Africa, and Turkey.
Source: Panel A: Transparency International; Panels B & C: World Bank, Worldwide Governance Indicators; Panel D: Varieties of Democracy Institute; University of Gothenburg and University of Notre Dame; Panels E and F: OECD Secretariat's own calculation based on the materials from the Global Forum on Transparency and Exchange of Information for Tax Purposes; and OECD, Financial Action Task Force (FATF).

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The KPK and the Elections Supervisory Agency have warned about policy capture risks, as many candidates depend on private donations, and potential vote buying in regional elections, as voters suffer from financial hardship (Bawaslu and KPK, 2020). A comprehensive framework for managing conflict of interest and preventing undue influence through lobbying should set clear definitions for “lobbyists” and “lobbying” and regulate private donations to candidates, as well as the engagement of elected officials with lobbyists and other third parties who seek to influence the legislative process. It remains crucial to protect the policymaking cycle from undue influence and capture by implementing standards for integrity in lobbying and managing conflict of interest situations (OECD, 2015).

A greener post-COVID-19 Indonesia?

Indonesia’s recent economic development, population growth and rising living standards have combined to increase demand for land, energy, water, and other natural resources, as well as to put pressure on the environment. As one of the world’s largest greenhouse gas emitters, Indonesia also plays an important role in addressing climate change. While it is far too early to draw firm conclusions, available data suggest a deterioration of the environment during COVID-19. Independent estimates based on Landsat satellite imagery suggest that the forest surface lost to burning rose dramatically as budget reallocations and travel restrictions hit the agencies in charge of fire prevention and impoverished farmers and return migrants turned to illegal activities, including gold mining and logging (Margono et al., 2014 and WWF Deutschland, 2020). The pandemic has produced a surge in pollution from disposable products, which coincided with a reduction in the number of formal workers and informal waste pickers in the plastics recycling chain. On the other hand, as long as mobility restrictions were in place, greenhouse gas (GHG) emissions dropped and air quality in cities improved, although the impact was only temporary (Rossita, 2020). Indonesia is the second largest plastic polluter after China and in mid-2020 the government announced its intention to cut plastic waste by 70% by 2025, and cut it entirely by 2040 – the most ambitious national plan to tackle plastic pollution anywhere. The ban on single-use plastics was introduced in mid-2020 in Jakarta and it is too early to assess its impact.

Climate change mitigation

Progress in decoupling GHGs emissions from economic growth has been substantial (Figure 1.22, Panel A), driven by the decline of energy-intensive industries, the switch to services, and higher penetration of cleaner forms of energy sources, although it recently slowed down. Low-carbon action was streamlined in the National Medium-term Development Planning 2020-24 (OECD, 2019b). The Nationally Determined Contribution target to reduce GHG emission levels from business-as-usual by 29% by 2030 (or even 41% with international support) is ambitious (Bappenas, 2019). As in any other major economy, including ones that are much richer than Indonesia, decarbonisation is a tough challenge. Although energy productivity has increased, Indonesia remains very carbon-intensive due to high reliance on fossil fuels across all sectors and recent addition of coal-fired capacity. Despite the 2015 reform, in 2019 fossil fuel subsidies equalled 1.7% of GDP, the second-highest incidence in the G20 (IEA, 2020). In the wake of the COVID-19 crisis, low oil prices may generate further headwinds to the energy transition. Authorities should double down on efforts to move away from fuel subsidies and, considering the close link between the carbon content of fuels and the associated CO_2 emissions, increase the carbon price.

Policy coherence, government coordination and capacity building are needed to plan and implement the energy transition and gradually decarbonise the energy system – tough challenges for any country. The Asia-Pacific experience highlights the importance of strengthening coordination among ministries and establishing a stable and consistent enabling environment for the private sector (UN, 2019). Financial innovation can also make an important contribution (Box 1.6).

Figure 1.22. The transition to a greener economy could be quicker

A. CO_2 emissions

B. Share of renewable energy in primary energy supply (excluding biomass), 2007-25

C. Energy productivity has increased
GDP in 2015 USD per unit of TPES[2]

D. Population exposure to PM

Note: 1. Data refer to production based CO_2 emissions; 2. TPES stands for total primary energy supply; 3. Exposure to PM2.5 refers to mean population exposure to fine particulate matter that is calculated as the mean annual outdoor PM2.5 concentration weighted by population living in the area. It is the concentration level, expressed in micrograms per cubic meter (µg/m^3), to which a typical resident is exposed throughout a year.

Source: OECD, Green Growth Indicators; OECD, Environmental risks and health; World Bank, World Development Indicators; IEA (2018), IEA World Energy Statistics (database); MoEMR (2020), 2019 Handbook of Energy & Economic Statistics of Indonesia.

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Box 1.6. Financing Indonesia’s clean energy transition

Realising Indonesia’s clean energy potential will require an unprecedented scale-up in investment (estimated at USD 10-15 billion annually for renewables, see IRENA 2017) and the development of bankable pipelines of clean energy projects. Notwithstanding numerous opportunities, there are significant barriers, including lack of grid access, an unattractive tariff structure in certain areas,

concerns around the electricity system impacts of variable renewables, insufficient financial capacity among smaller project developers, and lack of access to land.

Low energy and electricity prices make the business case for investing in energy efficiency less compelling. Consumers do not have the right incentives to change behaviour, as prices do not reflect the full costs of energy. Financial innovation, such as aggregation models, is needed to overcome the small-scale challenge and high transition costs related to financing and developing energy efficiency projects.

In the financial sector, innovative financing instruments and mechanisms will also be needed to increase access to affordable capital for clean energy projects. Such efforts will need to focus on reducing transaction costs particularly for small projects. Blended finance instruments, for example, could help mobilise commercial finance in Indonesia. A de-risking instrument or guarantee could blend public funds from international financial institutions and philanthropy to leverage private capital with a potential multiplier effect of up to 10 to 20 times in some cases and help create early markets for clean energy. This would also provide the financial sector with experience and help build capacity to better appraise clean energy projects that are still perceived to be high-risk even though such technologies already are becoming the norm in other parts of the world.

In 2019, the OECD launched a multi-year engagement with the Government of Indonesia to help support the country's efforts to accelerate the development and scale-up of investments in clean energy. The OECD Clean Energy Finance and Investment Mobilisation Programme supports Indonesia to strengthen and align policy frameworks; build robust pipelines of bankable projects; and mobilise institutional investors for clean energy and sustainable infrastructure projects.

Meeting the Nationally Determined Contribution targets (and eventually adopting the zero-net emissions target in the country's Long-Term Strategy for Low-Carbon Climate Resilience) will require higher energy efficiency and development of renewable energy sources. The geography of Indonesia should facilitate the development of renewables, but their share remains modest (Figure 1.22, Panel B). The electricity buy-in tariff is the major stumbling block in attracting investors, since the regulation uses average historical accounting cost as the benchmark for determining the price at which electricity from renewables can be sold to the grid (ADB, 2020b). However, Regulation No. 4/2020 issued during the pandemic abolishes the Build-Own-Operate-Transfer scheme which obliged independent power producers (IPPs) to transfer all assets to PLN (the state-owned electricity company) at the end of the project. The possibility for IPPs to own renewable energy facilities will help to alleviate the bankability concern surrounding most such projects. Foreign equity restrictions in renewables should also be removed.

The stimulus packages designed to address the short-and medium-term socio-economic impacts of the pandemic offer an opportunity to rebuild the Indonesian economy and enhance resilience against future shocks. There is a high employment generated per dollar invested in efficiency and in general, the job creation intensity in emerging economies is higher than that of developed economies. Stimulus can be used to subsidise installations such as energy efficient lighting, cooling and motor systems and help manage project risks associated with new technologies or new business models. So far, few of the announced measures integrate environmental sustainability (OECD, 2020f). Better coordination among ministries and other government institutions would help identify priority measures that can be supported by green stimulus programmes, as well as commitments from development partners under the SDG One Fund and the BPLDH (the environment fund). In addition, it would be desirable to better align financial support to businesses with energy efficiency improvements and renewable energy installations.

Deforestation and air pollution are major environmental challenges

Deforestation (largely due to "slash and burn" clearing to cultivate palm) and the resulting peatland megafires, combined with the burning of fossil fuels for energy generation, as well as transportation and

residential buildings, make Indonesia one of the world's largest GHG emitters, the fourth in 2019 (BP, 2020). Per capita emissions exceed the world average, as well as those of China and the European Union, although they are 55% lower than in the United States (Carbon Brief, 2019). In addition, palm oil plantations have broader environmental impacts, such as destruction of endangered animal habitats, biodiversity loss, and the relocation of indigenous communities.

Indonesia contains 10% of the world's tropical rainforests and 36% of tropical peatlands. A nationwide moratorium on peatlands draining was announced in 2015 and the Peatlands Restoration Agency (BRG) was established with the goal of restoring 2.7 million hectares of tropical peatlands by 2020. Results have been encouraging (primary forest loss has decreased for three years in a row since 2017) and a three-year moratorium on new permits for palm plantations was introduced in September 2018 (OECD, 2019b). International cooperation has been important, in particular with Norway under the Reducing Emissions from Deforestation and Forest Degradation (REDD+) scheme that resulted in a USD 56 million grant to Indonesia. However, more than a quarter of the peatlands put under protection by the BRG had already been auctioned off and the government is compensating the companies concerned with a "land swap" scheme, offering access to unprotected land (Carbon Brief, 2019). The BRG mandate should be renewed beyond 2020.

Under the Omnibus Bill on Job Creation, the authority on spatial planning and management is set to move from local administrations to the central government (PWYP Indonesia, 2020). The envisaged centralisation of the issuance of the Environmental Impact Assessment document ought not weaken the evaluation of authorisation requirements, nor drop strict corporate liability for environmental damages. More generally, the natural resources sector suffers from corruption, as documented since 2009 by the KPK National Movement to Save Natural Resources. The secrecy surrounding commodity trading also makes it difficult to identify corruption risks (EITI, 2018). More transparency should be pursued with respect to both contracts and trading. Indonesia also has the sixth-highest number of "threatened" species in the list of the International Union for Conservation of Nature, and the largest number of mammals: illegal trade remains a problem and the 1990 law on natural resources conservation could be revised to introduce heavier sanctions on hunters and traders.

Air pollution

Although the right to clean air is enshrined in the 1945 Constitution (Article 28 H1), Indonesians face major environmental and health hazards caused by air pollution. Despite a slight improvement since 2000 (Panel D), the great majority of the population is exposed to fine particles above 10 micrograms per cubic metre levels, the maximum threshold recommended by the World Health Organisation (WHO, 2018a). According to the US Embassy's air monitoring stations, air quality in Jakarta was "unhealthy" or worse on 226 working days in 2019, and good on just 15 days. According to the TomTom Traffic Index 2019, Jakarta is the 10th most congested city in the world, an improvement in the ranking that is mostly due to longer commuting and traffic-related exposures in other mega-cities in the Global South. Bappenas has estimated that traffic congestion in Greater Jakarta costs around IDR 65 trillion (USD 4.6 billion) each year.

The average Indonesian can expect to lose 1.2 years of life expectancy because air quality fails to meet the WHO guideline for concentrations of fine particulate matter (PM2.5) (Greenstone and Fan, 2019). The health effects are much larger in Jakarta, where residents can expect to lose 2.3 years of life expectancy if 2016 pollution levels are sustained over their lifetime. At least 7 390 Jakartans die early every year due to high levels of PM2.5 (Koplitz et al., 2017). The yearly welfare costs of premature deaths associated with ambient particulate matter pollution amount to 3.5% of GDP (Roy and Braathen, 2017).

There has been significant progress in public transportation. The first corridor of the TransJakarta busway, now the backbone of the capital's transportation service along with the rail-based commuter line service, was opened in 2004, the first such system in Southeast Asia. City-owned PT TransJakarta operated 3 865 buses in 2018, compared with fewer than 500 in 2005, while users report a level of satisfaction in line with

international standards (Nurlukman et al., 2020). Nonetheless, public transportation only accounted for 32% of all movements in 2019, as against the Jakarta transportation masterplan target of 60% by 2029. The authorities should encourage the creation of a single clearing house to coordinate the public fare and payment systems and facilitate private investment in transit-oriented urban development. Electric vehicles, including scooters, can also contribute to improving air quality. A Presidential Regulation (No. 55/2020) was published, as recommended by the *Green Growth Policy Review* (OECD, 2019b), with modest 2025 targets (in particular, 2.1 million electric motorcycles, whereas there are already more than 18 million traditional units in Jakarta alone). Technical regulations have also been recently published, but need to be backed by fiscal incentives.

Considerable risks arise from the burning of solid fuels for cooking and heating within houses. Roughly 40% of households cook with firewood and are exposed to higher levels of indoor pollutants than households that cook with cleaner fuels (Silwal and McKay, 2015). A lot of the biomass is burned in traditional old stoves with incomplete combustion, which are energy-inefficient and emit polluting fine particles. Between 2007 and 2012, the Kerosene-to-LPG Conversion Programme proved very successful in increasing the number of liquid petroleum gas (LPG) users in urban areas (World Bank, 2013). Interim results from the Indonesia Clean Stove Initiative to universalise clean cooking solutions by 2030 highlight the benefits of integrating culturally-rooted social practices in designing and executing development projects (Durix et al., 2018), a finding that should have broader applications.

Sustainable buildings

The building sector is a big energy consumer and policies aimed at improving the energy efficiency of buildings can bring significant benefits. Most of the expected growth of energy consumption in the residential sector is in space cooling, as only 10% of households currently have access to air conditioning (IEA, 2019). Specific regulations have been enacted to optimise the environmental design and construction of buildings and Green Building Council Indonesia (GBCI) has introduced a voluntary green ratings tool. According to an IFC survey, in June 2018 there were 339 buildings covering 21 million sqm in Jakarta that complied with the GBCI code, and over 3 000 buildings covering 880 000 sqm in Bandung. Faster transition towards sustainable buildings requires tax and technical incentives, stronger administrative capacity, and greater involvement of homeowners. Non-compliance with standards (or labelling regulations) should also be subject to penalties (OECD, 2019b).

Ambitious reforms are needed to sustain improvements in living standards

Reforms can deliver strong gains in productivity and living standards, without necessarily involving high upfront fiscal outlays. For example, making one year of early childhood education compulsory is estimated to add 0.4 percentage points per year to GDP growth in the long run (Table 1.7) at a relatively small cost (Table 1.8). More broadly, investing to improve Indonesia’s PISA scores – for instance by equipping schools with more computers – would also enhance skills, productivity and GDP per capita. There are also ways to boost adult education and training to accelerate skills acquisition in the population. Boosting human capital has a tremendous potential to develop Indonesia’s economy including through higher rate of formality (see also Chapter 2).

Overly stringent product market regulation hampers the functioning of the economy and the allocation of resources. Lowering barriers to trade and investment to the average OECD level would add 1.3 percentage points to Indonesia’s GDP growth in the long run (Table 1.7). Reducing the reach of state controls would have an even larger estimated impact on GDP growth (1.5 percentage points). Even though these numbers are simply illustrative, they highlight the huge potential gains from liberalising policy settings and bringing them closer to those in OECD countries. Last but not least, reducing corruption – which largely overlaps with the abovementioned liberalisation measures – would boost growth by as much as 1.9 percentage points over the long term.

Table 1.7. Structural reforms to close gaps can yield large long-term gains

Average additional annual GDP growth over 2020-2060 relative to baseline

Reform	Detail	%
Make compulsory one year of early childhood education	Equivalent to increasing average PISA score by 25 points	0.4[1]
Lower barriers to trade and investment	The respective sub-index of the OECD Product Market Regulation indicator declines to the OECD average	1.3[2]
Diminish state control	The respective sub-index of the OECD Product Market Regulation indicator declines to the OECD average	1.5[2]
Reduce corruption	Improvement in control of corruption index to the OECD median country, equivalent to an increase of 1.6 point in the index	1.9[2]

1. Estimates are based on OECD (2017) and OECD, Hanushek and Woessman (2015), and corresponds to the long-run growth increase.
2. Estimates are based on Égert and Gal (2016) and Égert (2017).
Note: Outcomes should not be cumulated across reforms as they sometimes cover similar benefits.
Source: OECD (2017), *Starting Strong 2017*, OECD Publishing, Paris; OECD, E. Hanushek and L. Woessmann (2015), *Universal Basic Skills*, OECD Publishing, Paris; B. Égert and P. Gal (2016), "The Quantification of Structural reforms in OECD countries: A new framework", OECD Economics Department Working Papers, No. 1354; B. Égert (2017), "The quantification of structural reforms: Extending the framework to emerging market economies", OECD Economics Department Working Papers, No. 1442.

Table 1.8. The fiscal cost of reforms is modest

Additional annual cost as a share of GDP

Reform	Detail	%
Mandatory schooling starts at age five	Based on 2013-14 estimate of cost per student, multiplied by number of five-year old children, and divided by two to take into account the average enrolment rate.	0.03
ICT equipment in all schools	Install one computer per class	<0.01

Source: OECD calculations.

Key policy insights recommendations

FINDINGS	RECOMMENDATIONS (Key ones in bold)
Policies to mitigate the impact of COVID-19 pandemic	
A broad range of temporary measures has been adopted to succour vulnerable households and businesses.	**Prolong measures directed at providing financial support to households and businesses to protect livelihoods and employment.**
The central bank has lowered the policy rate in steps during the crisis and inflation has drifted down to below target.	**The monetary stance should remain accommodative as long as inflation is within target, with forward guidance on normalisation as conditions improve.**
In the current highly volatile financial environment, emerging economies are subject to sudden changes in investor sentiment.	Keep using macro-prudential tools to preserve financial stability.
Disbursements in the context of the emergency fiscal package have been slow, but have accelerated in the latter part of 2020.	**Improve inter-ministerial policy coordination and between government levels and ensure consistency between government accounting systems.**
Past fiscal prudence has made room for fiscal expansion in the face of exceptional circumstances.	**Authorities should plan for fiscal consolidation over the medium run but avoid a premature and abrupt removal of stimulus.**
The economic crisis and the tax policy actions to mitigate its impact have further reduced tax revenue from already low levels.	**Efforts to raise tax revenue should be stepped up, notably by:** • **improving compliance;** • **broadening the base;** • **increasing selected tax rates (e.g. on tobacco);** • **enhancing international cooperation; and** • **closing loopholes.**
Blanket support measures to businesses carry the risk of artificially guaranteeing the survival of low-productivity firms and stifling business dynamism, especially in view of very stringent product market regulations, as measured by OECD indicators.	Monitor the implementation of the Omnibus Bills in order to improve resource allocation.
The "burden sharing" scheme is part of the unconventional apparatus, unlikely to generate inflationary pressures as long as demand stays compressed, and intended as temporary.	**Phase out "burden sharing" agreement, as envisaged.**
Central bank independence is key for the credibility of macroeconomic policy, especially in difficult times.	**Bank Indonesia's independence should continue to be fostered.**
Extra healthcare resources are being primarily channelled to COVID-19.	Maintain preparation to fight against still-widespread diseases like TBC, HIV, and dengue.
State-owned enterprises and other forms of government intervention	
SOEs' financial and operational performance has deteriorated during the crisis and some needed capital injections or restructuring.	**Improve SOEs' corporate governance to align it with global best practices.**
The government is rationalising the SOE universe through the creation of holding companies that control operating companies in different sectors.	Reinforce financial reporting of operating companies before establishing sectoral holding companies.
A number of SOEs enjoy various competitive advantages and the lack of a level playing field may hamper private sector growth.	**SOEs should always be subject to competition law and be held responsible for abusing their dominant market position.**
Restrictions on FDI are amongst the highest in the G20.	**Review existing restrictions, eliminate those that generate costs without producing benefits, and monitor the remaining ones.**
Public procurement	
Procurement, despite improvements, remains highly vulnerable to bribe solicitation, conflicts of interest, cronyism, and bid-rigging.	Adopt global public procurement standards (with respect to the quality of bidding documents, the possibility to comment on procurement-related regulations and the establishment an independent review mechanism).
Streamlined procedures and direct awards may be an efficient, but only temporary, solution for procuring specific goods, services and works in emergency situations like COVID-19.	**Limit direct awards only to current, urgent and unforeseeable needs, when there really is only one qualified supplier, and terminate them as soon as possible.**
Corruption	
The recent requirements to seek prior approval by the supervisory board before launching investigations and to turn investigators into civil servants weaken the independence of the Corruption Eradication Commission (KPK).	**Safeguard the independence and authority of the KPK to ensure the effective prevention, detection and investigation of corruption.**
Indonesia has ratified the UN Convention against Corruption in 2006 and participates in OECD and G20 anti-bribery activities.	Strengthen implementation of the UN Convention against Corruption and align more closely with the OECD Anti-Bribery Convention.
There are no clear rules on how members of Parliament engage with lobbyists.	Introduce a clear definition of lobbyists and lobbying activities and a code of conduct for the engagement of members of Parliament with lobbyists.

Environmental policies	
Estimates suggest that the forest and peatland cover lost to burning rose during the pandemic.	**Protect, rewet and restore peatlands and forests and increase the budget resources for environmental protection agencies.**
Cost-reflective energy pricing is fundamental to reduce emissions.	**Establish a carbon price on fossil fuels.**
Jakarta and other metropolitan areas suffer from high pollution.	**Accelerate investment in public transport and pursue inter-modal integration.**
The share of renewables in the energy mix is still low.	**Confirm plans to reform buy-in tariffs, to make cost recovery possible.**

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Annex 1.A. Evolution of budgetary allocations since 2019

Annex Table 1. Budget comparison, 2019-2021 (IDR trillions)

	2021 Budget	2020 Budget			2019 Budget (audited)
		Second revision	First revision	Original	
REVENUE					
Total revenue	1 743.6	1 699.9	1 760.9	2 233.2	1 960.6
Domestic revenue	*1 742.7*	*1 698.6*	*1 760.4*	*2 232.7*	*1 955.1*
Tax revenue	1 444.5	1 404.5	1 462.6	1 865.7	1 546.1
Income tax	683.8	670.4	703.3	929.9	772.3
Value added tax	518.5	507.5	529.7	685.9	531.6
Excise	180.0	172.2	172.9	180.5	172.4
Non-taxation revenue	298.2	294.1	297.8	366.9	409.0
Oil and gas revenue	75.0	53.3	53.3	127.3	121.1
Grants	*0.9*	*1.3*	*0.5*	*0.5*	*5.5*
EXPENDITURE					
Total expenditure	2 750.0	2 739.2	2 613.8	2 540.4	2 309.3
Central government expenditure	*1 954.5*	*1 975.2*	*1 851.1*	*1 683.5*	*1 496.3*
Interest payments	373.3	338.8	335.2	295.2	275.5
Subsidies	175.4	192.0	157.3	187.6	201.8
Energy subsidies	110.5	95.6	97.4	125.3	136.9
Funds for regional autonomy	*795.5*	*763.9*	*762.7*	*856.9*	*813.0*
BUDGET FINANCING					
Budget balance	-1 006.4	-1 039.2	-852.9	-307.2	-348.7
Budget balance as % of GDP	-5.7	-6.3	-5.1	-1.8	-2.2
Total financing	1 006.4	1 220.5	852.9	307.2	402.1
Net bond issuance	1 207.3	1 173.7	549.6	389.3	446.3

Source: Reuters.