

Aspiring Indonesia — Expanding *the* Middle Class

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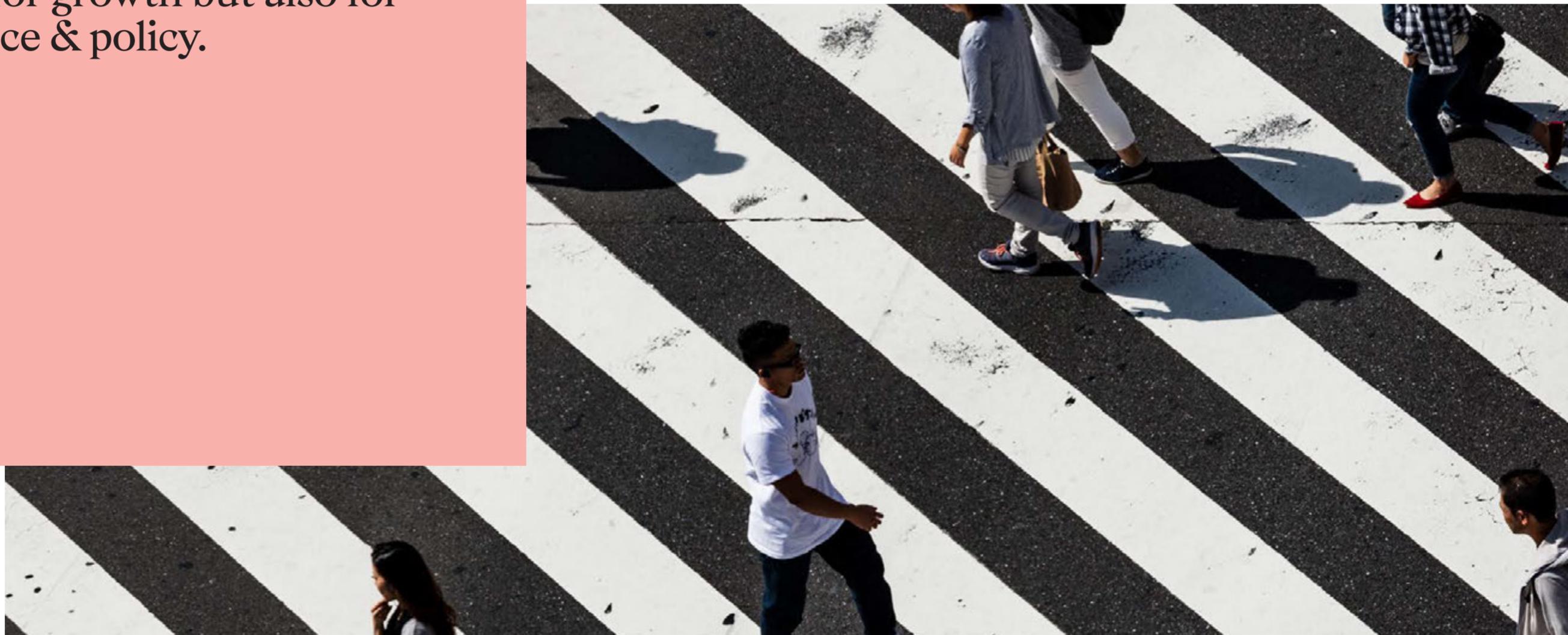


Why should we care
about the middle class?

There are a number of reasons why the middle class matters to Indonesia. It is linked to economic growth in several important ways, which we explore. But it also plays important social & political roles, which have consequences not only for growth but also for governance & policy.

How can we expand
the middle class?

What will be required to bring the 115 million people who are no longer poor into the middle class? The future of Indonesia lies partly in the fate of this *aspiring middle class* so that they can both share in & help to drive the country's growing prosperity.



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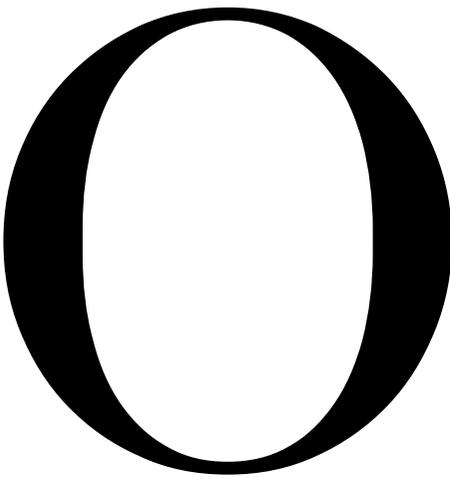
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Foreword

Rodrigo A. Chaves
Country Director, Indonesia

The World Bank



Over 50 years ago Indonesia was one of the poorest countries in the world. With growth averaging 5.6 percent annually since then, the country has remarkably reached middle-income status. Alongside one of the more rapid reductions in poverty in history, we also witnessed the emergence of a vibrant and growing middle class in Indonesia. Today, one in five Indonesians are middle-class and are free from worry about poverty.

A stronger and more secure middle class is crucial for continuing Indonesia's upward trajectory. The middle class is an engine of economic growth, accounting for nearly half of all household consumption. Representing 43 percent of business owners, they generate many of the new jobs that employ the growing workforce. They are more likely to invest in human capital for future generations and they pay nearly half of all indirect taxes that finance government investments for growth.

If Indonesia is to realize its ambitions of spurting growth and someday becoming a high-income country, it will need a much larger middle class. This will require a focus on promoting the *aspiring middle class* that includes the 115 million Indonesians – 45 percent of the population – who are no longer considered poor or vulnerable but have not yet been able to reach middle class status. Providing them with a pathway to the middle class will not only help drive the country's growing prosperity but it will also help in further reducing poverty and inequality.

Lifting aspiring Indonesians into the middle class will require more students finishing their secondary and tertiary education in schools that can equip them with the skills needed in the modern economy. This will position them to

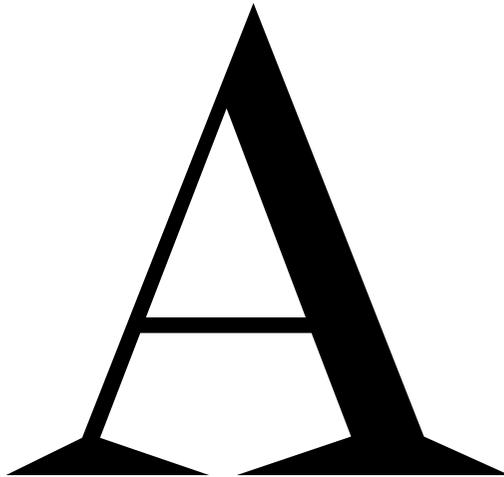
access better jobs, especially higher paid formal jobs in services, which can propel them into the middle class. And because almost 40 percent of those in the middle class fall back into the aspiring class, it will also require a comprehensive social protection system to buffer people from the effects of major shocks.

There is no time for complacency. There is a risk that Indonesia's middle class may not play the transformative role that it could. Already there are signs that they are choosing to opt out of supporting Indonesia's development. Most of the middle class does not pay personal income tax and increasingly more are bypassing public services for private health services and schools.

To ensure the participation of all those who currently belong to the middle class as well as those who aspire to do so, Indonesia will need to agree on a new social contract: a new pact that binds the state and its increasingly prosperous citizens in a mutually beneficial arrangement. By providing higher-quality public services, promoting upward mobility through access to better jobs, and building resilience through more effective social protection, the state will secure continued participation of its citizens in the services it provides. And, by paying their fair share in taxes, the citizens will enable the state to finance these services.

Our hope is that this report will stimulate a much-needed conversation about how to increase upward mobility and developing a new model of inclusive growth for Indonesia. Bolstered with a clear diagnosis of the challenges and inspired by clear policy directions ahead, it is possible for Indonesia to achieve another miracle: avoiding the middle-income trap and transforming itself into an inclusive and prosperous country.

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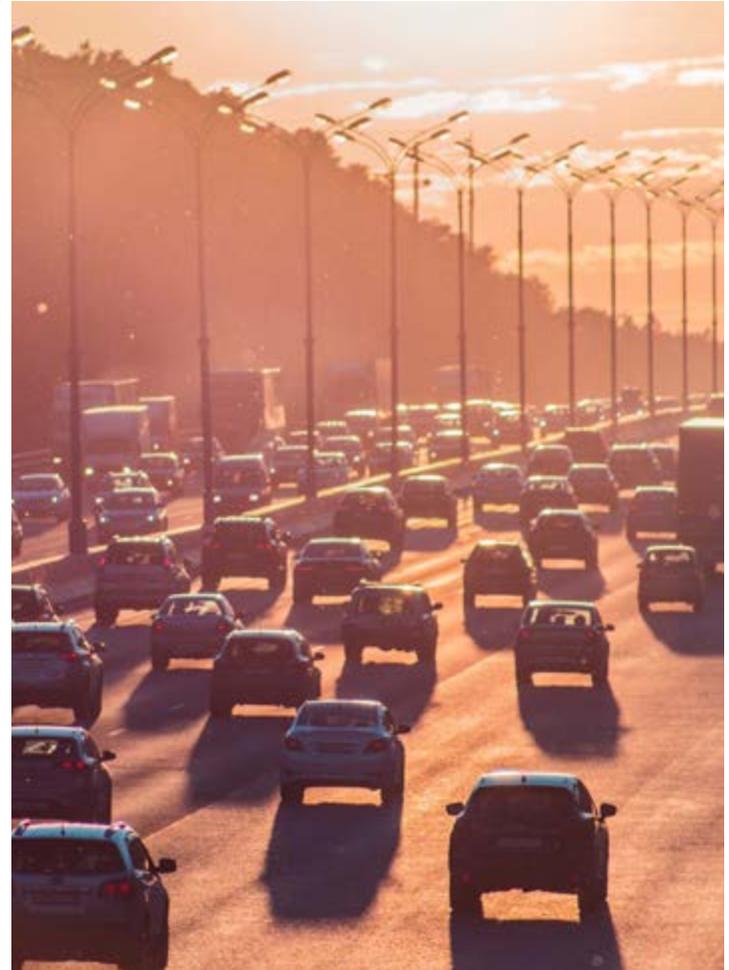
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The middle class has been growing faster than other groups; there are now at least *52 million* economically secure Indonesians, or *one Indonesian in every five*

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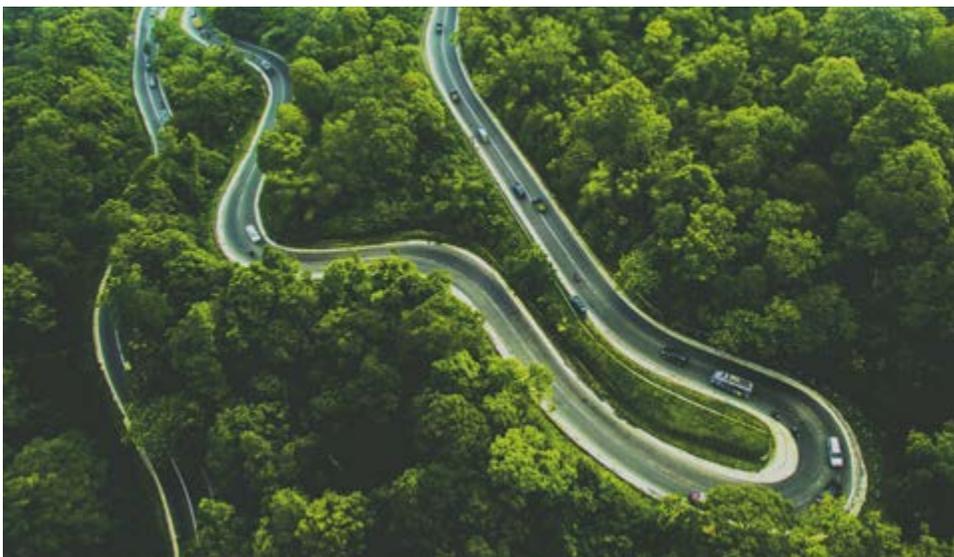
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List of Abbreviations, Acronyms & Indonesian Terms

TERM	DEFINITION
AMC	aspiring middle class
BCG	Boston Consulting Group
BOP-PAUD	<i>Bantuan Operasional Pendidikan PAUD</i> (ECED operational assistance grants)
BOS	<i>Bantuan Operasional Sekolah</i> (school operational funds)
BPJS	<i>Badan Penyelenggara Jaminan Sosial</i> (Social Security Provider Agency)

TERM	DEFINITION
BPKP	<i>Badan Pengawasan Keuangan dan Pembangunan</i> (Financial and Development Supervision Agency)
BPS	<i>Badan Pusat Statistik</i> (Statistics Indonesia)
CAGR	compound annual growth rate
CPD	continuous professional development
CPI	consumer price index
DAK	<i>Dana Alokasi Khusus</i> (special allocation fund)
Dapodik	<i>Data Pokok Pendidikan</i> (basic education data)
DAU	<i>Dana Alokasi Umum</i> (general allocation fund)
DD	<i>Dana Desa</i> (village fund)
DGT	Directorate General of Taxes
DKI	<i>Daerah Khusus Ibukota</i> (capital city special area)
ECED	early childhood education
EFC	error, fraud, and corruption
EKPPD	<i>Evaluasi Kinerja Penyelenggaraan Pemerintahan Daerah</i> (local government performance evaluation)
ES	economically secure
GDP	gross domestic product
GMC	global middle class
Hibah	grant
HIV	human immunodeficiency virus
ICT	information and communication technology
IFLS	Indonesian Family Life Survey
IPL	international poverty line
IT	information technology
JKN	<i>Jaminan Kesehatan Nasional</i> (national health insurance)

TERM	DEFINITION
MAC	middle Class and affluent customer
MC	middle class
MenPAN	<i>Kementerian Pendayagunaan Aparatur Negara dan Reformasi Birokrasi (Ministry of State Apparatus Empowerment and Bureaucracy Reform)</i>
MoH	Ministry of Health
MoEC	Ministry of Education and Culture
MSS	minimum services standards
NCD	non-communicable diseases
NPL	national poverty line
OECD	Organisation for Economic Co-operation and Development
OM-SPAN	<i>Online Monitoring Sistem Perbendaharaan dan Anggaran Negara (Online Monitoring of Treasury System and State Budget)</i>
OOP	out-of-pocket
PAUD	<i>Pendidikan Anak Usia Dini (early childhood education)</i>
PDR	performance development review
Pemekaran	district splitting
Pergub	<i>Peraturan Gubernur (governor regulation)</i>
PFM	public financial management
PIP	<i>Program Indonesia Pintar (Smart Indonesia Program)</i>
PISA	Programme for International Student Assessment
PIT	personal income tax
PPP	purchasing power parity
PTKP	<i>Penghasilan Tidak Kena Pajak (non-taxable income)</i>
Puskesmas	<i>Pusat Kesehatan Masyarakat (community health center)</i>
QSDS	Quantitative Service Delivery Survey
RPJMN	<i>Rencana Pembangunan Jangka Menengah Nasional (National Medium-Term Development Plan)</i>

TERM	DEFINITION
Sakernas	<i>Survei Angkatan Kerja Nasional</i> (national labor force survey)
SEZ	special economic zones
SJSN	<i>Sistem Jaminan Sosial Nasional</i> (National Social Security System)
STR	student-to-teacher ratio
Susenas	<i>Survei Sosial Ekonomi Nasional</i> (national socio-economic survey)
TB	tuberculosis
TKD	<i>Tunjangan Kinerja Daerah</i> (regional performance allowance)
UC	upper class
UHC	universal health coverage
UN	United Nations
UNDP	United Nations Development Programme
USD	United States dollar
VAT	value-added tax
WVS	World Values Survey

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Aspiring

EXPANDING
THE MIDDLE
CLASS

A
WORLD BANK
REPORT

Indonesia

Overview

Over the past half century, Indonesia has seen strong economic growth and substantial decreases in extreme poverty, enabling it to achieve middle-income status. In 1967, Indonesia's GDP was just US\$657 per person, making it one of the poorest countries in the world. Over the next 50 years, with growth averaging 5.6 percent annually, GDP per capita grew six-fold to nearly US\$4,000. This sustained and high growth rate resulted in one of the most rapid reductions in poverty in history. For instance, extreme poverty—calculated using the US\$1.90 per day international poverty line—at 70 percent in 1984, fell to just 7 percent by 2016.

A vibrant and rapidly growing middle class has emerged, economically secure and growing in influence. There are now about 52 million middle-class Indonesians, or one in every five. These mainly urban households have achieved economic security, are free from worry about poverty and vulnerability, and their incomes are turning from subsistence to discretionary consumption. Living on between Rp 1.2 million and Rp 6.0 million per person per month, the middle class is the fastest growing segment of the population, at 10 percent annually, and now accounts for close to half of national consumption.

While a continued focus on poverty and vulnerability remains vital, Indonesia's next challenge is to bring many more millions of aspiring Indonesians into the middle class. Despite the massive reductions in poverty, 35 percent of Indonesians remain poor or vulnerable, and sustained attention is required to lift them out of subsistence and provide them with greater opportunities. However, action is also required for a further 45 percent of the population—115 million people—who, while free from poverty, have yet to achieve the economic security and lifestyle of the middle class.

This report uses economic security to define the middle class. The report moves beyond thinking simply of the poor or non-poor divide and instead begins to consider the middle class and the pathways toward it. The main innovation used here is to take a more nuanced look at the consumption distribution in Indonesia. As such, we identify five different consumption classes: poor; vulnerable; aspiring middle class; middle class; and upper class.

The report has three primary objectives. First, it examines how the dynamism of the middle class can be harnessed to drive development without polarizing the country. Then it tries to understand Indonesia's aspiring

middle class (AMC), and how its members differ from the many millions of middle-class Indonesians who have not only emerged from poverty but, unlike the aspiring middle class, have also achieved economic security. Finally, it examines what the government can do to significantly expand the middle class to the millions (the 115 million people in the AMC) who aspire to join it.

The structure of the report. To achieve these objectives, the report first looks at the recent rapid expansion of the middle class and asks why we should care about it. It then examines what makes the middle class different from the aspiring middle class and what it would take for the latter to join the middle class. There is a focus on the importance of improving educational attainment for the aspiring middle class to access better jobs, as well as looking at how to create more of these better jobs. We then look at the growing middle- and upper-class trend of opting out of public services, while the aspiring middle class remains highly reliant on them, before considering the shocks that can hit both the aspiring and middle classes, and why this makes social protection for all so crucial. We then conclude by highlighting the dangers of polarization and growing inequality if the government fails to provide a new social

contract for all, including providing higher quality public services and better tax policy and administration—the only way to ensure that Indonesia can pay for the transition from middle-income to high-income status. The report finishes by looking at possible recommendations for addressing the challenges in four main areas, namely education, health, taxation and regional government.

At its heart, the report makes a case for a new social contract and an Indonesia where public investments and policies benefit both the current middle class and those who aspire to join it. An arrangement for all Indonesians would be one in which public investments drive growth, growth is inclusive, and social insurance protects the gains of all. For the non-middle class, access to high-quality public services and good jobs can provide opportunities to achieve economic security and join the ranks of the middle class. At the same time, upward mobility of the non-middle class and investments in productivity and infrastructure will drive greater economic growth, benefiting the existing middle class. Furthermore, stronger social insurance to provide employment and health protection, as well as pensions, means that the economic gains of an expanding middle class—both those who

are currently in it and those who will join—can be secured from the shocks that can affect everyone. Finally, strengthening tax policies and compliance by the current middle class and boosting new collections from an expanding middle class mean that there should be adequate financing for needed investments.

Thus, a social contract that focuses on quality public services, economic mobility, and social security for all would help to expand the middle class and protect those already in it. A new relationship between the government and its people could focus on three areas. First, quality public services, especially in health and education, but also water and sanitation, are necessary so that aspiring middle-class children can develop the health and skills they need to succeed later in life. Better quality services may also mean that those in the middle class use and appreciate them more widely, generating broader support for financing them. Second, access to livelihoods that allows those in the middle class to prosper and those below the middle class to enter can help to ensure economic mobility for all. This means a focus not only on better education, discussed earlier, but also on making it easier to become an entrepreneur, which increases the prosperity of the middle class and creates

new jobs for others. Mobility can also be promoted through economic reforms, including closing the infrastructure gap, improving how decentralization is working, better leveraging urbanization, and targeted place-based policies for lagging regions. Finally, effective and sustainable health, employment and old-age insurance can provide the safety net that the aspiring middle class needs to enter the middle class, and can protect the economic gains that the middle class has already achieved.

This will reduce the risk that those outside the middle class become shut out, resulting in a more fractured society. Instead, social cohesion and stability will in turn drive further growth. Nearly half of Indonesia's population is in the group that aspires to join the middle class. This group includes the median voter and, if they can join the middle class, they will combine with the existing 20 percent of middle-class Indonesians to represent two-thirds of the country. Meeting their aspirations and delivering economic security to many will help strengthen social cohesion and address rising inequality. In turn, greater stability and lower inequality have been shown to drive economic growth.



EXECUTIVE
SUMMARY

ES

99—01

Strong economic growth has led to a massive reduction in poverty & the emergence of a prosperous middle class

Over the past half century, Indonesia has seen strong economic growth and substantial decreases in extreme poverty, enabling it to achieve middle-income status. In 1967, Indonesia's GDP was US\$657 per person in 2010 prices,¹ making it one of the poorest countries in the world, and the country was "accounted the number one failure among the major underdeveloped countries."² Growth that year was an anemic 1.4 percent. Over the next 50 years, growth averaged 5.6 percent annually, despite a crippling financial, economic, and political crisis in the late 1990s (Figure E.1). Per capita GDP is now six times higher, at nearly US\$4,000. This sustained period of high growth resulted in one of the largest and most rapid reductions in poverty in history. Extreme poverty, calculated using the US\$1.90 per day international poverty line, was 70 percent in 1984. By 2016 it had fallen to just 7 percent (Figure E.2).³

This report moves beyond thinking simply of the poor or non-poor divide and instead begins to consider the middle class and the pathways toward it. The World Bank's (2015a) *Indonesia's Rising Divide: Why Inequality is Rising, Why it Matters and What Can be Done* takes a comprehensive look at inequality in Indonesia, with an extensive policy focus on what can be done to pull households out of poverty and vulnerability. This report on the middle class is a companion report to the earlier one in the sense that it examines what happens once households have moved out of poverty and vulnerability. The main innovation of this report is to take a more nuanced look at the consumption distribution in Indonesia. As such, we identify five different consumption classes:

1

Poor (P)

Those living below the national poverty line, or around **Rp 354,000** per person per month (US\$2.20 per person per day in 2016 PPP-adjusted terms);

2

Vulnerable (V)

Those living above the poverty line but with a non-negligible risk of falling into poverty, or between **Rp 354,000** and **Rp 532,000** per person per month (US\$2.20-3.30 per person per day)

3

Aspiring Middle Class (AMC)

Those no longer living in poverty or vulnerability but who are not yet economically secure, or between **Rp 532,000** and **Rp 1.2 million** per person per month (US\$3.30-7.75 per person per day)

4

Middle Class (MC)

Economically secure Indonesians with little chance of falling into poverty or vulnerability, or between **Rp 1.2 million** and **Rp 6.0 million** per person per month (US\$7.75-38 per person per day)

5

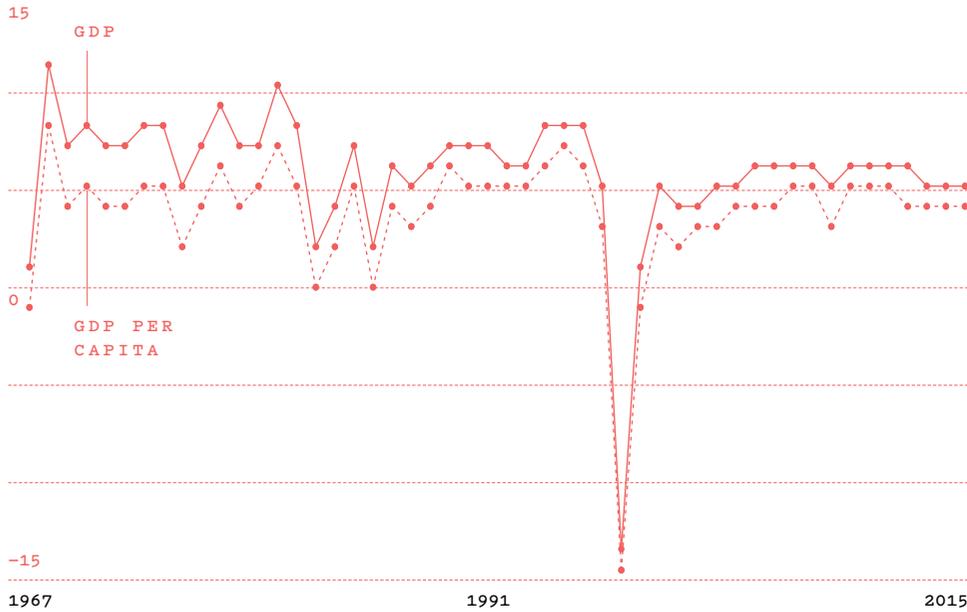
Upper Class (UC)

The wealthiest Indonesians who consume more than **Rp 6 million** per person per month (>US\$38 per person per day)

5.6%

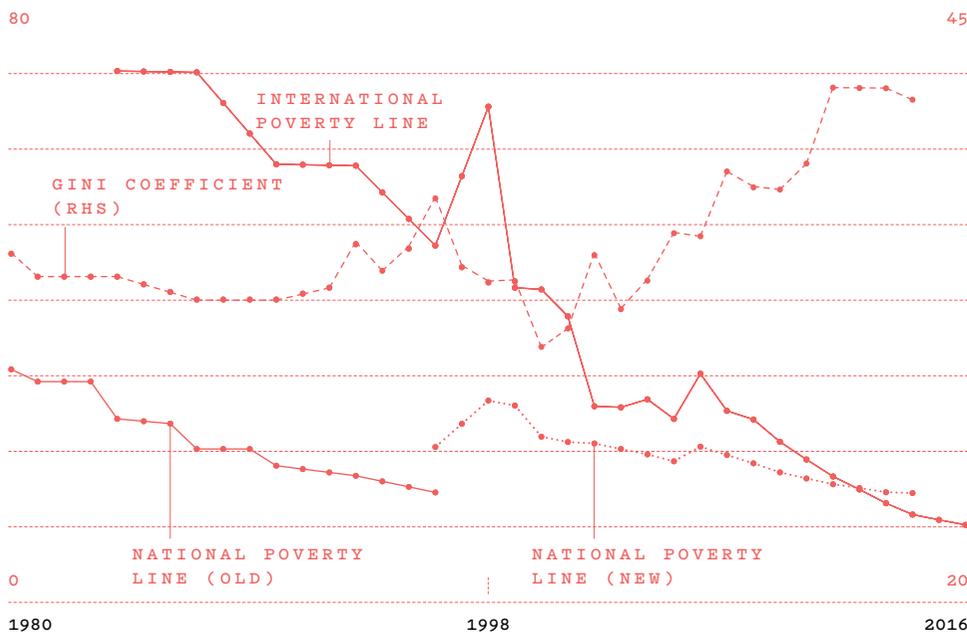
Indonesia has sustained an average annual growth rate of 5.6 percent over the past half century.

FIGURE E.1 Real GDP and GDP per capita growth, 1967-2016 (percent)



Source: World Development Indicators.

FIGURE E.2 Poverty headcount ratio and Gini coefficient, 1980-2017 (percent/points)



Note: International Poverty Line is US\$1.90 in 2011 Purchasing Power Parity prices.

Source: World Development Indicators.

1 In 2010 US\$, from the World Development Indicators.

2 Higgins (1968) Economic Development (2nd ed.), p678, cited in Hill, H. (2000) The Indonesian Economy (2nd ed.).

3 Using the International Poverty Line (IPL, \$1.90 at 2011 Purchasing Power Parity prices) from the World Development Indicators and the 2017 Indonesia Country Poverty Brief. Poverty using the national poverty line (NPL) has shown similar declines. The NPL is more appropriate for assessing poverty in Indonesia than the IPL as it adjusts for spatial differences in the cost of living and is based upon a reference basket of goods and services commonly used by the poor. The IPL is based on the poverty line of selected poor countries and is converted into local currency using Purchasing Power Parity (PPP) adjusted exchange rates. The IPL is best for international comparisons of poverty rates but does not best represent poverty in any particular country. The IPL trend shows greater falls in poverty than the NPL because of both differences in methodology and because it is inflated over time using the CPI, which has risen more slowly, especially in recent years, than the cost of a representative basket of the poor in Indonesia.

ES 01

Below The middle class is the only class that spends more on non-food items than food, increasingly on entertainment, durables and vehicles.

Right It is only those in the middle class who predominantly have the high school or better education required by better jobs, with increasingly large numbers having tertiary education.

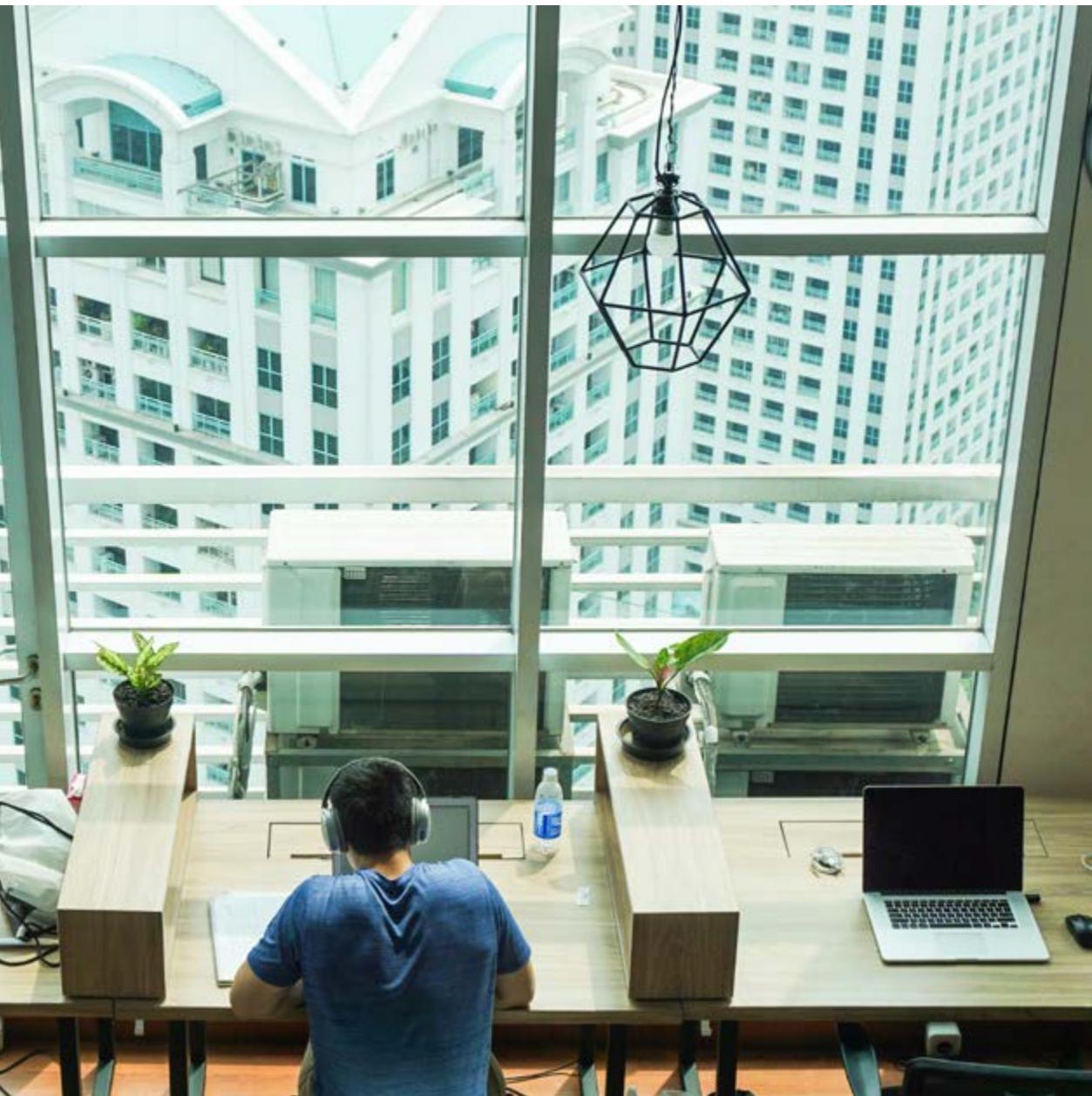


We define the middle class as those who enjoy economic security. This means they are free from worry about monetary poverty and, as a consequence, are turning their disposable income toward discretionary consumption rather than subsistence (see Box E.1 for the advantages of this methodological approach). However, it is important to note that this does not mean they are necessarily free from poverty on some non-monetary dimensions. Indeed, as we shall see later, many of the economically secure are deprived in

some other way, often having poor roofing or other sub-standard housing conditions. By analyzing household survey data, the middle-class threshold is set at the point where there is less than a 10 percent chance of being poor or vulnerable next year, given this year's consumption levels. In practice, this means households consuming more than Rp 1.2 million per person per month, or US\$7.75 per person per day (PPP-adjusted). Moreover, we look at two different sub-groups within the middle class. While households

with per-capita consumption of Rp 1.2 million per month no longer worry about falling into poverty or vulnerability, at this level they are only just starting to move toward discretionary consumption or buying higher-quality goods and services. As they become wealthier, their behavior and investments change. Consequently, we look at two sub-groups within the middle class, based on consumption levels of Rp 1.2-3.2 million per person per month (or US\$7.75-20 per person per day), and Rp 3.2-6.0 million per person per month





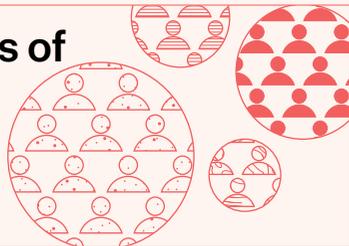
(or around US\$20-38 per person per day), to understand how those in the middle class evolve as they prosper further.

An upper class that also lives in economic security is a separate category and is not a direct focus of this report. We classify those earning above Rp 6.0 million per person per month as upper class (UC), whose characteristics, as we shall see, are different again from those of the middle class. These wealthier individuals and households, most of which are not captured by the household survey data that underpin this report's analysis of welfare, are not the focus of this report.⁴ However, the relatively small upper class does highlight that those in the middle class in Indonesia are currently close to the top end of the distribution and, in this sense, are not "middle". Nonetheless, as those who comprise the wealthier middle class graduate to the upper class, and the middle class expands from below as some aspiring middle class join it, over time the middle class will move more toward the middle of the distribution.

⁴ See World Bank (forthcoming) *Estimating the Top End of Indonesia's Consumption Distribution*.

BOX E.1

Who are members of the middle class?



There has been a surge of interest in the Indonesian middle class in recent years, but little agreement on who they are or how numerous they are. There have been at least four major reports on Indonesia's middle class since 2010, highlighting the topic's current interest.⁵ While they have all defined the middle class in terms of income or consumption, they have used a range of different thresholds, somewhat arbitrarily determined, and their estimates of the size of the middle class range from 30 million to 81 million people.

The size of the middle class, the characteristics of its members and their roles depend on how we define them.⁶ Those in the middle class are indeed often defined by their incomes or consumption levels.⁷ In the global literature on the middle class, such definitions range from US\$2-20 per person per day to US\$10-100 per person per day, or use global benchmarks, such as poverty lines in middle- and high-income countries, to define its members.⁸ Others literally define the middle class as comprising those lying somewhere in the middle of the distribution.⁹ The middle class can also be defined by households' self-perceived position in the income distribution or certain behaviors or characteristics, such as education and occupation.¹⁰

There are advantages to defining the middle-class threshold as free from economic vulnerability. One definition of the middle class is that it comprises those whose income level is sufficient to allow them to enjoy economic security and who are safe from falling back into poverty or vulnerability.¹¹ This has several advantages. First, it is conceptually grounded in the notion of economic security, unlike arbitrary thresholds that have no basis. Second, what counts as economic security is developed in the Indonesian context, rather than by using global benchmarks that may be less relevant. Third, it allows behaviors and characteristics of the middle class to be explored empirically, rather than being pre-determined to define its members, as behavioral definitions do.

“There has been a surge of interest in the Indonesian middle class in recent years, but little agreement on who they are or how numerous they are.”

⁵ See ADB (2010), BCG (2013), McKinsey Global Institute (2012) and Tempo Magazine (2012). See also The Economist (2011) and Financial Times (2010, 2014).

⁶ See Wai-Poi, M., Purnamasari, R., Indrakesuma, T., Uochi, I. and Wijaya, L. (2016) for a broader discussion on different definitions of the middle class, and World Bank (2017) for a similar approach across the East Asia and Pacific region.

⁷ Most countries' household surveys only collect information on one of these, and they are often treated interchangeably, although they should not be.

⁸ See, for example, ADB (2010), Banerjee and Duflo (2008), Kharas and Gertz (2010), Milanovic and Yitzhaki (2002), Ravallion (2010).

⁹ See Birdsall, Graham, and Pettinato (2000), Easterly (2001), OECD (2011). Birdsall (2007 and 2010) uses an absolute threshold to bound the bottom of the middle class, but a relative threshold to bound the top.

¹⁰ See PRC (2008) and Amoranto et al. (2010) for examples of the former and Adelman and Morris (1967) for the latter.

¹¹ See the World Bank's (2013) Economic Mobility and the Rise of the Latin American Middle Class.

Below The aspiring middle class and the middle class have the size and economic influence to be politically salient; while the middle class has only half as many voters, it represents half of all consumption.

52 Million

The middle class has been growing faster than other groups; there are now at least 52 million economically secure Indonesians, or one Indonesian in every five.



The middle class has been growing faster than other groups; there are now at least 52 million economically secure Indonesians, or one Indonesian in every five. Figure E.3 shows the evolution of Indonesia's consumption classes since 2002 and their current sizes. By 2016, based on the national household consumption survey, there were 52 million middle-class (MC) Indonesians, representing 20 percent of the population. This compares with 11 percent who were poor (labelled P in charts) and a further 24 percent who were vulnerable (V). The largest segment of the population is the aspiring middle class (AMC), namely those who have escaped poverty but are not yet economically secure, with a greater-than-10-percent chance of being vulnerable next year (Table E.1).

Most of those in the middle class consume less than US\$20 a day, although many richer Indonesians are missing from the data. The great majority of the middle class, despite being economically secure, are not that wealthy; 90 percent (47 million) consume be-

tween US\$7.75 and US\$20 a day (referred to as MC 1 in the charts), while the remainder (5 million) consume from US\$20 to US\$38 a day (MC 2). The survey data find less than 1 percent (1.3 million) who consume more than US\$38 a day, or Rp 6 million (the upper class, or UC). However, the national household consumption survey (Susenas) is believed to exclude many richer Indonesians. Forthcoming work is trying to estimate the top end of the income and consumption distributions more accurately. While still missing many wealthy Indonesians, initial results indicate that the upper class is much larger and richer than the survey data suggest.¹²

The middle class is growing fast, expanding at 10 percent every year, although not as quickly as elsewhere in East Asia. The middle class is growing faster than most other segments of the Indonesian consumption distribution, with the exception of the small upper class. The middle class tripled as a proportion of the population between 2002 and 2016, during which time it grew at an average

rate of 10 percent annually. This is four times faster than the aspiring middle class while, over the same period, the share of poor and vulnerable households in the population shrank slowly (Figure E.3). Although rapid growth of the middle class was from a small base of only about 14 million in 2002, it also added the most people in absolute terms (38 million compared with the 31 million for the aspiring middle class). Nonetheless, growth in the proportion of the economically secure classes in Indonesia was slower than in Thailand, and less than half as large as seen in China, Mongolia, and Vietnam.¹³

¹² World Bank (forthcoming) *Estimating the Top End of Indonesia's Consumption Distribution*.

¹³ See World Bank (2017a). Figure 2. Note, this regional study uses the same economic security definition for the middle class, but based on regional data and international poverty lines rather than just Indonesia's. As such, the class definitions are not the same, although they are broadly consistent.

TABLE E.1 Class definitions (2016 per-capita consumption)

The middle class comprises those who have less than a 10 percent chance of being poor or vulnerable in the future, given their current consumption.

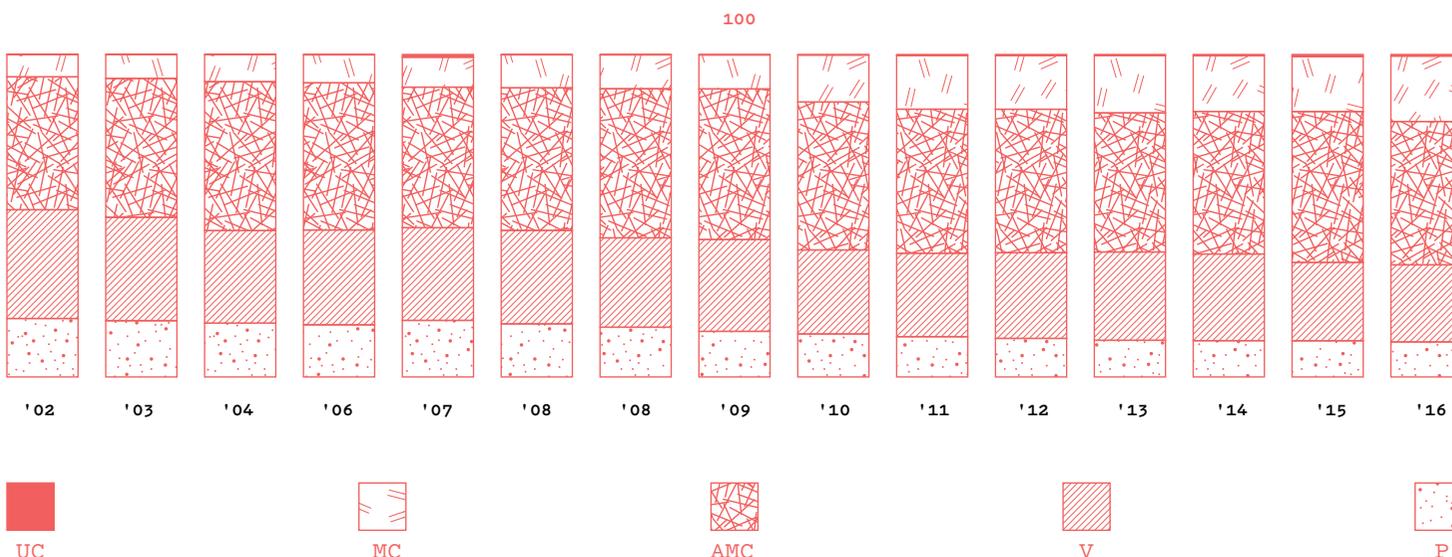
Class	P	V	A M C	M C	U C
	Poor	Vulnerable	Aspiring Middle Class	Middle Class	Upper Class
Household status	Below national poverty line (PL)	>10 percent chance of being poor next year (1.0-1.5xPL)	<10 percent chance of being poor but >10 percent chance of being vulnerable (1.5-3.5xPL)	<10 percent chance of being poor or vulnerable (3.5-17xPL)	>17xPL
Per capita consumption —Rp is Monthly US\$* is daily	<Rp 354k <US\$2.20	Rp 354-532k US\$2.20-3.30	Rp 532k-1.2m US\$3.30-7.75	Rp 1.2-6.0m US\$7.75-38 SUB-GROUPS: MC 1 (Rp 1.2-3.2m; US\$7.75-20); MC 2 (Rp 3.2-6.0m; US\$20-38)	>Rp 6m >US\$38

Note: Daily per capita consumption is measured in US\$PPP, which are US dollars adjusted for purchasing power parity across countries.

Source: Susenas and World Bank calculations.

FIGURE E.3 Consumption distribution by class, 2002-16 (percent of population)

The middle class is the fastest growing major segment of the Indonesian population in both percentage and absolute terms, expanding at 10 percent per year and 38 million between 2002 and 2016. It now represents 20 percent of the population.



Note: CAGR is the compound annual growth rate from 2002-16.

Source: Susenas and World Bank calculations.

THIS
REPORT HAS
THREE KEY
OBJECTIVES:

OBJECTIVE 01

Examine how the dynamism of the middle class can be harnessed to drive development without polarizing the country

OBJECTIVE 02

Understand Indonesia's aspiring middle class (AMC), and how its members differ from the many millions of middle class Indonesians who have not only emerged from poverty but, unlike those in the AMC, have also achieved economic security

OBJECTIVE 03

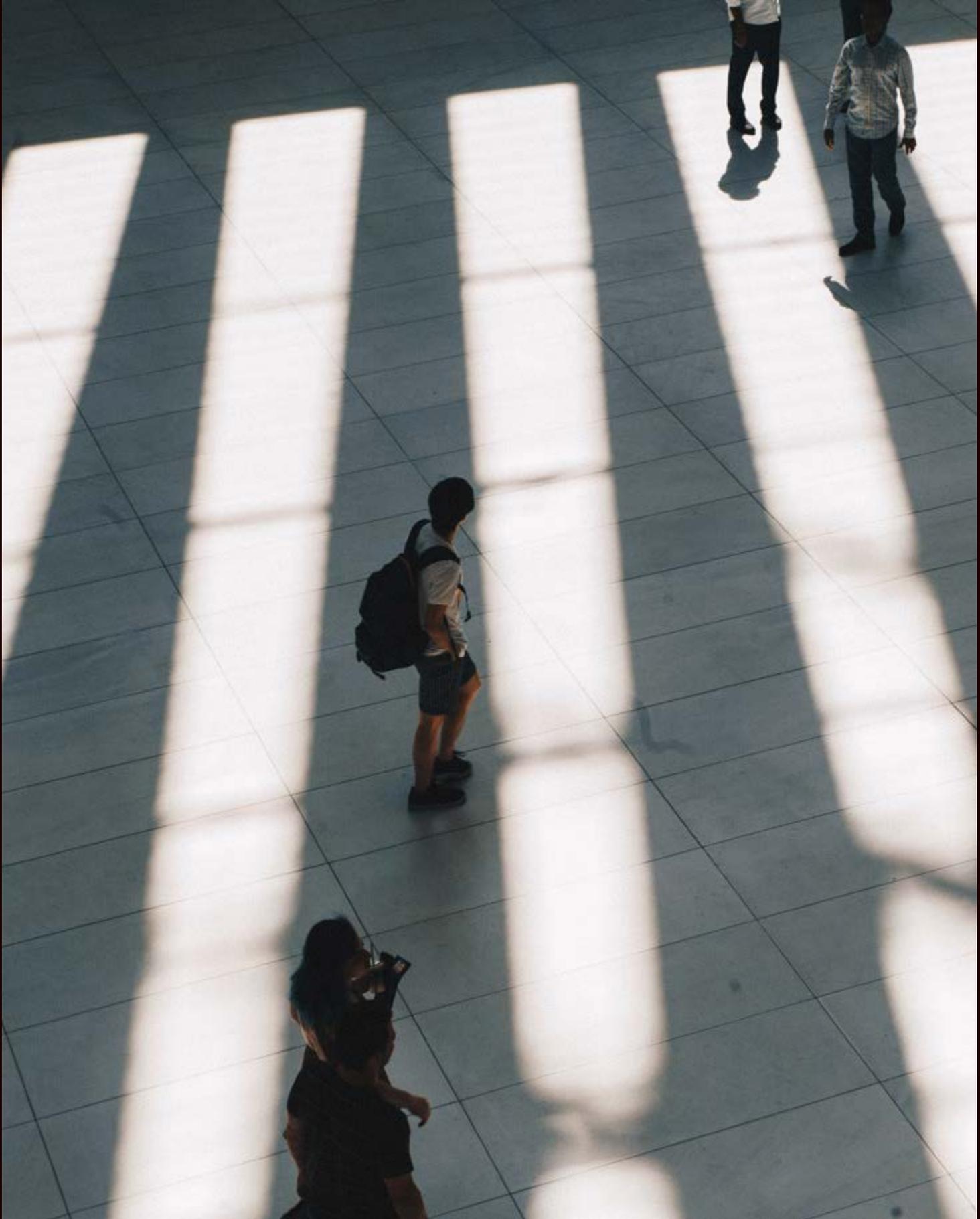
Examine what the government can do to significantly expand the middle class to the millions who aspire to join it.

The remainder of this Executive Summary summarizes the findings on these three issues.

It first looks at the recent rapid expansion of the middle class and asks why we should care about it. The summary then examines what makes the middle class different from the aspiring middle class and what it would take for the latter to join the middle class. There is a focus on the importance of improving educational attainment for the aspiring middle class to access better jobs, as well as looking

at how to create more of these better jobs. It then looks at how easy or difficult it is to move from the aspiring middle class to the middle class proper, as well as asking how secure being in the middle class really is, underlining that economic security does not always mean freedom from non-monetary poverty. We then look at the growing middle- and upper-class trend of opting out of public services, while the aspiring middle class remains highly reliant on such services, followed by considering the shocks

that can hit both the aspiring and middle classes and why this makes social protection for all so crucial. We then conclude by highlighting the dangers of polarization and growing inequality if the government fails to provide a new social contract for all, including providing higher-quality public services and better tax administration—the only way to ensure that Indonesia can pay for the transition from middle-income to high-income country status.



A rapidly growing middle class is good for its members and good for Indonesia's economy.

This report focuses on the middle class for three main inter-related reasons. First, there are the benefits that a rapidly growing middle class enjoys, as its members achieve economic security and higher standards of living. Second, there are broader benefits for the country, as the middle class is a key driver of consumption growth, is an influential constituency for better governance, and will be by far the largest provider of the income tax revenues that are needed to fund poverty reduction and

risk-mitigating agendas, as well as public investments for growth. Third, growing the middle class is closely related to reducing inequality, as the agenda of improved delivery of public services required to lift aspiring households into the middle class will also help those in the bottom 40 percent. Finally, there are risks that the middle class fails to expand to include the millions more who aspire to join it, or that the middle class favors policies that benefit only those in the middle class, but not others, resulting in a more polarized and fractious society.

The middle class & its dynamism will be vital to Indonesia's future as it stands at a cross-road

The Indonesian middle class has been a major driver of economic growth in recent years.

The expansion of the middle class in the late 20th century has helped to sustain Indonesia's enviable record of economic growth. A large middle class (as opposed to a few rich and many poor) leads to higher domestic consumption because the middle class has a higher marginal propensity to consume than the rich, and more income than the poor. The middle class is also more likely to have

crossed the threshold of assets at which risk-taking becomes more likely and it can therefore become a source of entrepreneurship and job creation.¹⁴ Finally, the middle class supports growth by strengthening social cohesion and enhancing political stability.¹⁵ The process of growing the middle class also supports economic growth because human capital investments are key to acquiring the skills required to obtain middle-class jobs, and also to accelerating growth.

¹⁴ See Banjeree and Newman (1993).

¹⁵ See Lipset (1959).



12%

Middle-class consumption has grown at 12 percent annually since 2002 and now represents close to half of all household consumption in Indonesia.

“The Indonesian middle class has been a major driver of economic growth”

Middle-class consumption has grown at 12 percent annually since 2002 and now represents close to half of all household consumption in Indonesia. In 2002, middle-class consumption was 21 percent of all private consumption in Indonesia. By 2016, it was Rp 1,260 trillion, or 43 percent of total household consumption (Figure E.4), having grown at 12.0 percent annually in real terms. By comparison, total average household consumption growth was only 6.3 percent annually over the same period and just 4.6 percent for the aspiring middle class. Total poor household consumption actually declined by 0.4 percent annually in real terms and grew at only 0.9 percent annually for the vulnerable. This is a key reason that, despite the focus of this report on growing the middle class, the government should also retain a strong focus on reducing poverty and vulnerability.

This rapidly growing middle-class consumption has helped accelerate consump-

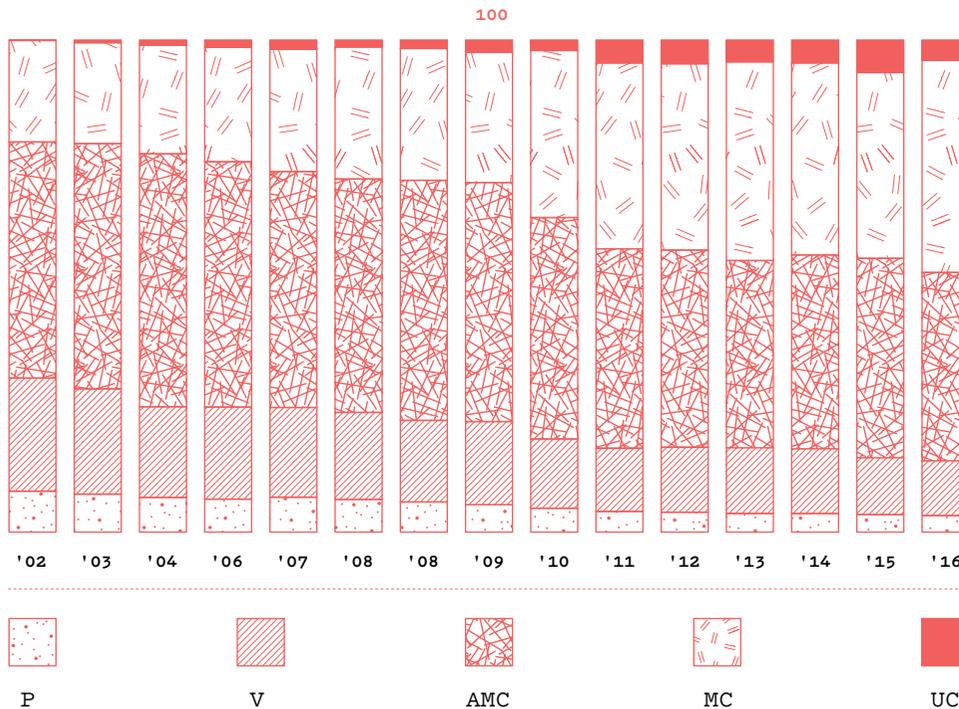
tion growth in the national accounts, a key component of recent economic growth.

Private consumption in the national accounts grew at 3.0 percent annually between 2002 and 2015. Attributing this growth across the economic classes is difficult, as total household consumption in Susenas accounts for only 40 percent of private consumption in the national accounts. While there are differences of methodology, and private consumption includes some non-household spending such as by institutions such as prisons and orphanages, there is still a large discrepancy between the two. Due to this, the role of middle class consumption in the growing national accounts consumption can only be estimated within a range. Under certain assumptions, however, between 1.2 and 2.0 percentage points of annualized growth in national account private consumption came from middle-class consumption, with a further 0.2 to 0.4 of a percentage point coming from the upper class.¹⁶

¹⁶ There is a significant difference in the size of private consumption as measured by the national accounts (upon which GDP measures are based) and household consumption surveys (upon which our middle-class analysis is based). Household surveys exclude non-household private consumption such as institutions (like prisons and orphanages). They also fail to capture many richer households, and so under-estimate household consumption, particularly that of the middle class (see World Bank (forthcoming) Estimating the Top End of Indonesia’s Consumption Distribution). In fact, total consumption in Susenas represents only 40 percent of that estimated in the national accounts, which attempt to capture other private consumption and large one-off expenditures such as the Hajj. If we conservatively allocate the missing 60 percent of private consumption to the consumption classes according to their observed consumption in the survey, then we have a lower bound where the middle class represents 1.2 percentage points of the 5.6 percent annualized growth of the economy (and the upper class 0.2 points). However, the missing richer households and economic activity are much more likely to be from the middle and upper classes; if we allocate all missing private consumption growth to the middle and upper classes in proportion to their relative shares of observed Susenas consumption growth (84 and 16 percent respectively), then an upper bound of their share of growth increases to 2.0 percent for the middle class and 0.4 percent of the upper class.

FIGURE E.4 Share of total national household consumption, 2002-16 (percent)

Despite comprising just 20 percent of the population, the middle class makes up close to half of total national consumption.



Note: The UC share is poorly estimated due to the small number of households participating in the survey data.

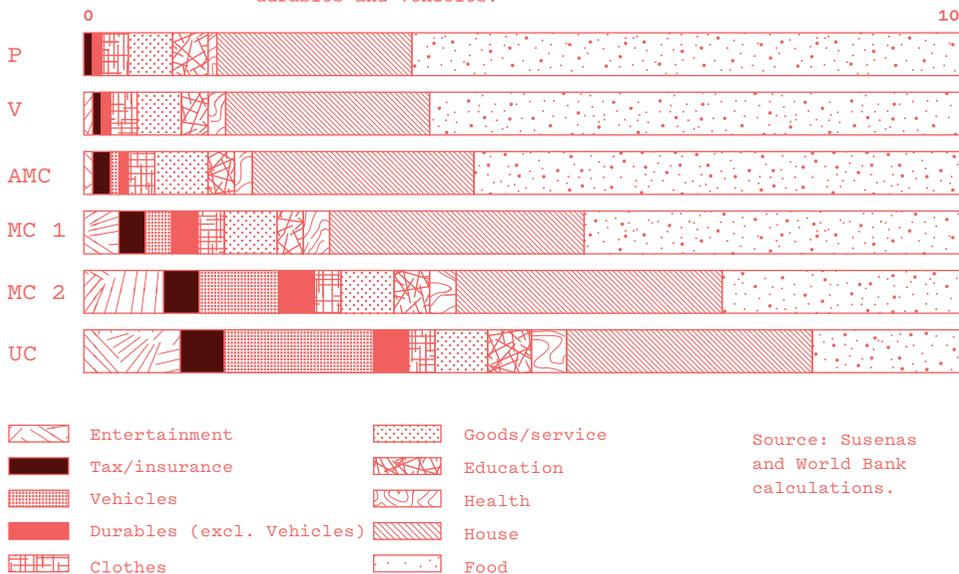
Source: Susenas and World Bank calculations.

Increasingly, the middle class is driving this growth by spending its growing disposable income on non-food items such as health, education, and other services, as well as taxes and insurance. Most Indonesians spend the majority of their money on food. Food represents 60 to 62 percent of all consumption for the poor and vulnerable, and 56 percent for the aspiring middle class. The middle and upper classes are the only groups where more is spent on non-food items than food (Figure E.5). However, for most middle-class households, food still comprises 44 percent of consumption. Only for 10 percent of the middle class (MC 2) and the upper class is food below one-third of consumption. With greater affluence, the middle class is spending more on health and education (combined, this represents 6 percent of MC 1 spending, 7 percent of MC 2 and 9 percent of upper class spending), and clothes, goods and other services (9 percent of MC 1 and MC 2 spending). The middle class is also beginning to pay direct taxes and buy insurance (3, 4, and 5 percent of MC 1, MC 2 and UC spending, respectively).

Those in the middle class are also becoming big consumers of entertainment and durables, with car ownership in particular being a clear dividing line between the middle and upper classes, and those below. The middle class is spending more on entertainment (only 4 percent for MC 1, but increasing to 9 percent of total consumption for MC 2 and 11 percent for UC). While many households are now buying more essential durables, such as refrigerators, the middle and upper classes are the only ones starting to buy amenities more oriented to comfort and convenience, such as air-conditioners and water-heaters, especially in urban areas (Figure E.6). In particular, almost no households below the middle class own cars, while 20 percent of MC 1 and 60 percent of MC 2 own cars, marking it a clear class delineation; most upper-class households own cars. In fact, vehicles account for 9 and 17 percent of total consumption for MC 2 and UC, respectively.¹⁷

FIGURE E.5 Breakdown of consumption, 2016 (percent of total consumption)

The middle class is the only class that spends more on non-food items than food, increasingly on entertainment, durables and vehicles.



Source: Susenas and World Bank calculations.

¹⁷ Although BPS treats the stock of vehicle purchases as consumption, whereas common practice is to calculate the flow (depreciation) of the vehicle and use this for annual consumption.

FIGURE E.6 Selected durable ownership by class, 2016 (percent)

Household luxuries such as air conditioners and water heaters are non-existent below the middle class, while car ownership in particular divides richer middle- and upper-class households from all other Indonesians.

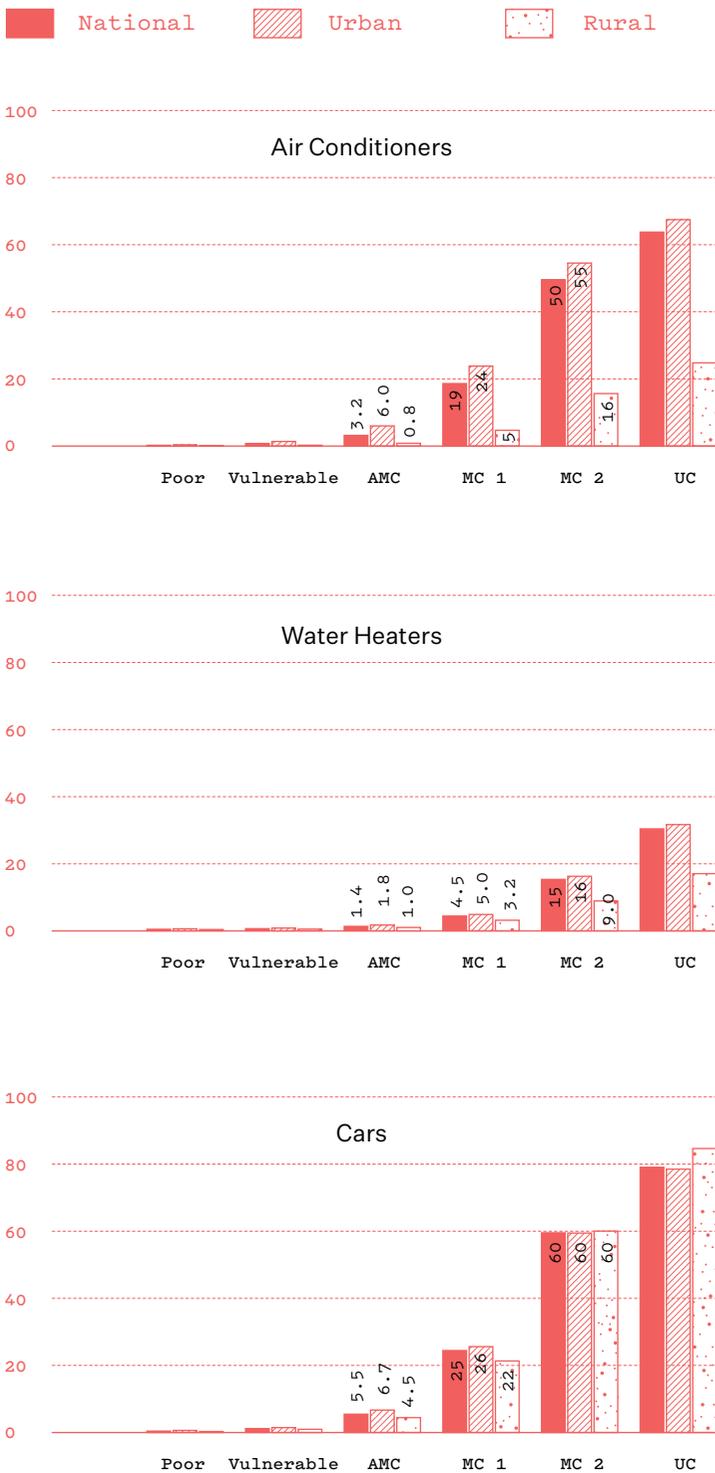
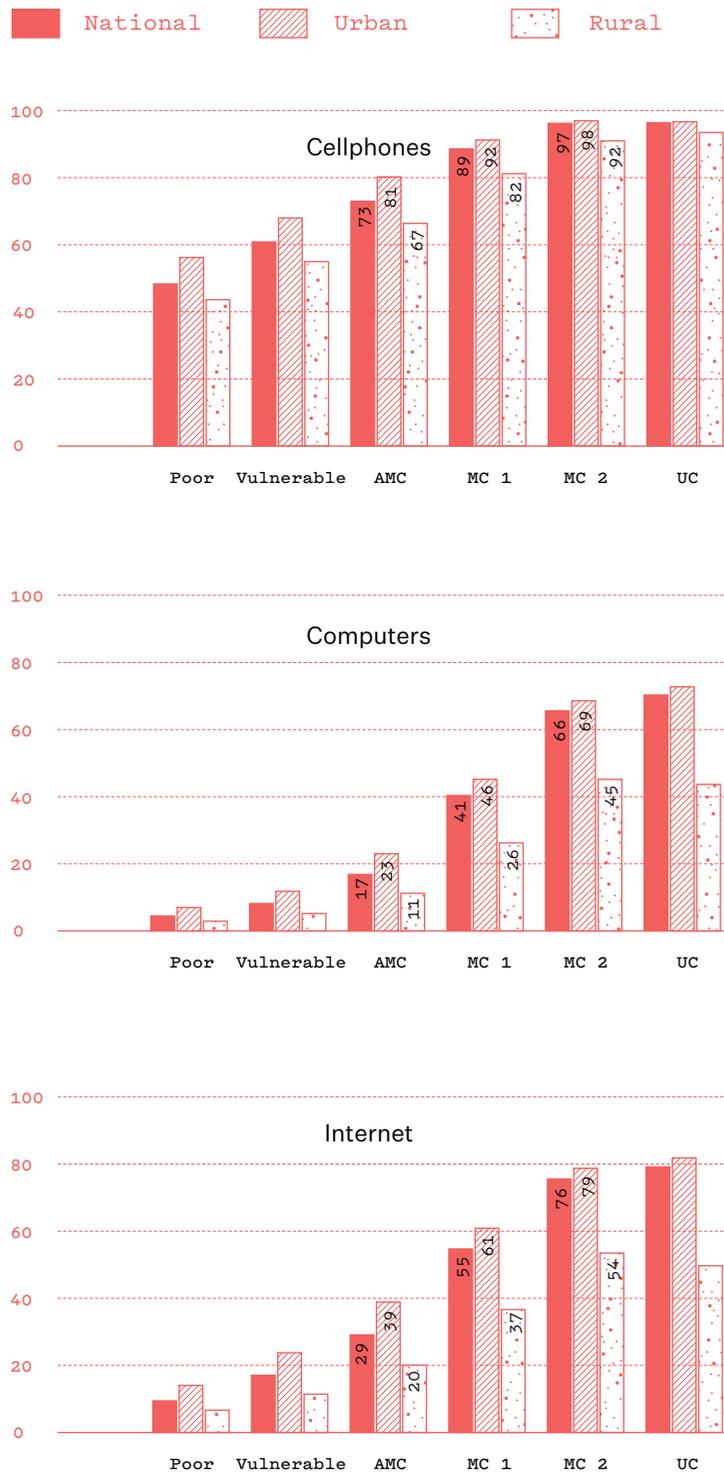


FIGURE E.7 Access to technology and information by class, 2016 (percent)

Access to computers and the internet are uncommon outside the middle class; thus middle-class children are far more likely to gain exposure to the ICT that underpins the modern global economy.



Source: Susenas and World Bank calculations.

“The challenge now for Indonesia is to make growth more inclusive by providing economic mobility and growing the middle class”

The challenge now for Indonesia is to make growth more inclusive by providing economic mobility and growing the middle class. To become a high-income country and sustain or even accelerate historical growth rates¹⁸—a challenge that is faced by much of developing East Asia¹⁹—Indonesia will need to develop a more inclusive growth model so that more of the population can both contribute to and benefit from that growth. Despite low rates of poverty, many Indonesians remain vulnerable, with around one-third below the vulnerability line,²⁰ while inequality, despite recent moderation, has been rising rapidly (Figure E.2). Moreover, Indonesia’s population will soon begin to age, creating further pressures. This means that Indonesia will face a demographic burden, with a steep drop in the size of its workforce and sharp increases in public spending on pensions, health care, and long-term day-to-day care in the coming decades. This, in turn, will pose a challenge to sustained economic growth.²¹

cial tensions and disharmony, which can in turn create conflict. Indeed, districts with higher levels of inequality than the average in Indonesia have 1.6 times the rate of conflict compared with districts with lower levels of inequality.²³ Indonesians already think inequality is too high and should be reduced.²⁴

At the same time, aiming to become a high-income country and increasing economic mobility will require new investments. The key to Indonesia’s closing the gap with high-income countries is a growth strategy that is based on improving labor productivity.²⁵ To achieve this, in addition to improving the functioning of product, labor, land, and capital markets, significant investment is required to close the infrastructure gap (roads, ports, electricity, water and sanitation, and irrigation networks) and the skills gap (which requires improving access to key public services for young children and improving the quality and relevance of education for older children).

In terms of relative incomes, inequality has risen in Indonesia since 2000, as most Indonesians have been left behind by the middle class, with possibly significant consequences not only for growth but also for social and political stability. High levels of inequality may slow economic growth, while more equal countries may grow faster.²² High inequality may reduce economic growth for all if poorer people are unable to properly invest in their children’s development, if people fail to exit poverty and vulnerability, and struggle to move into the middle class, and if people fail to find productive jobs. Recent research indicates that higher inequality leads to lower and less stable economic growth. High inequality can also have social costs: when people perceive large differences in wealth, this can create so-

The middle and upper classes pay taxes, and a new social contract is needed to grow tax collections from those already in the middle class, and those joining it over time. Indonesia’s government revenues are lower than many other middle-income countries and many other countries in East Asia. Total revenues are only 10.9 percent of GDP, compared with 16.5 percent in Thailand, 16.1 percent in Malaysia, and 12.9 percent in the Philippines. Low personal income-tax collection (at just 1.1 percent of GDP) is due mainly to non-compliance. Increased income-tax collection would significantly increase available funding for investment in infrastructure and skills, but the progressivity of such taxes means they will predominantly be paid for by middle-class Indonesians.

¹⁸ See World Bank (2014) *Indonesia: Avoiding the Trap*, Development Policy Review.

¹⁹ World Bank (2017a) *Riding the Wave*.

²⁰ 35 percent of the population is below the national vulnerability line (1.5 times the poverty line), while 32 percent are below the Lower Middle Income Countries poverty line of PPP US\$3.20 in 2011 prices; see 2017 Indonesia Country Poverty Brief.

²¹ See World Bank (2015b) *Live Long and Prosper: Aging in East Asia Pacific*, World Bank.

²² Berg, A. and Ostry, J. (2011) “Inequality and Unsustainable Growth: Two Sides of the Same Coin?” International Monetary Fund Staff Discussion Note SDN/11/08.

²³ World Bank (2015a).

²⁴ World Bank (2015c) *A Perceived Divide*.

²⁵ See World Bank (2014a) *Indonesia: Avoiding the Trap*, Development Policy Review.

What makes the middle class different? Most of the middle class lives in cities...



Left Around 13 million middle-class people live in Greater Jakarta alone, accounting for 31 percent of the urban middle class and 24 percent of the middle class nationally.

Below Despite having achieved economic security, close to half of the middle class is deprived on at least one non-monetary dimension, primarily poor housing conditions.



ESOS

Unlike all other classes (except for the upper class), most of the middle class lives in the major urban agglomerations that dominate the Indonesian landscape and are mostly found in Java. There are more poor, vulnerable, and AMC in rural areas than in urban areas.²⁶ However, three-quarters of the middle class live in urban areas (Figure E.8), with two-thirds of those urban middle class living in major metropolitan agglomerations—the fastest growing urban areas.²⁷ Although some regions enjoy a higher percentage of middle class among the population—for example, in Sulawesi—the much greater population of Java means that around two-thirds of the middle class live there. In fact, around 13 million

middle-class people live in Greater Jakarta alone (Figure E.9), accounting for 31 percent of the urban middle class and 24 percent of the middle class nationally. The relatively low urban poverty and vulnerability rates mean that, while more of the AMC lives in rural areas, it also makes up most of the non-middle class in cities. Only in a small number of cities is the middle-class rate similar to the AMC rate (Jakarta, Bandung, Denpasar and Yogyakarta), or significantly higher (Surabaya and Makassar). This implies that policies to support the expansion of the middle class will need to have a strong urban dimension, which is the focus of a major ongoing research project.²⁸



²⁶ See main body of report.

²⁷ See World Bank (forthcoming) *Recent Trends in Urban Indonesia* for more details.

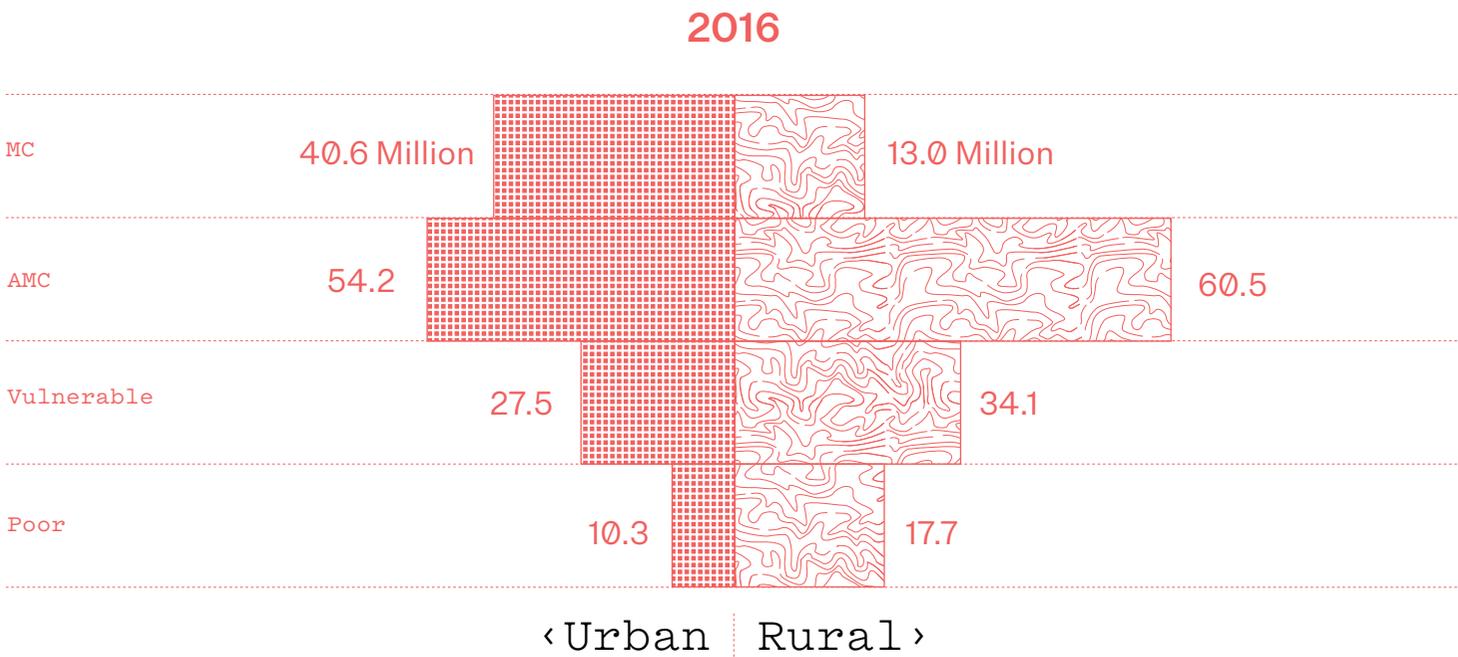
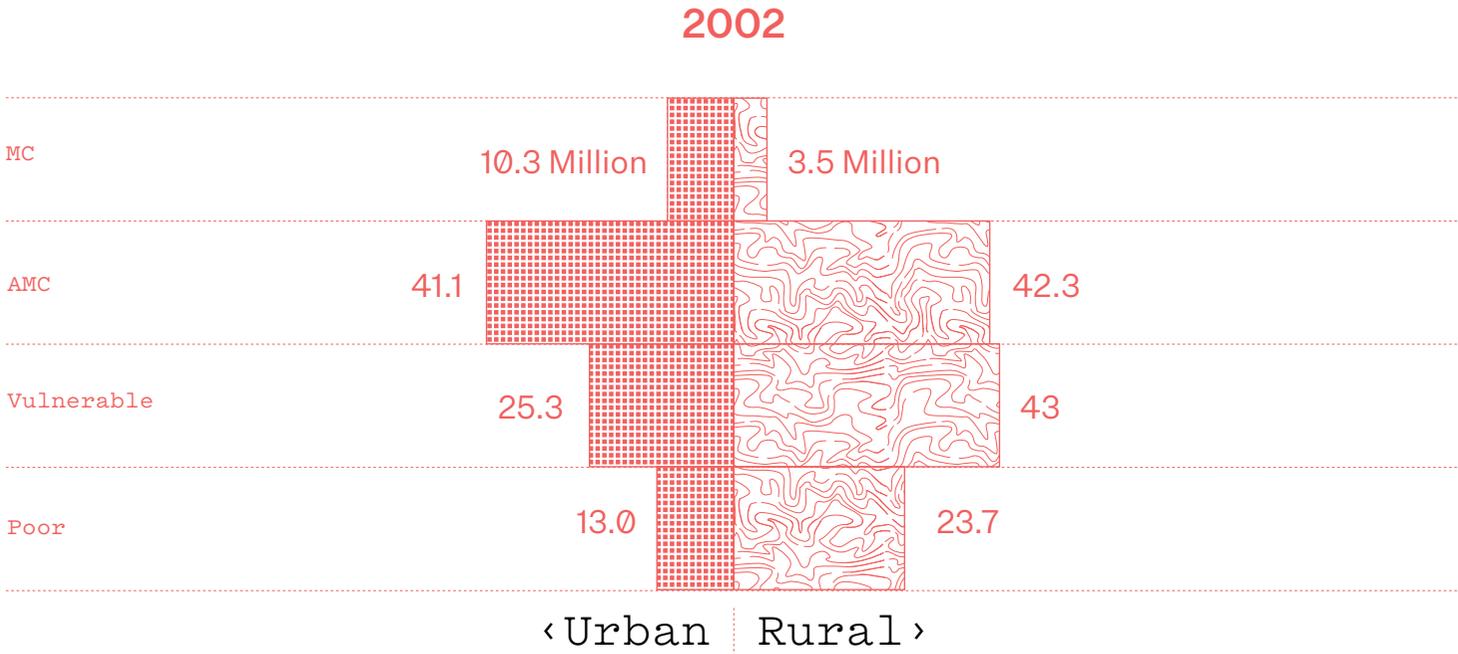
²⁸ See the World Bank's forthcoming flagship report on Indonesian urbanization.

FIGURE E.8

Urban-rural breakdown of Indonesian consumption classes, 2002 and 2016 (million)

76%

At about 76 percent, most of the middle class live in urban areas, many in the urban agglomerations of Java.

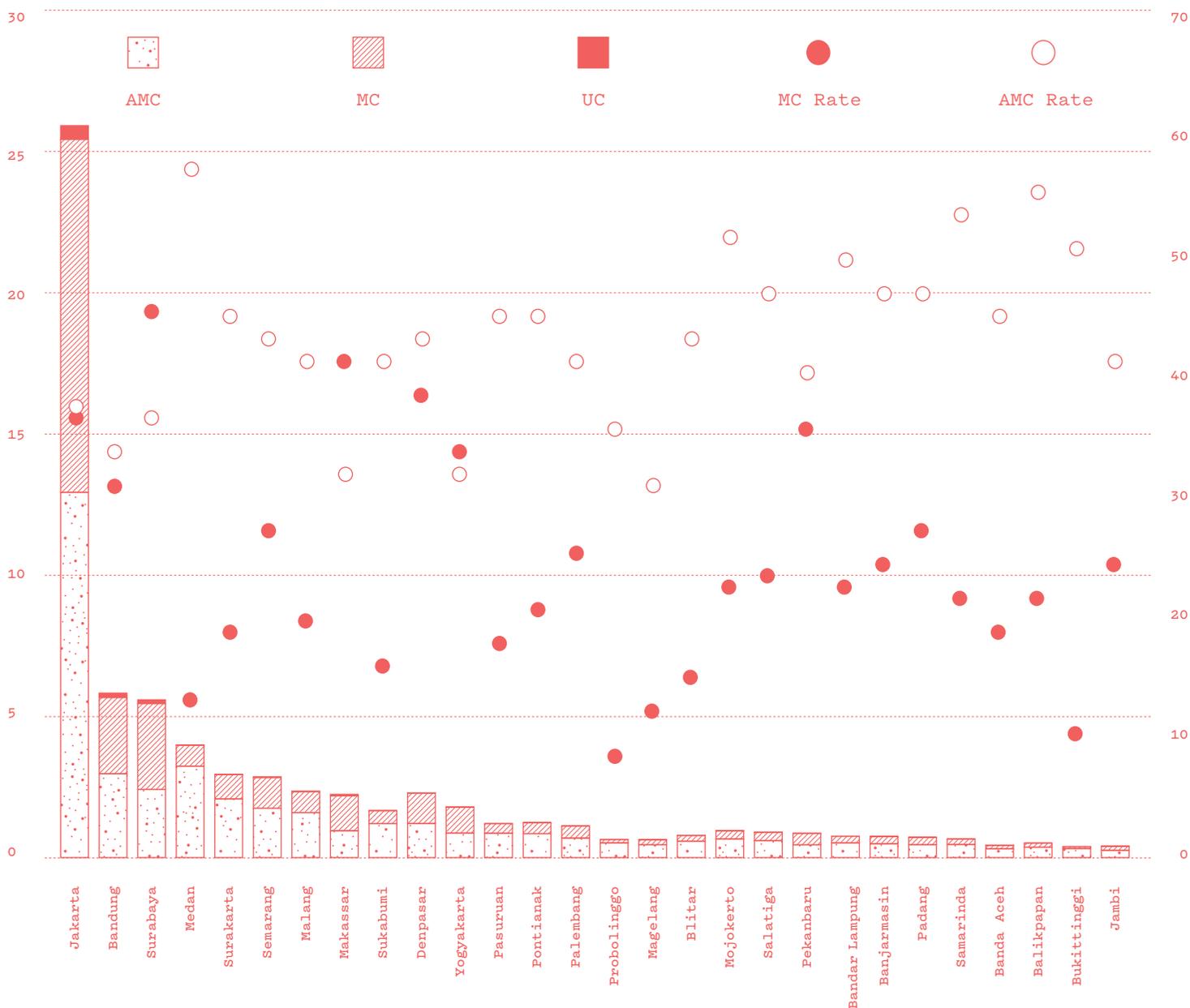


Source: Susenas and World Bank calculations.

FIGURE E.9

Urban agglomerations with largest MC and AMC populations, 2016 [million (LHS) and percentage of population (RHS)]

The middle class is largely an urban phenomenon and is clustered in the major Indonesian urban metropolises, mostly in Java.



Source: Susenas and World Bank calculations.

Note: Agglomeration definitions of cities are based on World Bank (forthcoming).²⁹

²⁹ The definition of metropolitan areas follows that of the World Bank’s Flagship report on Urbanization in Indonesia, which is currently underway. Multi-district metropolitan areas are thus defined based on daily commuting flows between Indonesian districts using data from the August 2013-2015 rounds of Sakernas. Single-district metropolitan areas, meanwhile, are those which satisfy the following three criteria: (i) the district is classified as a Kota; (ii) the district has a population of at least 500,000; and (iii) the district has an average population density which is at least 1,500 people per sq. km.

Right It is only as a household becomes middle class that it begins to own home amenities that are more oriented toward convenience and comfort.

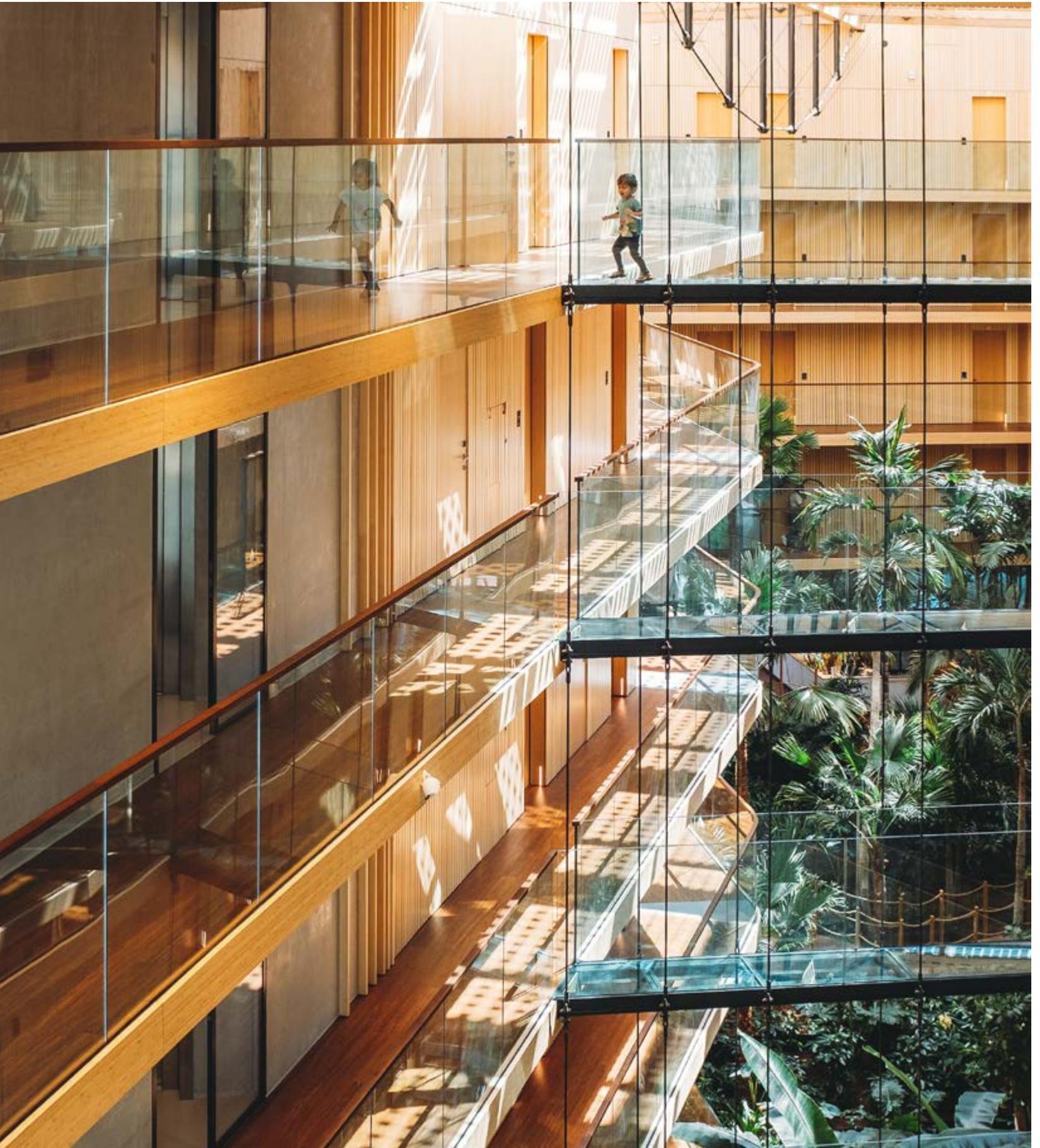
Expansion of the middle class will also require better leveraging of the potential of Indonesian cities to deliver on prosperity, inclusion, and livability. More than half of the Indonesian population lives in urban areas that are already home to three-quarters of the middle class. On the other hand, while more of those in the AMC live in rural areas, they also make up most of the non-middle class in the cities. Higher population density that comes with urbanization can boost productivity and growth. Density not only concentrates firms, workers and consumers, but also ideas. This fosters innovation, specialization and greater opportunities to realize scale economies. However, density can also dampen these agglomeration benefits of cities if the resulting congestion, pollution, and other negative externalities are not properly managed. At the same time, it will also be important to ensure that the prosperity of cities and the leading regions also benefit the AMC, together with the poor and vulnerable, in the less urbanized lagging island regions of the country through strengthened backward linkages.

Dealing with the urbanization challenges that confront Indonesia has become increasingly important, especially from the perspective of the AMC. The following three broad policy directions are aimed at meeting these challenges.³⁰ First, Indonesia's decentralization needs to work better.

While the sweeping decentralization reforms have provided greater autonomy to local governments, including on matters related to the provision of urban infrastructure and services, there are several overlapping provisions within the decentralization law that weaken outcomes by reducing accountability and hampering coordination. This compounds the well-recognized challenges of weak technical capacity of local governments, especially outside of the major metropolitan areas such as Jakarta and Surabaya, in carrying out their mandated functions. Second, there is an urgent need to invest in closing Indonesia's large infrastructure gap. This includes infrastructure related to the better provision of social and economic services, such as education, health, drinking water, sanitation, solid waste management, and so on, as well as connectivity infrastructure such as roads, highways, and ports. This will enable those in the AMC to invest in the human capital of their children and to also better link up with labor market opportunities generated in the growth poles. Third, targeted place-based policies will be required to ensure that those in the AMC in the lagging island regions also have a decent chance of joining the ranks of the middle class. Fine-tuning policies on special economic zones (SEZs) and other incentive-based mechanisms, for example, to attract professionals such as teachers and doctors to serve in these areas, based on evidence on what works and what does not, is one way forward.

30 A major World Bank report on urbanization is currently in process and will address these issues in far greater detail.









Left Indonesian students do not have equal access to learning opportunities; comparisons of the characteristics of schools attended by poorer and wealthier students in Indonesia shows important differences in the quality of service delivery.

ES 04

Being better educated is the key dividing line between the middle class & those below

Most of the middle class is now completing high school and many go on to tertiary education. Nearly half of the aspiring middle class aged 25-29 years old drops out of school before senior high school. At the same time, nearly 80 percent of the middle-class cohort at least

completes high school, while one-third goes on to complete some form of tertiary education (Figure E.10). Moreover, almost none of MC 2 or the upper class fails to finish high school. In fact, 60 to 67 percent of these two groups have some form of tertiary education (Figure E.11).

FIGURE E.10 Educational attainment by class, ages 25-29, 2016 (percent)

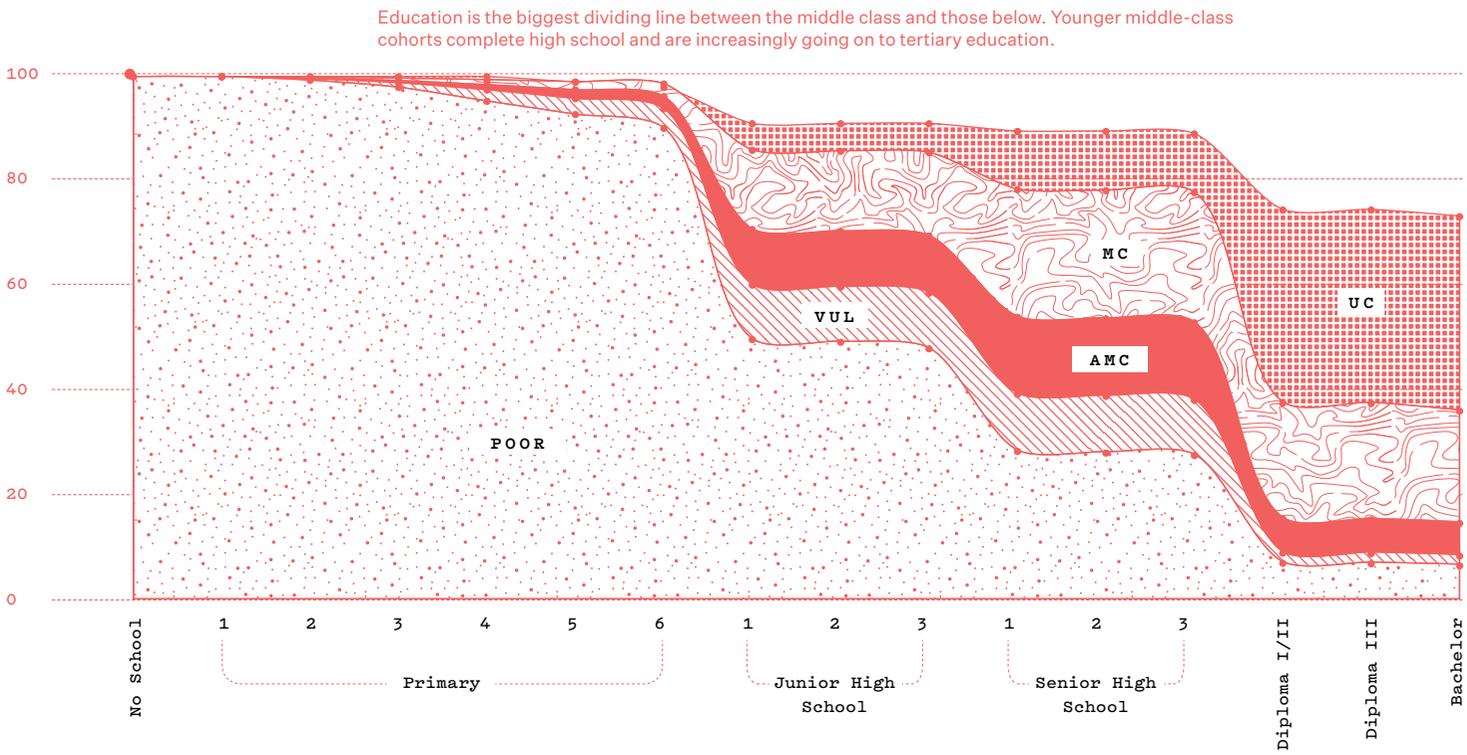
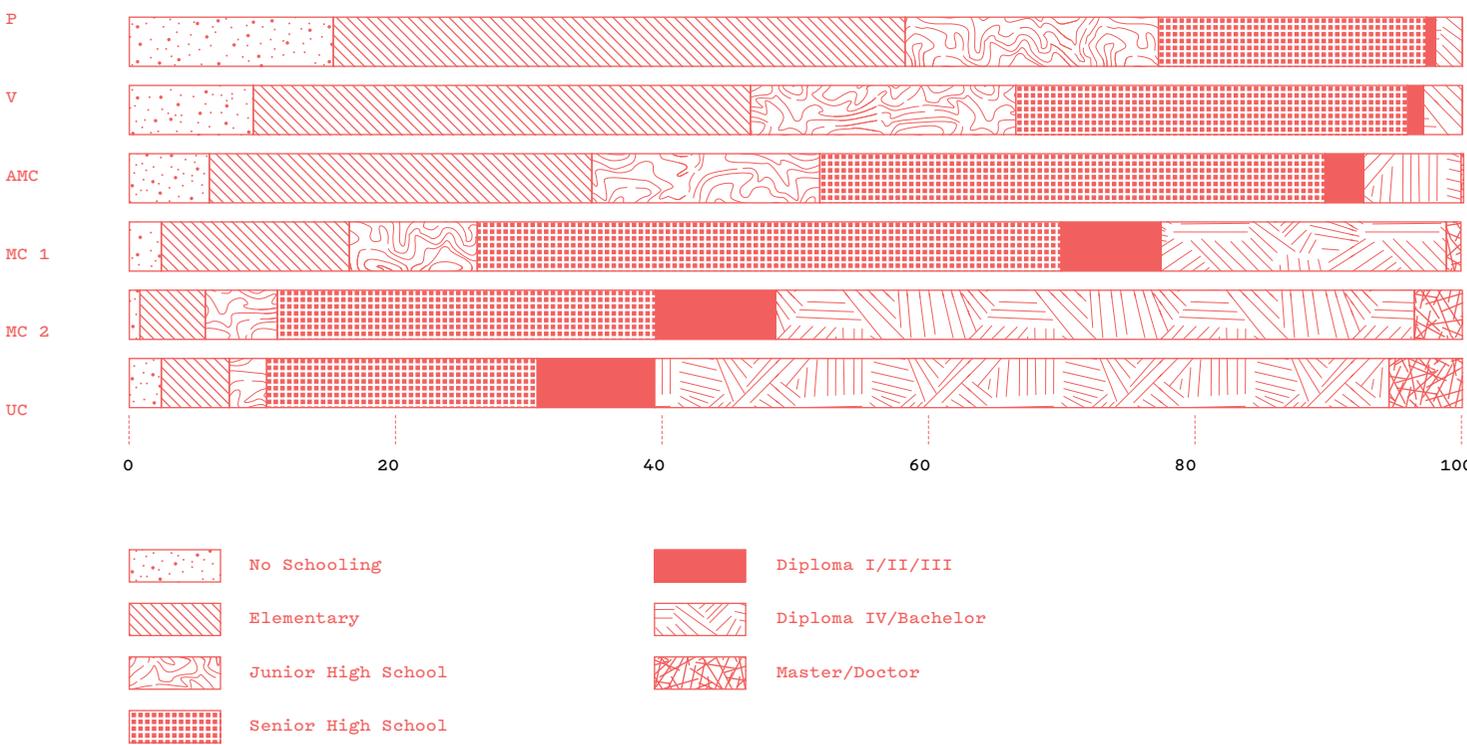


FIGURE E.11 Educational attainment by class, ages 25-34, 2016 (percent)



Source: Susenas and World Bank calculations.

The poor quality of Indonesian education is a limitation for the middle class, but progress is being made. While the level of years of educational attainment for the Indonesian middle class is higher than for other East Asian middle classes,³¹ the low quality of Indonesian education relative to most other countries undermines these attainment levels. Test scores in Indonesia continue to lag those in OECD countries across the socioeconomic distribution, although the gap has been closing in recent years. Figure E.12 compares international test scores for 15-year-olds between Indonesians across the national socioeconomic status (SES) distribution and the OECD average for the same range (bearing in mind that these OECD students are relatively poor by developed country standards). Even when comparing children of

the same SES status, average Indonesian test scores significantly lag those of the OECD average in mathematics, reading, and science. This holds true even if we look only at the middle class (SES deciles 9 and 10). In fact, the gap between the Indonesian middle class and OECD children of comparable SES levels is 47 to 63 points, where 30 points is equivalent to one year of education.³² Despite this, Indonesia has been closing the gap. For example, those in the middle-class SES range increased their scores from 2003 to 2015 by 40 to 50 points.³³ If this rate of progress continues, the middle class could close the gap with the OECD average within a decade or so. Nonetheless, greater skills and productivity in the future will require smarter public investment in education to capitalize on middle-class employment in higher

value-added sectors, such as financial services and information and communication technologies.

The middle class is also producing the skilled workers of tomorrow, with more educated children who are more exposed to the technology that drives the modern global economy. The middle class has fewer children but invests more heavily in their education. Middle-class children start school earlier and stay in school longer, increasing the base of skilled workers for the future. Importantly, middle-class children are much more likely to be exposed to the ICT that drives, and will continue to drive, the modern global economy (Figure E.7), particularly for children of the urban middle class.

³¹ World Bank (2017a).

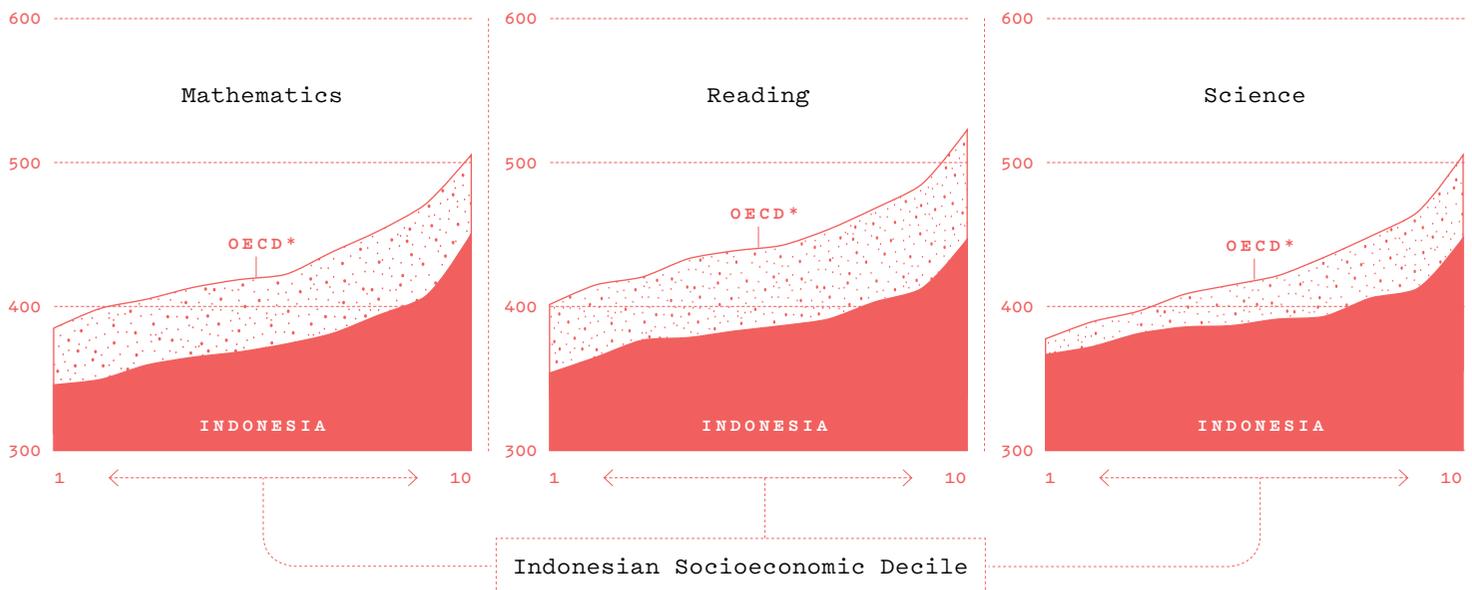
³² World Bank (forthcoming) *Growing Smarter: Learning and Growth in East Asia Pacific*.

³³ PISA data and World Bank calculations.

FIGURE E.12

Average Indonesian and OECD* PISA scores by Indonesian socioeconomic decile, 2015 (points)

Test scores in Indonesia continue to lag those in OECD countries across the socioeconomic distribution, although the gap has been closing in recent years.



Note: *OECD excluding Mexico and Chile. SES deciles are based on the Indonesian SES distribution, with the mean OECD scores for the same SES ranges included for comparison purposes.

Source: Programme for International Student Assessments (PISA) and World Bank calculations.

Due to greater education & skills, most of those in the middle class have formal jobs, although female labor participation remains low

While most middle-class workers have formal jobs, the remainder are increasingly running productive businesses, which drives growth and creates jobs for others. Over half of employed middle-class workers are formal employees and salaried workers, rising to two-thirds for MC 2 and the UC, compared with just one-third of the AMC and one-quarter or less of the poor and vulnerable (Figure E.13). At the same time, while many of those in the middle class remain self-employed, they are increasingly likely to run a business with permanent employees, rather than one with unpaid employees (likely family workers), as is the case for poorer households. This indicates that these enterprises are sufficiently productive to sustain both the owner and paid workers. Moreover, it may well be the case that they already enjoy sufficiently high incomes, which give them the confidence to take entrepreneurial risks.³⁴

However, Indonesia's middle-class women do not work much more than those in the non-middle class and less than other middle-class women in East Asia and around the world. As more people in a country work, so its economy grows. In almost all countries, most men work (or look for work) and the differences in total labor-force participation depend on how many women work. A recent paper, using a similar but slightly different definition of the middle class based on economic security, found that in East Asia Pacific, while only about 50 percent of non-middle class women participate, this rises to 70 percent for the middle class.³⁵ However, while middle-class Indonesian women are slightly more likely to work than other Indonesian women (Figure E.14), the rates remain much lower than those for other middle-class women in East Asia (Figure E.15), undermining a potential contribution to economic growth.

Education plays a role in female labor participation rates, but this is not the whole story. Although only around 60 percent of middle- and upper-class women work, this increases to 81 percent for those with tertiary degrees. As such, post-secondary education plays a role in having more women work.³⁶ However, lower middle-class participation rates are not strictly due to education; as discussed earlier, the Indonesian middle class has similar or better education rates than other middle classes in East Asia. More research is required to better understand this phenomenon, also observed in Malaysia; possible explanations could be cultural norms around child-rearing and care, a lack of external childcare options, discrimination in the labor market, and a lack of good jobs in some areas.

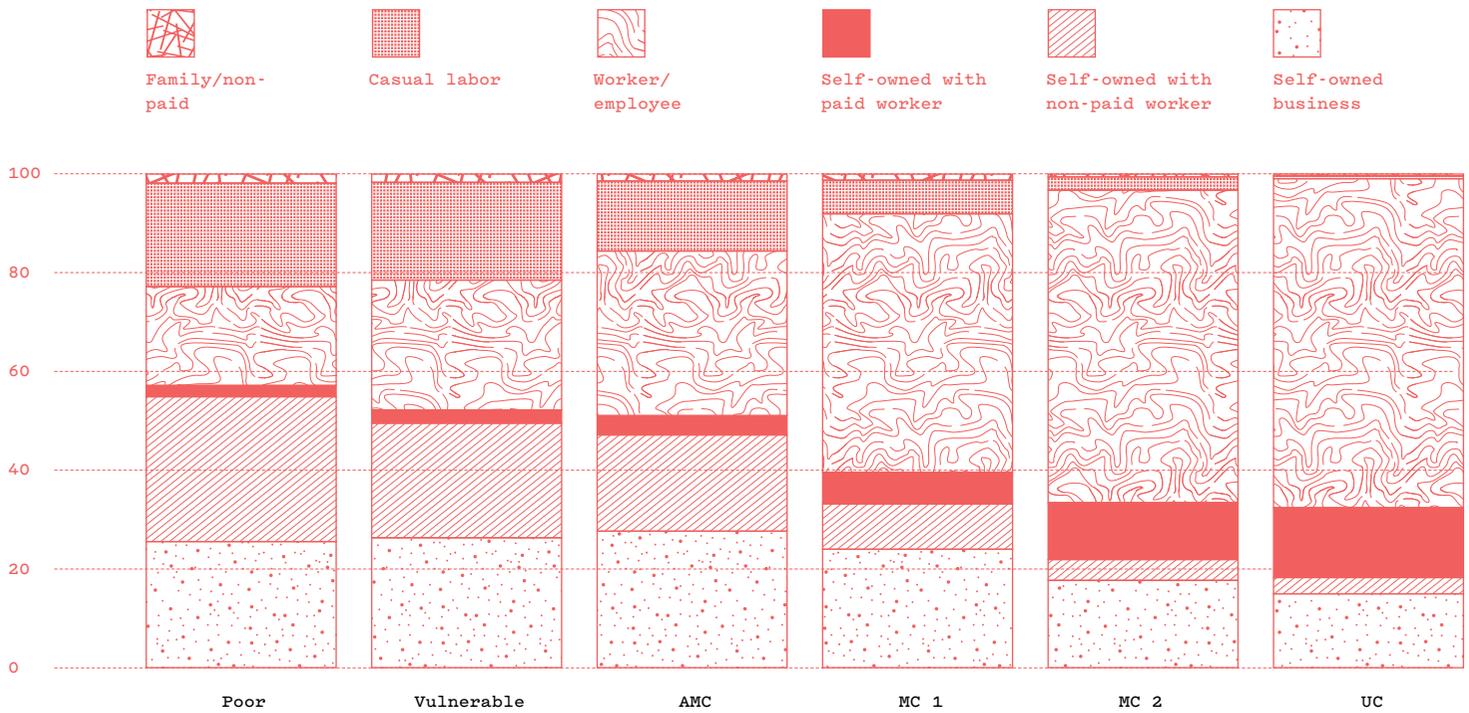
³⁴ See Banerjee and Newman (1993) 'Occupational Choice and the Process of Development', *Journal of Political Economy* 101(2):274-298.

³⁵ Wai-Poi et al. (2016). Malaysia is not included in this regional comparison due to data limitations, but has a similarly low rate of female labor participation.

³⁶ World Economic Forum (2016) *Global Gender Gap Report 2016*.

FIGURE E.13 Occupational status of head of household by class, 2016 (percent)

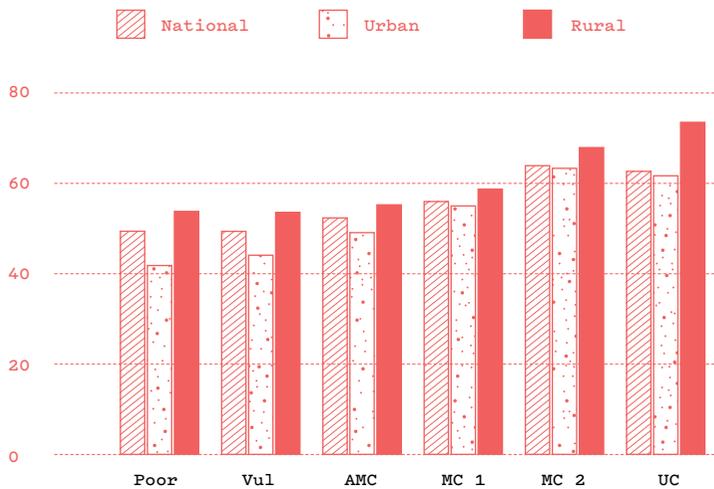
The majority of middle class workers are formal employees, while the rest are increasingly likely to be business owners who employ others.



Source: Susenas and World Bank calculations.

FIGURE E.14 Female employment rates by class, 2016 (percent)

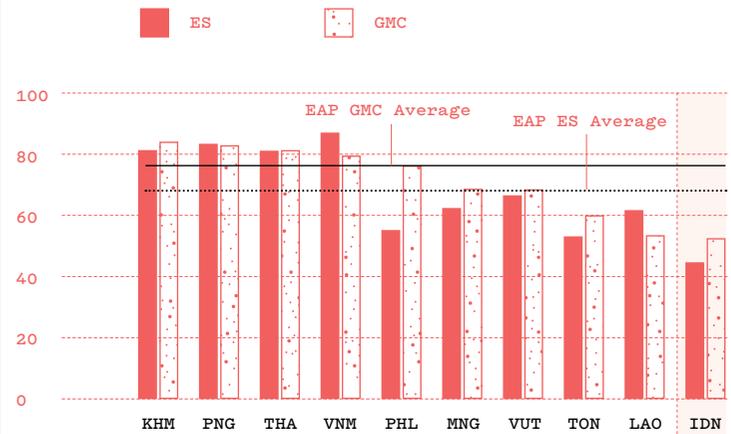
Middle-class women are slightly more likely to work than other Indonesian women...



Source: Susenas and World Bank calculations.

FIGURE E.15 Middle-class female labor-force participation in East Asia (percent)

...but they work much less than most East Asian middle-class women, contributing less to the economy.



Note: ES are the Economically Secure, consuming PPP US\$5.50-15 per person per day, while the GMC are the Global Middle Class, consuming more than PPP US\$15 a day.

Source: Wai-Poi et al. (2016).

Making it easier for firms & entrepreneurs to create good jobs...

Almost half of the business owners who employ others are from the middle class. While most middle-class workers have well-paid productive jobs in the formal sector, a significant number own their own businesses and employ others (Figure E.13). Despite comprising only 20 percent of the population, they represent nearly half of all business owners with permanent employees. Policies that support these entrepreneurs will increase their economic mobility, helping to drive economic growth, and create more jobs for the aspiring middle class. Two key areas are the regulatory environment and access to credit.

Recent improvements in the ease of doing business need to be sustained and deepened. The investment climate and ease of doing business has long been identified as a constraint on firms in Indonesia.³⁷ As recently as 2013, Indonesia ranked 120th out of 185 countries in the World Bank Group's Doing Business rankings. However, a series of reforms implemented by the government has seen significant improvements and Indonesia has achieved one of the greatest gains in the rankings in recent years, improving from 106th in the 2016 rankings to 91st in 2017 to 72nd in the Doing Business 2018 rankings. The World Bank credits positive reforms in the areas of: starting a business, getting electricity, registering property, getting credit, paying taxes,

trading across borders, and enforcing contracts. However, with a goal of 40th by 2019, the government now needs to move beyond "quick-win" reforms and implement medium-term structural reforms to further improve Indonesia's business environment. To this end, it is important that the government continues with its plan for coordinating and monitoring the reform process.³⁸

In addition, more needs to be done to make Indonesian firms less credit constrained.³⁹ There is ample evidence that firms in Indonesia are credit constrained, relying more on retained earnings than bank credit for expansion. The credit constraints faced by firms reflect the lack of depth in Indonesia's financial markets. Public policy could help nudge the system toward greater financial depth, through easing strict investment requirements, building a more credible legal system that allows for the effective enforcement of contracts and property rights, and providing greater investor protection. The recent reforms of the social security regime further present an opportunity to deepen financial markets, with the new National Social Security System (SJSN) expected to cover 10 times the number of workers than the previous body, multiplying assets under management, and presenting an opportunity to widen the choice of eligible investments.

72nd

Indonesia is improving from 106th in the 2016 rankings to 91st in 2017 to 72nd in the Doing Business 2018 rankings.

³⁷ World Bank (2014a).

³⁸ World Bank (2017d) *Indonesia Economic Quarterly: Sustaining Reform Momentum*.

³⁹ See World Bank (2014a).



Below About 28 million new jobs were created in Indonesia between 2001 and 2016. Of these, 85 percent were formal, 70 percent were fulltime employees and 77 percent were in services.



28m

Of jobs created
between 2001 and
2016 in Indonesia

84%

were formal Jobs

70%

were in wage-
employment

77%

were in services

E S O 7

**...can help expand
the middle class by
allowing the aspiring
middle class to take
advantage of the many
new formal jobs in
services with higher
wages...**

Most of the new jobs created since 2001 have been formal, in wage-employment and the services sector, and pay almost twice as much as informal and non-wage jobs. About 28 million new jobs were created in Indonesia between 2001 and 2016. Of these, 84 percent were formal, 70 percent were in wage-employment and 77 percent were in services (Figure E.16), although job growth in the past two years has been more informal. While the strong legal protection of formal employment is often not observed in practice,⁴⁰ these jobs do pay more. Formal jobs pay 1.7 times more than informal jobs on average, while wage employees earn 1.6 times more on average than the self-employed (without workers) and 1.7 times more than non-agricultural casual workers.

However, most of these jobs require high school or tertiary education. Sixty-nine percent of formal workers have a high-school education or better, compared with just 18 percent of informal workers. This percentage is 64 percent for wage employees and 50 percent for business-owners with permanent employees, but 30 percent or lower for other self-employed or casual workers. Fifty-nine percent of services sector jobs require high school or more, compared with 37 percent in industry and 14 percent in agriculture. Better and higher paid jobs require better education. Moreover, most of the new jobs being created require better education. For example, of the 21 million jobs created in services between 2001 and 2016, 10 million required a high-school education and a further 9 million required tertiary education, while just 2 million required junior secondary or less.⁴¹

⁴⁰ Indonesia has some of the strictest labor regulations in the world, but they are poorly observed, meaning they provide little protection for many nominally formal workers. See World Bank (2015a).

⁴¹ Sakernas and World Bank calculations.

FIGURE E.16 **Change in jobs, 2001-16 by formality, occupational status and sector (million)**

Most of the new jobs created between 2001 and 2016 were good on paper, mainly being formal, in wage-employment, and in services. These jobs tend to require high school education or better, but pay more.

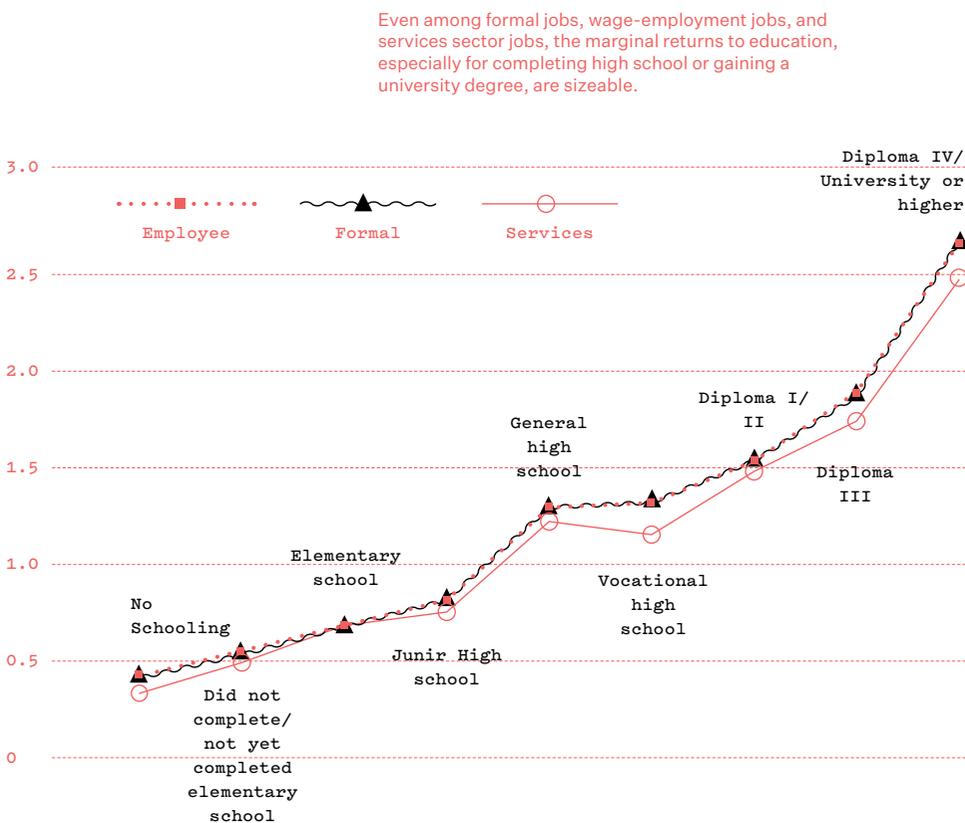


Source: Sakernas and World Bank calculations.

...which will mean ensuring that they complete at least high school & obtain the skills required for these better jobs

FIGURE E.17

Mean monthly earnings for formal, employee and services jobs by education required, 2016 (Rp million)



Source: Sakernas and World Bank calculations.

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Below Education is the biggest dividing line between the middle class and those below. Younger middle-class cohorts complete high school and are increasingly going on to tertiary education.

Higher education levels single those in the middle class out from the aspiring middle class and other Indonesians, and qualifies them for better jobs. As discussed earlier, the middle class has significantly greater educational attainment than the other classes, with the younger cohorts (up to 44 years old) mostly completing high school and many going on to tertiary education. Meanwhile, only about half of the aspiring middle class completes the high-school education required for the higher-paying formal jobs in the services sector (Figure E.10).

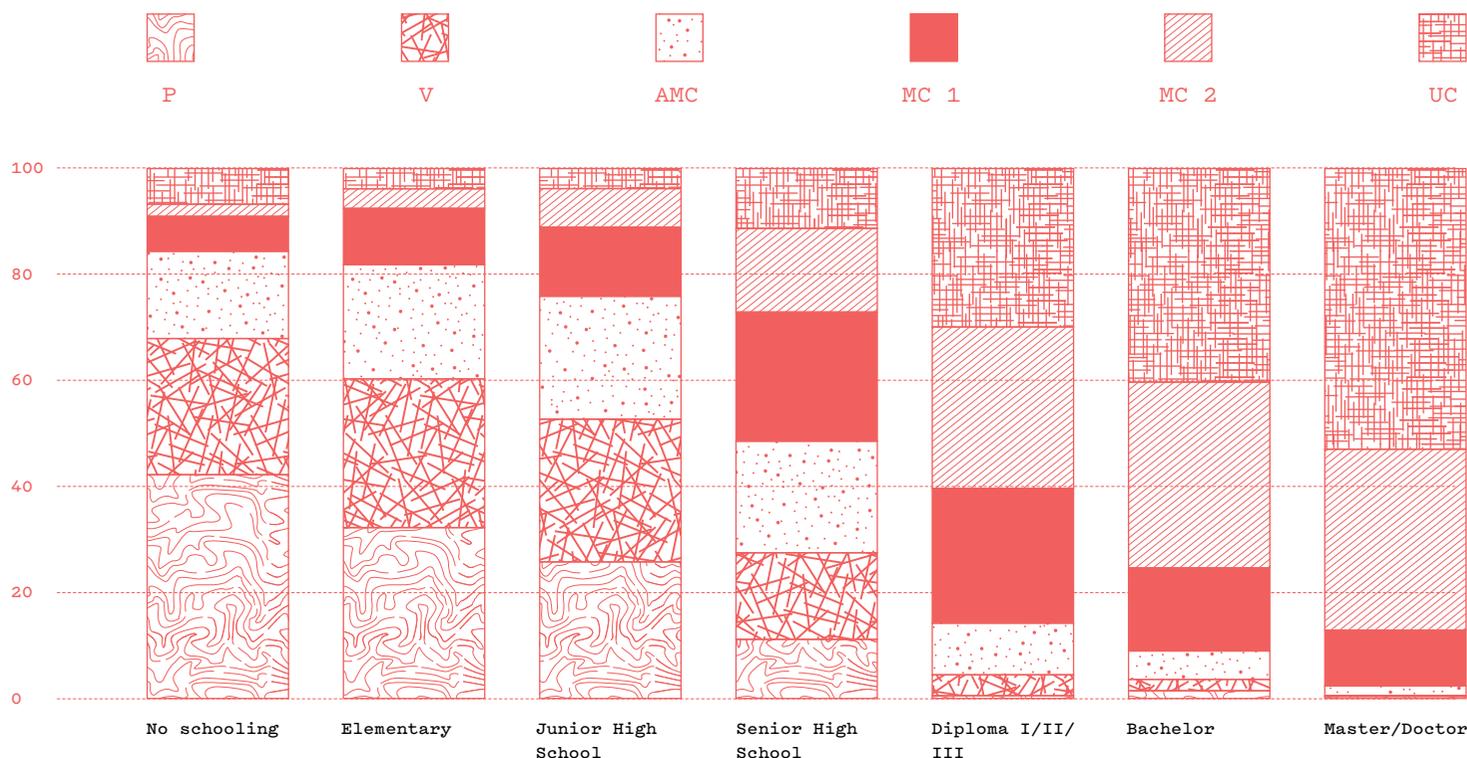
Moreover, tertiary education is a clear demarcation of the middle and upper classes. Not only do the middle and upper classes have better education, but better education is also a strict marker of the middle and upper classes. While only half of those who finish high school are middle or upper class, almost all of those who have some tertiary education are middle or upper class, making higher education both an aspiration and a demarcation of the middle class (Figure E.18).



FIGURE E.18

Highest educational attainment by class, 25- to 34-year-olds, 2016 (percent)

It is only those in the middle class who predominantly have the high school or better education required for better jobs, with relatively few not completing high school and increasingly large numbers having tertiary education.



Source: Susenas and World Bank calculations.

Thus, lifting aspiring Indonesians into the middle class means having more of them finishing high school and ideally going further. The government has been implementing education reforms, including compulsory and free primary and junior secondary education spanning 12 years, which should provide greater incentives for more students to complete high school. Nonetheless, failure to finish senior secondary school for the aspiring middle class is generally due to dropout after junior secondary. This can be because of family pressures to earn an income, but it may also reflect low perceived returns to further schooling. Improving the quality (or perceived quality) of secondary education may help to increase educational attainment among this group.

More needs to be spent on secondary and vocational education to make them more attractive to children of the aspiring middle class and to rebalance the fairness of spend-

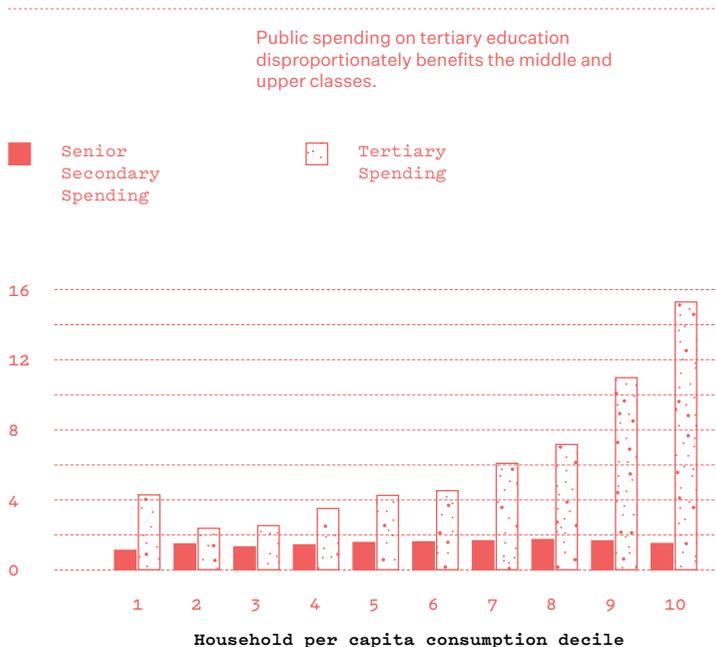
ing between secondary and tertiary. Only 10 percent of central government spending on education goes to secondary schooling, compared with 24 percent on primary education and 33 percent on tertiary. Moreover, vocational education—a key alternative channel for developing skilled workers outside of general education—receives only 9 percent of the Ministry of Education and Culture’s (MoEC) budget.⁴² Meanwhile, the imbalance of spending between secondary and tertiary education disproportionately benefits the middle and upper classes at the expense of the much larger aspiring middle class. Although they comprise only 20 percent of the population, the middle and upper classes benefit from 43 percent of all public spending on tertiary education (Figure E.19). Although tertiary spending is 3.5 times larger than secondary school spending, only 44 percent of this spending benefits deciles 5–8 (roughly the aspiring middle class). This imbalance between tertiary and other educational spending is a broader regional pattern.⁴³

The education system also needs to provide the skills demanded by well-paid jobs in the modern economy. Not only have Indonesia’s education outcomes long been poorly ranked in international scoring, recent changes to the national curriculum mean that less time is being spent on subjects that have more relevance to skilled employment. In 2013, hours spent on English, mathematics, physics, chemistry and biology were reduced, along with the related ICT training, in favor of more time spent on civics and religious teaching. This means today’s children are spending even less time developing the skills that firms have identified as gaps (Figure E.20).

⁴² See World Bank (forthcoming) *Spending Better: Indonesia Public Expenditure Review 2016–2018*.

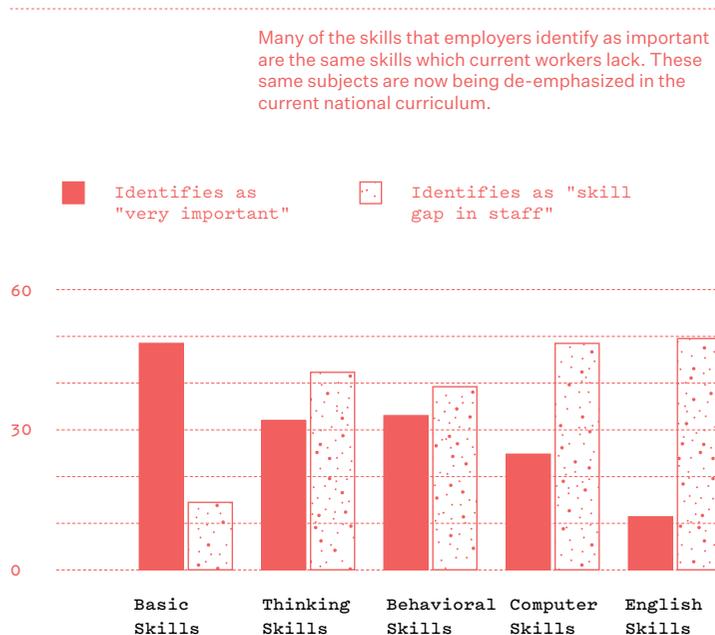
⁴³ World Bank (forthcoming) *Growing Smarter: Learning and Growth in East Asia Pacific*.

FIGURE E.19 Public education spending incidence by consumption decile (Rp trillion)



Source: Susenas, administrative budget data and World Bank calculations, in the forthcoming update to World Bank (2015) *Taxes and Public Spending*.

FIGURE E.20 Important skills identified by employers, and skill gaps (percent)



Source: World Bank (2011) *Skills for the Labor Market in Indonesia*.

“lifting aspiring Indonesians into the middle class means having more of them finishing high school & ideally going further”

Greater investments in early childhood education will also bring more children into education earlier and better prepare them to take advantage of later schooling. The majority of middle-class children are enrolled in early childhood education and development (ECED), but only half of children aged 5-6 years old in aspiring middle-class households are enrolled in school, and only 20 percent of those aged 3-4. ECED is relatively inexpensive and has been shown to generate strong returns.⁴⁴ Not only will greater enrolment in ECED of children in aspiring middle-class families make education more of a habit for them, it will also mean that they are better prepared to learn later when they go to secondary school.

At the same time, current workers need to be given the opportunity to adapt and improve their skills as the types of jobs required by the economy change. For those Indonesians who are already of working age,

reforms to the formal education system come too late. These workers will need additional training to ensure their skills remain relevant as job creation continues to tilt toward certain elements of the services sector. Currently, public provision of vocational training is scattered across several line ministries, making it difficult to coordinate efforts to adapt and improve the skills of current workers.⁴⁵ This issue is intensified because a relatively small proportion of Indonesian firms offer on-the-job training: just 8 percent of firms in Indonesia provide on-the-job training to workers compared with 32 percent of firms in the East Asia and Pacific (EAP) region at large.⁴⁶ Therefore, more can be done to establish a unified and comprehensive system for providing training to current workers, coordinated by the National Commission for Vocational Education and Training.

⁴⁴ See World Bank (2015a).

⁴⁵ Ministry of Manpower (2017), ‘Grand design pelatihan vokasi nasional’.

⁴⁶ World Bank Enterprise Survey 2015 and World Bank calculations.

The aspiring middle class is more likely to suffer from non-monetary poverty

Two-thirds of the aspiring middle class suffer deprivation on at least one non-monetary dimension of welfare. Fifty-three percent suffer from lower-quality housing, 30 percent lack access to proper sanitation, and 7 percent do not have access to clean water (Figure E.21). These deprivations have significant consequences, especially for the children of the aspiring middle class, as poor living conditions growing up, combined with inadequate feeding practices, can increase the risk of stunting. Stunted children develop their cognitive skills more slowly, reach lower educational levels, and earn less as adults, compared with children who grow up healthy. This is one of the most important development challenges for Indonesia, where 37 percent of children are

stunted—a much higher level than Indonesia’s regional peers—and a key constraint on the children of the aspiring middle class when they grow up.⁴⁷

However, despite economic security, half of those in the middle class are also deprived on at least one non-monetary dimension, mostly due to poor roofing. The middle class enjoys current incomes that indicate economic security; those in the middle class have a very low chance of being poor or vulnerable next year. However, economic security does not guarantee freedom from deprivation and non-monetary poverty. Nearly half of those in the middle class lacks access to one of clean water, proper sanitation, or ade-

quate housing conditions, primarily the latter (Figure E.21). Of the 20 percent of Indonesians who are middle class, 11 percentage points are also free from non-monetary poverty on these dimensions, while 9 percentage points are not. This is predominantly driven by sub-optimal building materials for floors, walls and roofs, although nearly 20 percent of the majority of the middle class also lack proper sanitation.⁴⁸ Even around 20 percent of upper-class households suffer from poor roofing materials or, to a lesser extent, improper sanitation. That is, while security from monetary poverty means living above subsistence, it does not yet guarantee non-deprivation on all dimensions of welfare.

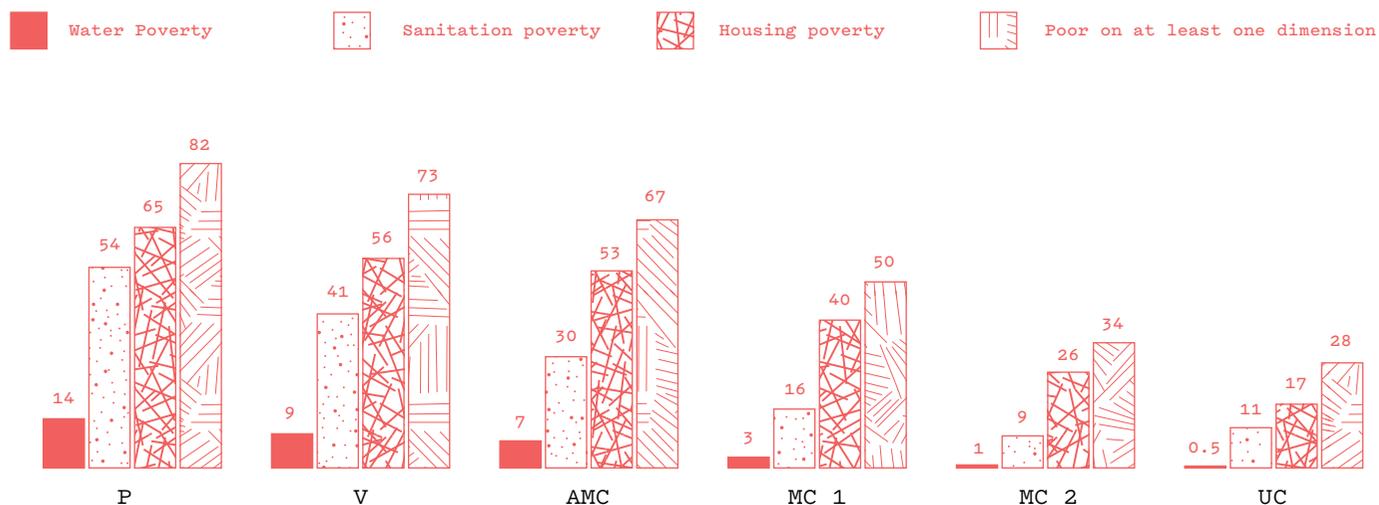
Right Nearly half of those in the middle class lacks access to either clean water, proper sanitation, or adequate housing conditions.

⁴⁷ See World Bank (2015a).

⁴⁸ Good roofing materials are considered to be concrete or tile. Sub-optimal roofing is that which is made from asbestos, tin, bamboo, wood, leaves, and other materials.

FIGURE E.21 Non-monetary poverty by class, 2016 (percent)

Despite having achieved economic security, close to half of the middle class is deprived on at least one non-monetary dimension, primarily poor housing conditions.



Note: Water poverty means a household does not have access to clean drinking water (bottled, piped or protected well/spring); sanitation poverty means no access to a toilet with septic tank; housing poor means a poor-quality roof (not concrete or tile), floor (dirt), walls (not brick or concrete).

Source: Susenas and World Bank calculations.





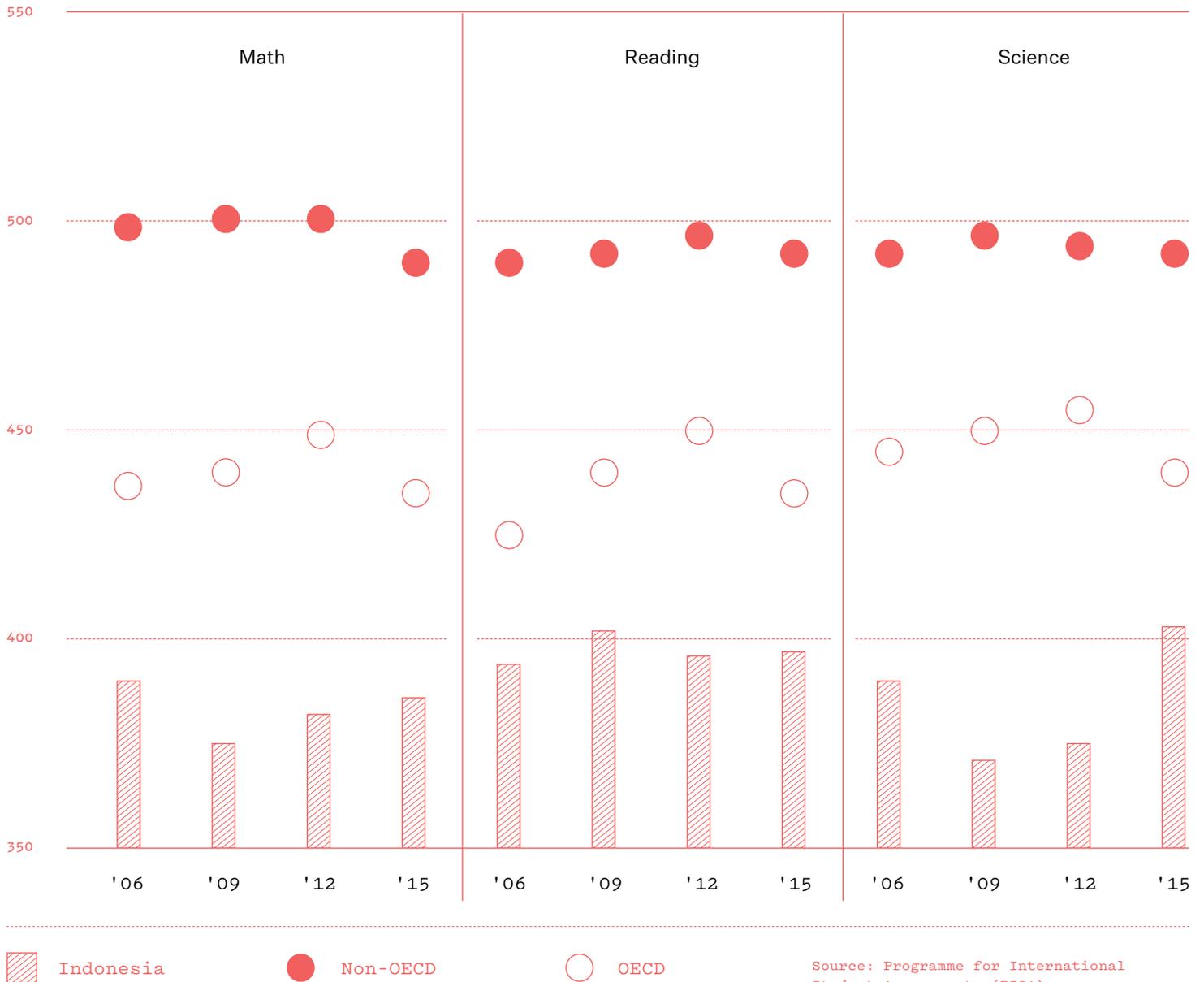
Moreover, the middle & upper classes are beginning to opt out of public services & into private provision, while the aspiring middle class is still reliant on public services

ES 10

At the same time, growing affluence and limitations in public service delivery mean that significant proportions of the middle and upper classes are beginning to opt out of key public services. In addition to wanting proper water and sanitation, those in the middle class also care about health and education. Access to public education and health is nearly universal for the middle class, but physical access is not enough to guarantee good service; quality matters as well. Many local health facilities do not have equipment or training to provide basic care or key services such as blood and urine tests, even in urban areas where most of the middle class live.⁴⁹ In education, despite increases in teacher numbers and teachers' pay, as well as a certification program, learning outcomes have not improved.⁵⁰ Indonesia's education outcomes remain among the lowest in the world and far behind the OECD average (Figure E.22), despite recent progress.

FIGURE E.22 International PISA scores, 2006-15 (points)

Indonesian 15-year-olds have some of the lowest test scores in core subjects undertaking PISA tests, reflecting the need for better quality education.



49 See World Bank (forthcoming) *Spending Better: Indonesia Public Expenditure Review 2016-18*.

50 See World Bank (forthcoming) *Spending Better: Indonesia Public Expenditure Review 2016-18*.

Consequently, those in the middle class are increasingly likely to turn to the private sector, particularly in health, while poorer Indonesians rely upon the public sector. Wealthier Indonesians are increasingly seeking private health care, despite near universal access to public services. The middle class is much less likely to use local health centers for inpatient and outpatient care than less-wealthy Indonesians, who are more likely to use public hospitals and, for the upper class, much more

likely to use private hospitals. Half of the middle class and three-quarters of the upper class use private hospitals for inpatient treatment, compared with just one-third of the aspiring middle class (Figure E.23). Similarly, the middle and upper classes are more likely to go to a hospital for childbirth than the local health center or clinic, and they are more likely to be attended by a specialized or general doctor rather than a midwife or nurse.

FIGURE E.23 Choice of health care by class, 2016 (percent)

As Indonesians get richer, they are increasingly seeking private health care...

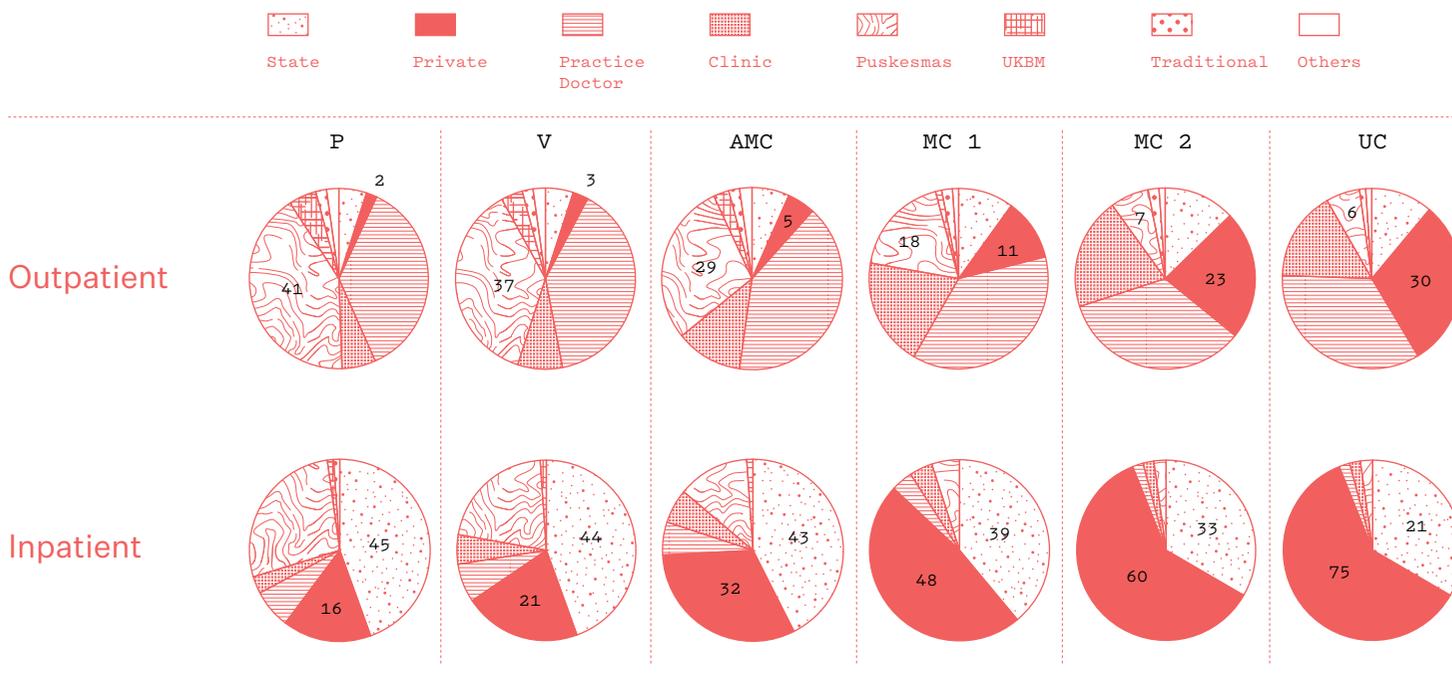
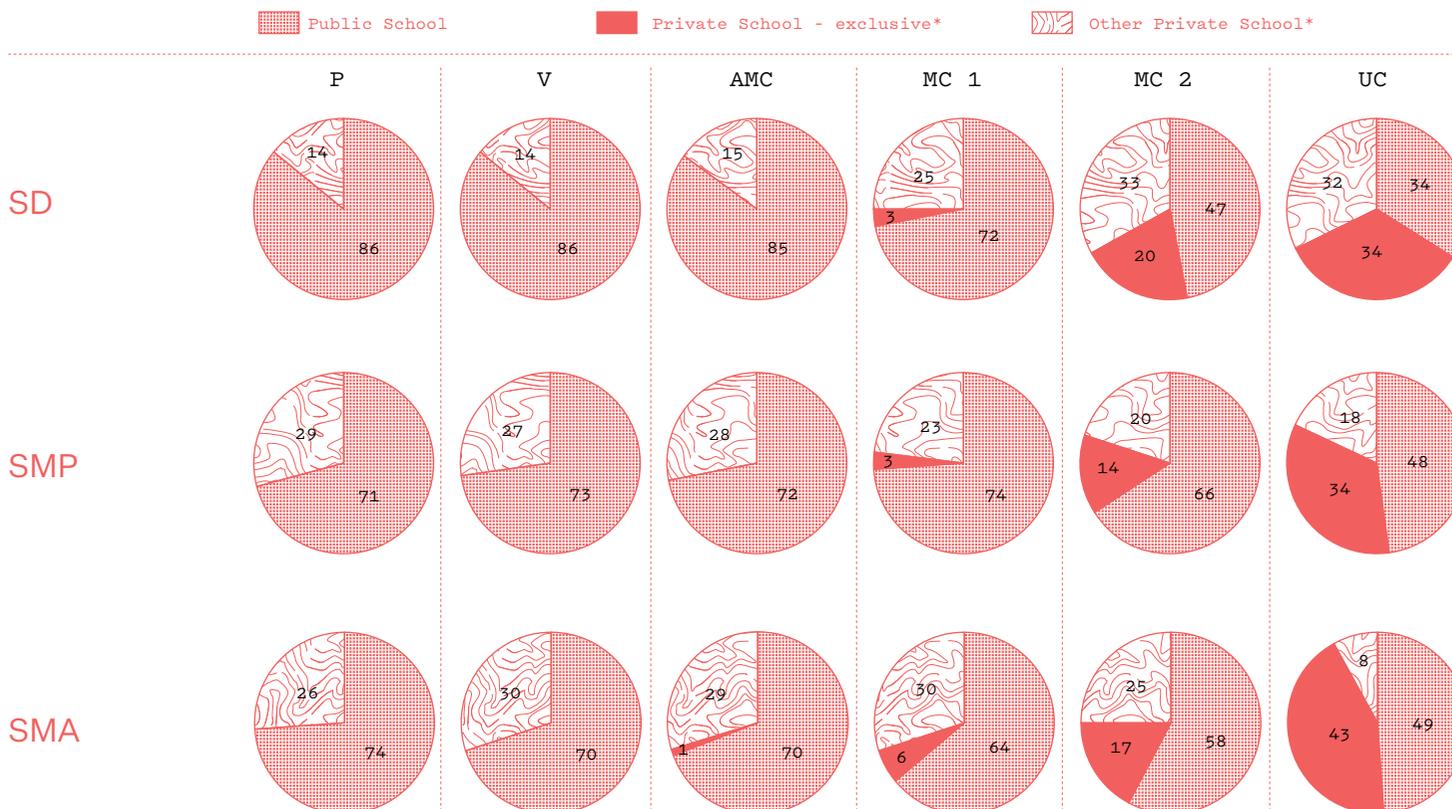


FIGURE E.24 Choice of school by class, 2015 (percent)

...while the richest of the middle class are often sending their children to exclusive private schools.



Note: Exclusive private schools are those whose tuition fees are in the top 10 percent of all schools.

Source: Susenas and World Bank calculations.

51 See Appendix 1 of World Bank (2017b) *Revealing the Missing Link: Private Sector Supply-side Readiness for Primary Maternal Health Services in Indonesia* and Table 4.9, based on the Quantitative Service Delivery Survey (QSDS) 2016.

52 See Table 4.2 of World Bank (2016) *Indonesia Health Financing System Assessment: Spend More, Right & Better*.

53 Quantitative Service Delivery Survey 2016 and World Bank calculations.

54 PISA data and World Bank calculations.

55 This summary is from Wai-Poi et al. (2016).

56 Firman (1999) 'Indonesian Cities under the 'Krismon'', *Cities* 16(2).

57 Hogan and Houston (2002) 'Corporate Cities - Urban Gateways or Gated Communities against the City? The Case of Lippo, Jakarta' in in T. Bunnell, LBW. Drummond and KC. Ho (eds) (2002) *Critical Reflections on Cities in Southeast Asia* Singapore Times Academic, 243-264.

58 Sharpe (2014) *Meet Indonesia's middle class (part 2): Jakarta's two cities*. Retrieved 31 March 2016 from <http://www.lowyinterpreter.org/post/2014/02/20/A-tale-of-two-cities.aspx>; Kompas (2010) *Mengapa BSD Master Plan Perkotaan Terbaik?* Retrieved March 31 2016 from <http://properti.kompas.com/read/2010/11/13/17180782/mengapa.bsd.master.plan.perkotaan.terbaik>.

59 Widjojo (2015) 'BSD City: A Response to Jakarta's Rapid Urbanisation'. Retrieved March 31, 2016. <http://www.citymetric.com/skylines/bsd-city-response-jakarta-s-rapid-urbanisation-1107>; Kompas (2010).

60 Hogan and Houston (2002).

61 Lippo Karawaci (2015) *Annual Report 2015*. Retrieved March 31 2015 from https://www.lippokarawaci.co.id/uploads/file/Publication/AnnualReport/AnnualReport%202015_IND.pdf.

62 Alam Sutera (2014) *Annual Report 2014*. Retrieved March 31, 2016 from <http://www.indonesia-investments.com/upload/bedrijfsprofiel/461/Alam-Sutera-Realty-Annual-Report-2014-Indonesia-Investments.pdf>.

63 Bintaro Jaya (2011) *The Professional City Bintaro Jaya*. Retrieved March 31, 2016 from <https://bintaroyayashinta.wordpress.com/2011/07/14/the-professional-city-bintaro-jaya/>.

The middle class, and especially the upper class, are also beginning to use exclusive private schools. In general, there is less opting out of public education by the middle class. Despite historical issues with the quality of public schooling in Indonesia, there are many excellent public schools, especially in wealthy neighborhoods of larger cities where the middle class often lives. Nonetheless, we are beginning to see the middle class sending its children to elite private schools. While less than 10 percent of most middle-class children attend these schools, this increases to 14 to 20 percent for MC 2 depending on schooling level, and for the upper-class group it reaches 34 percent for primary and junior secondary, and 43 percent for senior secondary (Figure E.24).

Some evidence suggests, however, that private sector quality is not necessarily higher. It is difficult to measure the true quality of the private health care that the upper class, and some of the middle class, are beginning to use. However, on a number of indicators of service readiness, the private sector does not outperform the public sector. For example, average service readiness among sampled priority districts was 79 percent among public health centers (Puskesmas) compared with 68 percent among single-practitioner private maternal health-providers and 71 percent among multi-practitioner private maternal health-providers.⁵¹ This means the private providers surveyed typically have reduced access to medicines and commodities, but also potentially fewer staff with less adherence to clinical guidelines. While the middle class may be opting for private hospitals rather than private clinics and public providers,⁵² even comparing public and private hospitals there are some indications that public provision outperforms private provision, for example in terms of HIV and TB services.⁵³ Similarly, average international test scores for 15-year-olds in the middle-class range of the SES distribution score on average 20 points higher if they are enrolled at a public school than at a private school, although this does not distinguish between elite private schools and other private schools as we do elsewhere in this report.⁵⁴ It is not possible to separate out those attending exclusive private schools who may have superior scores, but in terms of health and education it is not clear that private means better quality.

An extreme example of this opting-out behavior that the middle and upper classes are beginning to display is the increase of planned communities.⁵⁵ Not only are many middle- and upper-class Indonesians opting out of public services, but many middle- and upper-class Jakartans are opting out of Jakarta. In one survey, Jakarta ranked as the 35th best Asian city, behind its main regional competitors: Singapore (4th), Kuala Lumpur (9th), Beijing (10th), Metro Manila (14th) and Bangkok (26th).⁵⁶ Jakarta suffers from air and water pollution well beyond United Nations threshold levels; most wastewater is discharged without treatment.⁵⁷ Traffic is crippling; Jakarta is the only major city in Southeast Asia without a mass transit system of some kind. In response, many richer Jakartans are choosing to live in planned communities, or kota mandiri, as they are known locally. Among the most well-known are BSD City, Lippo Karawaci and Lippo Cikarang. BSD City had 200,000 residents in 2010⁵⁸ in a growing township that covers 1,300 hectares and is planned to expand to 6,000 hectares by 2035, with 150,000 new homes being built in the next decade and an expected population of 1 million people by 2035.⁵⁹ In 2002, Lippo Karawaci had 30,000 residents (plus 40,000 workers and 50,000 transient day visitors);⁶⁰ by 2015, 120,000 people lived in the three Lippo cities of Lippo Village, Lippo Cikarang and Tanjung Bunga.⁶¹ About 32,000 people reportedly live in Alam Sutera⁶² and over 100,000 in Bintaro Jaya.⁶³ These planned communities are in some ways the embodiment of the richer middle class and upper class opting out of public services. They provide complete amenities such as security, clean drinking water, proper sewage, reliable power, malls and entertainment complexes, parks, and golf courses. Many include prestigious private schools, from kindergarten up to university. As an increasing number of middle- and upper-class Indonesians begin to live in these planned communities with privately-provided services and amenities, the risk is not only that some of the louder and more influential public voices will remain silent on public services, but also that those comprising the class that bears a significant part of personal income tax burden will become reluctant to pay for poor quality public services that they themselves do not use.

64 The IFLS is a five wave panel data set spanning 1993 to 2014, representative of 83 percent of the national population. As it uses a different consumption aggregate than Susenas, applying Susenas poverty lines will not give comparable poverty lines. Instead, the poverty rates for the provinces covered by IFLS are used to determine what an equivalent poverty line in each province would be to give the same rate. The different class thresholds are then determined by the same multiple of this new poverty line as used in Susenas and elsewhere in this report. While using a fixed multiple of the poverty line ensures we are using a consistent living standard across time, it does not ensure we have the same rates of each of the classes, as the shape of the IFLS consumption distribution also varies from that of Susenas. The results shown are from balanced pairs across the starting and ending waves; results for balanced pairs across all waves are very similar. See World Bank (forthcoming) Economic Mobility in Urban Indonesia for more details.

ES 11

Entry to the middle class is difficult for most, while even the middle class is not immune to shocks, highlighting the importance of more comprehensive & effective social protection to help aspiring Indonesians into the middle class & then keep them from falling back

Over the past 20 years, the majority of the poor and vulnerable have climbed out of poverty and into the aspiring middle class. Of those who were poor in 1993, 80 percent were no longer poor by 2014, although one-quarter was still vulnerable. However, 44 percent had become AMC and 12 percent managed to reach the middle class (Table E.2).⁶⁴ Similarly, while 14 percent of the vulnerable had fallen back into poverty and one-fifth remained vulnerable, half had climbed into the AMC and 16 percent into the middle class.

However, for the aspiring middle class, becoming middle class is far harder. Few of the aspiring middle class in 1993 had fall-

en back into poverty by 2014, although nearly one-fifth had become vulnerable. However, only one-quarter of the AMC had managed to become middle class over the two decades, while half of them remained in the AMC (Table E.2). This persists in post-Suharto Indonesia, following the Asian financial crisis, democratization and decentralization (Table E.3).

At the same time, while those in the middle class are largely no longer vulnerable to poverty, they can still fall back down the distribution. Since 2000, only 10 percent of the middle class became poor or vulnerable (Table E.3). However, only half stayed middle class, with 40 percent falling back into AMC status.

TABLE E.2 Mobility matrix 1993-2014 (percent)

Many have risen out of poverty and vulnerability in the past 20 years, although moving up from the AMC to the MC has proved more difficult.

		2014			
		P	V	AMC	MC
1993	P	20	24	44	12
	V	14	21	49	16
	AMC	7	17	51	26
	MC	3	9	44	45

TABLE E.3 Mobility matrix 2000-14 (percent)

Very few middle-class Indonesians have fallen back into poverty and vulnerability, but around 40 percent have dropped into the AMC.

		2014			
		P	V	AMC	MC
1993	P	22	27	42	10
	V	13	23	50	14
	AMC	8	15	52	25
	MC	2	8	40	50

Source: Indonesian Family Life Survey (IFLS) and World Bank calculations.

Note: The percentage of population in each class in IFLS is not the same as presented in the rest of the report as the IFLS only represents 83 percent of the population and uses a different consumption aggregate. Consequently, there are more MC and less V in the IFLS and IFLS matrix than in Susenas, used in the rest of the report.

80%

Of those who were poor in 1993, 80 percent were no longer poor by 2014.

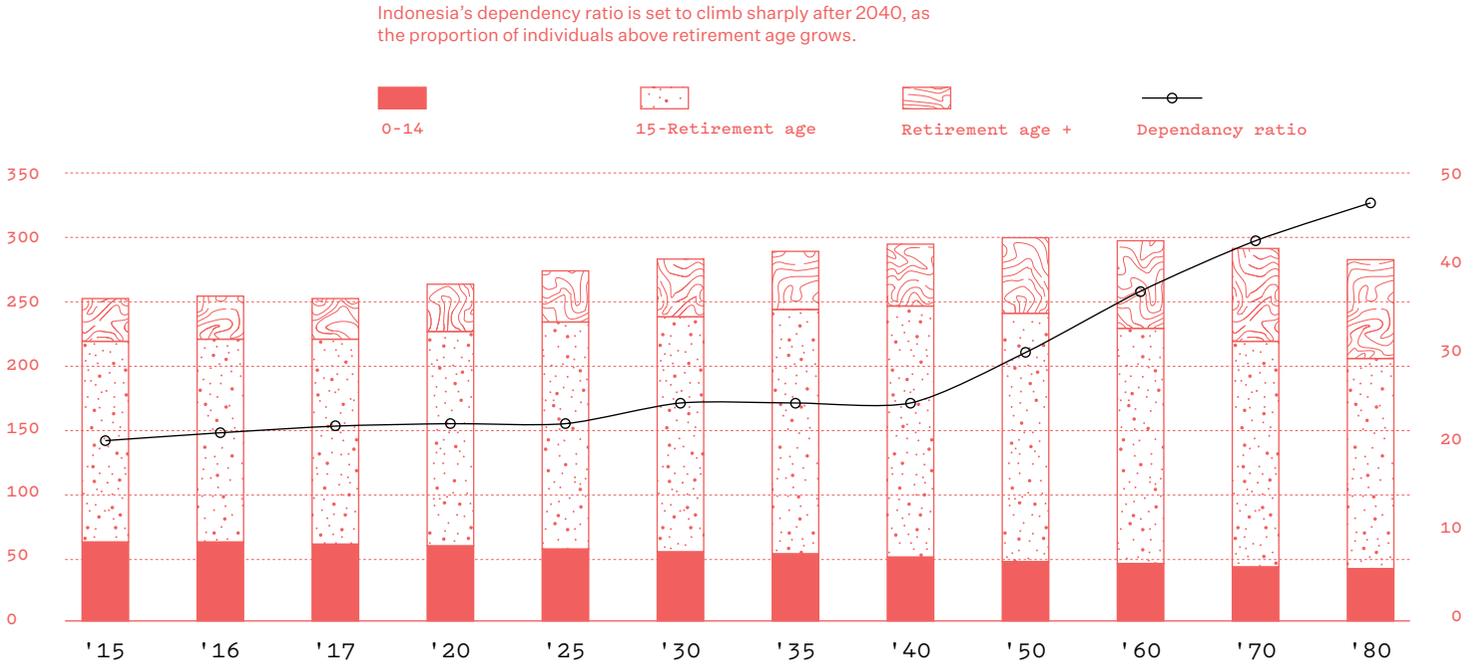
“Over the past 20 years, the majority of the poor and vulnerable have climbed out of poverty and into the aspiring middle class”

A key reason why the aspiring middle class struggles to enter the middle class, and why the middle class themselves can sometimes fall back down, are the many shocks that can erode household resources and incomes. Households can be affected by economic, health, social and political shocks, as well as natural disasters. As we have seen, these shocks affect all classes of Indonesians. Job loss or the death or disability of a key breadwinner can drastically reduce income. Many of the urban areas in which the aspiring middle class and the middle class live are prone to flooding and earthquakes. Without formal protection mechanisms, people affected usually turn to family and friends.⁶⁵ However, this typ-

ically does not provide enough support to fully cope and also fails to work when a shock such as a natural disaster hits an entire community. When informal borrowing is not enough, households may resort to steps that reduce their future income, such as selling productive assets or pulling children out of school. Thus, shocks can reduce household income by either destroying or impairing the underlying assets that generate income (productive assets such as equipment or human assets such as labor), or by forcing households to use or sell these assets (savings or productive assets) to cope with the shock.

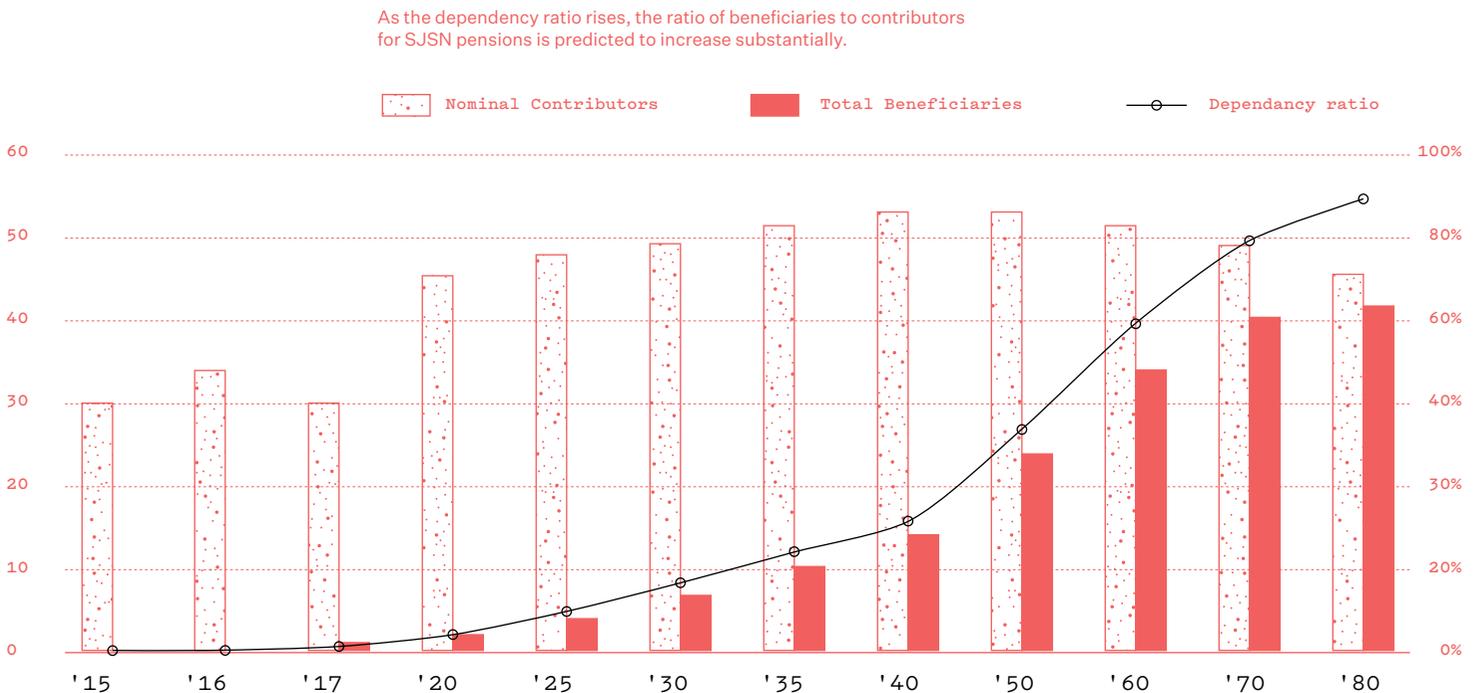
⁶⁵ World Bank (2015d) Social Impacts of Temporary Unconditional Cash Transfers in Indonesia.

FIGURE E.25 Indonesian population projections by age group (million on LHS and percentage of population on RHS)



Source: UNFPA.

FIGURE E.26 Contributors, beneficiaries and pension system dependency ratio of SJSN Pension (million on LHS and percentage of members on RHS)



Note: Pension system dependency ratio is the number of beneficiaries compared with the number of contributors

Source: World Bank calculations.

Therefore, a key challenge in expanding the middle class and keeping new entrants in the middle class is developing a comprehensive social protection system.

There are two key components to effective social protection. First, social insurance allows households and workers to contribute to insurance schemes that protect them from shocks, both those that are predictable, such as old age and retirement, and those that are not, such as illness and unemployment. Under such schemes, workers pay monthly social insurance premiums and in return gain access to health care, employment and disability cover when they need it, as well as ensuring an income when they retire. Second, social assistance provides an important safety net for those who cannot afford to contribute to social insurance.

For the aspiring middle class and the middle class, effective social insurance is the key to economic security; social assistance can act as a last resort for some.

While a small number of the aspiring middle class participates in some social assistance programs, these programs are mainly targeted at the chronically poor and vulnerable, and do not currently capture transient poverty—when the aspiring middle class suffer shocks. Clear recommendations for strengthening Indonesia's social assistance framework—a vital step in eliminating poverty and vulnerability—are addressed elsewhere.⁶⁶ However, social assistance programs are not as effective at helping aspiring and middle-class households that suffer major shocks. It takes time and resources to bring new households into social assistance programs, although current ini-

tiatives are underway to make the current eligibility and enrolment system more dynamic. For those in the aspiring and middle classes, who in most cases can afford to pay the contributions to the country's emerging social insurance schemes, such schemes offer the best protection from shocks.

Indonesia's new National Social Security System (SJSN) intends to provide universal social insurance cover for all Indonesians by 2019.

Sistem Jaminan Sosial Nasional, or SJSN, was introduced in 2014 to provide health, employment and old-age insurance to all Indonesians by 2019. It replaced a previously fragmented system that covered only some of the poor, civil servants and the military, as well as around 25 percent of formal workers. This meant that the majority of Indonesians were left out. The previous system also had inadequate benefits, a weak legal structure, and poor supervision and control.

SJSN has been successfully introduced but faces four key challenges if it is to offer the comprehensive and effective protection the aspiring and middle classes need and demand.

Since 2014, the government has launched a comprehensive roadmap for the employment program of SJSN and completed the design and financing strategy for the pensions and old-age savings programs. It has also completed the transformation of the legal structure into two new administrators, one for SJSN Health (BPJS Kesehatan) and the other for SJSN Employment (BPJS Ketenagakerjaan). SJSN Health now covers 171 million members. However, SJSN faces four key challenges. First, it must be fiscally sustainable in the

long run. Second, it must deal with issues related to extending coverage to both formal and informal workers. Third, not all risks are covered by SJSN programs. Finally, coverage alone is not sufficient to protect members from shocks; the program also needs to provide access to quality, especially in health care.

Indonesia's changing demographics mean that the fiscal sustainability of SJSN is in question.

As Indonesia's population begins to age, the number of working contributors to SJSN will begin to decline and the number of non-working beneficiaries who draw on SJSN will begin to increase. Between 2040 and 2080, Indonesia's dependency ratio—the number of young and elderly compared with the number of working age adults—is projected to rise from 25 to 47 percent (Figure E.25). This increase in dependents and reduction in contributing adults means the projected pension system dependency ratio—the number of beneficiaries compared with the number of contributors—starts out near zero and increases to about 95 percent by 2080 (Figure E.26). Without ensuring that current contribution levels match program benefits, SJSN may fail to look after the growing middle class, which will come to rely upon it in the future. Furthermore, premiums are paid, in practice, by both formal workers and by the government on behalf of the poor and vulnerable; government subsidies make up half of all National Health Insurance (*Jaminan Kesehatan Nasional*, or JKN) revenues. However, JKN does not cover the full costs of health care, which means that central and local governments make up the difference.⁶⁷

⁶⁶ World Bank (2017c) *Towards a Comprehensive, Integrated, and Effective Social Assistance System in Indonesia*.

⁶⁷ World Bank (forthcoming) *Spending Better: Indonesia Public Expenditure Review 2016-2018*.

“Introducing unemployment insurance & fulfilling the ambitions of the SJSN framework can better protect workers from job loss shocks”

Extending SJSN coverage to both all formal salaried workers and informal workers is proving difficult. SJSN Health targets universal coverage by 2019, while SJSN Employment targets universal coverage of salaried workers by the same date. However, private sector salaried worker participation is still low. Key reasons for this that need to be addressed include: employers failing to register for the program (especially smaller employers); employers registering some but not all workers; and some employers evading contributions entirely. At the same time, most non-salaried workers remain outside the program for a variety of reasons. Potential members often do not understand the programs and realize the value of participation; programs are not always designed for informal sector needs; it is difficult to register workers, estimate income and enforce contribution compliance; making payments and receiving benefits can be time-consuming and expensive; the infrastructure for registering and collecting contributions from informal workers is limited; and irregular income for informal workers means it can be difficult to make contributions each month. Overcoming the difficulties of extending coverage to informal workers is a challenge experienced by developing countries throughout the world. The most practical solution is to increase the formalization of jobs and increase the coverage of formal workers.

Not all risks are covered by SJSN, particularly unemploy-

ment. Although now being discussed, unemployment insurance is not currently part of the SJSN Employment program coverage. This means a sudden loss of a job can impede members of the aspiring middle class in their climb to join the middle class, or it can mean that even when they get there they can easily fall back.

Introducing unemployment insurance and fulfilling the ambitions of the SJSN framework can better protect workers from job loss shocks. The roll-out of SJSN may have expanded the access and entitlement to social insurance. This has not provided adequate protection for workers; observance of severance pay remains low even among workers with an employment contract, and many do not receive it in the event of job loss. Although the current severance pay system offers limited support for laid-off workers, Indonesia’s employment protection legislation, including severance rates and restrictions on the use of temporary contracts and outsourcing, ranks among the most restrictive in East Asia and compared with other middle-income countries. These restrictive regulations can have the unintended effect of discouraging formal employment, which is a key pathway through which the middle class can be expanded. SJSN can provide better protection against the risk of job loss by introducing benefits for unemployment to workers through a centrally administered income support system. Such a system, alongside a reform of the

severance system, can offer more reliable protection during unemployment, supporting workers’ mobility, while building on Indonesia’s institutional investment in SJSN.

Finally, SJSN has governance issues.... The potential for error, fraud, and corruption (EFC) in social security systems is high. OECD studies have identified that the potential EFC loss in the implementation of these systems in developed countries ranges from 0.1 percent to 16 percent of the total budget. Given SJSN Health’s 2014 disbursement and payments of Rp 45 trillion, this implies that the potential EFC losses could reach as high as Rp 7 trillion.⁶⁸ Despite its many supervisory bodies, SJSN does not yet have an integrated EFC mitigation strategy.

...and service delivery issues, especially in health. SJSN faces a number of service delivery issues. For example, SJSN Employment old-age savings claims experience a long processing time. However, the issues are most severe in health, including limited hours, long queues, unavailability of doctors and rooms in hospitals, delayed treatments, and limited services in more remote areas. Improving health service delivery in Indonesia is critical to helping the aspiring middle class to cope with health shocks and expanding the middle class. We address the key steps needed to make health care more effective in Indonesia in a later section.

Right Expansion of the middle class will also require better leveraging of the potential of Indonesian cities to deliver on prosperity, inclusion, and livability.

⁶⁸ World Bank and Rand International (2015).



At the same time, the government needs to avoid the risk of a polarized Indonesia...

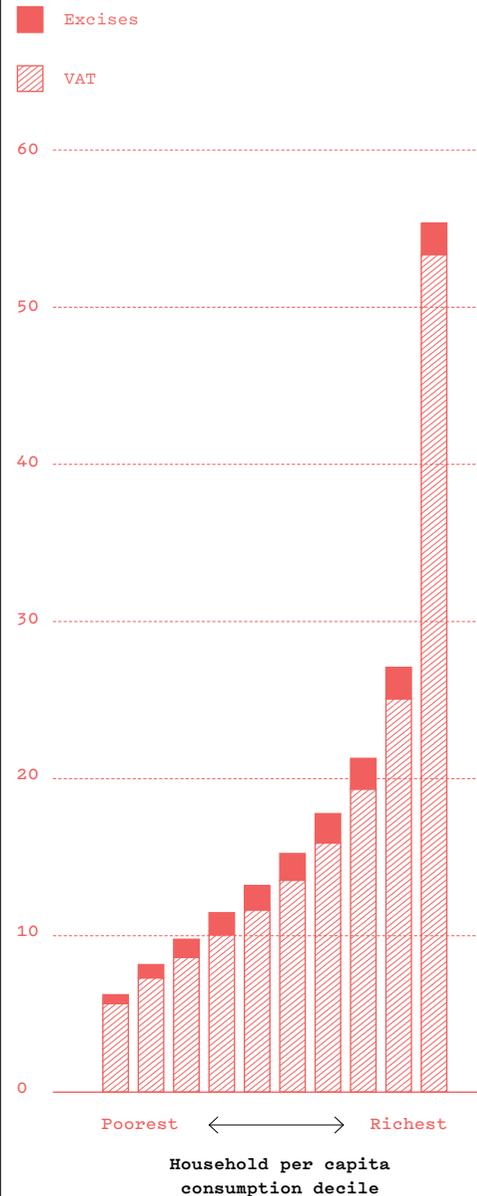
As Indonesians become richer and more people become economically secure, those in the expanding middle class will not only begin to think beyond economic security but also how their incomes compare with others. We have been using the concept of economic security to capture the increasing numbers of prosperous Indonesians. However, what happens once most people are secure? As most of a country's population becomes economically secure, security itself is no longer sufficient to be considered middle class. Continuing in-

creases in aspirations and expectations affect households all the way up the income distribution. A good example in East Asia is the case of Malaysia, which is now an upper-middle-income country, with almost no poor households and where 86 percent of people are above the regional economic security line. Despite this, only 41 percent of Malaysians think that they are even lower middle class or better; hence, middle class has become a relative concept in Malaysia.⁶⁹

FIGURE E.27

Incidence of indirect taxes, 2015 (Rp trillion)

The middle class—the richest two consumption deciles—already pays nearly half of all indirect taxes and almost all direct taxes.



Note: Excises are those on tobacco, which make up 95 percent of total excises.

Source: Susenas and World Bank calculations.⁷⁰

⁶⁹ See World Bank (2014b) *Malaysia Economic Monitor: Towards a Middle Class Society*.

⁷⁰ See the forthcoming World Bank update to the 2015 report *Revisiting the Distributional Impact of Fiscal Policy in Indonesia: Who Benefits, Why Pays?*



Above Almost half of the business owners who employ others are from the middle class. Policies that support these entrepreneurs will increase their economic mobility, helping to drive economic growth, and create more jobs for the aspiring middle class.

Paying for investments in infrastructure, health, education and productivity to enable more Indonesians to meet their aspirations means, in part, more income tax revenue, which will be largely paid by the middle class. Greater public investment is needed not only to drive future economic growth and transform Indonesia into a high-income country, but also to allow those below the middle class to gain economic security and meet their aspirations.⁷¹ Even with greater private sector investment,⁷² the government will need to increase spending in these areas, which means increasing public revenues. With personal income tax collection very low, at only 1.1 percent of GDP, it offers the potential to collect significant new revenue from those who can afford it most and finance these critical investments needed for Indonesia's development and stability. However, greater income taxes will be largely paid for by the middle class, which already provides 42 percent of indirect taxes

(Figure E.27) and, along with the small upper class, comprised almost all of Indonesia's 11.8 million income taxpayers in 2016.⁷³

Thus, Indonesia will need to make public investments and policies that benefit both the current middle class and those who aspire to join it. With the upper class very likely to opt out of most public services, retaining middle-class support for public investments in areas needed for Indonesia's development is vital. Not only do those in the middle class need to appreciate public spending in areas that matter to them, but they must also be prepared to pay to support public investments that provide upward economic mobility for the non-middle class, including the aspiring middle class, when they observe public spending and programs that benefit the latter. It will also be important that all members of society are seen to be paying their fair share of taxes.

⁷¹ World Bank (2014) and World Bank (2017d) *Indonesia Economic Quarterly: Sustaining Reform Momentum*.

⁷² World Bank (2017d).

⁷³ Data on number of individual income taxpayers who submitted annual tax returns comes from the Directorate General of Taxes, Ministry of Finance. The confirmed number of filers in 2015 was 10.3 million; the 2016 number is still provisional.

...by developing a new social contract based on the common interests of quality services, economic mobility & social security for all

An arrangement for all Indonesians would be one in which public investments drive growth, growth is inclusive, and social insurance protects the gains of all. For the non-middle class, access to high-quality public services and good jobs can provide opportunities to achieve economic security and join the ranks of the middle class. At the same time, upward mobility of the non-middle class and investments in productivity and infrastructure will drive greater economic growth, benefiting the existing middle class. Furthermore, stronger social insurance to provide employment and health protection, as well as pensions, means that the economic gains of an expanding middle class—both those who are currently in it and those who will join—can be secured from

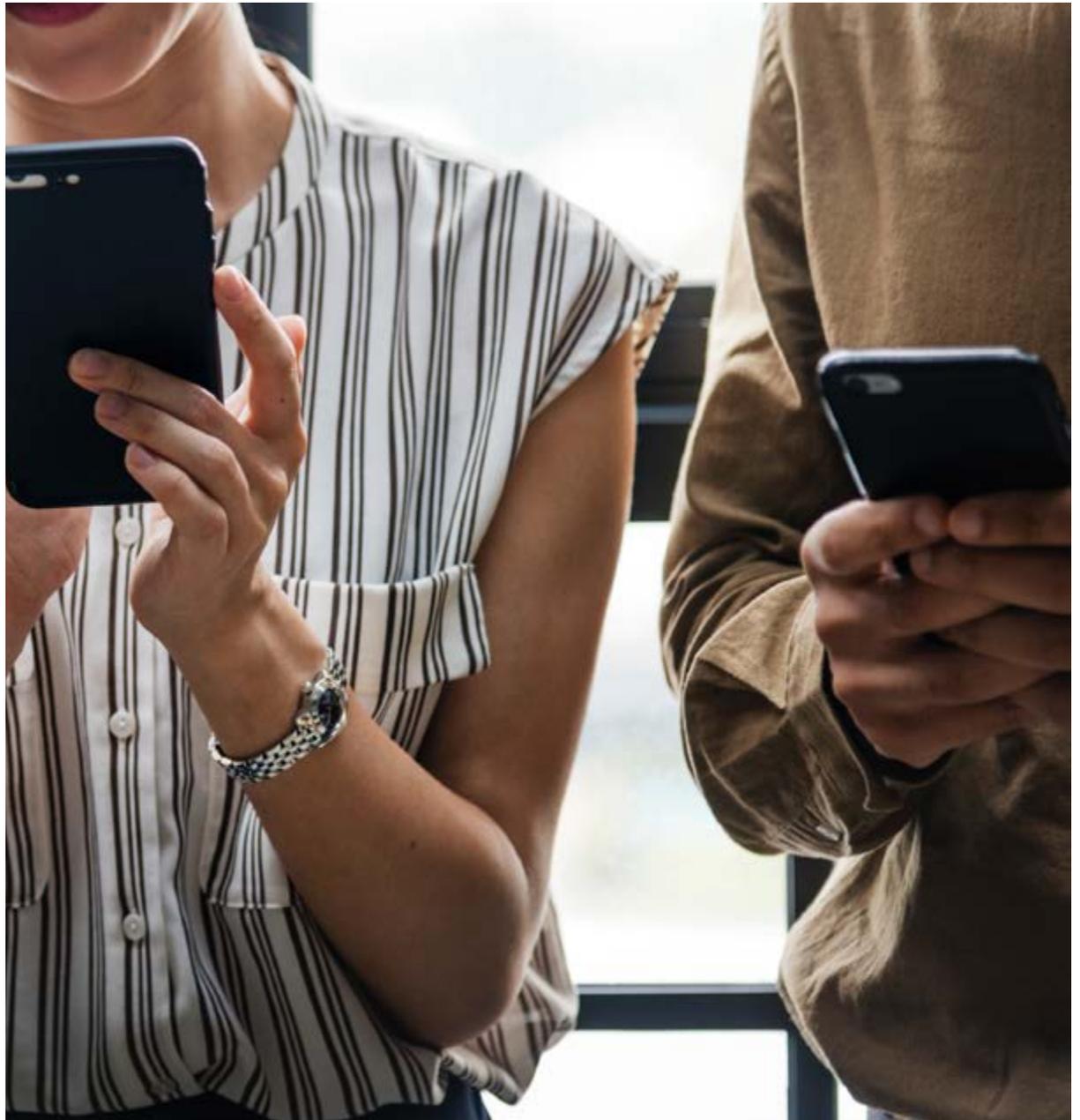
the shocks that can affect everyone. Finally, strengthening income tax compliance by the current middle class and boosting new collections from an expanding middle class mean that there should be adequate financing for needed investments.

Thus, a social contract that focuses on quality public services, economic mobility, and social security for all would help expand the middle class and protect those already in it. A new relationship between the government and its people could focus on three areas. First, quality public services, especially in health and education, but also water and sanitation, are necessary so that aspiring middle-class children can develop the health and

skills they need to succeed later in life. Better quality services may also mean that those in the middle class use and appreciate them more widely, generating broader support for financing them. Second, access to livelihoods that allows those in the middle class to prosper and those below the middle class to enter can help to ensure economic mobility for all. This means a focus not only on better education, discussed earlier, but also on making it easier to become an entrepreneur, which increases the prosperity of the middle class and creates new jobs for others. Mobility can also be promoted through economic reforms, including closing the infrastructure gap, improving how decentralization is working, better leveraging urbanization, and targeted place-based policies for lagging regions. Finally, effective and sustainable health, employment and old-age insurance can provide the safety net that the aspiring middle class needs to enter the middle class, and can protect the economic gains that the middle class has already achieved.

Moreover, this will reduce the risk that those outside the middle class become shut out, resulting in a more fractured society. Instead, social cohesion and stability will in turn drive further growth. Nearly half of Indonesia's population is in the group that aspires to join the middle class. This group includes the median voter and, if they can join the middle class, they will combine with the existing 20 percent of middle-class Indonesians to represent two-thirds of the country. Meeting their aspirations and delivering economic security to many will help strengthen social cohesion and address rising inequality. In turn, greater stability and lower inequality have been shown to drive economic growth.⁷⁴

Below Since access to computers and the internet are uncommon outside the middle class, middle-class children are far more likely to gain exposure to the information and communications technology that underpins the modern global economy.



74 For a comprehensive study of inequality in Indonesia see World Bank (2015a). See Gupta (1990), Keefer and Knack (2002) on the effects of political instability on economic growth, and Alesina and Rodrik (1994), Alesina and Perotti (1994) and Persson and Tabellini (1994) on links between political economy and economic growth.

75 This discussion on public service delivery and quality is expanded significantly in the main report and draws heavily on World Bank (forthcoming) *Spending Better: Indonesia Public Expenditure Review 2016-2018*.

76 On economic mobility, see World Bank (forthcoming) 'Economic and Social Mobility in Urbanizing Indonesia', Urban Poverty background paper, as well as the forthcoming Urban Flagship report. On social security, see World Bank (2017c) *Towards a Comprehensive, Integrated, and Effective Social Assistance System in Indonesia*, World Bank (2015e) *Indonesia Economic Quarterly*, October 2015 which discusses the national health insurance system. A new flagship *Social Protection* report is also underway in Indonesia, which will provide a comprehensive analysis of all elements of social protection and formulate policy recommendations.

77 World Bank (forthcoming) *Spending Better: Indonesia Public Expenditure Review 2016-2018*.

78 See World Bank (2016) *Health Financing System Assessment: Spend More, Right, and Better*.

Quality public services can be delivered by linking local government financing & performance⁷⁵

A key element of a new social contract is quality public services. The other two elements of the proposed social contract, namely economic mobility and social security, are addressed in more depth in the body of the report, and in other reports.⁷⁶ This section looks further into how better quality public services can be delivered, with a focus on health, education and governance. The following section discusses how the various investments needed to deliver the new social contract can be financed through improved tax policy and administration.

Despite significant investments in education, an increased number of teachers and higher teachers' salaries, learning outcomes continue to lag. Education spending in Indonesia quadrupled between 2001 and 2016 in real terms, and now represents 20 percent of all public spending and 3.3 percent of GDP. The number of teachers has increased dramatically since 2005, with 15 percent more civil servant teachers and 40 percent more temporary teachers by 2015. Indonesia's student-to-teacher ratio (STR) of 17 is far below the average for other lower middle-income countries, at 29, and is nearing the high-in-

come country average of 14. At the same time, a teacher certification program has expanded sharply and is reflected in greatly increased teacher allowances. However, despite increased spending on educational inputs, learning outcomes have not improved, with little change in international PISA scores and no relationship between lower STRs and test scores.

Increasing the focus on continuous professional development and linking performance to rewards, both at the teacher and local government level, could improve the quality of teaching and education. There is a lack of continuous professional development (CPD) and the School Operational Fund (BOS) spends three times more on honorariums (17 percent) than professional development (5 percent). At the same time, there is no link between teacher performance and teachers' allowances and professional progression, so quality is neither developed nor rewarded. Moreover, funding and spending are not linked to performance either. Local governments are responsible for spending their education budgets to achieve minimum service standards, but spending is only weakly correlated



“Total health spending in Indonesia is low relative to other countries in the region and much of it comes from consumers themselves”

with these achievements, while BOS allocations are generally not allocated based on school performance. The World Bank currently pilots the tying of teacher allowances with teacher performance through the KIAT Guru project. In this project, the payment of the remote area allowance to teachers in pilot schools is tied with either teacher presence or service performance, with inputs from parents and broader community members. Initial findings indicate significant improvements in teacher presence and service performance. Another example of how reforms could tie spending to performance is the reform introduced by the Jakarta Provincial Government in 2015.⁷⁷

Unlike education, there is insufficient spending to ensure supply-side readiness in the Indonesian health system.⁷⁸ Total health spending in Indonesia is low relative to other countries in the region and much of it comes from consumers themselves. De-

spite increases in recent years, public spending on health is among the lowest in the world at just 5.9 percent of total public expenditures, which represents only 1.1 percent of GDP—far lower than the 3.3 percent average for countries of similar income levels. Consequently, many health facilities lack the equipment and training to provide key services. Moreover, central government spending represents only one-third of total health spending, and this is compounded by a disconnect between local government spending and supply-side readiness.

In addition to increasing health spending, Indonesia needs to focus on spending better. More spending on health could help to reduce gaps in access. Moreover, the priority is improving the *quality* of health services. Specific actions include targeted public investments with built-in incentives for performance to equip local health facilities to

deliver results; producing sufficient competent health workers and ensuring they are deployed to where they are needed; and scaling up and enforcing the accreditation system.

More broadly, improvements are needed in the way local governments deliver public services. In a decentralized Indonesia, local governments are critical for delivering public services, not just in health and education, but also in areas such as water, sanitation and roads. And in an urbanizing Indonesia, service delivery in cities is failing, where only 33 percent of urban households have access to clean water, only 12 cities have piped sewerage networks serving 2 percent of the urban population, and 40 percent of urban residents do not have access to proper sanitation.

Five strategies have been identified to maximize the effectiveness of local governments' spending of transfers.⁷⁹ To improve local government spending on service delivery, the government should:

1

Build a robust system to measure performance



Relate inputs, processes and outputs to outcomes; invest in higher quality data; combine finance and performance data for a more meaningful picture; and utilize the Statistics Indonesia (BPS) and the Financial and Development Supervision Agency (BPKP) in monitoring.

2

Make the most of incentives



Remove bad incentives, such as the general allocation fund (DAU) basic share that encourages the hiring of more district staff; use financial incentives in different ways, such as rewarding process compliance and paying for outputs; use matching funding to drive ownership; and encourage positive competition, by publicizing local performance data

3

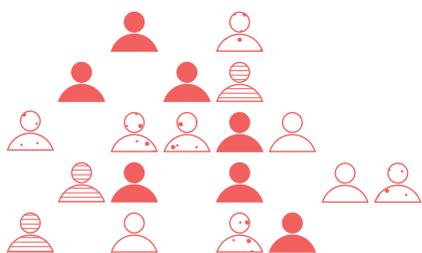
Address poor performance in graduated ways



Issue letters to improve; provide technical support; require performance action plans; and reduce funding allocations.

4

Use citizens to provide incentives for better performance



Make budget and spending data public; involve citizens in the local decision-making and development; and provide feedback mechanisms.

5

Fix systems & capacity



Streamline subnational public financial management (PFM) systems; measure the performance of subnational PFM systems to targeting capacity building; modernize district financial management accounting software; and develop a comprehensive capacity-building program for subnational governments.

⁷⁹ World Bank (forthcoming) *Spending Better: Indonesia Public Expenditure Review 2016-2018*.

In addition, reforming Law No. 33/2004 on Fiscal Decentralization’s comprehensive intergovernmental financing framework could make decentralization more effective. Two core changes would help. First, conditional transfers to regions

(DAK) should address well-defined national priority outcomes, rather than broad functional areas. Second, getting the DAU right matters. The current formula basis for DAU allocations is per district, not per person. This not only encourages districts to split, but it

also means that large urban populations—where most of the middle class and much of the aspiring middle class live—lack sufficient financing for their local infrastructure needs, undermining local service delivery.

Right A social contract that focuses on quality public services, economic mobility, and social security for all would help expand the middle class and protect those already in it.





Improving tax policy & tax administration is also important to fund the investments required to grow the middle class

Indonesia needs to invest more to grow the middle class, which will mean increasing its tax collection. Indonesia's level of central government spending is lower than in other developing countries and is insufficient to build and serve a growing middle class. Without increasing the level of spending and improving the quality of that spending, Indonesia will struggle to provide the services that are necessary to build and serve a growing middle class, namely health, education, housing and social insurance. However, spending more will mean raising more revenue. Indonesia's revenue-to-GDP ratio is low, at just 12.2 percent in 2017, compared with an emerging economy average of 27.8 percent, and tax collections are lower than both regional peers and countries with similar levels of GDP per capita.

Increased revenues will require substantial reforms to tax policy, broadening the tax base and raising rates for select taxes.

Indonesia can collect more taxes on goods and services. Indonesia collects about the same share of GDP in VAT as Thailand and Malaysia, despite having a rate that is 30 and 40 percent higher, respectively. This is in part because too few firms have to pay VAT; Indonesia has the highest business revenue threshold for paying VAT in the world (relative to GDP per capita). This, combined with a policy of allowing for many goods and services to be exempt from VAT, significantly reduces the VAT base. The government also has an opportunity to collect more taxes and significantly broaden the personal income tax regime, which currently excludes about 98.8 percent of citizens. A high threshold narrows the income tax base and, as a result, only about 15 percent of employed workers have an obligation to file income tax returns, compared with rates of 50 percent or higher in many advanced economies. In fact, the annual non-taxable personal income threshold means that 94 percent of the middle

Left Tax revenues from the growing middle class will be critical to fund the investments in health and education, infrastructure and productivity necessary for Indonesia to keep developing.

class and all of the aspiring middle class are exempt from paying any income tax. Adding more taxpayers to the tax base will not only generate greater revenues but will also have the benefit of increasing accountability and the demand for services by the middle class, as more of those in the middle class start paying taxes.

However, these policy reforms will also require significant investments in tax administration capacity. Plausible tax-broadening measures include lowering the VAT registration threshold and replacing the non-taxable income threshold (PTKP) with tax credits for taxpayers who are poor or vulnerable. Other needed tax policy reforms include increasing taxes on alcohol, tobacco and vehicles, and introducing more environmental taxes, such as on plastic bag consumption. The enabling factor for successful policy reforms will be improving the tax administration capacity of the Directorate General of Taxes (DGT) and facilitating a high degree of voluntary compliance. Currently, DGT continues to rely heavily on paper filing due to limited IT capacity and staff expertise, while business processes for registration, filing and payment remain too complex. Moreover, current regulations require that all business requests for VAT refunds are audited, creating an undue burden on DGT and delays for businesses receiving back their VAT refunds. To increase tax administration capacity, DGT requires significant investment in IT capacity, as well as reforms of human resources and business processes. Moving to a risk-based approach for auditing VAT refunds is a critical component. A major cultural shift at DGT will also be needed—one that entails treating taxpayers as consumers and setting targets on regular improvements in the ease with which citizens can pay their taxes.

Indonesia aspires to move from middle- to high-income country status. Meeting these aspirations will mean meeting the aspirations of its people and becoming a middle-class society. The emergence of a prosperous middle class in Indonesia has been a key driver of recent economic growth. However, to sustain and even accelerate growth and the public investments needed to transition into a high-income country, Indonesia will need to substantially expand the middle class, beginning with the two-fifths of its citizens who have successfully escaped poverty and vulnerability, and now aspire to the economic security and prosperity of the middle class. Achieving this means ensuring that they stay in school lon-

ger and develop the skills they need for better jobs. It also means expanding social insurance so that their newfound prosperity is protected from shocks.

However, this also means a new social contract for Indonesia. Tax revenues from the growing middle class will be critical to fund the investments in health and education, infrastructure and productivity necessary for Indonesia to keep developing. In return, those in the middle class will want to see high-quality public services and continued upward mobility if they are not to start to resent the tax burden that will fall substantially on them in the future.

Right Mobility can also be promoted through economic reforms, including closing the infrastructure gap, improving how decentralization is working, better leveraging urbanization, and targeted place-based policies for lagging regions.

Conclusion



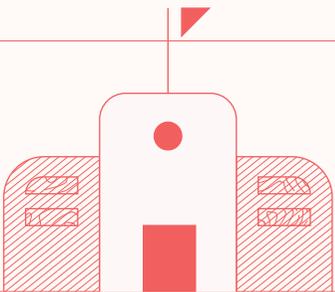
Summarized Recommendations by Sector

Recommendations	Reform Details
<p>01</p>	<p>Education</p> 
<p>Making the higher levels of spending on teacher salaries and allowances commensurate with similar gains in student learning outcomes.</p>	<p>Update the existing Teacher Performance Management System to more directly link teachers' allowances (DAK-Profesi Guru) with competency achievements, continuous professional development (CPD) and classroom performance.</p> <hr/> <p>Commence a rigorous teacher re-certification process to ensure that certification is more directly linked to the achievement of key professional competencies, and that periodic re-certification becomes a condition for teachers to continue to receive professional allowances and opportunities for further career progression.</p> <hr/> <p>Provide greater support for teachers to benefit from CPD.</p>

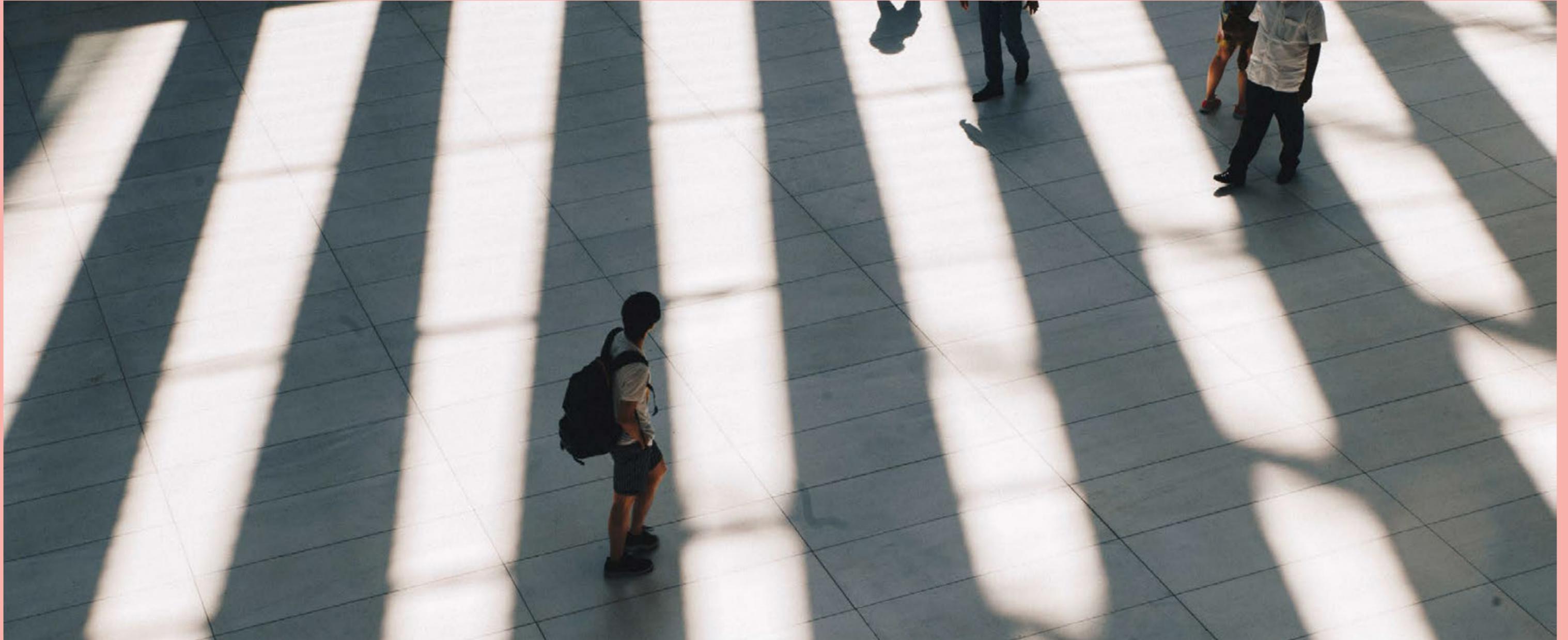
Recommendations	Reform Details
<p>Increasing student-teacher ratios to allow more resources to be made available for other quality-improving interventions.</p>	<p>Redistribute teachers across schools within districts: districts should identify oversupply and undersupply of teachers in their areas of jurisdiction and create a redistribution plan.</p> <hr/> <p>Redistribute teachers across districts and provinces: develop and implement a mechanism to enable such a redistribution to take place.</p> <hr/> <p>Standardize the recruitment process for non-permanent teachers: MoEC and MenPAN should develop national guidelines for recruiting non-permanent teachers who can teach the main subjects and extracurricular activities.</p>
<p>Distributing resources to schools based on equity, need and performance.</p>	<p>Basic allocation: based on the number of students.</p> <hr/> <p>Equity allocation: based on the school location/special needs.</p> <hr/> <p>Performance allocation: based on the improvement in results in the national exams.</p>
<p>Improving and expanding early childhood education and development (ECED).</p>	<p>This will require The MoEC to increase the budget for ECED to allow for an expansion in the coverage and the unit cost of BOP (School Operational Assistance Grants for ECED) based on Dapodik data linking the use of BOP to meet national ECED standards. Specific reforms actions include:</p> <hr/> <ol style="list-style-type: none"> 1. At the national level: (i) issue MSS as a basis for districts to allocate and manage resources; and (ii) build district capacity to manage services based on ECED MSS. 2. At the district level: (i) establish ECED units in Dinas and provide funding for staffing support; (ii) build the capacity of supervisors (Penilik PAUD) to conduct quality assurance visits to ECED centers; and (iii) support the provision of incentives and training for community teachers. 3. Leverage <i>Dana Desa</i> as an alternative funding source: include ECED in the annual <i>Dana Desa</i> prioritization regulation to support village planning to identify early childhood education centers as priority programs for investment from <i>Dana Desa</i>.
<p>Ensuring that all aspiring middle-class Indonesians who reach secondary education have the necessary conditions to learn.</p>	<p>Strengthen the mechanisms to guarantee education quality. In particular, school accreditation should be accelerated.</p>
<p>02</p>	<p>Health</p> 
<p>Increasing and diversifying the sources of revenue for a sustainable and equitable system.</p>	<p>Increase government health expenditures to benchmark itself against countries of similar economic status, especially those that have progressed further along the path to achieving UHC.</p> <hr/> <p>Pursue new revenue sources from increased taxation of tobacco and alcohol products, specifically earmarked for the health sector.</p>

Recommendations	Reform Details
<p>Targeting limited resources to cost-effective health services and underserved populations, improving the quality of service delivery, and introducing integrated care.</p>	<p>Focus its limited resources on targeting the most cost-effective interventions, such as preventive and promotive interventions delivered at the primary health-care level.</p> <hr/> <p>Improve the quality of service delivery, both in public and private facilities. Strengthen the preparation and implementation of national procedures, guidelines and standards to reduce inappropriate or low-value care, prevent avoidable costly adverse effects, decrease operational waste, and improve clinical and managerial performance.</p> <hr/> <p>Ensure equitable access to quality services across Indonesia, especially in the eastern islands of Indonesia.</p> <hr/> <p>Transform service delivery models that integrate and coordinate care across different care providers (such as hospitals, single specialty centers, diagnostic facilities and home-based care), while placing primary care in a central ‘gate-keeping’ role that connects all these various providers to cope with the increased burden of chronic diseases, such as NCDs.</p>
<p>Improving JKN design and implementation to ensure fiscal sustainability of JKN, and improve provider performance.</p>	<p>Defining an explicit benefits package and target population that is commensurate with available resources, through a systematic and transparent process for prioritizing interventions.</p> <hr/> <p>Building government capacity to identify the incentives that encourage private sector engagement, while also ensuring public sector interests.</p> <hr/> <p>Designing provider payment systems that incentivize and reward performance. This will need to include inter-fiscal transfers from the national to subnational governments, for example through designing DAK fisik and DAK non-fisik to be more results-oriented.</p> <hr/> <p>Strengthening the purchasing functions of BPJS, such as contracting, performance monitoring, the processing and payment of claims, and auditing.</p> <hr/> <p>Introducing incentives that reward institutional and provider performance in the DAK.</p>
<p>Investing in the institutions, systems and processes that hold the health-care system together.</p>	<p>Strengthen the public sector management functions for health, including encouraging planning and budgeting that links inputs to outcomes.</p> <hr/> <p>Strengthen health management information systems that could be used to benchmark performance, and improve budget execution and other financial management functions such as procurement, financial reporting, internal controls and audits.</p> <hr/> <p>Improve human resource management for the public sector, including improving managerial and clinical competencies and skills, and ensuring a more equitable distribution of human resources.</p>

Recommendations	Reform Details
<h1>03</h1>	<h1>Tax</h1> 
<p>Broadening the tax base.</p>	<p>Lowering the VAT registration threshold.</p> <hr/> <p>Replacing the non-taxable income threshold (PTKP) with tax credits for taxpayers who are poor or vulnerable.</p>
<p>Raising the rates on select taxes.</p>	<p>Increasing taxes on alcohol, tobacco and vehicles.</p> <hr/> <p>Introducing more environmental taxes, such as on plastic bag consumption.</p>
<p>Investing in tax administration capacity.</p>	<p>Making significant investments in IT capacity at the Directorate General of Taxes (DGT).</p> <hr/> <p>Reforming DGT's human resources and business processes.</p> <hr/> <p>Moving to a risk-based approach for auditing VAT refunds.</p> <hr/> <p>Cultivating a major mindset shift within DGT toward treating taxpayers as consumers and setting targets on regular improvements in the ease with which citizens can pay their taxes. This will facilitate a higher degree of voluntary compliance.</p>

Recommendations	Reform Details	
<h1>04</h1>	<h1>Regional Government</h1> 	
<p>Re-balancing fiscal transfers.</p>	<p>Quick wins</p>	<p>Revising the formula for fiscal capacity (which informs the allocation of DAK and hibah) to use a per-capita transfer norm.^a</p> <hr/> <p>Developing and disseminating advocacy materials on the impact of the current DAU formula on the equity of fiscal transfers.</p> <hr/> <p>Increasing the proportion of the Dana Desa allocated on the basis of the formula.</p>
	<p>More challenging reforms</p>	<p>Introducing a revision of Law No. 33/2014 to include a shift to a ‘per-client’ norm for the DAU formula.</p> <hr/> <p>Developing a more comprehensive approach to transition that is better aligned with local government incentives.</p>
<p>Financing urban infrastructure.</p>	<p>Quick wins</p>	<p>Reforming hibah as a more flexible instrument for selective financing of larger, multi-year infrastructure projects by regional governments, including aligning with the incentives of both central ministries and regional governments.</p> <hr/> <p>Developing a new government regulation to operationalize cross-regional service provision, including addressing the challenges of financing.</p> <hr/> <p>Building the capacity of provincial governments to supervise and support development of subnational PFM capacity in larger urban areas.</p> <hr/> <p>Introducing a PFM regulatory framework to address the asset planning and management challenges of larger cities.</p>
	<p>More challenging reforms</p>	<p>Addressing the limitations on subnational borrowing through a more equitable distribution of the annual limit on public sector borrowing.</p> <hr/> <p>Expanding the scope for cities to raise revenue, including through additional sources of revenue.</p> <hr/> <p>Setting timelines in the next RPJMN for a transition to the full regional government implementation of larger urban infrastructure projects, including solid waste, wastewater treatment and mass transport.</p> <hr/> <p>Revising and reforming subnational PFM arrangements to provide a simpler, more streamlined approach adapted to the different needs of large, medium and small district governments.</p>

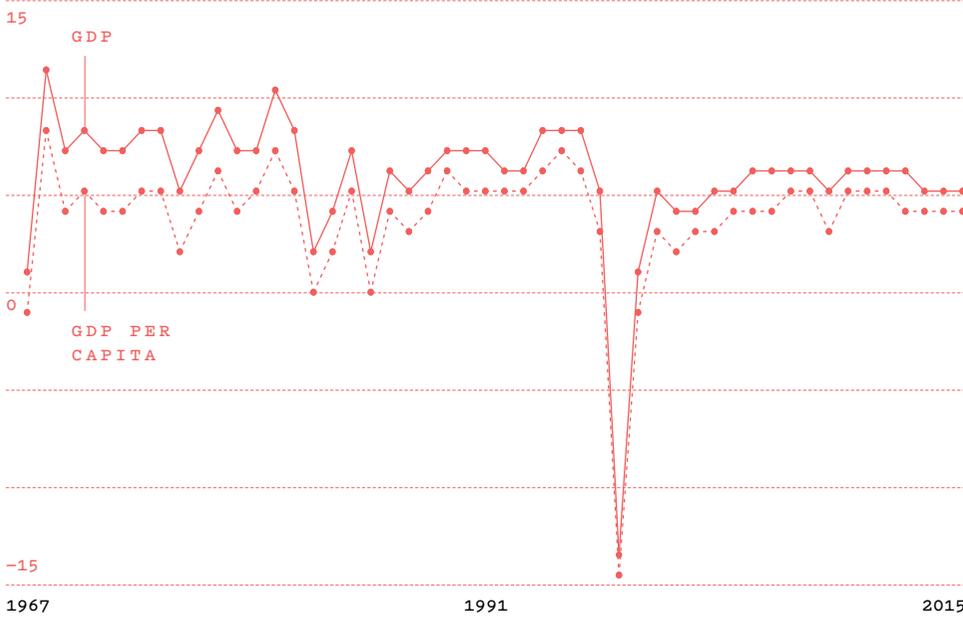
Recommendations	Reform Details	
<p>Developing and implementing an incentive framework.</p>	<p>Quick wins</p>	<p>Mandating the use of standard data sources and indicators, and building in verification to address the incentives to ‘game’ the data.</p>
		<p>Establishing rewards and sanctions for districts’ collection of accurate data, and using those data to better inform decision-making.</p>
		<p>Rationalizing the reporting requirements by local governments to minimize the transaction burden and ensure that the data are not only useful but also used.</p>
		<p>Expanding the use of OM-SPAN to report a broader range of performance information in relation to DAK and Dana Desa, and making the data available to line ministries.</p>
		<p>Developing the scope for greater results orientation in the monitoring the use of DAK and Dana Desa funds.</p>
	<p>More challenging reforms</p>	<p>Developing a framework for subnational data governance to improve the management and dissemination of data on district service delivery that incorporates data quality assurance.</p>
<p>As part of the next RPJMN, developing a framework for managing across levels of government that includes supervision, support, capacity-building, and rewards and interventions to address poor performance.</p>		



5.6%

Indonesia has sustained an average annual growth rate of 5.6 percent over the past half century.

FIGURE 1.1 Real GDP and GDP per capita growth, 1967-2016 (percent)



Source: World Development Indicators.

FIGURE 1.2 Poverty headcount ratio and Gini coefficient, 1980-2017 (percent/points)



Note: International Poverty Line is US\$1.90 in 2011 Purchasing Power Parity prices.

Source: World Development Indicators.

Over nearly a half century, Indonesia has seen strong economic growth and substantial decreases in extreme poverty, enabling it to achieve middle-income status. In 1967, Indonesia’s GDP was US\$657 per person,⁸⁰ one of the poorest countries in the world, and the country was “accounted the number one failure among the major underdeveloped countries.”⁸¹ Growth that year was an anemic 1.4 percent. Over the next 50 years, growth averaged 5.6 percent annually (Figure 1.1), despite a crippling financial, economic and political crisis in the late 1990s. Per capita GDP is now six times higher at nearly US\$4,000. This sustained period of high growth resulted in one of the most rapid reductions in poverty in history. Extreme poverty was 70 percent in 1984, but this fell to just 7 percent by 2016 (Figure 1.2).⁸²

⁸⁰ In 2010 US\$, from the World Development Indicators.

⁸¹ Higgins (1968) *Economic Development* (2nd ed.), p678, cited in Hill, H. (2000) *The Indonesian Economy* (2nd ed.).

⁸² Using the International Poverty Line (PPP US\$1.90 at 2011 prices) from the World Development Indicators and the 2017 Indonesia Country Poverty Brief. Poverty using the national poverty line has shown similarly considerable declines.



Over this time, a new class has emerged within Indonesia, that of the middle class.

As more and more Indonesians escaped from poverty and vulnerability in recent decades, their children have enjoyed greater opportunities, with better access to education and health, cleaner and safer living conditions, and have entered the workforce with greater skills than their parents. The thriving Indonesian economy has shown high demand for these relatively few skilled workers and rewarded them well. They now represent the emergence of a new class of Indonesians who enjoy higher incomes, more consumption, freedom from insecurity and vulnerability, and who are an increasingly confident and visible part of Indonesia. The emergence of this new middle class has occurred within a single generation.

Below Over the past half century, Indonesia has seen strong economic growth and substantial decreases in extreme poverty, enabling it to achieve middle-income status.

This emergence has been accompanied by a surge of interest by policymakers and the private sector in recent years.

With its growing income and disposable consumption, policymakers have become interested in the middle class as an engine of economic growth, while the private sector sees a large and growing market for higher-priced goods and services than has existed in Indonesia previously. This interest is reflected in a range of recent reports and features on the Indonesian middle class, including BCG (2013), McKinsey Global Institute (2012) and *Tempo* (2012), as well as coverage in *The Economist* (2011) and *The Financial Times* (2010, 2014). This attention has occurred against a backdrop of wider interest in the growing middle classes seen across developing East Asia (ADB, 2010; World Bank, 2017) and the world (Banerjee and Duflo, 2008;

Birdsall, 2007, 2010 and 2015; Birdsall et al., 2000; Easterly, 2001; Kharas, 2010; World Bank, 2013).

At the same time, the challenge now for Indonesia is less one of poverty reduction and more one of providing economic mobility and escaping the middle-income trap.

To become a high-income country and sustain historical growth rates, Indonesia faces a challenge that is common across much of developing East Asia (World Bank, 2017): Indonesia will need to develop a more inclusive growth model so that more of its population can both contribute to, and benefit from, that growth (World Bank, 2014a). Despite low rates of poverty, many Indonesians remain vulnerable, with around one-third below the vulnerability line,⁸³ while inequality, despite recent

⁸³ Thirty-five percent of the population lives below the vulnerability line (1.5 times the poverty line), while 32 percent are below the lower-middle income countries' poverty line of PPP US\$3.20 in 2011 prices; see Jolliffe and Prydz (2016).



“The emergence of this new middle class has occurred within a single generation”

Right Upward mobility of the non-middle class and investments in productivity and infrastructure will drive greater economic growth, benefiting the existing middle class

moderation, has been rising rapidly (Figure 1.2 and World Bank, 2015a).

Moreover, soon Indonesia’s population will begin to age, creating additional pressures.

Many high- and middle-income countries in the East Asia and Pacific are already aging quickly and face pressing challenges in managing their aging societies (World Bank, 2015b). Indonesia will soon join these countries, with the ratio of workers to young and elderly dependents projected to start declining from around 2030 onward. The country’s demographic and epidemiological transitions will require proactive policy responses on pensions, health care and labor markets. These policy responses will need to mitigate the labor-supply and fiscal effects of rapid aging through ongoing reforms of pension, health systems and labor policies to extend the working lives of urban and formal sector workers as they undergo rapid urbanization.

As the middle class continues to grow, it will play an important part in delivering economic growth that Indonesia needs to transition to a high-income country and cope with an aging population. The middle class has played, and will continue to play, an important role in Indonesia’s development, representing an important driver of economic growth and this role is likely to become even more important in this regard going forward.

However, there is little agreement on who comprises the middle class, or how large it is, other than that it is growing rapidly. Recent reports on the Indonesian middle class have used different definitions, such as per capita daily consumption of US\$2-US\$20 (ADB, 2010), annual net income of more than US\$3,600 in 2005 PPP (McKinsey, 2012), Rp 2.0 million to Rp 7.5 million in monthly household expenditure (BCG, 2013), and disposable household income of over US\$3,000 per year (Nomura in *The Economist*, 2011). Consequently, estimates of the size of the middle class have varied wildly from 30 million (AC Nielsen in *Tempo*, 2012) to 45 million (McKinsey, 2012) to 74 million (BCG, 2013) and to 81 million (ADB, 2010).

In addition, “middle class” means different things to different people, covering economic, social and political dimensions. Some are interested in the economic and market influence the middle class has; its size and contribution to economic growth. Some are interested in its socioeconomic characteristics, such as its members’ attitudes and behaviors. Others are interested in its political influence on governance, policies and public services.

At the same time, escaping the middle-income trap and increasing economic mobility will require new and considerable investments. The key to Indonesia’s closing

the gap with high-income countries is a growth strategy that is based on improving labor productivity (World Bank, 2014a). To achieve this, in addition to improving the functioning of product, labor, and land and capital markets, significant investments are required to close the infrastructure gap (roads, ports, electricity, and water, sanitation, and irrigation networks) and the skills gap (which requires improving access to key public services for young children and improving the quality and relevance of education for older children).

Those in the middle class will bear much of the burden of funding these needed investments. But what will they expect in return?

Indonesia’s government revenues are lower than many other middle-income countries and those in East Asia. Total revenues are only 12.2 percent of GDP in 2017, compared with 16.5 percent in Thailand, 16.1 percent in Malaysia, and 12.9 percent in the Philippines. Low personal income tax collection (just 1.1 percent of GDP) is due mainly to non-compliance. Increased income-tax collection can significantly increase available funding for investments in infrastructure and skills, but the progressivity of such taxes means they will predominantly be paid for by middle-income Indonesians. What will they expect in return for paying more tax?



This report
looks at
five main
questions.

1

Why does the middle
class matter?



2

How large is the
Indonesian middle
class and how
does it differ
from the rest of
the consumption
classes?



3

What role has it played in Indonesia's economic growth?



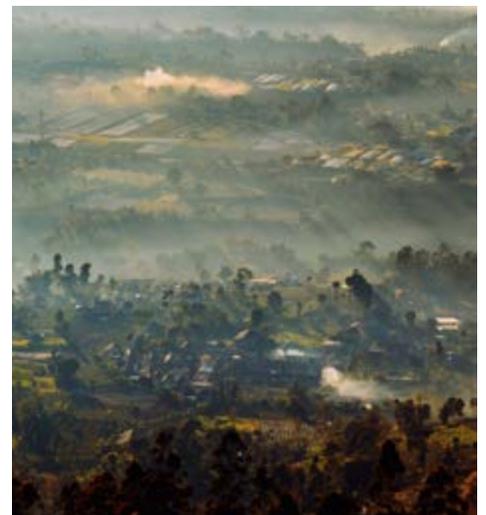
4

What is the relationship between Indonesia's middle class and public services?



5

What are the policy implications for a growing middle class?





THE MIDDLE CLASS :

Why do We Care?

Chapter 2

76—86

2.1
Linking the middle class to
economic growth

2.2
Exploring the social & political
roles of the middle class

Why should we care about the middle class?

There are a number of reasons why the middle class matters to Indonesia. It is linked to economic growth in several important ways, which we explore. But it also plays important social & political roles, which have consequences not only for growth but also for governance & policy.⁸⁴

⁸⁴ This section draws from Wai-Poi et al. (2016).



Left Middle-class consumption has grown at 12 percent annually since 2002 and now represents close to half of all household consumption in Indonesia.

2.1

Linking the middle class to economic growth

The middle class has been linked to economic growth in a number of ways. The middle class has been seen as a key driving force of economic development in Western Europe (Adelman and Morris, 1967). There are a number of channels through which the middle class has economic influence.

The first channel is due to the importance of domestic markets for growth. The role of the middle class in economic growth can be significant if its size is substantial, especially given the middle class's higher purchasing power and its demand for quality goods. Given that industrialization has fixed costs and international trade is costly, Murphy, Shleifer and Vishny (1989) argue that a domestic market of a certain size is necessary to overcome such costs. When inequality is high, they argue that there is insufficient demand to cover these costs, and thus a large middle class is required. Moreover, middle-class consumers can play a catalytic role by providing a large market for

innovation that helps lower the price of new goods (Matsuyama, 2002). In the global context, growth of the middle classes in emerging countries such as India and China is also likely to drive future global consumption, offsetting falling demand among American and European consumers (OECD, 2010).

The middle class also has greater means to invest in and accumulate human and physical capital, further boosting growth. Under imperfect credit markets, the poor may not earn enough or have sufficient savings to overcome a minimum investment requirement for the acquisition of human capital or productive physical capital (Banerjee and Newman, 1993; Galor and Zeira, 1993). The middle class, on the other hand, enjoys higher incomes and is able to invest in both forms of capital, thus increasing a country's stocks and consequently economic growth; the larger the middle class, the more capital is accumulated over time.

Moreover, a larger and more homogeneous middle class may also lead to social norms on greater human capital investment. Easterly (2001) finds that countries that have a larger middle class tend to grow faster, at least if they are not too ethnically diverse. In the absence of "the middle-class consensus"—a situation of relative equality and ethnic homogeneity—he contends that high inequality means the few rich will refrain from investing in human capital for fear that they may be replaced. Similarly, the ethnicity or class in power may not want to invest in human capital for the majority out of power in case it increases the political voice of the majority and weakens the elite's hold on power. Conversely, a large middle class that has a political voice and influence would not have these concerns, and so investment in human capital would be encouraged, contributing to economic growth.

Exploring the social & political roles of the middle class

There is also a link between the sociopolitical role that the middle class plays, and economic policies and growth. A large middle class may result in policies focused on growing the economic pie, rather than in competition solely for the existing pie. “Societies that are polarized tend to focus on redistribution between polarized factions that alternate in power,” while “societies that are not polarized are able to reach a consensus on public goods and overall economic development” (Easterly, 2001, p.318), meaning that a “middle-class consensus facilitates higher levels of income and growth, as well as high levels of public goods” (p.319). One means of facilitating higher growth is sustaining support for market reforms. Birdsall et al. (2000) examine support for market reforms across income groups. Using cross-country public opinion data over 17 countries in Latin America, they regress the pro-market reform index against wealth and country reform status, finding that there tends to be general support for market reforms “early in the process, when the collective memory of

post reform crisis is stronger and the benefits of reducing inflation are most evident,” but that as reforms are implemented “the public, especially those in the middle, becomes more critical and pays more attention to issues such as distribution, volatility, job insecurity” (p.18).

The middle class has also been perceived to be more politically active and play a role in democratization and improving institutional quality. Using modernization theory, Lipset (1959) looks at the extent to which more affluent societies favor the creation and consolidation of democracies and, more generally, good institutions. Easterly, Ritzen and Woolcock (2006) find that measures of social cohesion, such as income inequality and ethnic fractionalization, endogenously determine institutional quality, while Amoranto et al. (2010) show that “the middle class has a higher tendency to take part in political activities than both the lower and upper classes” (p.1). Loayza et al. (2012) find that “when the size of the middle class increases ... social policy on

Below Nearly half of the aspiring middle class aged 25-29 years old drops out of school before senior high school. At the same time, nearly 80 percent of the middle-class cohort at least completes high school.

2.2





health and education becomes more active and the quality of governance regarding democratic participation and official corruption improves,” but “not ... at the expense of economic freedom, as an expansion of the middle class also implies more market-oriented economic policy on trade and finance” (p.444).

However, this support for political and economic reform may only hold if it is aligned with the middle class’s self-interest. The World Bank (2013) examined seven Latin American countries and was unable to identify values that distinguish the middle class from other classes in a particular way. Therefore, it argues, the middle class does not necessarily need to have ‘good values’ to push for reforms, as its higher incomes may simply give it greater voice to push for reforms that are beneficial for its members. However, its push for reform is beneficial to society only to the extent that its needs are aligned with society as a whole.

Nonetheless, a politically active middle class often tends to be centrist and support democracy, although it may be dissatisfied in how democracy is actually functioning. Mateju (1996) shows that in the Czech Republic and its Central European neighbors, respondents who consider themselves middle class (rather than working class or wealthy) are less likely to vote for extremes of the political spectrum. Moreover, analysis of the self-reported Latin American middle-class attitudes toward democracy, fiscal policy and redistribution shows that the Latin American middle class supports democracy, although it remains dissatisfied with how democracy actually functions (OECD, 2011). In addition, there is empirical support that democracy is strengthened through the middle class. A cross-country regression of over 100 countries covering 1960 to 1995 finds that democracy, as measured by a subjective indicator of electoral rights, increases with the middle-class (as measured by the middle three quintiles) share of income (Barro, 1999).

CHAPTER 3

What Is *the* Middle Class & How Large Is It?



81—102

3.1
The Middle Class can be defined in different ways

3.2
Indonesia's Middle Class: growing rapidly

3.3
The Middle Class as an urban phenomenon



Above & Right The middle class is the only class that spends more on non-food items than food, increasingly on entertainment, durables and vehicles.

3.1

The Middle Class can be defined in different ways⁸⁵

⁸⁵ See Wai-Poi et al. (2016) for a broader discussion on different definitions of the middle class, and World Bank (2017) for a similar approach across the East Asia and Pacific region.

⁸⁶ Regional and global studies tend to treat income and consumption interchangeably due to data limitations, but they are conceptually distinct. Income can be saved or consumed, while consumption can come out of current income or savings. Income inequality is higher than consumption inequality because richer households tend to have higher savings rates than poorer households, leading to a wedge between income and consumption.

The size, characteristics and roles of the middle class depend on how it is defined. There are four common types of definition. The middle class can be defined by: (i) its income or consumption levels; (ii) against a global benchmark; (iii) by its behavior or perceptions; or (iv) by its economic security. Annex B: The Indonesian Poverty, Vulnerability and Economic Security Lines contains a comprehensive review of different middle-class definitions.

The middle class is often defined by its income levels. Perhaps the most common way to define the middle class is based on its economic welfare. This can mean either household or per-capita income or consumption, depending on the survey data in a particular country.⁸⁶ The income or consumption threshold for the middle class can be either absolute or relative. An absolute threshold represents the minimum income or consumption a household needs to be considered middle class and is fixed, regardless of the incomes of other households. For example, Kharas and Gertz (2010) define “the global middle class as those households with daily expenditures between US\$10 and US\$100 per person in purchasing power parity terms” (p.3). A relative threshold defines middle-class income relative to that of others, such as those lying between the 20th and 80th percentile on the income or consumption distribution (Easterly, 2001).

The middle-class income thresholds can be set arbitrarily or relative to an international benchmark. These thresholds can be set arbitrarily, such as Easterly’s percentiles or the Asian Development Bank’s US\$2-US\$20 per day (ADB, 2010), or relative to international benchmarks. For example, Milanovic and Yitzhaki (2002) define the middle class as comprising those between US\$4,000 (Brazilian average income, or US\$11 per day, which is also around the poverty line in



the US and Germany) and US\$17,000 (Italy's average income) annually in 2000 PPP terms, while Ravallion (2010) defines the middle class as comprising those who are not poor by developing country standards (household per-capita consumption above the median poverty line of 70 developing countries, or US\$2 a day at 2005 PPP) but still poor by developed country standards (below the US poverty line of US\$13 a day).

Within Indonesia, management consultants have defined the middle class in absolute terms based on market size potential.

BCG (2013) divides the population into seven categories, three of which are considered to be 'middle'. The upper middle comprises those whose expenditure is between Rp 3-5 million per month (around US\$600-US\$1,000 adjusted for purchasing power), the middle between Rp 2-3 million (US\$400-US\$600), and the emerging middle between Rp 1.5-2 million (US\$300-US\$400).⁸⁷ In 2012, the combined total of the population of these three groups was about 109.2 million people. The richest four categories are called the Middle Class and Affluent Customer (MAC) group, which consists of middle, upper-middle, affluent and elite consumers. Meanwhile, McKinsey (2012) defines a 'consuming class' "with enough income to purchase not just basic necessities such as food and clothing but also discretionary goods and services" (p.27) as those with annual net income of more than US\$3,600 in 2005 PPP.

Some studies looking at middle-class values in developing countries classify people based on self-perception of either status or position in the income distribution (PRC, 2008; Amoranto et al., 2010)., although self-reported status may be a poor predictor of someone's income, education, or occupation. Amoranto et al. (2010) utilize the World Values Survey (WVS) data to examine different perspectives on class status based on self-perceptions rather than income or expenditure measures. In the countries they studied, 2 percent see themselves as coming from the upper class, 45 percent from the lower class and 53 percent from the middle class. They find that "there is generally a wide range of variation in what people consider middle class, but perceived class status is largely related to higher education, more skilled and stable jobs, and the ability to 'save', which are all characteristics of people with higher incomes" (p.1).

There are also some who define the middle class as comprising those who exhibit certain behaviors, often in their occupation.

Lawrence James (2006), looking at Elizabethan England, defines the middle class as comprising those who live by their wits rather than manual labor. In a more modern sense, Adelman and Morris (1967) were among the first scholars to highlight the importance of the middle class, specifically the indigenous middle class, and occupation. They define the middle class as comprising those working in a particular occupation as evident in the way in which they construct the indicator of the importance of the indigenous middle class. To construct this indicator, they divide countries into five categories. A country categorized as having a relatively important indigenous middle class is one with at least 20 percent of the active male population working in commercial banking, insurance, or in technical, professional, managerial, administrative, or clerical employment. Countries fulfilling this criterion, but that are largely dominated by expatriates, are excluded from this category.

Nonetheless, income and behavioral definitions do not necessarily result in very different people being identified as belonging to the middle class.

Despite adopting an absolute definition, some scholars, such as Kharas and Gertz (2010), acknowledge that "the middle class is an ambiguous social classification, broadly reflecting the ability to lead a comfortable life" (p.2), and recognize that "the middle class usually enjoy stable housing, health care, educational opportunities (including college) for their children, reasonable retirement and job security, and discretionary income that can be spent on vacation and leisure pursuits" (p.2).

Finally, an absolute threshold can also be based not on global poverty line benchmarks but grounded in the concept of economic security.

The World Bank (2013) report on *Economic Mobility and the Rise of the Latin American Middle Class* sets an income threshold of US\$10 per day in PPP terms as a lower-bound per-capita household income, and an upper bound at US\$50 for the middle class. Thus, "according to these thresholds, a family of four would be considered middle class if its annual household income ranged between US\$14,600 and US\$73,000" (p.2). The lower bound was set by examining panel data in se-

⁸⁷ Expenditure includes: food, utilities, transportation, communication, and regular household supplies. Discretionary spending such as entertainment, restaurant dining, and similar categories are excluded.

⁸⁸ Our approach differs slightly in that we use a loess smoothing method to estimate the probability curve, rather than the logistic regression used in Lopez-Calva and Ortiz-Juarez. The result is very similar using either method.

lected Latin American countries and determining a household's probability of being poor next period based on its income in this period. The income level at which a household was safe from falling into poverty in the next period was averaged across countries to develop the US\$10 lower bound. The report then used self-perceptions of class membership in five countries (Brazil, Chile, Colombia, Mexico and Peru) to validate this lower-income threshold. Using this measure, the size of the middle class in the countries studied increased by half between 2003 and 2009, from 103 million people to around 152 million, so that the middle class now accounts for around one-third of the region's population—roughly the same as the poor.

This report adopts an economic security-based definition of the middle class. There are a number of advantages to defining the middle-class threshold as free from economic vulnerability. First, it is conceptually grounded in the notion of economic security, unlike arbitrary thresholds that have no

basis. Second, what counts as economic security is developed in the Indonesian context, rather than against global benchmarks, which may be less relevant. Third, it allows behaviors and characteristics of the middle class to be explored empirically, rather than being pre-determined to define them, as behavioral definitions do. Fourth, the definition can be held constant in conceptual terms over time, allowing a line that increases over time with inflation and growth but can be compared consistently over time.

In Indonesia, the economic security line begins at Rp 1.2 million of consumption per person per month, or around US\$7.75 a day. We take the 'poor' as comprising those below the national poverty line, currently monthly consumption of around Rp 350,000 per person. Using panel data that track the same households over time (Susenas, 2008-10), we look at how the level of per-capita consumption in one year predicts the poverty status in a later year (following Lopez-Calva and Ortiz-Juarez, 2014).^{88 89}

The data show that households with a monthly consumption of greater than Rp 1.2 million per person per month have less than 10 percent chance of being poor or vulnerable the following year, and can thus be considered economically secure. Annex B: The Indonesian Poverty, Vulnerability and Economic Security Lines contains the full details of the analysis.

However, as countries become upper-middle-income and most of the population is economically secure or better, 'middle class' may come to be more of a relative notion. When countries are still lower income and most of the population are still poor, then the economically secure are among the richest. However, as a country grows richer, the poorer end of the distribution may become economically secure, but its members may not consider themselves middle class at all, as they aspire to the greater wealth they see at the richer end of the distribution, as we see later in the case of Malaysia.

⁸⁹ World Bank analysis tested the creation of a comparable absolute class between Susenas and IFLS. The IFLS results were consistent in creating a comparable poor and aspiring middle classes with the 1993 Susenas. However, IFLS data produced a significantly larger middle-class than Susenas and a smaller vulnerable class. Nevertheless, these discrepancies diminish over time and, overall, the size of each economic classes using the multiples of the poverty line became more robust.

Economy Class	1993		1997		2000		2007		2014	
	Susenas	IFLS								
Poor	19%	19%	17%	17%	18%	18%	16%	16%	11%	11%
Vulnerable	35%	22%	32%	21%	36%	21%	29%	23%	26%	20%
Aspiring Middle Class	41%	43%	43%	43%	41%	43%	45%	45%	46%	49%
Middle Class	5%	16%	8%	20%	5%	18%	11%	16%	16%	20%

Source: World Bank calculations based on Susenas and IFLS 1993, 1997, 2000, 2007 and 2014.

3.2

Indonesia's Middle Class: growing rapidly

The middle class has been growing faster than other groups; there are now at least 52 million economically secure Indonesians, or one Indonesian in every five. Figure 3.1 shows the evolution of Indonesia's consumption classes since 2002 and their current sizes. By 2016, based on the national household consumption survey, there were 52 million middle-class (MC) Indonesians, representing 20 percent of the population. This compares with 11 percent who were poor (labelled P in charts) and a further 24 percent who were vulnerable (V). The largest segment of the population is the aspiring middle class (AMC), namely those who have escaped poverty but are not yet economically secure, with a greater-than-10-percent chance of being vulnerable next year (Table 3.1).

Most of those in the middle class consume less than US\$20 a day, although many richer

Indonesians are missing from the data. The great majority of the middle class, despite being economically secure, are not that wealthy; 90 percent (47 million) consume between US\$7.75 and US\$20 a day (referred to as MC 1 in charts), while the remainder (5 million) consume between US\$20-US\$38 a day (MC 2). The survey data find less than 1 percent (1.3 million) who consume more than US\$38 a day, or Rp 6 million (the upper class, or UC). However, the national household consumption survey (Susenas) is believed to exclude many richer Indonesians. Forthcoming work is trying to estimate the top end of the income and consumption distributions more accurately. While it still misses many wealthy Indonesians, initial results suggest that the upper class is much larger and richer than the survey data suggest.⁹⁰

The middle class is growing fast, expanding at 10 percent every year, although not as

quickly as elsewhere in East Asia. The middle class is growing faster than most other segments of the Indonesian consumption distribution, with the exception of the small upper class. The middle class tripled as a proportion of the population between 2002 and 2016, during which time it grew at 10 percent annually. This is four times faster than the aspiring middle class while, over the same period, the share of poor and vulnerable households in the population shrank slowly (Figure 3.1). Although rapid growth of the middle class was from a small base of only about 14 million in 2002, it also added the most people in absolute terms (38 million compared with the 31 million for the aspiring middle class). Nonetheless, growth in the proportion of the economically secure classes in Indonesia was slower than in Thailand, and less than half as large as growth seen in China, Mongolia and Vietnam.⁹¹

⁹⁰ World Bank (forthcoming) *Estimating the Top End of Indonesia's Consumption Distribution*.

⁹¹ See World Bank (2017) Figure 2. Note, this regional study uses the same economic security definition for the middle class, but it is based on regional data and international poverty lines rather than just Indonesia's. As such, the class definitions are not the same, although they are broadly consistent.

TABLE 3.1 Class definitions (2016 per-capita consumption)

The middle class comprises those who have less than a 10 percent chance of being poor or vulnerable in the future, given their current consumption.

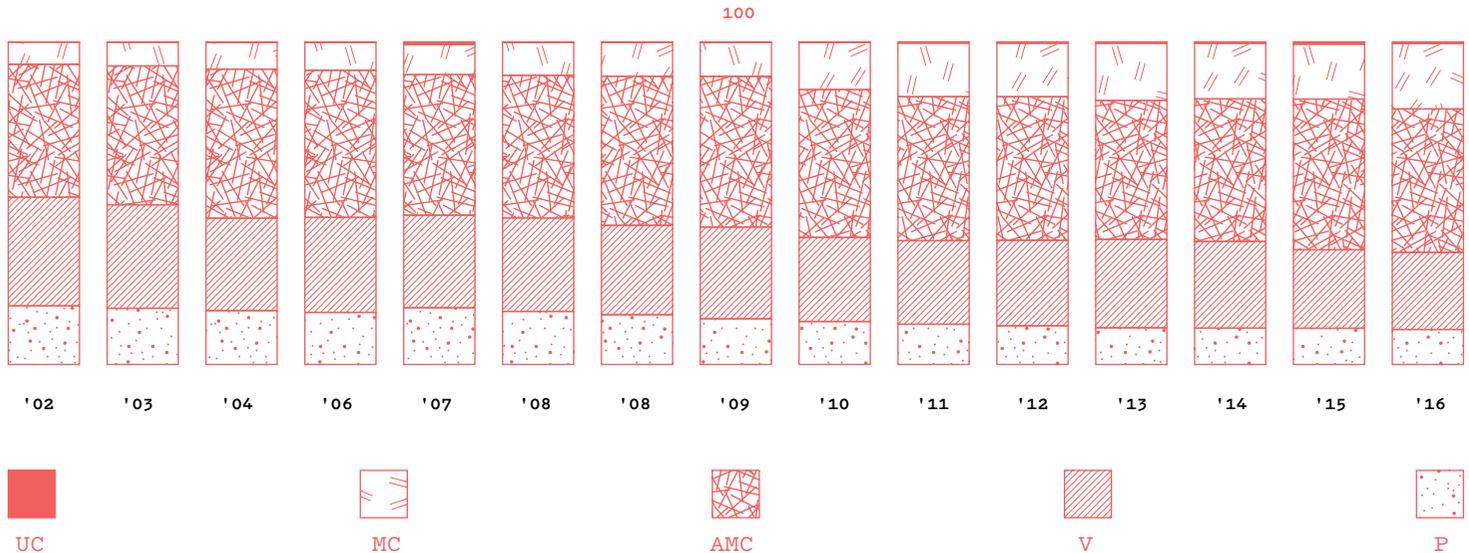
Class	P Poor	V Vulnerable	A M C Aspiring Middle Class	M C Middle Class	U C Upper Class
Household status	Below national poverty line (PL)	>10 percent chance of being poor next year (1.0-1.5xPL)	<10 percent chance of being poor but >10 percent chance of being vulnerable (1.5-3.5xPL)	<10 percent chance of being poor or vulnerable (3.5-17xPL)	>17xPL
Per capita consumption (Rp is monthly and US\$* is daily)	<Rp 354k <US\$2.20	Rp 354-532k US\$2.20-3.30	Rp 532k-1.2m US\$3.30-7.75	Rp 1.2-6.0m US\$7.75-38 <small>SUB-GROUPS: MC 1 (Rp 1.2-3.2m; US\$7.75-20); MC 2 (Rp 3.2-6.0m; US\$20-38)</small>	>Rp 6m >US\$38

Note: Daily per capita consumption is measured in US\$PPP, which are US dollars adjusted for purchasing power parity across countries.

Source: Susenas and World Bank calculations.

FIGURE 3.1 Consumption distribution by class, 2002-16 (percent of population)

The middle class is the fastest growing major segment of the Indonesian population in both percentage and absolute terms, expanding at 10 percent per year and 38 million between 2002 and 2016. It now represents 20 percent of the population.



Note: CAGR is compound annual growth rate from 2002-16.

Source: Susenas and World Bank calculations.

BOX 3.1

The number of the wealthiest Indonesians is under-estimated in survey data; recent work addresses this



In many developing countries, richer households are often more likely to be excluded from household survey data on income and consumption, or to under-report. In Indonesia, the World Bank has been collaborating with Bank Indonesia and the Ministry of Finance to estimate how many richer households might be excluded. This work uses Bank Indonesia’s consumer credit database, which includes home mortgages and vehicle loans. Income models are applied to the credit and debt servicing data to estimate household incomes and consumption, and the resulting households combined with the survey data to derive a more accurate consumption distribution.

The table below presents the number of households in different consumption categories before and after the top-income

data are incorporated. As household size is not captured in the top-income data, only total household consumption can be compared, not per capita consumption. Consequently, direct class size comparisons cannot be made, but rough approximations can. For example, in 2011 prices and assuming an average household size of 4, then Rp 10 million is roughly equal to US\$18 per person per day, making the category roughly the upper group of the middle class (MC 2) and upper class (UC). This category is 12 percent higher when we adjust for the top-income data. Estimates of the richer households (those above Rp 20 million monthly household consumption, or roughly US\$38 per day, which is UC) increase by 42 percent, with the largest proportional increases coming for the very richest households.

NUMBER OF INDONESIAN HOUSEHOLDS

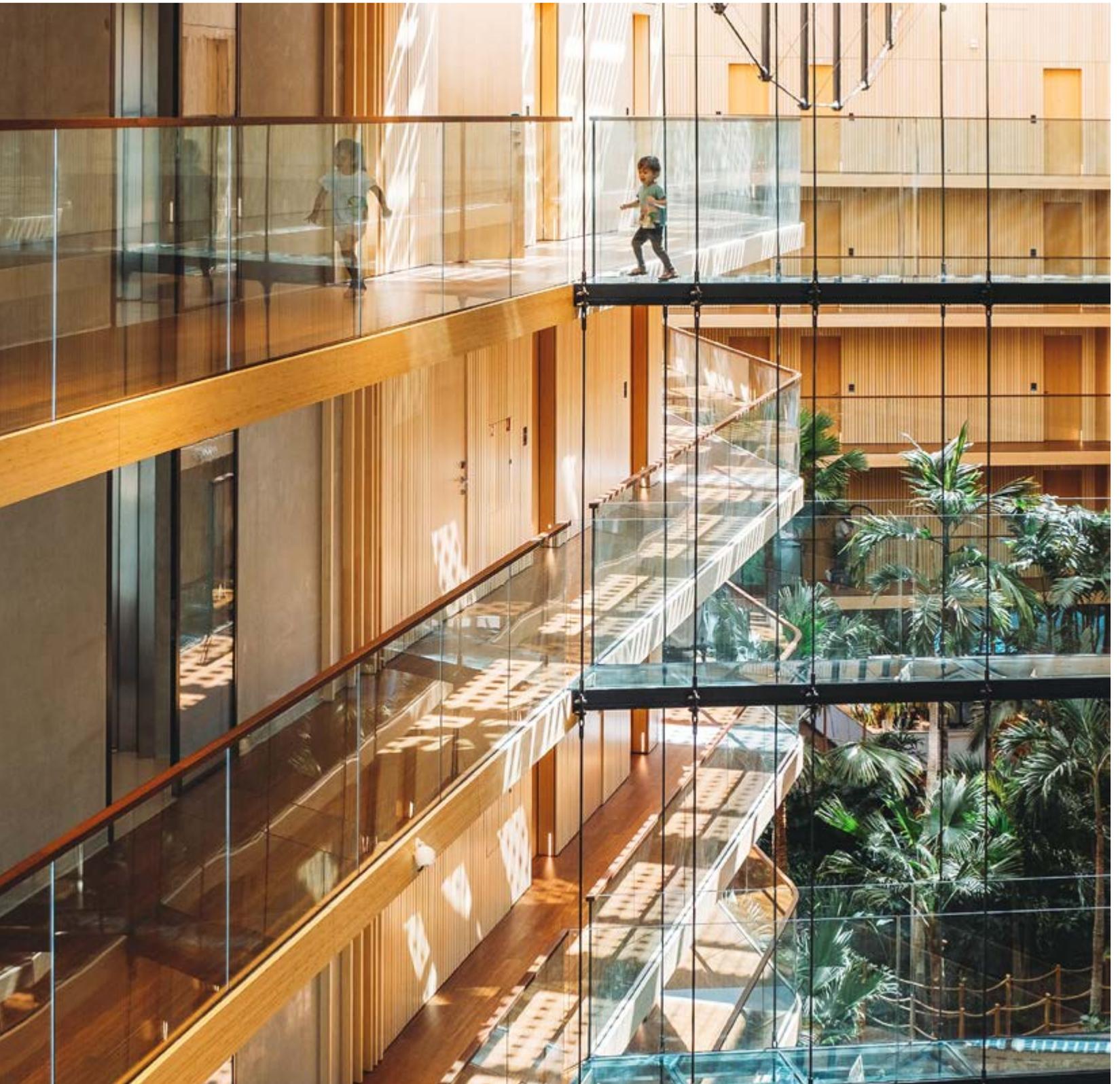
Monthly household consumption range (Rp million)	Survey estimate	Hybrid survey-Top income estimate	Increase in households (%)
>10	2.8 million	3.1 million	+12%
>20	553,000	772,000	+42%
>50	22,000	163,000	+773%
>100	0	61,000	-

Source: Household survey data, consumer credit database and World Bank calculations. From Bank Indonesia,

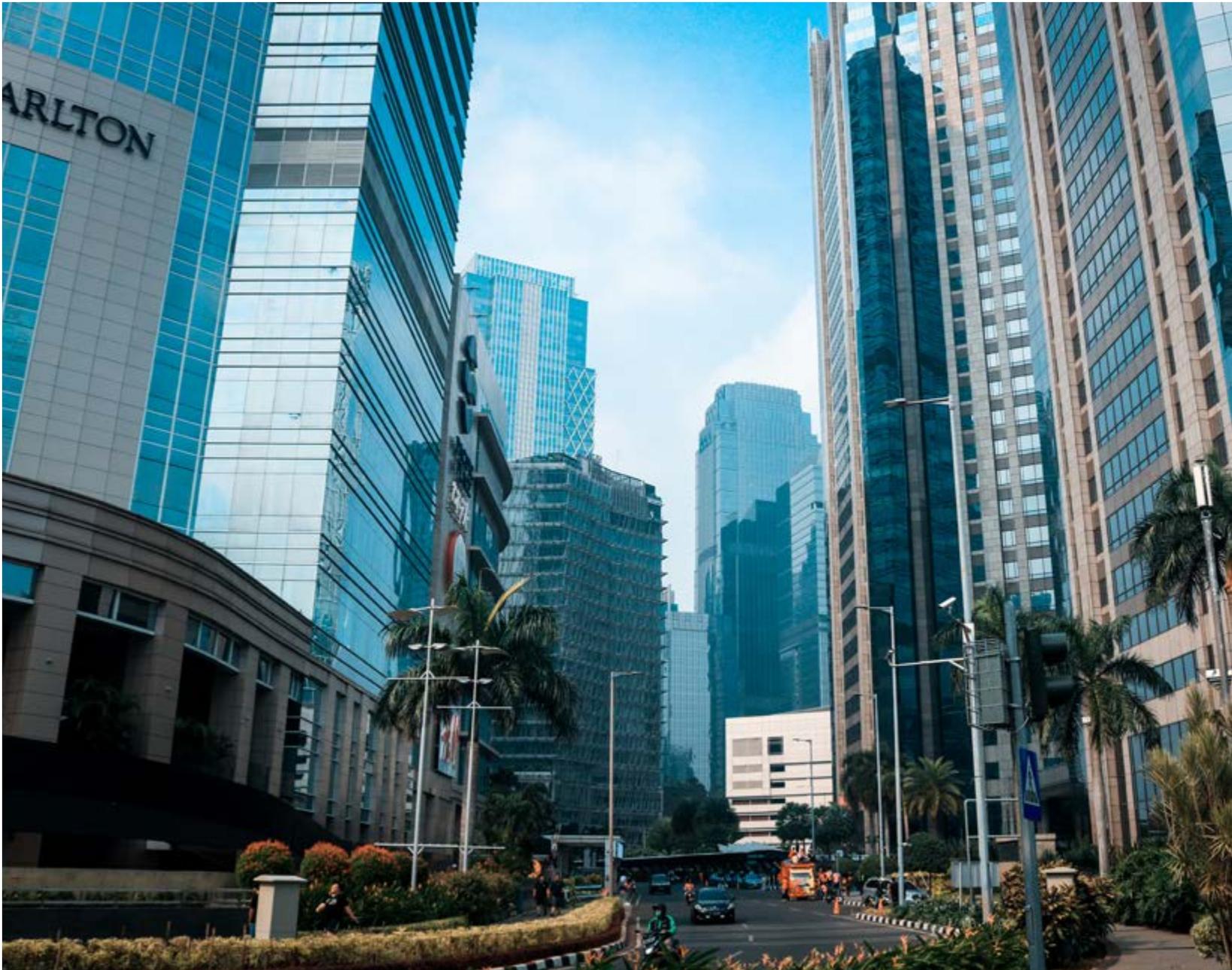
Ministry of Finance and World Bank (forthcoming) *Estimating Top Incomes in Indonesia*.



Below Inequality has risen in Indonesia since 2000, as most Indonesians have been left behind by the middle class, with possibly significant consequences not only for growth but also for social and political stability.



Below Aiming to become a high-income country and increasing economic mobility will require new investments.



3.3

The Middle Class as an urban phenomenon

Most of the middle class live in the major urban agglomerations that now dominate the Indonesian landscape, mainly in Java. Three-quarters of the middle class currently live in urban areas, the same fraction as in 2002 (Figure 3.2), with three-quarters again living in cities with more than 5 million people, the fastest growing urban areas.⁹² Although some regions enjoy a higher percentage of middle class among the

population—for example, in Sulawesi and Kalimantan—the much greater population of Java means that around two-thirds of the middle class live there. In fact, around 13 million middle-class people live in Greater Jakarta alone (Figure 3.3), accounting for 34 percent of the urban middle class and 25 percent of the middle class nationally. The relatively low urban poverty and vulnerability rates mean that, while more AMC live in rural ar-

reas, they also make up most of the non-middle class in cities. Only in a small number of cities is the middle-class rate similar to the AMC rate (Jakarta, Bandung, Denpasar and Yogyakarta), or significantly higher (Surabaya and Makassar). This implies that policies to support the expansion of the middle class will need to have a strong urban dimension, which is the focus of a major ongoing research project.

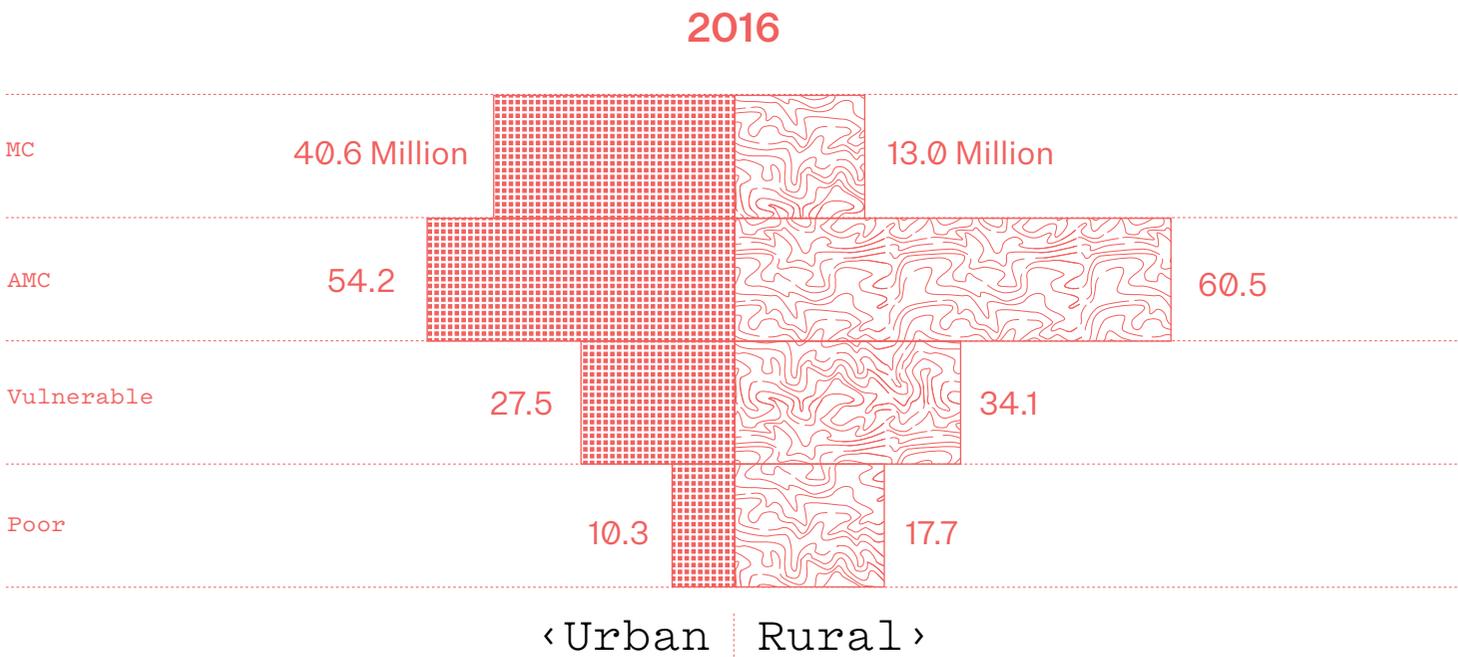
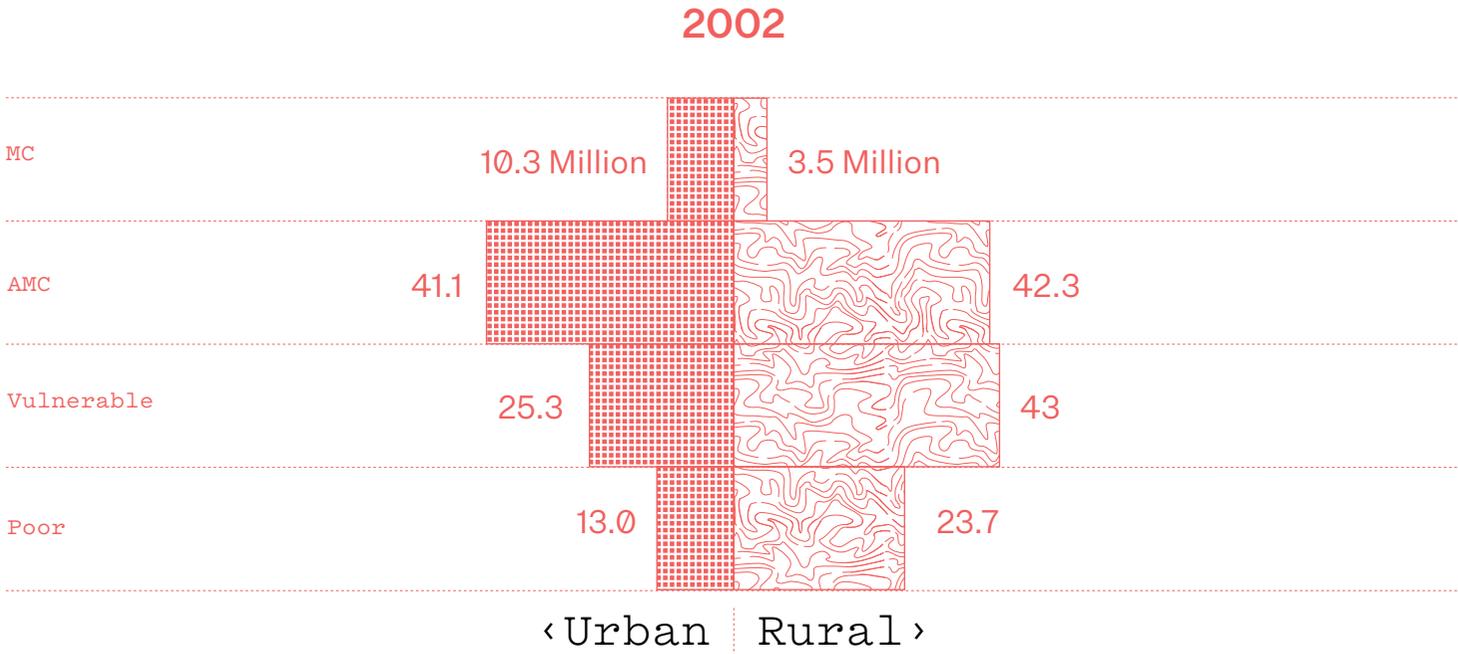
⁹² See World Bank (forthcoming) *Recent Trends in Urban Indonesia* for more details.



FIGURE 3.2 Urban-rural breakdown of Indonesian consumption classes, 2002 and 2016 (million)

76%

At about 76 percent, most of the middle class live in urban areas, many in the urban agglomerations of Java.

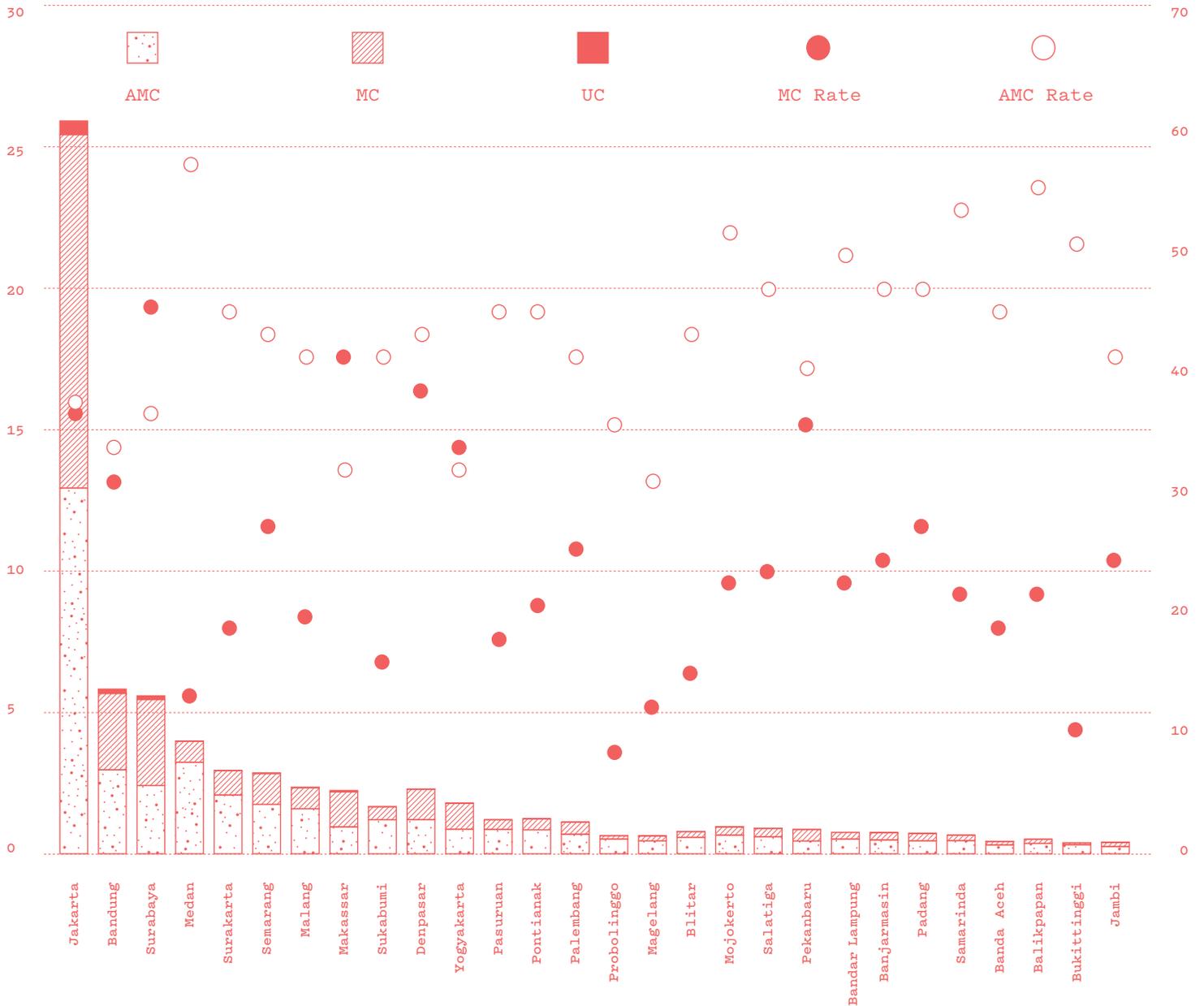


Source: Susenas and World Bank calculations.

FIGURE 3.3

**Urban agglomerations with largest MC and AMC populations, 2016
[million (LHS) and percentage of population (RHS)]**

The middle class is largely an urban phenomenon and is clustered in the major Indonesian urban metropolises, mostly in Java.



Note: Agglomeration definitions of cities are based on World Bank (forthcoming).⁹³

Source: Susenas and World Bank calculations.

⁹³ The definition of metropolitan areas follows that of the World Bank’s Flagship report on Urbanization in Indonesia, which is currently underway. Multi-district metropolitan areas are thus defined based on daily commuting flows between Indonesian districts using data from the August 2013-2015 rounds of Sakernas. Single-district metropolitan areas, meanwhile, are those which satisfy the following three criteria: (i) the district is classified as a Kota; (ii) the district has a population of at least 500,000; and (iii) the district has an average population density which is at least 1,500 people per sq. km.

Within these larger cities, the more prosperous city core has higher middle-class rates than the sprawling suburban periphery. Most urban growth has come in the suburban periphery of major urban agglomerations, with the population in the peripheries now 1.6 times larger than the core.⁹⁴ Consequently, the urban periphery has around 1.3 times more middle class than the core. However, the core population is richer, with 42 percent of the core urban population middle class, compared with 35 percent in the periphery.

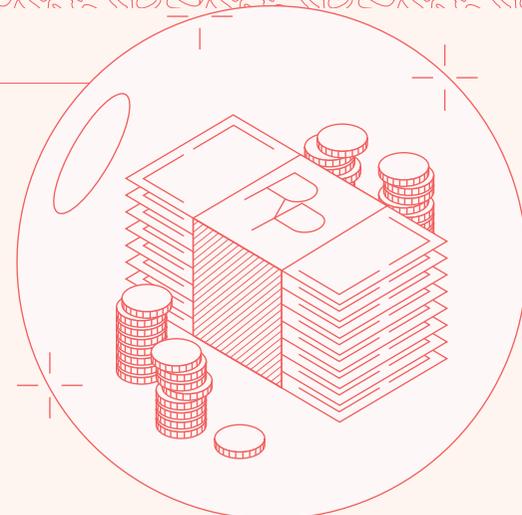
The urban nature of a highly urbanized middle class is also seen in China and the Philippines, but less so in Thailand and Vietnam. Similar to Indonesia, the large majority of the Philippines' and China's middle class also lives in cities (World Bank, 2017). However, entering the middle class need not be mostly an urban phenomenon. There are as many if not more economically secure people living in rural areas of Thailand, Vietnam, Cambodia and Lao PDR. Understanding how upward economic mobility has led to prosperity in each of these countries could hold lessons for boosting economic security in rural areas of Indonesia as well (Box 3.2). At the same time, new research is looking at how the middle class has achieved economic security in Indonesia's cities, where two-thirds of the population are expected to live by 2035.⁹⁵

⁹⁴ See World Bank (forthcoming) *Recent Trends in Urban Indonesia* for more details.

⁹⁵ World Bank (forthcoming) *Recent Trends in Urban Indonesia*; World Bank (forthcoming) *Urban Economic Mobility*; World Bank (forthcoming) *Indonesian urban flagship report*.

BOX 3.1

Prospering on the land: economic security in Thailand, Vietnam, Cambodia and Lao PDR



While economic prosperity tends to be an urban phenomenon in countries such as the China, Indonesia and the Philippines, there are just as many, if not more, economically secure people living in rural Thailand, Vietnam, Cambodia and Lao PDR.

In the case of Vietnam, the significant reduction in poverty and an increase in economic security has been predominantly a rural affair, driven by Vietnam's rural investments and agricultural transformation. The agricultural sector includes crops, livestock, forestry, aquaculture and fisheries, and in 2005 accounted for 22 percent of GDP, 30 percent of exports and 60 percent of employment (World Bank, 2005). Vietnam's success in the agricultural sector is largely driven by the *Doi Moi* or 'renovation policies' introduced in Vietnam in 1986, which have shifted Vietnam from suffering from a chronic food deficit to becoming the world's second-largest rice exporter, as the country moved from a centrally planned economy to a socialist-oriented market economy. Key policies introduced to tap the growth potential of rural Vietnam include farmland allocations to individual households in the early 1990s and market-based incentives such as commodity trade liberalization (World Bank, 2005). Furthermore, in 2005 Vietnam had a higher rural road access (at 76 percent) compared with other countries with similar income levels (at 43 percent), which improves rural access to markets and lowers distributional costs (World Bank, 2005).

In Thailand, most of the middle class lives in Bangkok, but the rural economically secure have always been larger in number than those in urban areas, both in 2002 and 2012. This partly reflects the fact that Thailand has historically had a lower urbanization rate than either Indonesia or the Philippines, but also the role of rural-urban migration (see the urbanization discussion later); living standards in rural areas have been boosted by significant remittances to rural areas in the North and Northeast from workers in Bangkok (Osaki, 2003) based on a web of family obligations (Rindfuss et al., 2012), while rural wages are driven higher by a smaller workforce (UNDP, 2010).

Cambodia and Lao PDR are poorer than Thailand and Vietnam, and they have only a small number of economically secure. However, despite a mainly rural population (and rural poverty), the economically secure are almost equally divided between the country and city, and the increase in both has been similar over 2002 to 2012 (Wai-Poi et al., 2016).

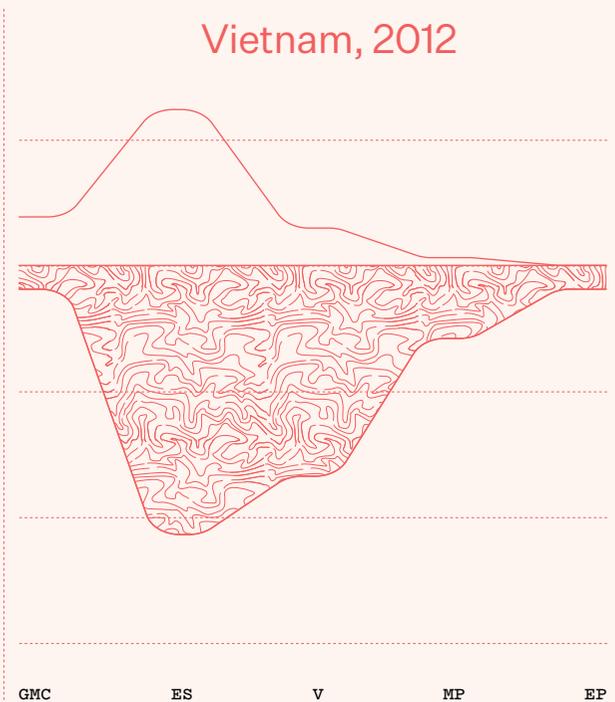
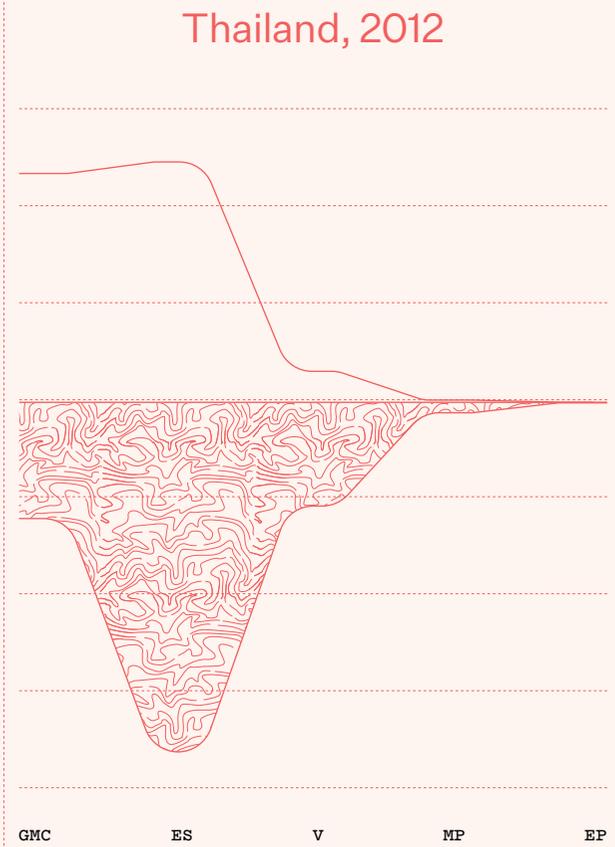
GMC = Global Middle Class

ES = Economically Secure

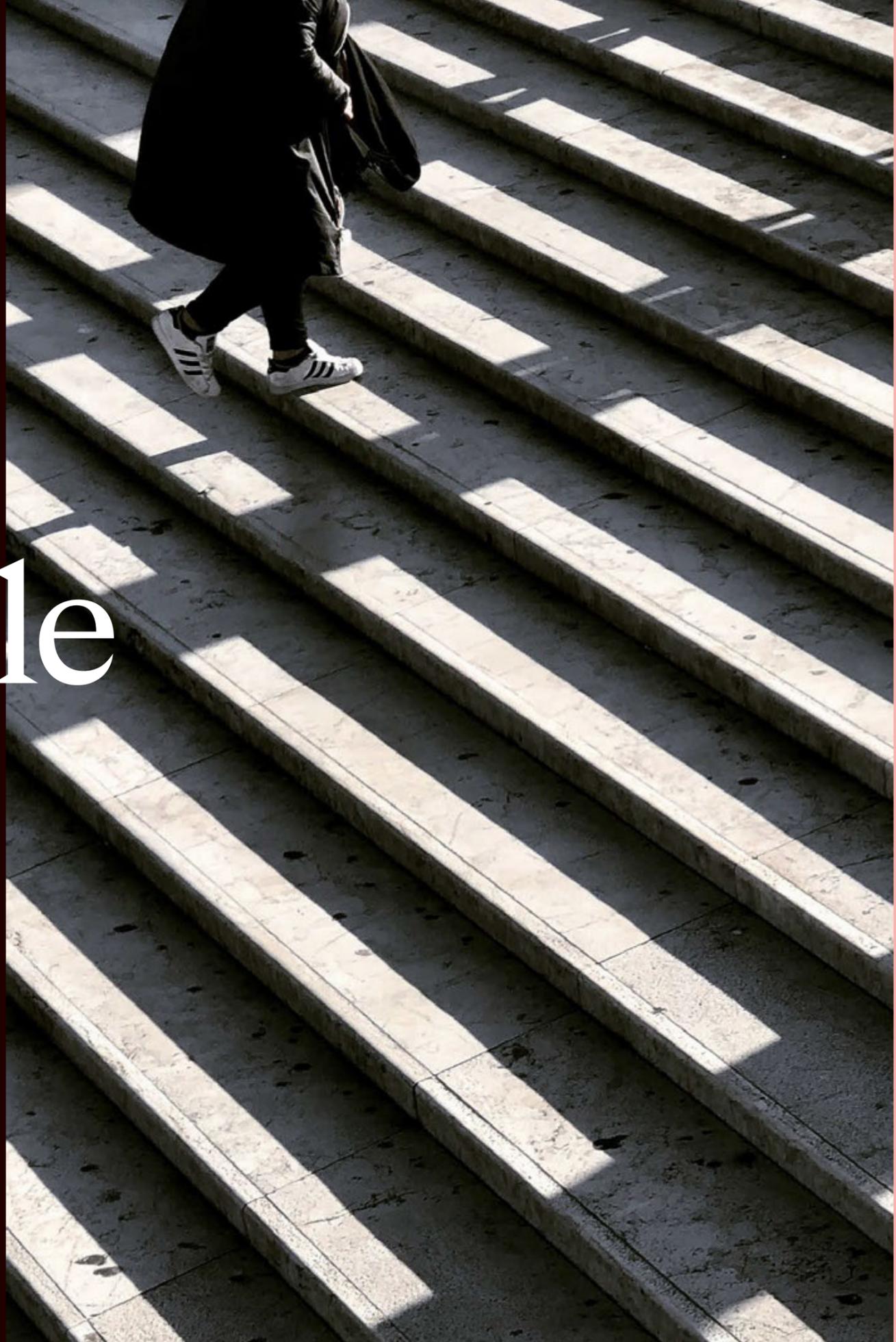
V = Vulnerable

EP = Extremely Poor

MP = Moderately Poor



The Middle Class



& Economic Growth

4.1
Middle-class consumption

4.2
Middle-class education & skills

4.3
Middle-class entrepreneurship

4.4
Middle Class female labor participation

The middle class can potentially contribute to growth through four main channels. There is strong evidence that it is contributing significantly through the first three.

01 As the most affluent Indonesians, their consumption drives a large part of the economy.

02 Middle class parents can provide better skills to their children, so growth of the middle class leads to greater investments in human capital.

03 At the same time, they have sufficient assets to take more risks and some of them become successful entrepreneurs whose enterprises drive growth and create jobs.

04 Greater female labor participation; the more workers there are, the greater the size of the economy. However, Indonesian middle-class women are only slightly more likely to work and participate in the workforce than non-middle-class women, and they do so much less than in other countries in the region.

4.1

Middle-class consumption

Middle-class consumption has grown at 12 percent annually since 2002, a much faster rate of increase than any other class. By comparison, average household consumption growth was only 6.1 percent per year over the same period, 5.8 percent for the aspiring middle class and only 0.7 percent for the vulnerable (Figure 4.1). Total poor household consumption declined by 0.2 percent per year in real terms. Moreover, given that household size decreases with income, the difference in per-capita growth rates in consumption between the middle class and the other classes is even greater, which is reflected in Indonesia's much higher rate of inequality over the period.⁹⁶

The middle class is now responsible for nearly half of all consumption in Indonesia. These sharp differences in consumption growth between the classes mean that the middle class has rapidly expanded how much of national consumption it enjoys. In 2002, middle-class consumption was 22 percent of all private consumption in Indonesia. By 2016, it was Rp 1,380 trillion, or 47 percent of total household consumption (Figure 4.1). Despite

growing in population, the share of the aspiring middle class has fallen from 48 to 38 percent, while that of the poor and vulnerable collapses from 8 to 3 percent and from 22 to 11 percent, respectively, over the period.

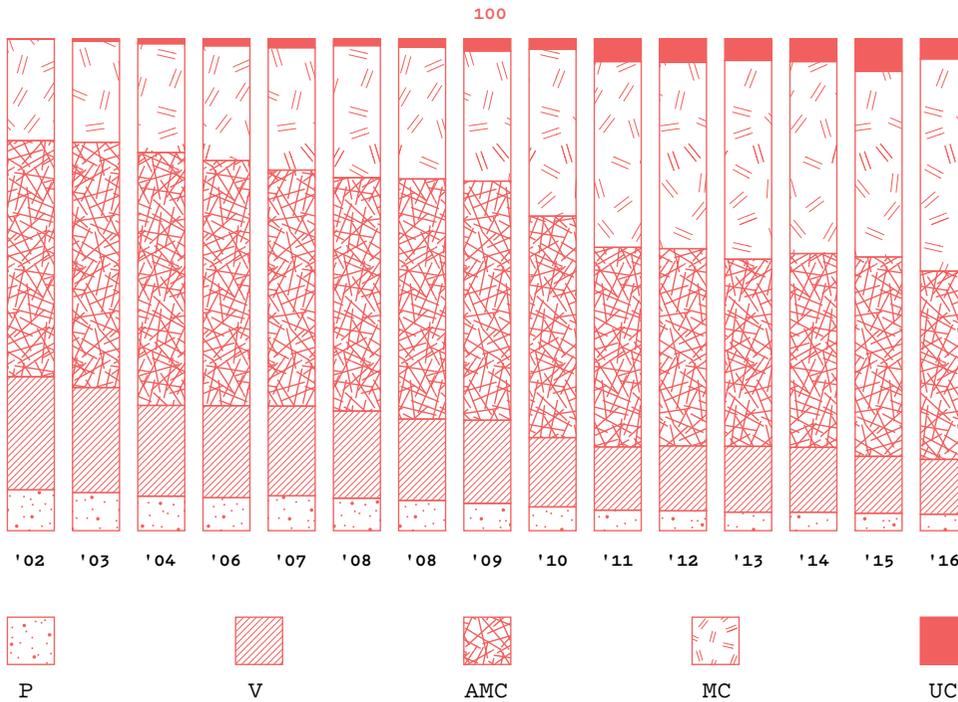
Unlike the other classes, the majority of this consumption by the middle class is not on food, with increased spending on discretionary items such as entertainment.

Most Indonesians spend most of their money on food; this represents 60 and 62 percent of all consumption for the poor and vulnerable, respectively, and 56 percent for the aspiring middle class. The middle class is the only group where more is spent on non-food than food (Figure 4.2). However, for most middle-class households, food still makes up 44 percent of consumption. Breaking out the middle class, it is only MC 2, as well as the upper class, where food is below one-third of consumption. As disposable income increases for these groups, it is being spent more on entertainment (9 and 11 percent of total consumption for MC 2 and UC, respectively).

⁹⁶ See World Bank (2015a) for a comprehensive discussion on the drivers and implications of rising inequality in Indonesia.

FIGURE 4.1 Share of total national household consumption, 2002-16 (percent)

Despite comprising just 20 percent of the population, the middle class makes up close to half of total national consumption.



*CAGR: Compound Average Growth Rate.
 Calculation based on the actual total consumption changes for 2002-16
 Poor: -7%
 Vulnerable: -5%
 Aspiring Middle Class: -2%
 Middle Class: 7%

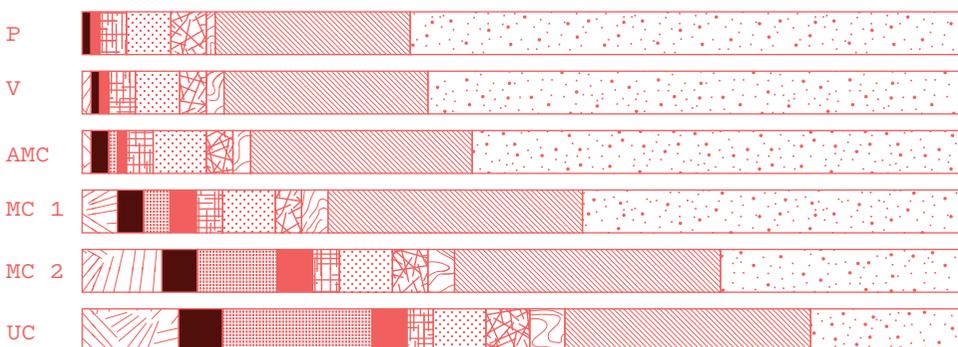
Note: The UC share is poorly estimated due to the small number of households participating in the survey data.
 Source: Susenas and World Bank calculations.

Switching from motorcycles to cars is one of the key hallmarks of the middle class. The majority of Indonesian households own a motorcycle; even among the poor, motorcycle ownership is close to 50 percent (Figure 4.3). However, car ownership is perhaps one of the most visible and starkest divides between the middle class and all others. The poor and vulnerable do not own cars, while less than 5 percent of the aspiring middle class do. Around one-quarter of the middle class own cars, with this reaching 60 and 80 percent for MC 2 and UC, respectively. MC 2 and UC spend 9 and 17 percent of total consumption, respectively, on vehicles (Figure 4.2).

Durable ownership is higher among those in the middle class, especially as they transition from home essentials to home conveniences. As households become richer, they begin investing in household durables, beginning with more essential items such as refrigerators. One-third or less of the poor and vulnerable have a refrigerator, but 50 percent of the aspiring middle class do, rising to 80 percent for the middle class (Figure 4.4). Rates for purchased drinking water are similar, in a country in which piped water is limited in supply and usually not safe to drink. However, it is only as a household becomes middle class that it begins to own home amenities that are more oriented toward convenience and comfort. The use of more convenient and unsubsidized large volume gas canisters for cooking and ownership of water heaters and air conditioners are almost non-existent outside the middle class.

FIGURE 4.2 Breakdown of consumption, 2016 (percent of total consumption)

The middle class is the only class that spends more on non-food items than food, increasingly on entertainment, durables and vehicles.



Entertainment
 Tax/insurance
 Vehicles
 Durables (excl. Vehicles)
 Clothes
 Goods/service
 Education
 Health
 House
 Food

Source: Susenas and World Bank calculations.

FIGURE 4.3

Vehicle ownership by class, 2016 (percent)

Car ownership is one of the most visible and starkest divides between the middle class and lower classes.

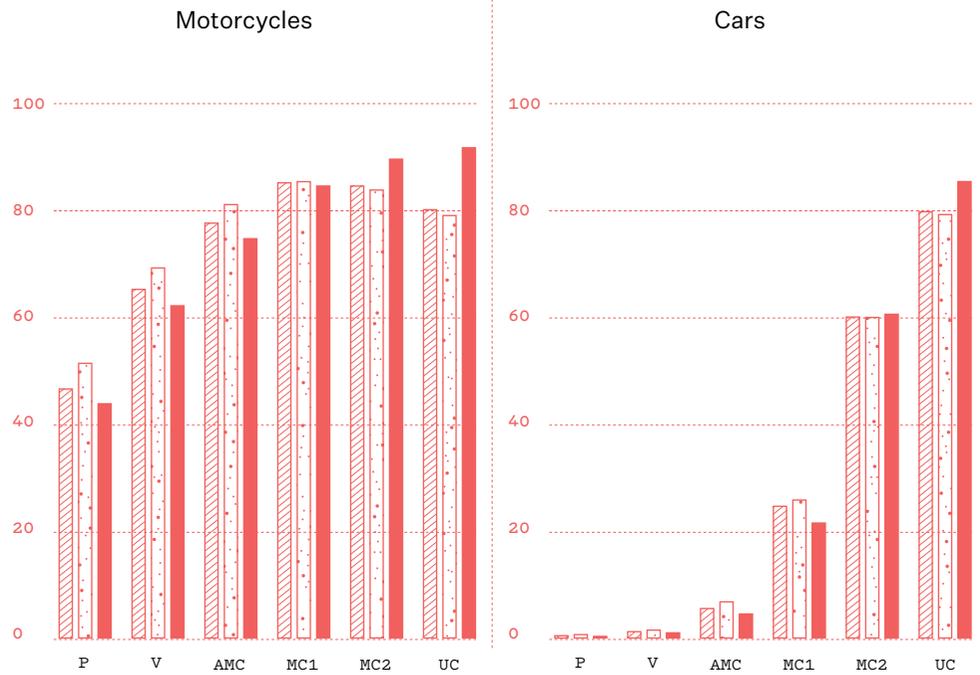
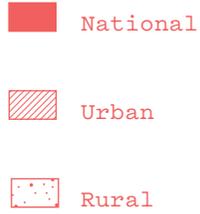
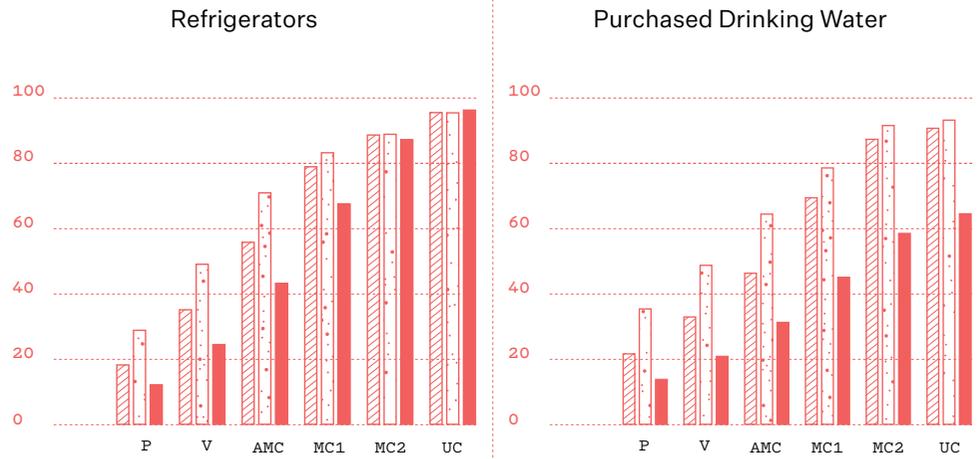
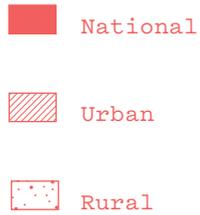


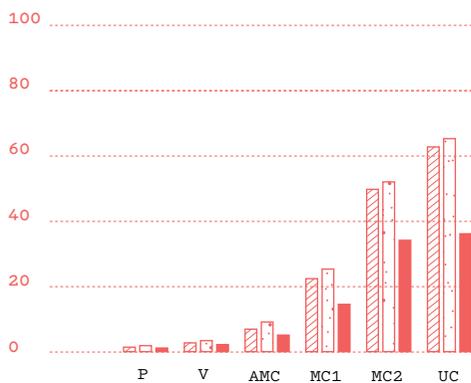
FIGURE 4.4

Selected durable ownership by class, 2016 (percent)

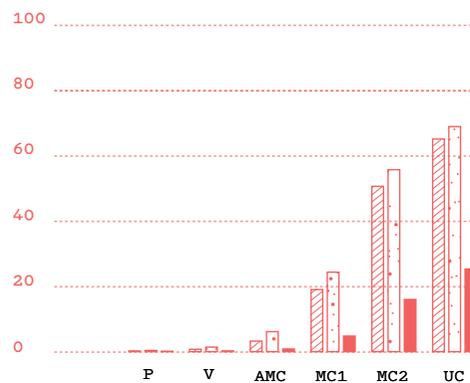
Middle-class households begin to own home amenities that are more oriented to convenience and comfort.



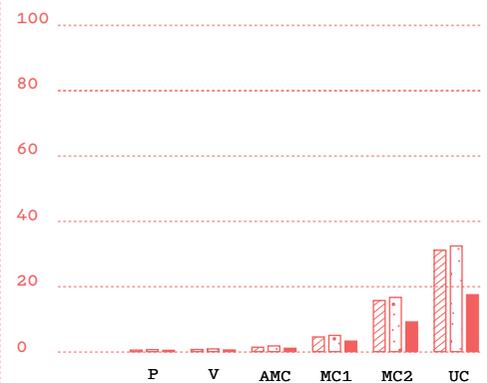
High Volume Gas Cooking



Air Conditioners

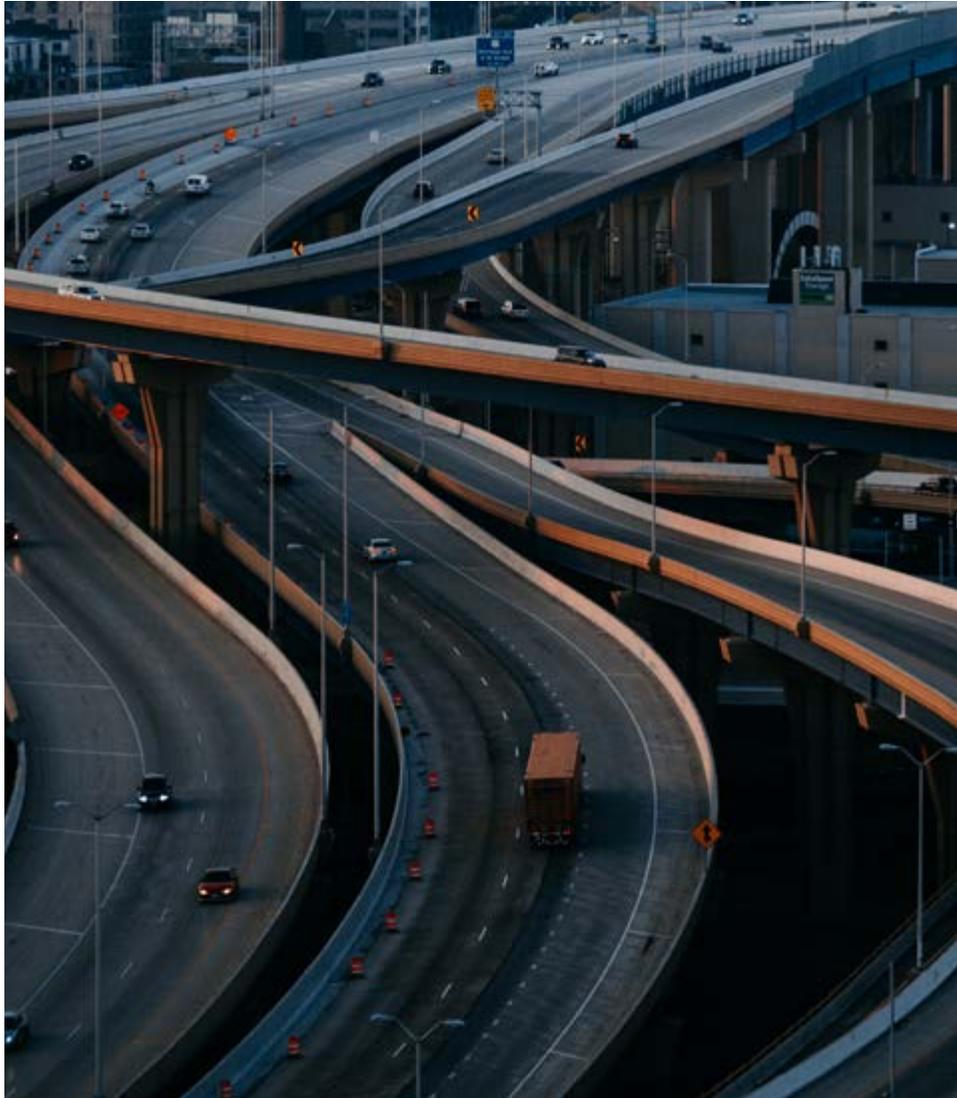


Water Heaters



High volume gas cooking means using non-subsidized 12kg LPG canisters.

Source: Susenas and World Bank calculations.



Left Indonesia's government revenues are lower than many other middle-income countries and many other countries in East Asia. Increased income-tax collection would significantly increase available funding for investment in infrastructure and skills, but the progressivity of such taxes means they will predominantly be paid for by middle-class Indonesians.

Right Almost no households below the middle class own cars, while 20 percent of Middle Class 1, 60 percent of Middle Class 2, and most upper-class households own cars, making it a clear class delineation.



FIGURE 4.5 Reason for traveling on last trip, 2016 (percent)

The middle class likes to travel more, and more often for pleasure.



The middle class is also more likely to travel, and more often travel for pleasure. Those in the middle class travel around 40 percent more frequently than other Indonesians, at around 1.4 trips every three months. Moreover, they are much more likely to do so for pleasure. Half of all non-middle-class travel is to visit friends or family, while only around one-quarter to one-third is on holiday (Figure 4.5). This ratio is switching for the middle class, with around 40 percent of middle-class travel being for holiday, rising to nearly half for richer households, while visits to friends and family fall to 40 percent.

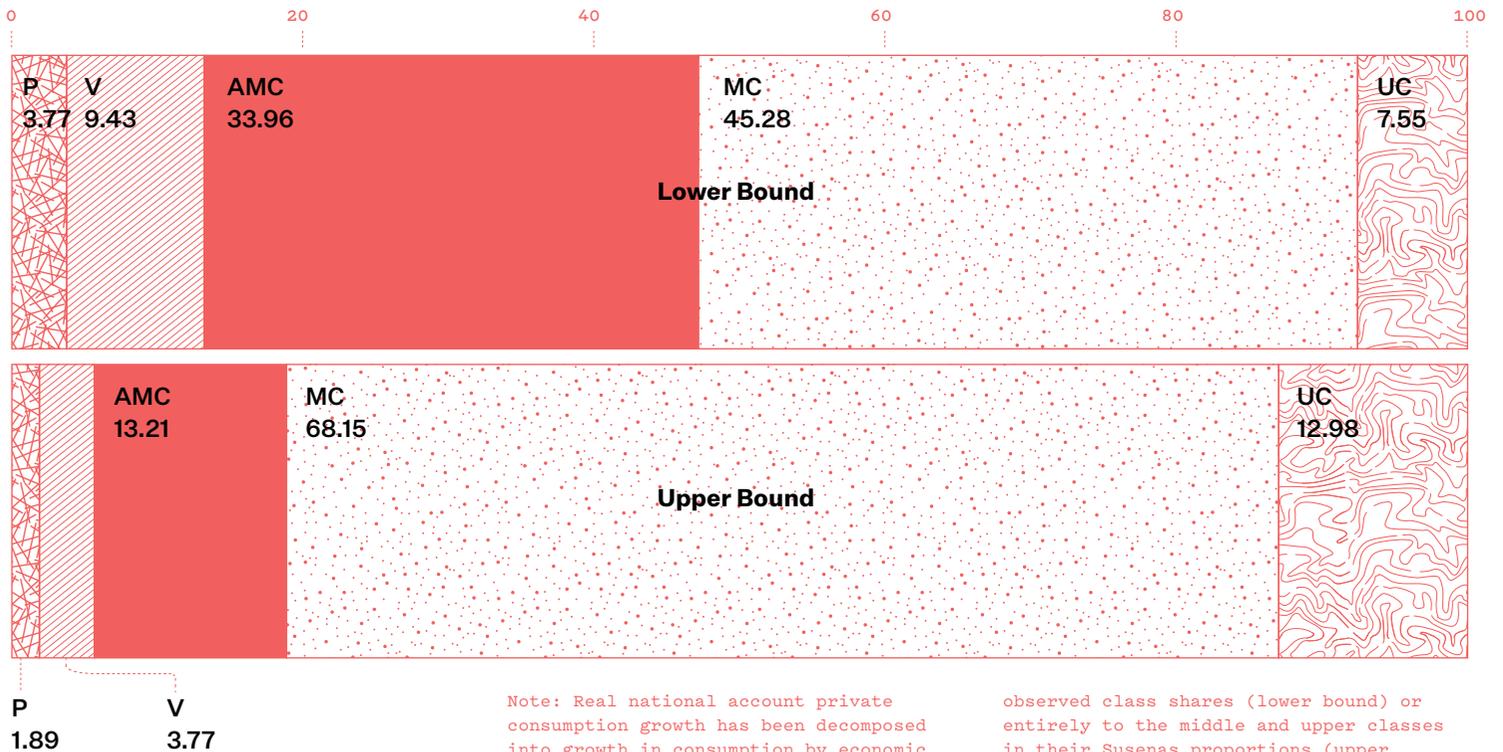
Rapidly growing middle-class consumption has helped accelerate consumption growth in the national accounts, a key component of recent economic growth. A growing mid-

dle class can create structurally higher consumption growth, as it has greater disposable income than the poor and a higher marginal propensity to consume than the upper class. Private consumption in the national accounts grew at 3.0 percent annually between 2002 and 2015. Attributing this growth across the economic classes is difficult as total household consumption in Susenas accounts for only 40 percent of private consumption in the national accounts. While there are differences of methodology, and private consumption includes some non-household spending, for example by institutions such as prisons and orphanages, there is still a large discrepancy between the two. Due to this, the role of middle class consumption in the growing national accounts consumption can only be estimated within a range.

Under reasonable assumptions, middle class consumption may be responsible for up to two-thirds of total national account private consumption. Total consumption in Susenas can be allocated directly out to each economic class. As a lower bound, the consumption gap between Susenas and the national accounts can be allocated out to the classes in the same proportion as is observed in Susenas. However, it is likely that much of this missing consumption would be due to the middle and upper classes, who may be under-represented in the survey data. An upper bound can be constructed which allocates the missing consumption entirely to the middle and upper classes in their relative Susenas proportions. On these assumptions, between 1.2 and 2.0 percentage points of annualized growth in national account private consumption came from middle-class

FIGURE 4.6 Annual real national account growth in private consumption, 2002-15 by source (percent)

The middle class may be responsible for up to 68 percent of all national accounts private consumption growth in the past 13 years.



Note: Real national account private consumption growth has been decomposed into growth in consumption by economic class. Total Susenas household consumption is allocated by class directly. The private consumption gap between the national accounts and Susenas is allocated either proportionally to the directly

observed class shares (lower bound) or entirely to the middle and upper classes in their Susenas proportions (upper bound).

Source: Susenas (2002-2015), BPS and World Bank calculations.

consumption, or 68 percent of total growth (Figure 4.6), with a further 0.2 to 0.4 of a percentage point coming from the upper class.⁹⁷

The consumption patterns of the middle class and its role in economic growth have important implications for growth in the future. Many growth-oriented consumption patterns belong only to the middle class, or become prevalent only among the richest middle-class households. This suggests that sustaining and increasing consumption-led growth in the future will require not just growing the middle class by making more people economically secure, but also ensuring that economic mobility continues beyond this to reach even higher incomes.

⁹⁷ There is a significant difference in the size of private consumption as measured by the national accounts (upon which GDP measures are based) and household consumption surveys (upon which our middle-class analysis is based). Household surveys exclude non-household private consumption such as institutions (like prisons and orphanages). They also fail to capture many richer households, and so under-estimate household consumption, particularly that of the middle class (see World Bank (forthcoming) *Estimating*

the Top End of Indonesia's Consumption Distribution). In fact, total consumption in Susenas represents only 40 percent of that estimated in the national accounts, which attempt to capture other private consumption and large one-off expenditures such as the Hajj. If we conservatively allocate the missing 60 percent of private consumption to the consumption classes according to their observed consumption in the survey, then we have a lower bound where the middle class represents 1.2 percentage points of the 5.6 percent annualized

growth of the economy (and the upper class 0.2 points). However, the missing richer households and economic activity are much more likely to be from the middle and upper classes; if we allocate all missing private consumption growth to the middle and upper classes in proportion to their relative shares of observed Susenas consumption growth (84 and 16 percent, respectively), then an upper bound of their share of growth increases to 2.0 percent for the middle class and 0.4 percent of the upper class.

Middle-class education & skills

Skilled workers in high value-added sectors are also more likely to come from the middle class, although the quality of Indonesian education limits this. Focusing on the youngest two cohorts of Indonesians who have finished education, those aged 25-34 and 35-44 years old, the poor and vulnerable on average complete only primary education, while those in the aspiring middle class only complete junior secondary. The younger middle-class cohorts, however, generally complete secondary school, while MC 2 and UC have tertiary education (Figure 4.7). This level of

educational attainment for the Indonesian middle class is higher than for other East Asian middle classes, using slightly different class thresholds (Figure 4.8),⁹⁸ but the low quality of Indonesian education relative to most other countries undermines these attainment levels. Consequently, while two- to three-fifths of the non-middle class work in agriculture, less than one-fifth of the middle class does, and those in the middle class are much more likely to work in higher value-added sectors such as finance, services and information and communication technology (ICT) (Figure 4.9).

98 In 2013, hours spent on English, mathematics, physics, chemistry and biology were reduced, along with the related ICT training, in favor of more time being spent on civics and religious teaching. This means today's children are spending even less time developing the skills firms have already identified as gaps.

4.2

Right It is only those in the middle class who predominantly have the high school or better education required by better jobs, with increasingly large numbers having tertiary education.



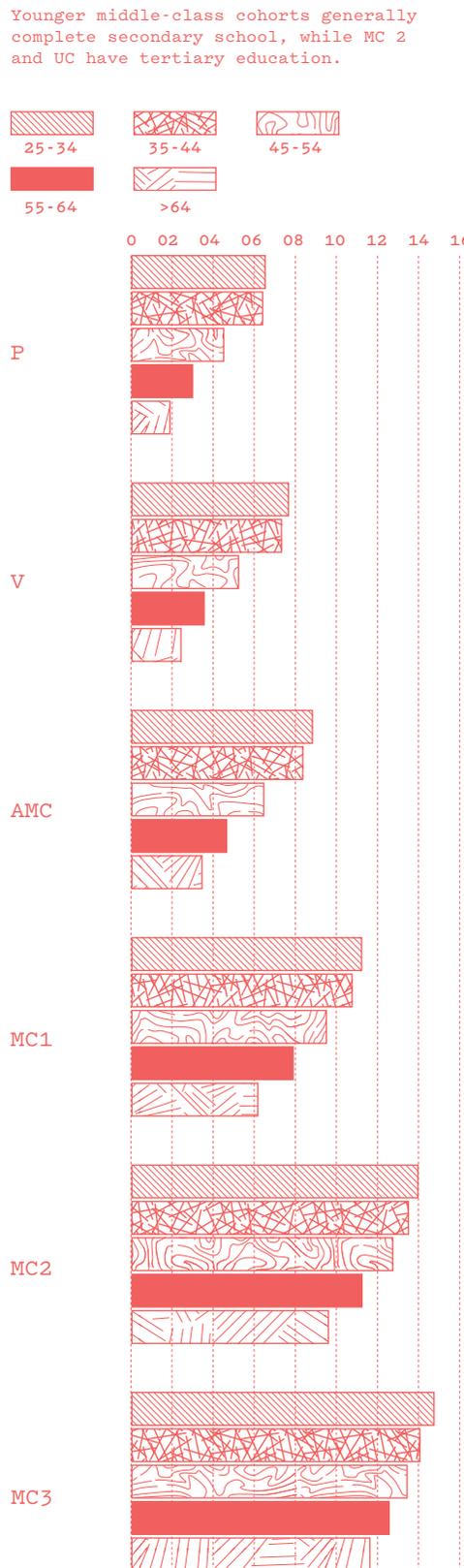


However, the poor quality of Indonesian education means that the country's productivity lags that of other countries in the region. The low quality of Indonesian education relative to most other countries undermines the higher middle-class educational attainment levels. For example, three-quarters of all Indonesian 15-year-olds do not meet even the basic proficiency level for mathematics, the fifth-worst performance among all countries in the dataset (World Bank, 2015a). Greater skill and productivity in the future will require smarter public investments in education to capitalize on middle-class employment in higher value-added sectors such as finance, services and ICT.

The middle class has fewer children, but middle-class children start school earlier and stay in school longer, increasing the base of future skilled workers. Fertility is higher among the poor and vulnerable, in part because of deteriorating access to family planning.⁹⁹ On average, poor and vulnerable households have 1.5 children aged under 15 years at home. This falls to 1.0 for the aspiring middle class before stabilizing at 0.6 for the middle class at all income levels.¹⁰⁰ Having fewer children allows those in the middle class to invest more in each child's health and education, which they do. Middle-class children are considerably more likely to be enrolled in early childhood education, especially at the earliest ages of 3-4 years old (Figure 4.10). Primary school enrolment is near universal for all classes. This continues for the middle class into junior secondary school but drop-outs and non-transition begin in the non-middle classes and, while over 80 percent of the middle class enroll in senior secondary school, the gap with the other classes increases. By the ages of 19-22 years old, those in the middle class are over twice as likely to still be studying.

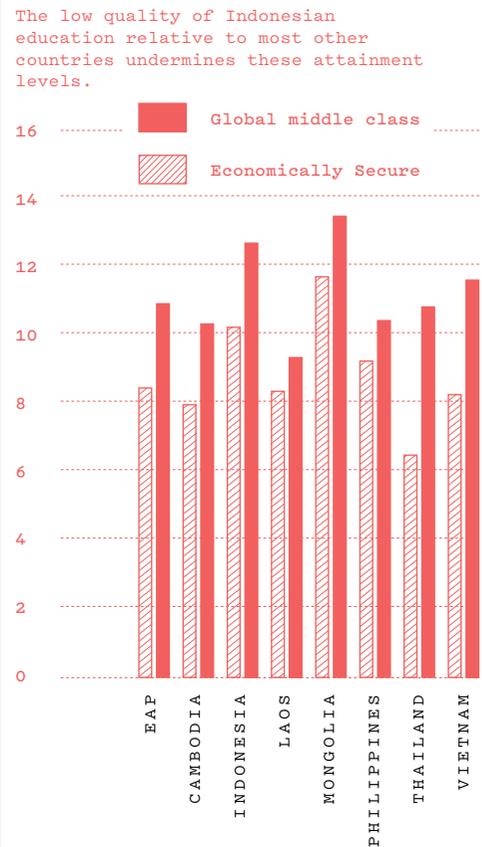
They are also more exposed to the technology that drives the modern global economy. In addition to receiving more education, and education that is likely of a higher quality, middle-class children live in an environment where they are also more exposed to modern ICT. Cellphone ownership is near universal in middle-class households (smartphone ownership data are unavailable), and around half have access to computers and the internet, significantly higher than for the poor and vulnerable (Figure 4.11). This access means they are more likely to be familiar with the ICT skills that are increasingly demanded in the modern global economy.

FIGURE 4.7
Average educational attainment by age cohort by class, 2016 (years)



Source: Susenas and World Bank calculations.

FIGURE 4.8
Middle-class educational attainment in East Asia and Pacific (EAP) (years)



Note: EAP is East Asia and Pacific average and includes all countries shown plus Papua New Guinea, Tonga and Vanuatu. ES is Economically Secure under the EAP definition, which is consumption from US\$5.50-US\$15.00 per person per day; GMC is Global Middle Class and is consumption above US\$15 per day.

Source: Wai-Poi et al. (2016).

⁹⁹ See World Bank (2015a) for a discussion of changes in family planning in Indonesia and its differential effects across the consumption distribution.

¹⁰⁰ Calculated from Susenas 2016.

FIGURE 4.9 Employment sector of head of household by class, 2016 (percent)

Those working in agriculture decline rapidly in the middle class, while those working in services increase.

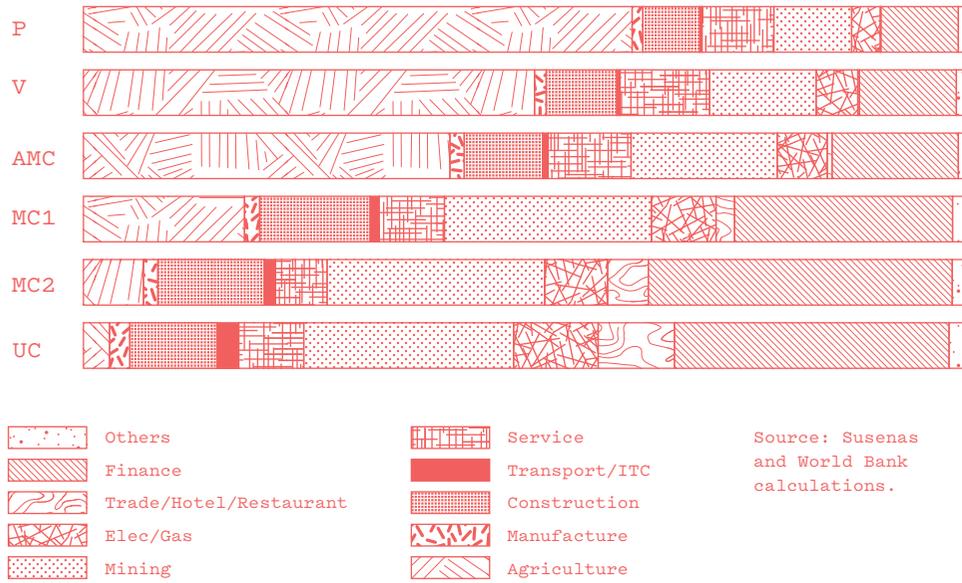
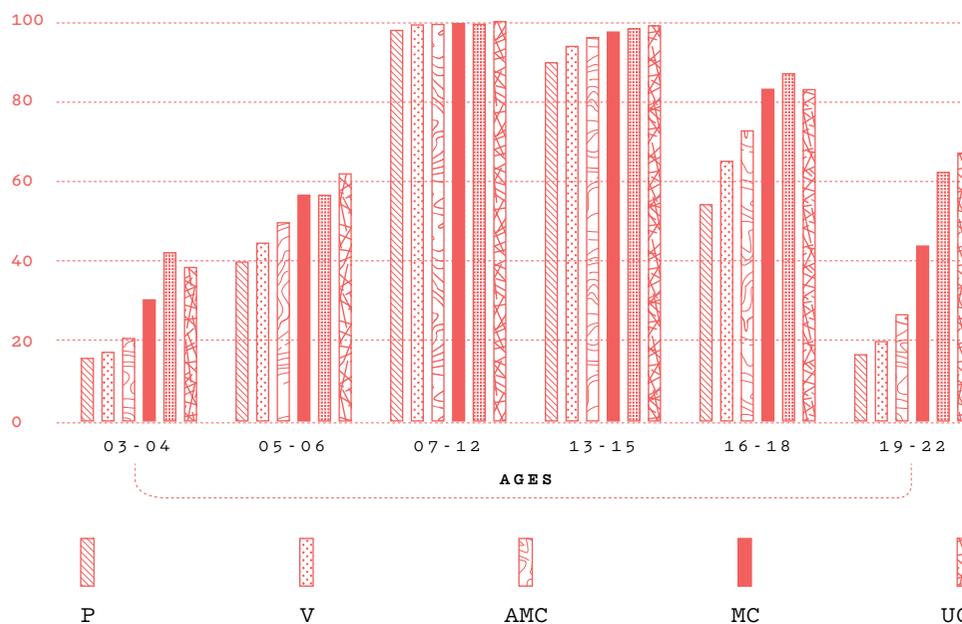


FIGURE 4.10 Enrolment of children by class and age, 2016 (percent)

In the oldest age group of 19-22 years old, those in the middle class are over twice as likely to still be studying.

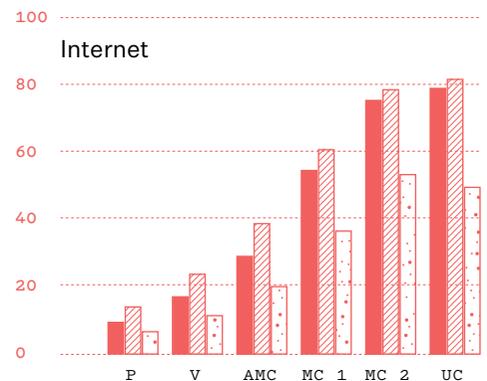
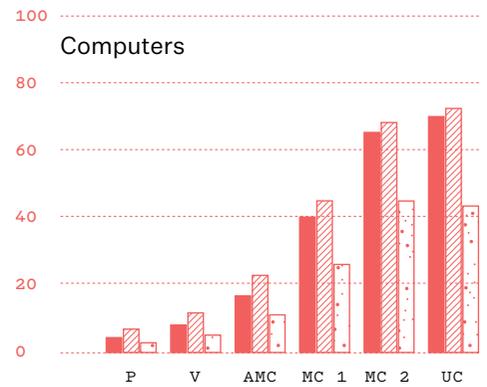
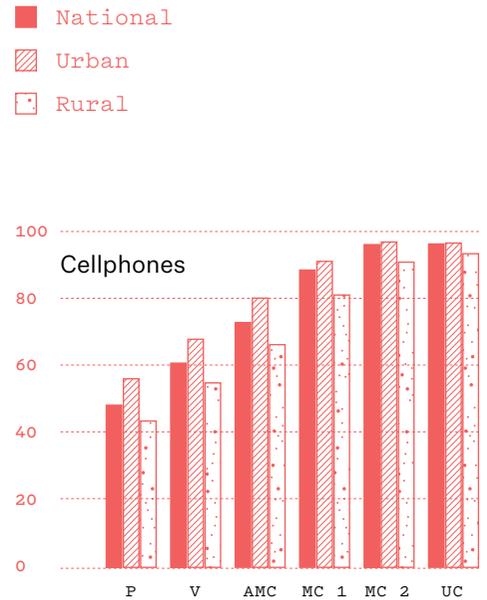


Source: Susenas and World Bank calculations.

FIGURE 4.11 Access to technology and information by class (percent)

Access to technology and information by class (percent)

Cellphone ownership is near universal in middle-class households and around half have access to computers and the internet.



Source: Susenas and World Bank calculations.

4.3

Middle-class entrepreneurship

The majority of those comprising the middle class are salaried workers. Only 20 percent of the poor and vulnerable are formal, salaried employees. The rest work as casual laborers or as small business owners, either with no employees or unpaid family ones (Figure 4.12). Workers from wealthier households are increasingly more likely to have formal employment, with decreases in casual labor

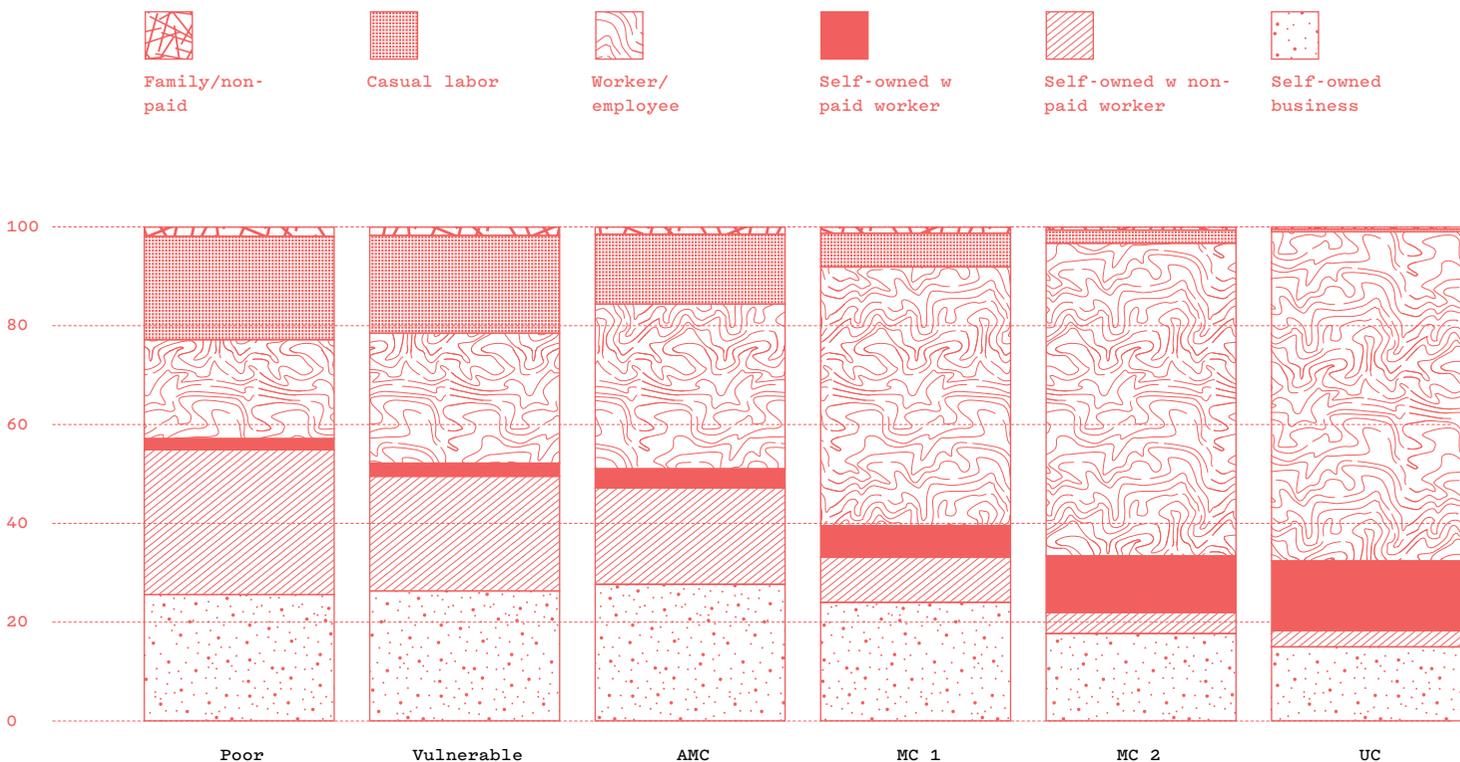
or self-employment. About 33 percent of the aspiring middle class work formally, increasing to over half for the middle class, and two-thirds for the richest sub-group; almost no middle-class workers are casual.

The remainder are increasingly running productive businesses that employ others. While just over one-third of middle-class

workers continue to be self-employed or own their own business, more and more of them run productive businesses that are capable of employing other paid workers. For the large majority of the middle class who are self-employed (those under US\$20 a day), only one in six is this successful. However, this rises to one in three for MC 2 and nearly one in two for the upper class.

FIGURE 4.12 Occupational status of head of household by class (percent)

The majority of middle-class workers are formal employees, while the rest are increasingly likely to be business owners who employ others.



Source: Susenas and World Bank calculations.



Middle-class female labor participation

Indonesian middle-class women do not work much more than the non-middle-class women and are much less likely to work than other middle-class women in East Asia and around the world. As more people in a country work, so its economy grows. In almost all countries, most men work (or look for work) and the differences in total labor force participation depend on how many

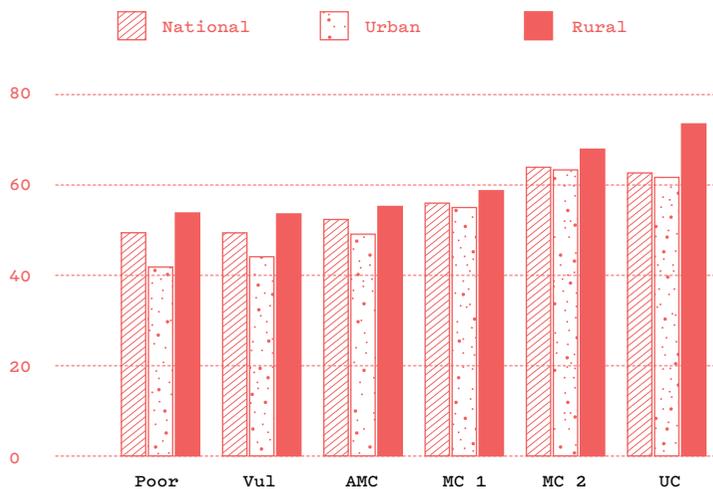
women work. A recent paper, using a similar but slightly different definition of the middle class based on economic security, found that in the East Asia and Pacific region, while only around 50 percent of non-middle-class women participate, this rises to 70 percent for the middle class. However, while Indonesia's middle-class women are slightly more likely to work than other Indonesian women (Figure

4.13), the rates remain much lower than for other middle-class women in East Asia (Figure 4.14),¹⁰¹ undermining a potential contribution to economic growth.

¹⁰¹ Wai-Poi et al. (2016). Malaysia is not included in this regional comparison due to data limitations but has a similarly low rate of female labor participation.

FIGURE 4.13 Female labor force participation by class, 2016 (percent)

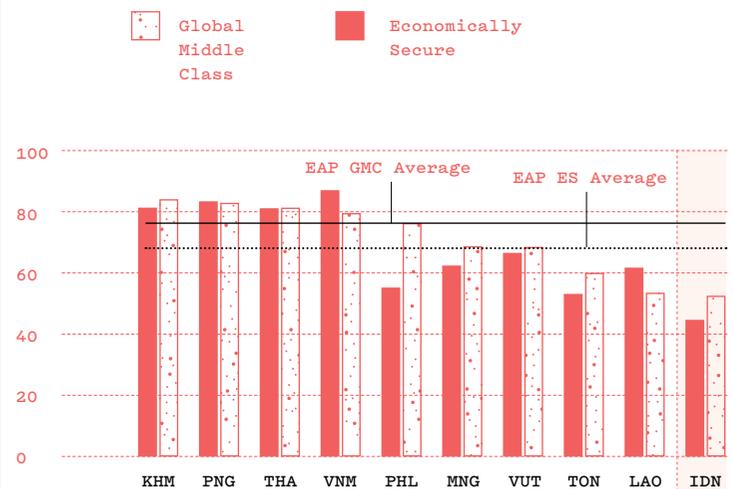
Middle-class women are only slightly more likely to work than other Indonesian women...



Source: Susenas and World Bank calculations.

FIGURE 4.14 Middle-class female labor force participation in East Asia (percent)

...and they work much less than most other East-Asian middle-class women, contributing less to the economy.



Note: ES are the Economically Secure, consuming PPP US\$5.50-15 per person per day, while the GMC are the Global Middle Class, consuming more than PPP US\$15 a day.

Source: Wai-Poi et al. (2016).

The Middle Class

Amenities &



Public Services

113—126

5.1
Unfulfilled prosperity: economic security with non-monetary poverty

5.2
Public health and education: accessible but undesirable?

5.3
Gated communities: the embodiment of middle-class self-exclusion

5.4
Expanding the middle class and delivering benefits to all

Despite economic security, half of those in the middle class are deprived on at least one non-monetary dimension, mostly due to poor housing conditions. Those in the middle class enjoy current incomes that indicate economic security; they have a very low chance of being poor or vulnerable next year. However, economic security does not guarantee freedom from deprivation and non-monetary poverty. Half of those in the middle class lacks access

to clean water, proper sanitation or adequate housing conditions, primarily the latter (Figure 5.1). Of the 20 percent of Indonesians who are middle class, 11 percentage points are also free from non-monetary poverty on these dimensions, while 9 points are not. Even around 20 percent of the wealthiest middle-class households suffer from poor housing or, to a lesser extent, improper sanitation.

This is higher than in many other countries in the region, mostly due to poor housing conditions. As Figure 5.1 indicates, poor housing conditions are the main reason for middle-class households to suffer from non-monetary deprivation. Across the East Asia region, Indonesia's economically secure people are much more likely to have poor housing conditions than those in the Philippines, Thailand and Vietnam (Figure 5.2).

Unfulfilled prosperity: economic security with non-monetary poverty

5.1



Left Only 33 percent of urban households have access to clean water, only 12 cities have piped sewerage networks serving 2 percent of the urban population, and 40 percent of urban residents do not have access to proper sanitation.

“Half of those in the middle class lacks access to clean water, proper sanitation or adequate housing conditions, primarily the latter”

FIGURE 5.1 Non-monetary poverty by class, 2016 (percent)

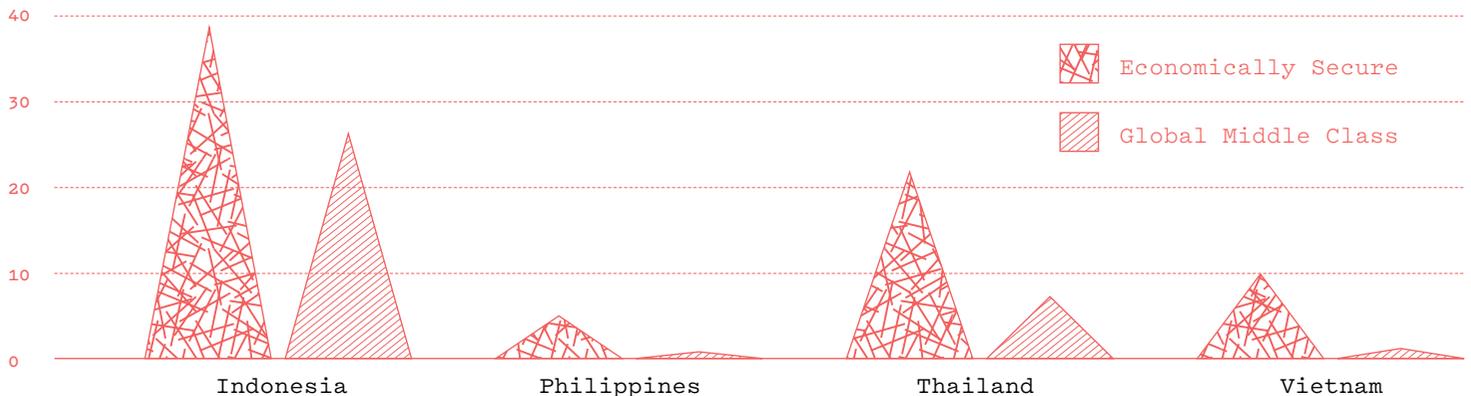
Despite having achieved economic security, close to half of the middle class is deprived on at least one non-monetary dimension, primarily poor housing conditions.



Source: Susenas and World Bank calculations.

FIGURE 5.2 Poor housing conditions for the economically secure in East Asian countries (percent)

Poor housing conditions affect the middle class and aspiring middle class far more in Indonesia than its regional peers.



Note: ES are the Economically Secure, which are those consuming between PPP US\$5.50-US\$15 per person per day, while the GMC are the Global Middle Class, consuming more than PPP US\$15 a day.

Source: Wai-Poi et al. (2016).

Public health & education: accessible but undesirable?¹⁰²

5.2

Almost all those in the middle class have access to public health and education. Most Indonesian children of all income levels have access to early childhood centers, and primary and junior secondary schools with reasonable facilities. This reaches 90 percent or higher for the middle class (Figure 5.3). Access to primary and secondary health care is near universal for the middle class (Figure 5.4).

However, access to good quality public services is not guaranteed. Physical access is not

enough to guarantee service; quality matters as well. We have seen that the quality of Indonesian education is problematic. If there is a school nearby a child, that does not mean he or she will receive a good education; if the teacher does not turn up or if the curriculum does not support the development of the skills needed in the modern economy, children will be less prepared to seek a well-paid skilled job when they leave school. Similar issues exist in many other sectors, including health, family planning, and water and sanitation.¹⁰³

¹⁰² This section draws upon Wai-Poi et al. (2016) Box 10.

¹⁰³ For a summary of changes in Indonesian family planning, see World Bank (2015a); for greater detail see Jones and Adioetomo (2014). For a discussion of water and sanitation, see World Bank (2017) *Improving Service Levels and Impact on the Poor: A Diagnostic of Water Supply, Sanitation, Hygiene, and Poverty in Indonesia*.



FIGURE 5.3

Access to education by class, 2014 (percent)

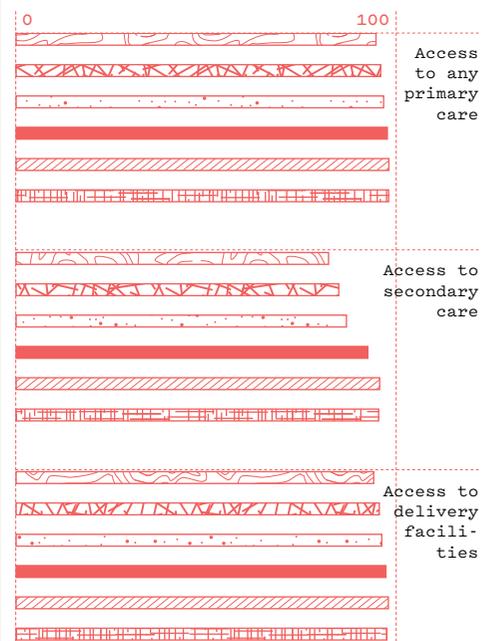
Ninety percent or higher of the middle class have access to education.



FIGURE 5.4

Access to health facilities by class, 2014 (percent)

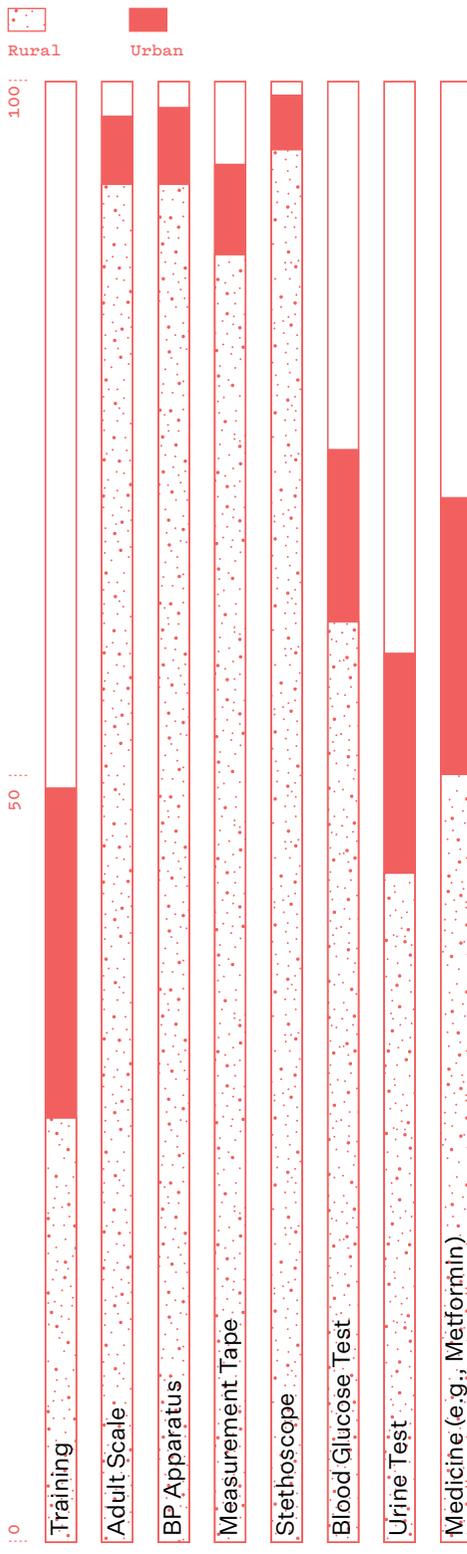
Access to primary and secondary health care is near universal for the middle class.



Source: Susenas and Podes 2014 and World Bank calculations.

FIGURE 5.5
Puskesmas readiness to provide health services (percent)

But while access may be high, most local health centers struggle to provide basic care facilities.



For example, many local health facilities do not have the necessary equipment or training to provide basic care or key services, even in urban areas where most of the middle class live. Reviews of the readiness of local health centers (Puskesmas) to provide a range of services show that many lack the training or equipment required, and that there has been little improvement since 2011 (World Bank, 2016). For example, only 62 percent of Puskesmas mandated to provide basic emergency obstetric and neonatal care had any staff trained in this area in the past two years. Only 39 percent of public hospitals maintained all 23 basic obstetric care tracer items. Only 54 percent of Puskesmas had the ability to conduct blood glucose tests for diabetes diagnoses, and 47 percent had the ability to conduct urine tests. These deficiencies were apparent in urban, as well as rural, areas (Figure 5.5).

Consequently, the middle class is seeking higher quality care, often by opting out of public services and into private health care. We look at the types of facility used by each class for inpatient and outpatient care, and for giving birth. Inpatient and outpatient options include state and private hospitals, private doctors and clinics, Puskesmas, medical

worker practices and traditional healers. Of these, the private hospitals and doctors can be considered privately provided. For outpatient care, the poor and vulnerable mostly use Puskesmas and medical workers, with some use of doctors or clinics (likely where public access does not exist). The use of private doctors expands considerably for the sub-groups of the middle class, and they are the only ones to use private hospitals in any significant number (7, 23 and 30 percent for MC 1, MC 2 and UC, respectively; Figure 5.6). For inpatient care, one-third or less of the poor, vulnerable and aspiring middle class use private hospitals, relying instead on state hospitals. However, the use of private hospitals rises to 48 percent for most of the middle class (MC 1) and to 60-75 percent for the MC 2 and UC. Childbirth can be performed by a doctor, a midwife, a paramedic, a traditional healer or a family member. As doctors and midwives can work in both public and private facilities, we cannot determine the extent of the public-private provision for childbirth deliveries, but the increasing use of doctors by the middle and upper classes (50 and 80 percent, respectively) points to the desire and access to more expensive health care, compared with the non-middle classes, two-thirds or more of which use a midwife.

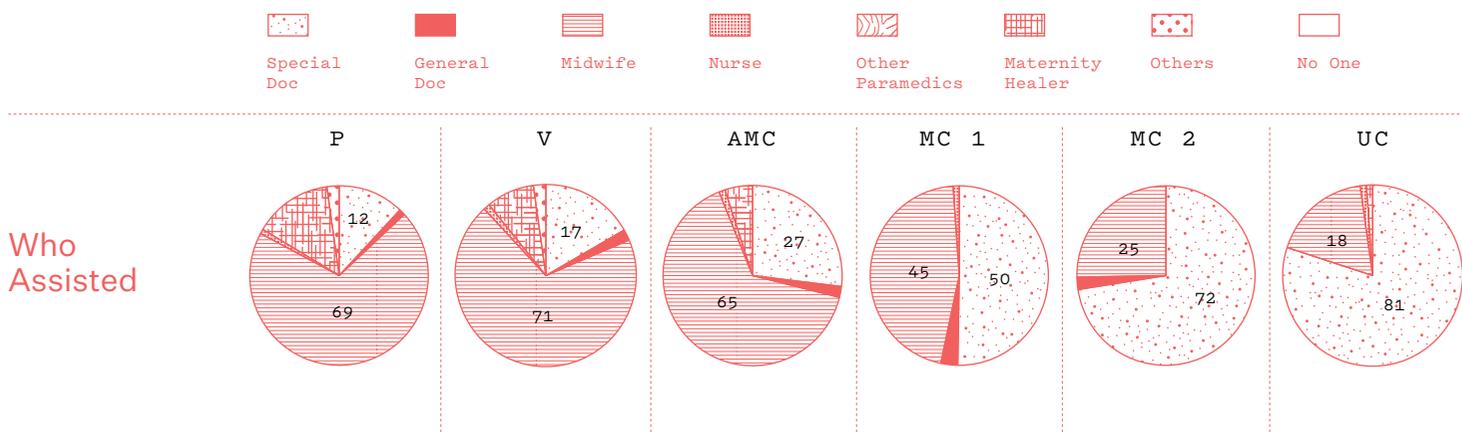
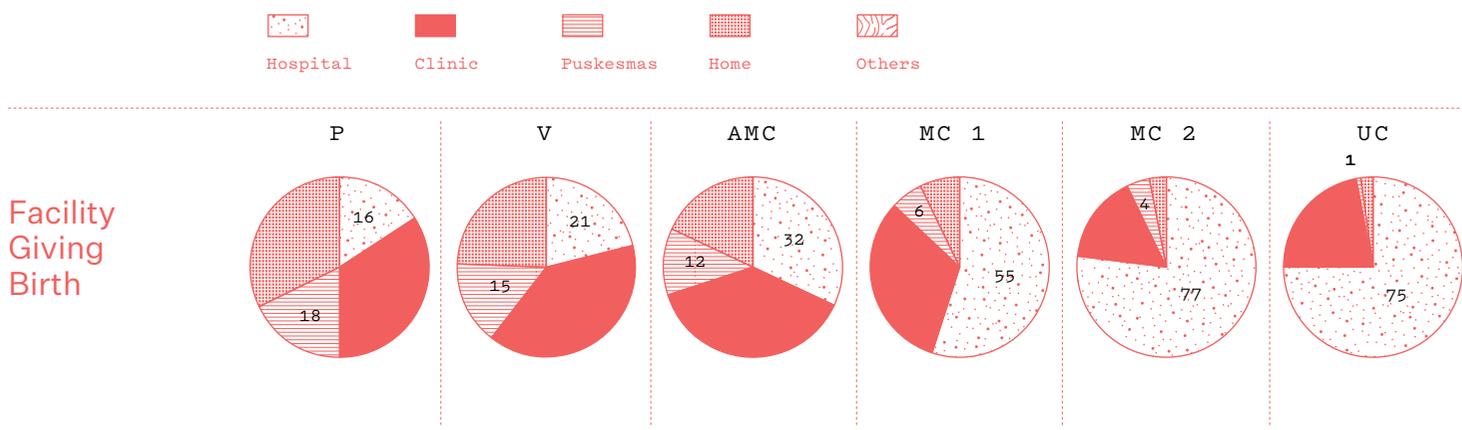
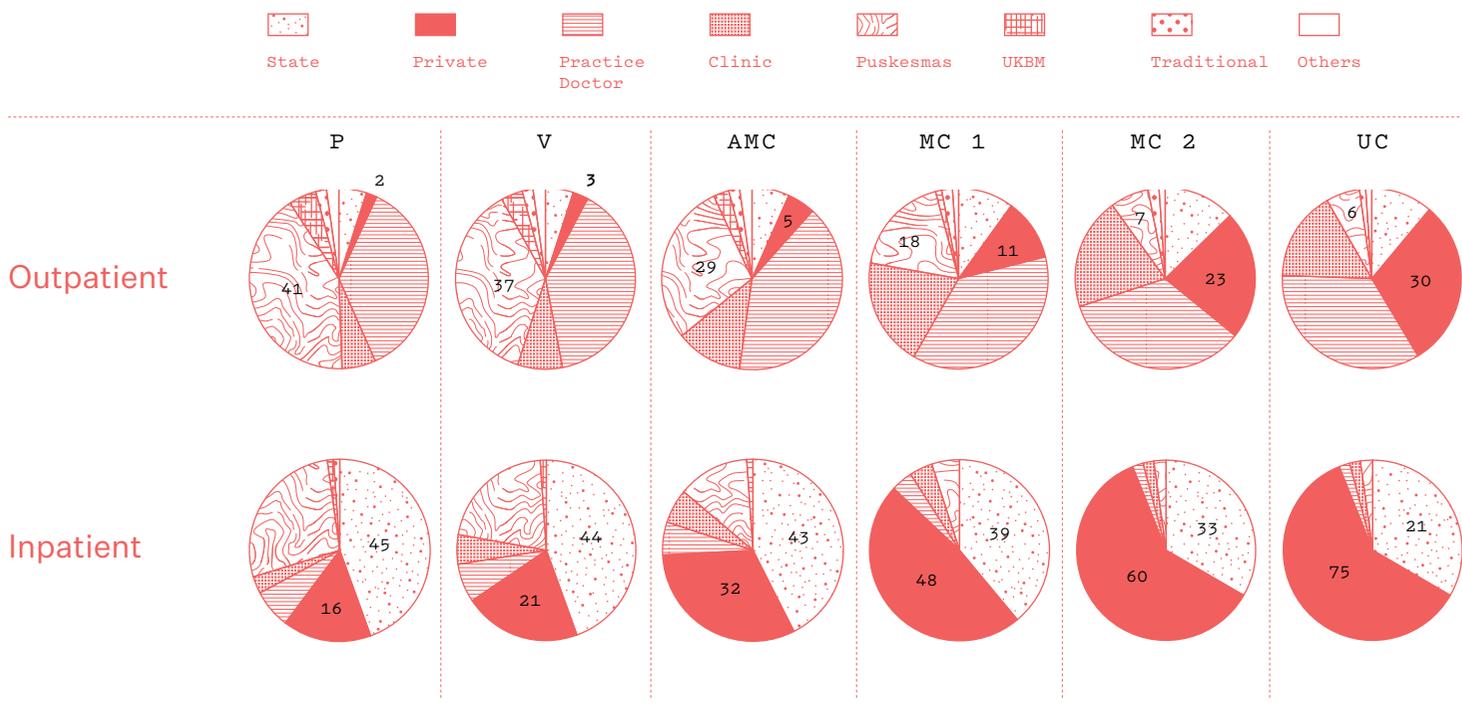
90%

Most Indonesian children of all income levels have access to early childhood centers, and primary and junior secondary schools with reasonable facilities. This reaches 90 percent or higher for the middle class.



FIGURE 5.6 Choice of health care by class, 2016 (percent)

As Indonesians get richer, they are increasingly seeking private health care...



Source: Susenas and World Bank calculations.

Those in the middle class are also beginning to use exclusive private schools, particularly in the wealthiest sub-group (MC 2). In general, there is less opting out of public education by the middle class. Despite historical issues with the quality of public schooling in Indonesia, there are many excellent public schools, especially in wealthy neighborhoods of larger cities where those in the middle class often live. Nonetheless, we are beginning to see those in the middle class send their children to elite private schools.¹⁰⁴ While less than 10 percent of most middle-class children (MC 1) attend these schools, this increases to 14–20 percent of MC 2 depending on schooling level, and for the upper class it reaches 34 percent for primary and junior secondary and 43 percent for senior secondary (Figure 5.7).

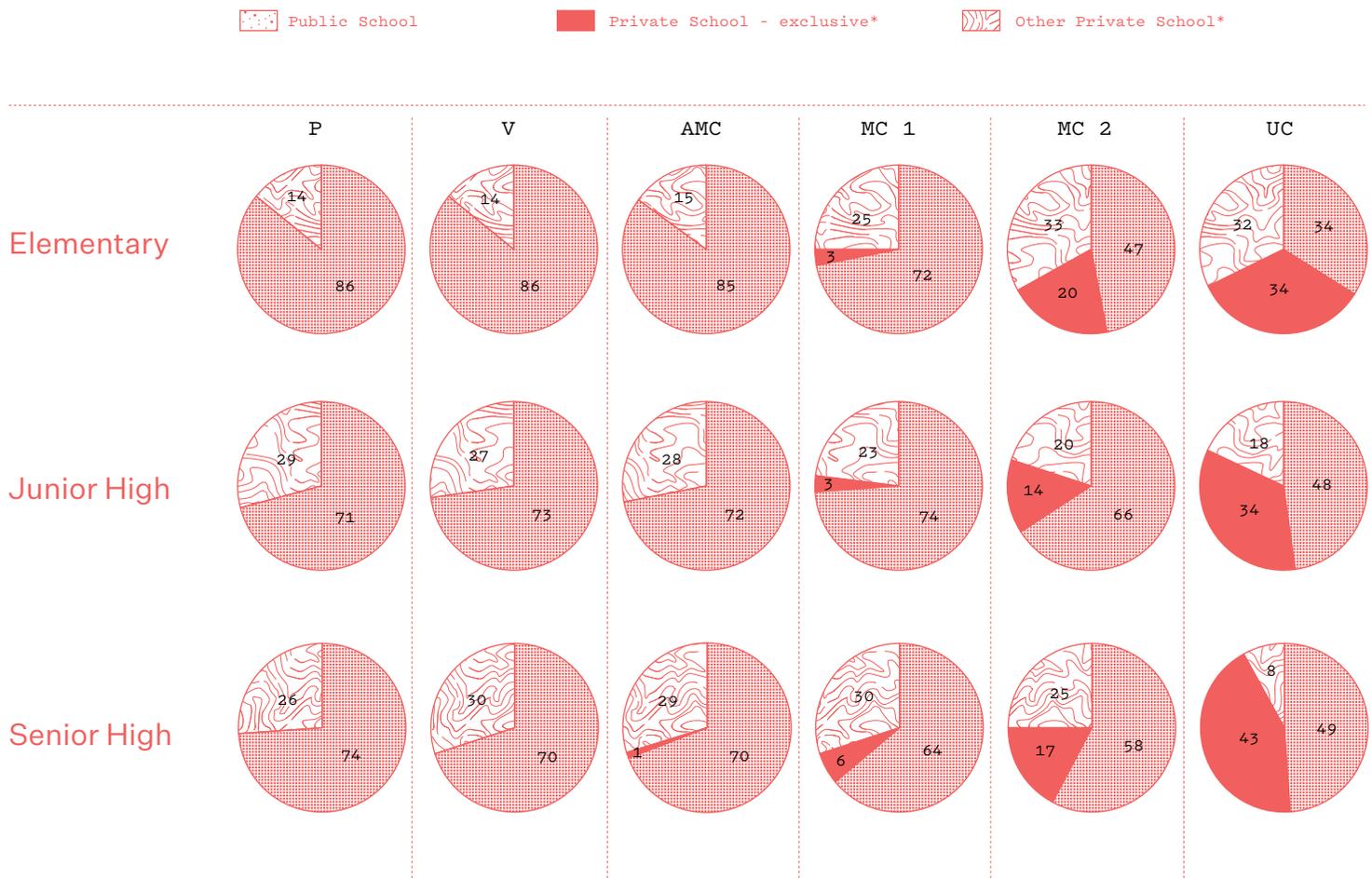
104 Private schools exist for various reasons. Some are religious, which can be good or bad in quality. Some are exclusive, focusing on a higher quality alternative to public schools. Some provide an option where a public one does not exist. Primary schools are available nearly everywhere in Indonesia, meaning most private schools at this level are either religious or exclusive (a high-quality alternative, sometimes religious as well). Junior secondary schools are not as universally available as primary schools, but national access is still relatively good. Consequently, most private schools at this level are also either religious, exclusive or both. However, access to public

senior secondary schools is more problematic in many parts of Indonesia; at this level, there are still religious and exclusive schools, but there are also private schools which exist because there is no public school. Finally, at the tertiary level, the top universities are elite public ones, while most private universities are of lower quality, with a few exceptions. To determine exclusive private schools, we examined the level of tuition fees being paid by the household and after visual inspection of the distribution, classified the 10 percent most expensive as exclusive.



FIGURE 5.7 Choice of school by class, 2015 (percent)

...while the richest of the middle class are often sending their children to exclusive private schools.



Note: Exclusive private schools are those whose tuition fees are in the top 10 percent of all schools.

Source: Susenas and World Bank calculations.

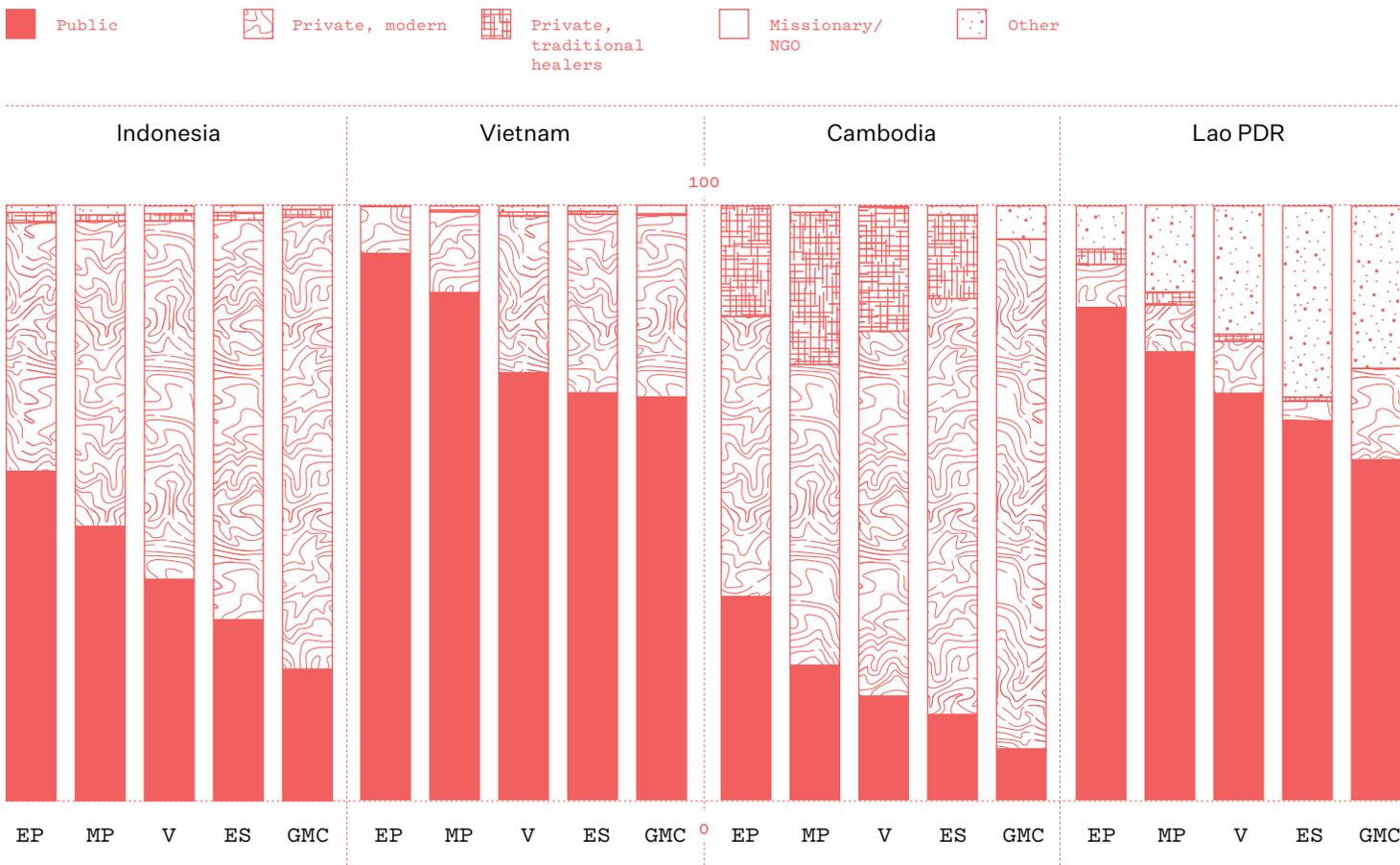
The opting out by the Indonesian middle class of public services reflects a regional trend. Across East Asia there is evidence that as households become wealthier they are opting out of public services. For example, those who are economically secure are more likely to seek private health care not only in Indonesia, but also in Vietnam, Cambodia and Lao PDR (Figure 5.8), as well as in China (Box 5.1).



Right Non-communicable diseases (NCDs), including complicated co-morbidities, are now exploding among middle-aged Indonesians, due to unhealthy lifestyle choices and health systems that are underfinanced, and unprepared to diagnose, treat or adequately manage chronic conditions.

FIGURE 5.8 Type of health facility used by class in selected East Asian countries (percent)

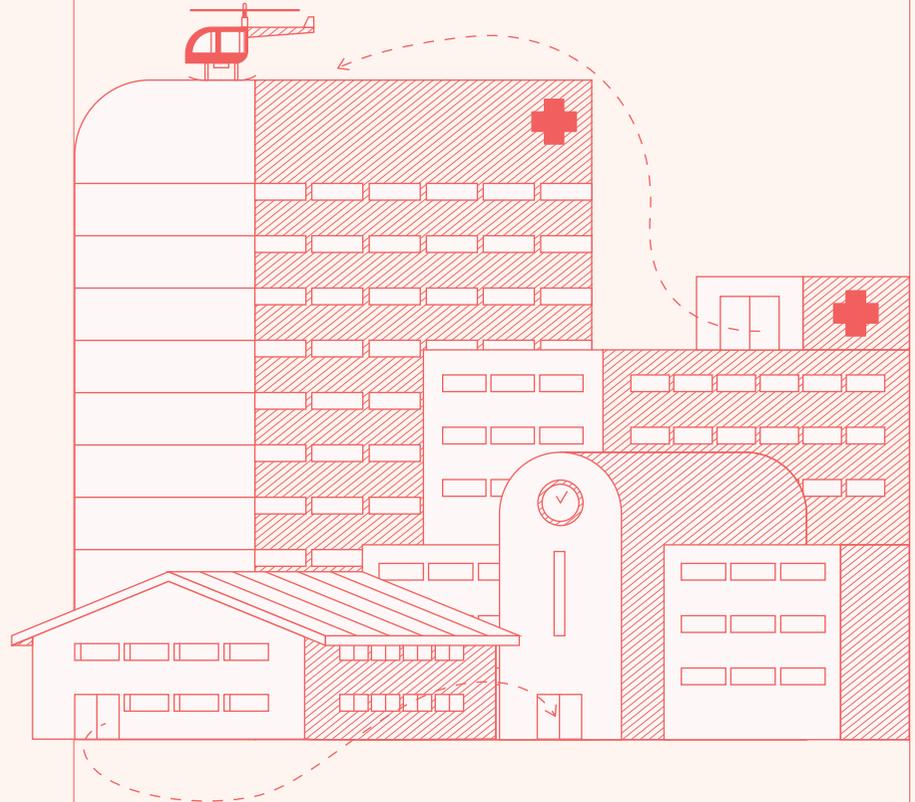
Across East Asia there is evidence that as households become wealthier they opt out of public services.



Note: EP is Extreme Poor under PPP US\$1.90 per day; MP is Moderate Poor between PPP US\$1.90-US\$3.10; V is Vulnerable between PPP US\$3.10-US\$5.50; ES is Economically Secure between PPP US\$5.50-US\$15; GMC is Global Middle Class above PPP US\$15.

Source: Wai-Poi et al. (2016).

BOX 5.1

Middle-class opting out in China¹⁰⁵

There are signs that the Chinese middle class is demanding higher quality education and health services and is willing to pay for it. The importance of education is becoming more instrumental in China since the implementation of the Ministry of Education's policy of expanding high education enrolment. This policy is supported by a huge investment in terms of capacity but less so in its quality (Jing, 2010). Having made children's education as their main priority, 39 percent of Chinese parents are willing to pay 50 percent more in order for their children to study at a university abroad, which they believe will provide a better education, in turn making them more competitive in the domestic labor market (HSBC, 2015; Jing, 2010). A similar attitude is being observed in relation to good quality health care. Results from a PricewaterhouseCoopers (2008) study on the behavior of middle-class consumers regarding their health care needs in three major cities (Beijing, Shanghai and Chengdu) show that the Chinese middle-class consumers are willing in some circumstances to pay more for health care to meet their higher expectations. In addition, middle-class consumers also expect greater privacy and dignity in the care-giving process. This new standard of demand is not being met by the existing Chinese public health-care system, where many medical institutions have lower staffing levels and efficiency compared with international ones. In part, not operating as a normal business may be limiting the ability of Chinese public medical institutions to respond to consumer demand relative to international ones; McKinsey projects that in the next two decades annual private health expenditure by urban consumers will increase by at least 11 percent to capture middle-class consumers likely to opt out of public health care.

¹⁰⁵ From Wai-Poi et al. (2016).

5.3

Gated communities: *the* embodiment of middle-class self- exclusion¹⁰⁶

Not only are many middle- and upper-class Indonesians opting out of public services, many middle- and upper-class Jakartans are opting out of Jakarta. According to one survey, Jakarta ranks the 35th best Asian city, behind its main regional competitors: Singapore (4th), Kuala Lumpur (9th), Beijing (10th), Metro Manila (14th) and Bangkok (26th) (Firman, 1999). Jakarta suffers from air, water and pollution well beyond United Nations standard threshold levels; most wastewater is discharged without treatment (Hogan and Houston, 2002). Traffic is crippling; Jakarta is the only major city in Southeast Asia without a mass transit system of some kind. In response, many richer Jakartans are choosing to live in planned communities, or *kota mandiri* (independent cities), as they are known locally. Among the most well-known are BSD City, Lippo Karawaci and Lippo Cikarang. BSD City now has between 100,000 and 200,000 residents (Sharpe, 2014; *Kompas*, 2010) in a growing township that covers 1,300 hectares and is planned to expand to 6,000 hectares by 2035, with 150,000 new homes being built in the next decade and an expected population of 1 million people by 2035 (Widjojo, 2015; *Kompas*, 2010). In 2002, Lippo Karawaci had 30,000 residents

(plus 40,000 workers and 50,000 transient day visitors) (Hogan and Houston, 2002); by 2015, 120,000 people lived in the three Lippo cities of Lippo Village, Lippo Cikarang and Tanjung Bunga (Lippo Karawaci, 2015). About 32,000 people reportedly live in Alam Sutera (Alam Sutera, 2014) and over 100,000 in Bintaro Jaya (Bintaro Jaya, 2011).

These planned communities are in many ways the embodiment of the middle and upper classes opting out of public services. They provide complete amenities, from security to clean drinking water and proper sewage to reliable power to malls and entertainment complexes to parks and golf courses. Many include prestigious private schools, from kindergarten up to universities. As an increasing number of middle- and upper-class Indonesians begin to live in these planned communities with privately provided services and amenities, the risk is that not only will some of the louder and more influential public voices for better quality public services remain silent, but that the same middle class that will bear the majority of the personal income tax burden could become reluctant to pay for poor quality public services that its members themselves do not use.

Right Planned communities are in many ways the embodiment of the middle and upper classes opting out of public services; they provide complete amenities, from security to clean drinking water and proper sewage to reliable power to malls and entertainment complexes to parks and golf courses.



106 From Wai-Poi et al. (2016).



5.4

Expanding *the* middle class & delivering benefits to all

Below Indonesia's future development depends in part on both expanding the middle class and delivering benefits to all



Indonesia's future development depends in part on both expanding the middle class and delivering benefits to all. One in five Indonesians is now economically secure and this segment forms the rapidly growing middle class, although some still suffer on non-monetary dimensions while others are opting out of public services. At the same time, another two-fifths have escaped poverty and vulnerability but aspire for more. Earlier work has focused on addressing poverty, vulnerability and inequality;¹⁰⁷ the remainder of this report focuses on the middle class and those who aspire to join it.

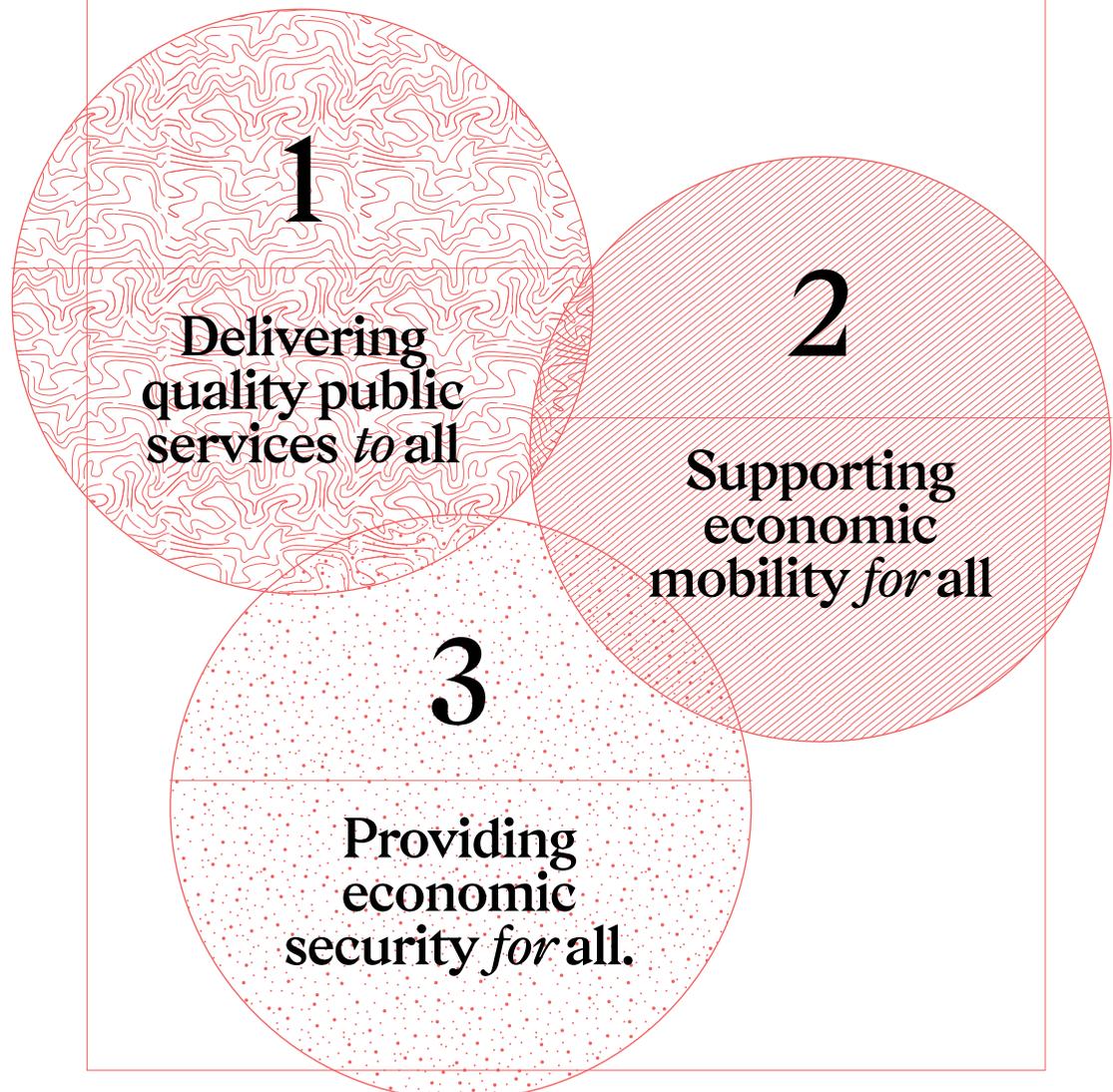
First, we ask how the Government can expand the middle class, creating greater

prosperity for the aspiring middle class and driving future economic growth in Indonesia. We focus on policy initiatives and reforms that provide the aspiring middle class with the skills to be productive workers, and the jobs that will bring them prosperity.

Second, we look at a new social contract that would unite and not divide the country. How will Indonesia finance the necessary investments to expand the middle class and grow into a high-income country without the current middle class opting out of public services and resisting tax contributions? That is, what would a new social contract look like that benefits all sections of society but in different ways?



We focus on 3 main issues





Chapter 6

127—136

6.1
Taking advantage of
new formal service
jobs with higher
wages

6.2
Completing high
school and getting
job skills

6.1

Taking advantage of new formal service jobs with higher wages

Most new jobs created since 2001 are formal, employee jobs in the services sector, which pay close to twice as much as informal and non-employee jobs. About 28 million new jobs were created in Indonesia between 2001 and 2016. Of these, 85 percent were formal, 70 percent were fulltime employees and 77 percent were in services (Figure 6.1).

In addition to the at least nominal protections of formal employment,¹⁰⁸ these jobs pay more. Formal jobs pay 1.7 times more than informal jobs on average, while employee jobs pay 1.6 times more on average than self-employment (without workers) and 1.7 times more than non-agricultural casual work.

About 28 million new jobs were created in Indonesia between 2001 and 2016

85%

Formal

70%

Fulltime

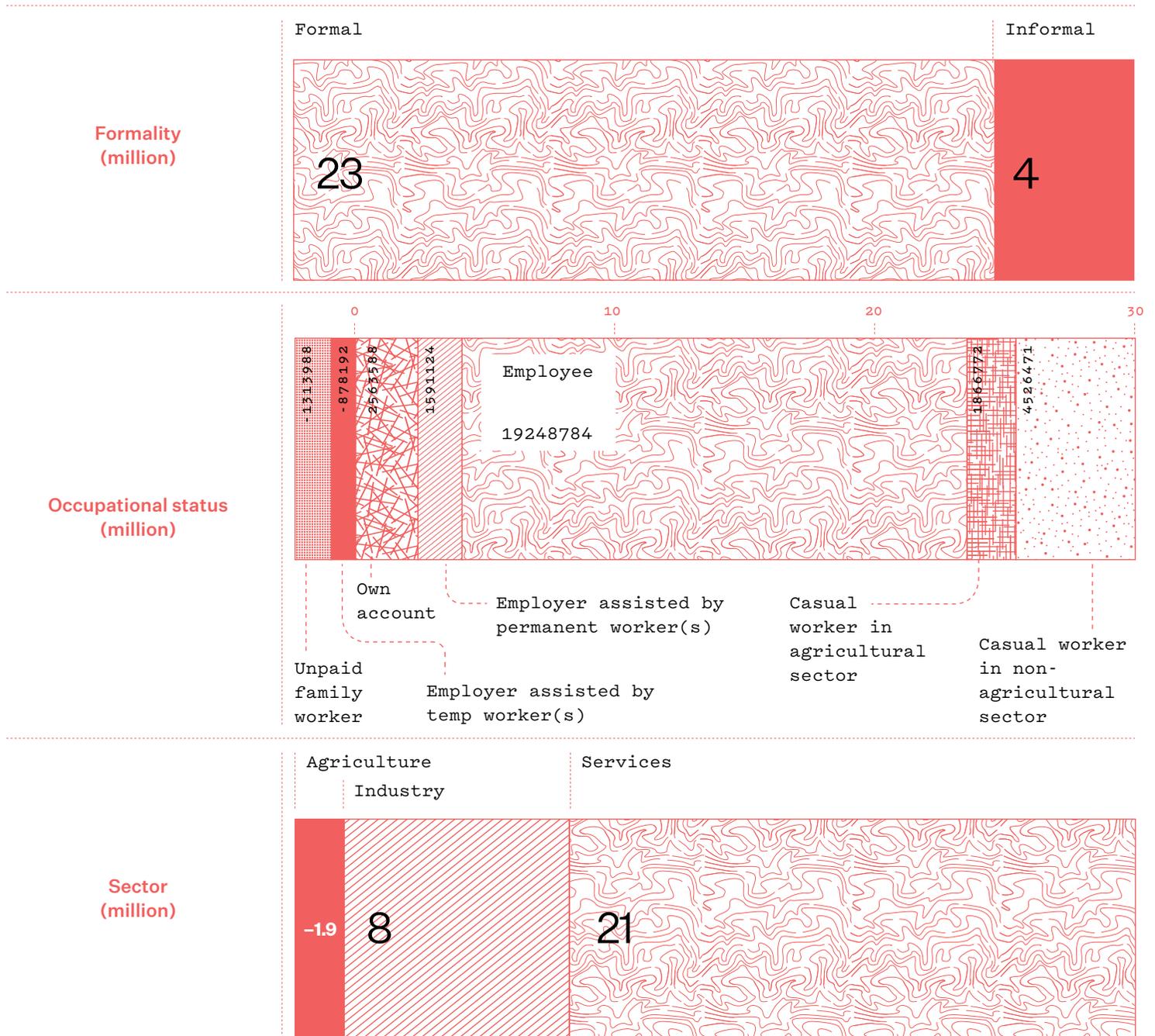
77%

Services

¹⁰⁸ Indonesia has some of the strictest labor regulations in the world, but they are poorly observed, meaning they provide little protection for many nominally formal workers. See World Bank (2015a).

FIGURE 6.1 Change in jobs, 2001-16 by formality, occupational status and sector (million)

Most of the new jobs created between 2001 and 2016 were good on paper, mainly being formal, in wage-employment, and in services. These jobs tend to require high school education or better, but pay more.



Source: Sakernas and World Bank calculations.

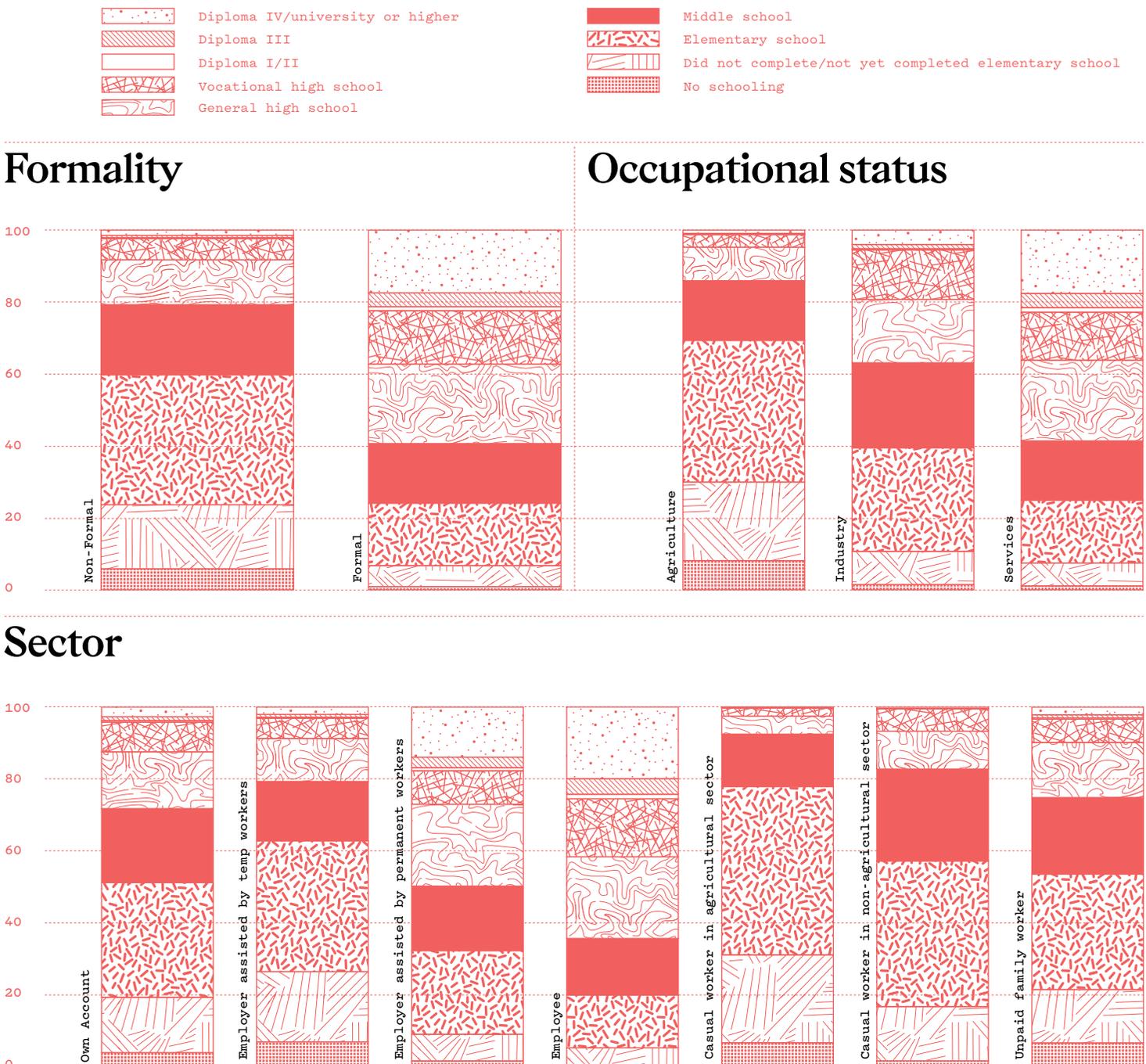
The majority of these jobs require high-school or tertiary education. Sixty-nine percent of formal workers have a high school education or better, compared with just 18 percent of informal workers (Figure 6.2). This

percentage is 64 percent for fulltime employees and 50 percent for business owners with permanent employees, but 30 percent or lower for other self-employed or casual workers. Fifty-nine percent of services sector jobs require

high-school or higher education, compared with 37 percent in industry and 14 percent in agriculture. Better and higher-paid jobs require higher levels of education.

FIGURE 6.1 Education by formality, occupational status and sector, 2016 (percent)

Most new jobs since 2016 have been good on paper: formal, employee and in services; jobs that tend to require high school education or higher, but pay more.



Source: Sakernas and World Bank calculations.

Bottom Formal jobs pay 1.7 times more than informal jobs on average, while wage employees earn 1.6 times more on average than the self-employed (without workers) and 1.7 times more than non-agricultural casual workers.





Completing high school & getting job skills

Greater educational attainment singles out those in the middle class from other Indonesians and qualifies them for better jobs. As we discussed earlier, the middle class has significantly greater educational attainment than the other classes, completing high school on average with many going on to tertiary education. For the youngest cohort aged 25-34 years old, only one-quarter of MC 1 fails to complete high school, while 30 percent have

some tertiary education; for MC 2 and the upper class of the younger cohorts, the majority have tertiary education (Figure 6.3). However, not enough of those in the aspiring middle class complete high school, which is required for most of the higher-paying formal jobs in services that are being created by the economy. Only around half have a senior secondary education or better.

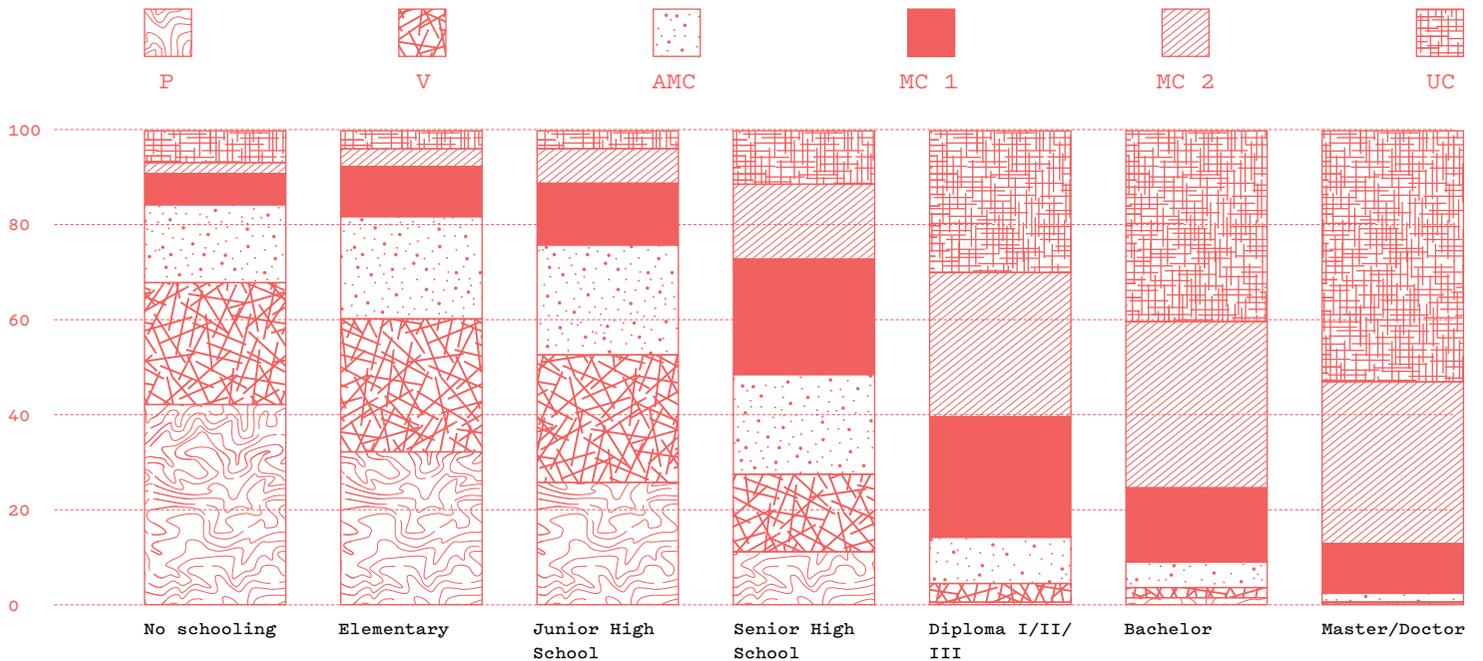
Thus, lifting aspiring middle-class Indonesians into the middle class means having more of them finish senior secondary school. The Government has been implementing education reforms, including compulsory and free primary and junior secondary education (spanning 12 years), which should provide greater incentives for more students to complete high school. Nonetheless, failure to finish senior secondary school for the aspiring middle class is generally due to dropout after junior secondary. This can be because of family pressures to earn an income, but it may also reflect low perceived returns to more schooling. Improving the quality (or perceived quality) of secondary education may help increase educational attainment among this group.

More needs to be spent on secondary and vocational education to make these more attractive to children of the aspiring middle class. Only 10 percent of central government spending on education goes to secondary schooling, compared with 24 percent on primary education and 33 percent on tertiary (Figure 6.4). This is indicative of spending needs, even though the bulk of basic and secondary education spending is at sub-national level. More-

6.2

FIGURE 6.3 Highest educational attainment by class, 25- to 34-year-olds, 2016 (percent)

It is only those in the middle class who predominantly have the high school or better education required for better jobs, with relatively few not completing high school and increasingly large numbers having tertiary education.



Source: Susenas and World Bank calculations.

Central government spending on education

24%

Primary education

10%

Secondary education

33%

Tertiary education

Left Lifting aspiring middle-class Indonesians into the middle class means having more of them finish senior secondary school.

“lifting aspiring middle-class Indonesians into the middle class means having more of them finish senior secondary school”

over, vocational education—a key alternative channel for developing skilled workers outside of general education—receives only 9 percent of the Ministry of Education and Culture’s (MoEC) budget.¹⁰⁹

The education system also needs to provide the skills demanded by well-paid jobs in

the modern economy. Not only have Indonesia’s education outcomes long been poorly ranked by international scoring, recent changes to the national curriculum mean that less time is being spent on subjects that have more relevance to skilled employment. In 2013, hours spent on English, mathematics, physics, chemistry

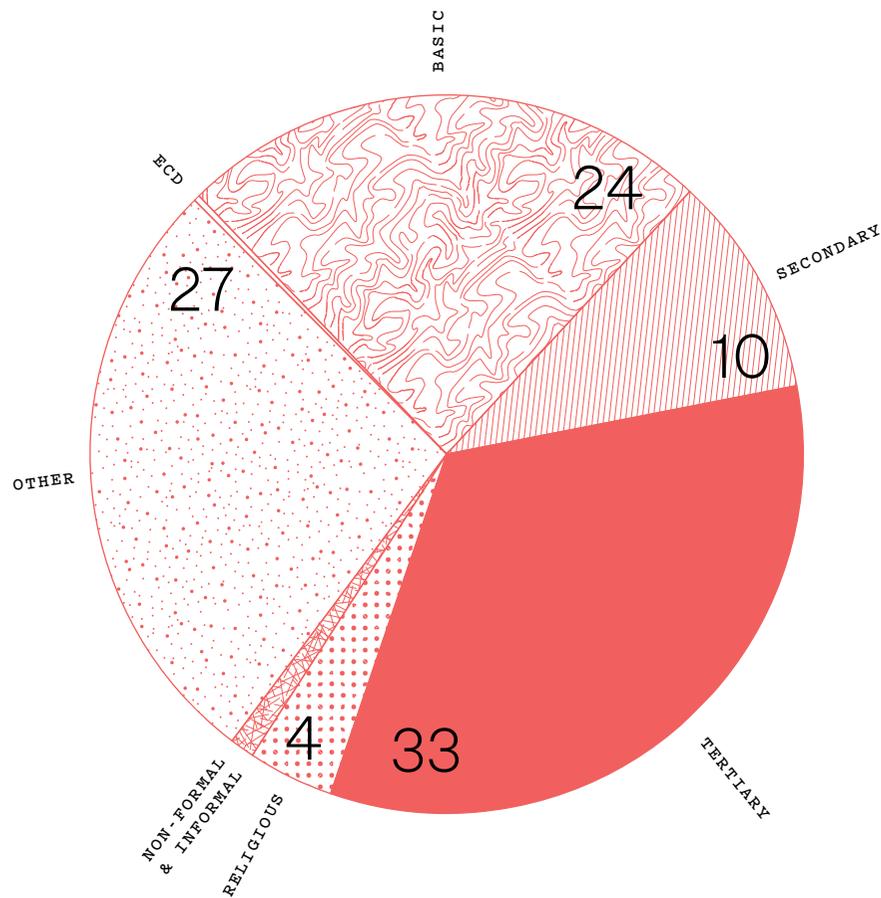
and biology were reduced, along with the related ICT training, in favor of more time being spent on civics and religious teaching. This means today’s children are spending even less time developing the skills firms have already identified as gaps (Figure 6.5).

¹⁰⁹ See World Bank (forthcoming) *Spending Better: Indonesia Public Expenditure Review 2016-18*.

FIGURE 6.4

Central government public spending on education by level, 2016 (percent)

Only 10 percent of central government spending on education goes to secondary schools, compared with 24 percent on primary and 33 percent on tertiary.

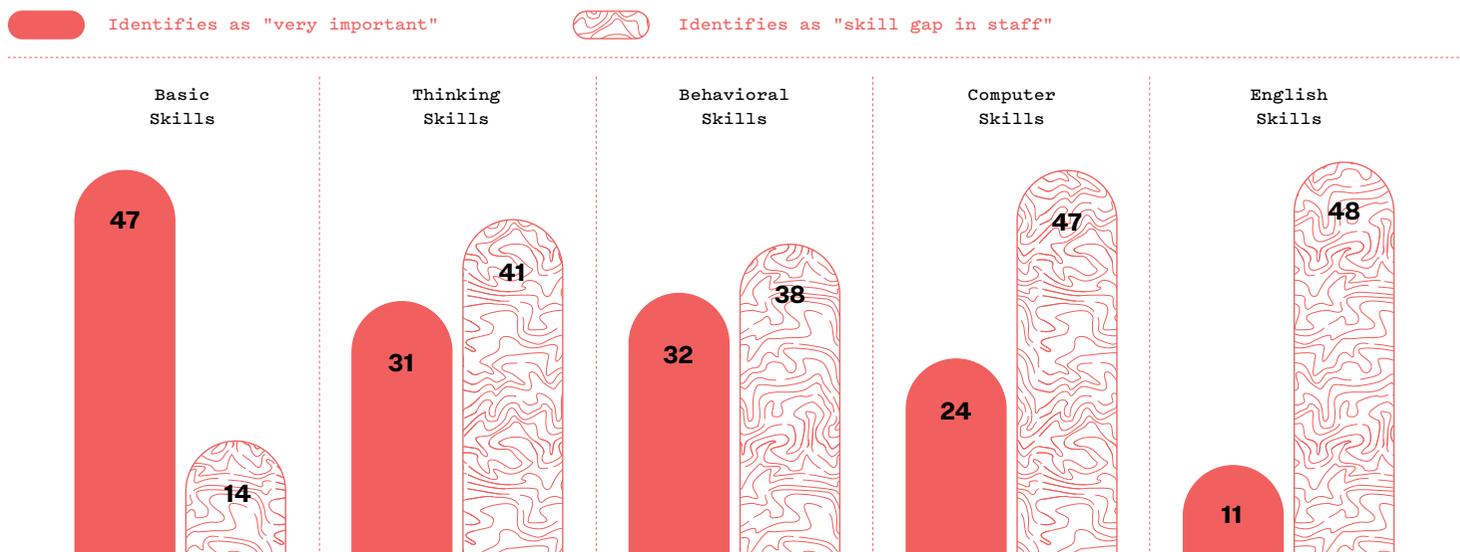


Source: Source: World Bank calculation using MoF data

FIGURE 6.5

Important skills identified by employers, and skill gaps (percent)

Many employers are identifying particular skills as important and also representing a skill gap to current workers. These are some of the same subjects that are now being de-emphasized in the current national curriculum.



Source: World Bank (2011) Skills for the Labor Market in Indonesia.

At the same time, greater investments in early childhood education will bring more children into education earlier and better prepare them to take advantage of later schooling. The middle class has a majority of children enrolled in early childhood education

and development (ECED), but only half of children aged 5-6 years in aspiring middle-class households are enrolled in school, and only 20 percent of those aged 3-4 (Figure 6.6). ECED is relatively inexpensive and has been shown to generate strong returns.¹¹⁰ Not only will greater

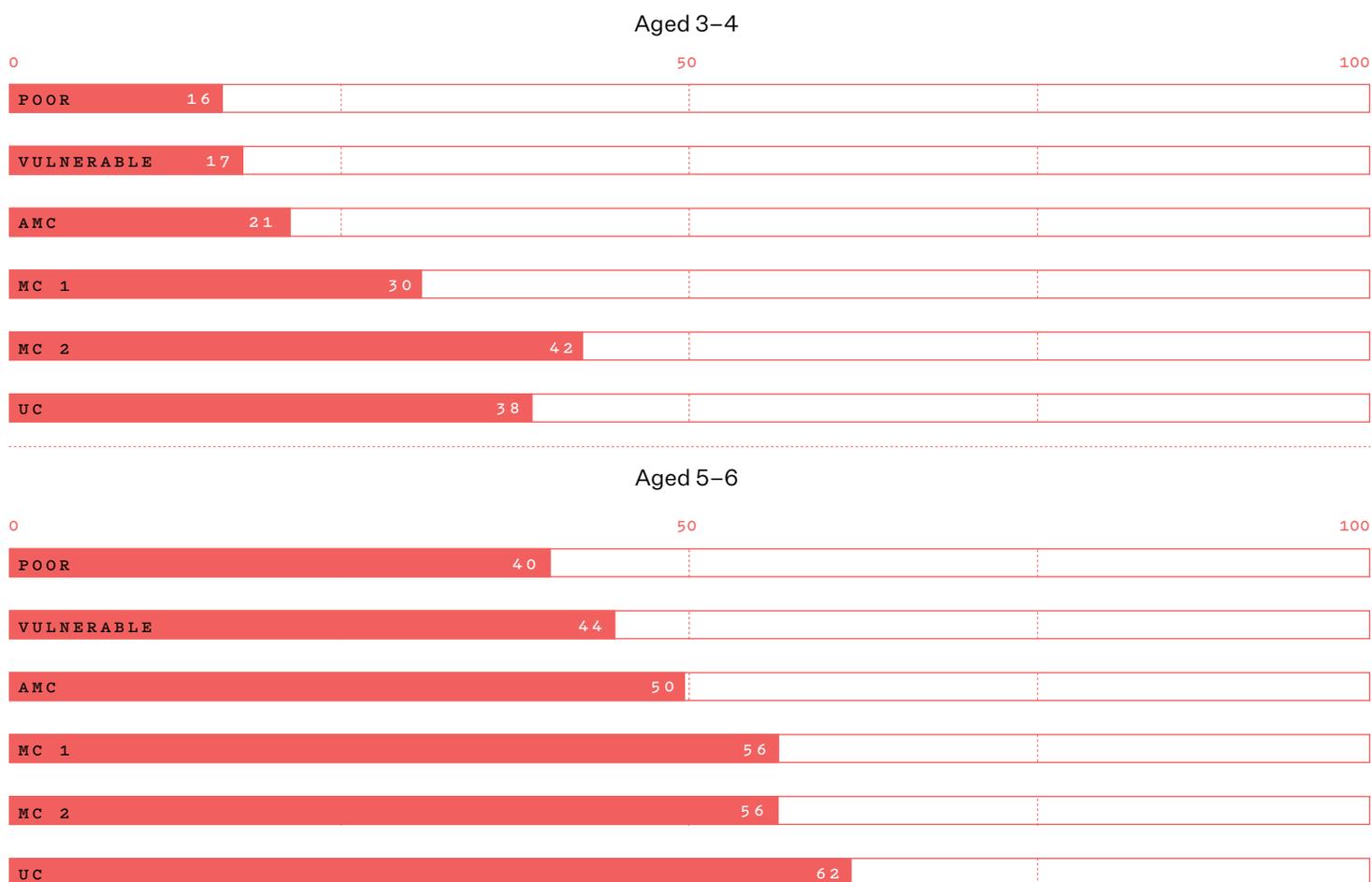
enrolment in ECED of children from aspiring middle-class families make education more of a habit for them, it will also mean that they are better prepared to learn later when they go to secondary school.

“Greater investments in early childhood education will bring more children into education earlier and better prepare them to take advantage of later schooling”

¹¹⁰ See World Bank (2015a).

FIGURE 6.6 Enrolment by age by class, 2016 (percent)

The middle class enrolls most children in ECED, but only half of children aged 5-6 years in aspiring middle-class households are enrolled in school, and only 20 percent of those aged 3-4.



Source: Susenas and World Bank calculations.



137—146

The Middle Class

Chapter 7

& the Social Contract

7.1
Aspiring to more than just economic security

7.2
The role of central and local government in meeting aspirations

7.3
Driving the social contract: votes & money

7.4
Middle-class influence: benefiting or harming others?

7.5
A new social contract



Aspiring to more than just economic security

7.1

As a country leaves absolute poverty behind, poverty becomes defined relative to the incomes of those higher up the income distribution.¹¹¹ We have been using the concept of economic security to capture the increasing numbers of prosperous Indonesian households. However, what happens once most or all of a country becomes economically secure? For example, almost no person in a developed country would be living below the Indonesian economic security line, yet all these countries have their own absolute poverty lines, often defined relative to the rest of the distribution (typically 40–60 percent of the mean or median income; Ravallion, 2010). That is, as countries become richer, the minimum level of welfare considered socially acceptable increases as well, and is usually defined in relation to the welfare of a reference household (World Bank, 2014b):

Left Those in the middle class travel around 40 percent more frequently than other Indonesians, at around 1.4 trips every three months, and they are much more likely to do so for pleasure.

¹¹¹ This section focusing on the social contract draws from Wai-Poi et al. (2016).

The argument for relative poverty lines comes from the perspective of how incomes of a reference group affect the well-being of households. Once basic needs have been met, the argument goes, deprivation is measured relative to the income of the reference group, which is generally taken to be the median, or ‘typical’ household in a society. The argument further notes that in the context of most high-income economies such a definition would require relatively limited transfers to eliminate even such relative poverty

–Marx & van den Bosch, 2007.

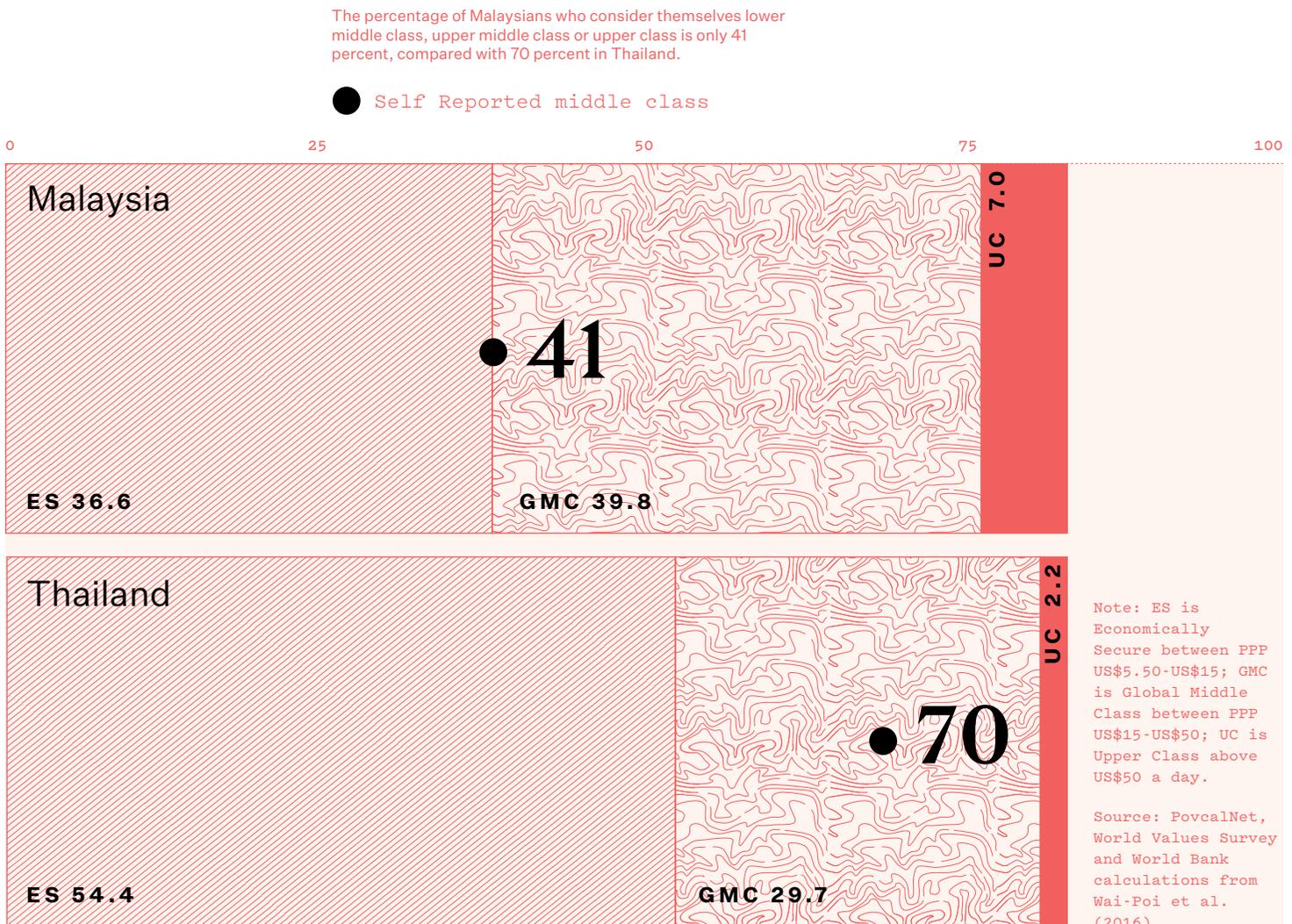
Similarly, as most of a country’s population becomes economically secure, security itself is no longer sufficient to be considered middle class. A similar increase in aspirations and expectations affects households all the way up the income distribution. A good example in the East Asia region is the case of Malaysia, which is now an upper-middle-income country, with almost no poverty and where 86 percent of the population are above the economic security line, 40 percent are in the global middle class of US\$15-US\$50 per day, and 7 percent live on more than US\$50 per

day. Do the 86 percent of Malaysians who are economically secure consider themselves middle class?¹¹²

As Figure 7.1 shows, the percentage of Malaysians who consider themselves lower middle class, upper middle class or upper class is only 41 percent, compared with 70 percent in Thailand. As the economically secure begin to compare themselves relative to a mean or median household income, they no longer consider themselves middle class. In fact, they aspire to more (Box 7.1).

¹¹² This discussion of the Malaysian middle class is taken from Wai-Poi et al. (2016), which summarizes World Bank (2014b) *Malaysia Economic Monitor: Towards a Middle-Class Society*.

FIGURE 7.1 Economic security and self-perceptions of middle class in Malaysia and Thailand



BOX 7.1

The Malaysian experience: from ‘economically secure’ to ‘aspirational’¹¹³

The World Bank (2014a) examined what it means to be middle class in Malaysia in Towards a Middle-Class Society. The following discussion and figures come from that report.



¹¹³ All discussion and figures are from World Bank (2014b). This summary from Wai-Poi et al. (2016).

¹¹⁴ Therefore, as income grows further and inequality is

reduced, a fraction of average income or a range around median incomes may become closer to perceptions and more appropriate. This suggests that any definitions should be periodically reviewed.

The middle class may also be defined as a set of aspirations. For example, a study by the US Department of Commerce (2010, p. 1) describes middle-class families in the US, noting that they “want economic stability, a home and a secure retirement. They want to protect their children’s health and send them to college. They also want to own cars and take family vacations.” In Malaysia most households own a house and a car, as well as basic appliances. Retirement balances are generally low, however, and relative to advanced economies few children of families from the bottom 60 percent attend university. While the aspirational definition reflects a subjective perception of members of each society, partly based on the reference income of their peers, by itself it provides little guidance to arrive at an income cut-off that may be used for policy.

Percentage of households with access to:

REFRIGERATOR	96.2
PIPED WATER INSIDE HOUSE	93.7
FLUSH TOILET	80.1
CAR	77.8
OWN A HOUSE	74.5
PAID TV	57.4
LAPTOP	46.3
AIRCON	37.6
TABLET	15.3

A definition of the middle class (and above) is proposed that includes those households earning more than the mean income. According to this definition, 33 percent of all Malaysian households with a monthly income of more than RM 5,919 in 2014 fall into the middle class or higher. The motivation for focusing on households below the mean income is twofold. First, as argued above, the mean income is a reasonable ‘comparison income’ in a given society. It is especially compatible with the upward asymmetry of reference incomes. Second, perception data from surveys suggest the figure is plausible in the Malaysian context and not inconsistent with perceptions of what it means to be middle class. Those who do not regard themselves as middle class are less likely to be satisfied with their finances, and it is only when one arrives at the seventh decile of the income distribution that more than half of the respondents report being middle class, and among the total number of individuals who report being in the middle class, more than half are at the top 40 percent of the distribution. One stark (and potentially undesirable) feature of using mean income is that distribution-neutral growth, no matter how rapid, will not increase the size of the middle class. As with vulnerability, the emphasis here is not on the specific measure but its features, namely that it is: (i) based on a simple aggregate; and (ii) compatible with society’s own perceptions and beliefs.¹¹⁴

The main distinguishing feature of the middle and upper classes from the aspirational group is post-secondary education. The educational difference between the upper and middle classes, and the aspiring middle class is starker: 55 percent of the middle and upper classes have a post-secondary education (including 29 percent with a bachelor’s degree), compared with just 16 percent of the aspirational group (3.7 percent with a bachelor’s degree). Looking from the other perspective, 83.5 percent of those households with a bachelor’s or post-graduate degree belong to the middle- and upper-class groups. This is strongly suggestive that higher education is a key to the middle class and above.

Percentage of each income decile regarding themselves as 'middle class'



Right 40 percent of Malaysians are in the global middle class of US\$15-US\$50 per day, and 7 percent live on more than US\$50 per day.

Educational attainment: Class contributions



Aspirational and middle- and upper-class households tend to work in the same broad sectors, but informality is still relatively high among the former group. Sixty-two percent of aspiring middle-class households work in the services sector (compared with 67 percent for middle- and upper-class households), followed by 16 percent in manufacturing. Only a minority (12 percent) work in agriculture, compared with nearly half of poor households and one-quarter of vulnerable households. Aspiring middle-class households are also more likely to have more formal and secure employment opportunities. Fifty-four percent are led by heads of household who work as private employees, 12 percent are public employees. Compared with poor and vulnerable households, which are almost never led by employers, a small percentage of aspiring middle-class households are entrepreneurs, generating employment for others. Informality, proxied by the number of 'own account workers', is lower in the aspiring middle class compared with the vulnerable group, but this is still 10 percentage points higher than among the middle- and upper-class groups.





The role of central & local government in meeting aspirations

7.2

As Indonesia went from impoverished nation to middle-income status, the expectation was that the government would deliver growth, jobs and an exit from poverty. Mass support for historical Indonesian regimes, as in much of East Asia, was based on an implicit social contract by which the government would deliver economic growth, create millions of jobs for a young and growing population, and lift most out of abject poverty. In return, political and civil rights were often sacrificed, and the emphasis on the economy was sometimes at the expense of public and social service delivery. A regional exception is China, where even

greater freedoms have been given up, but there has been a public focus on service delivery in addition to jobs, at least in urban areas. China aside, in many ways the Indonesian and East Asian experience has been in stark contrast to the social contract in many Latin American countries, which emphasized services and rights over jobs.

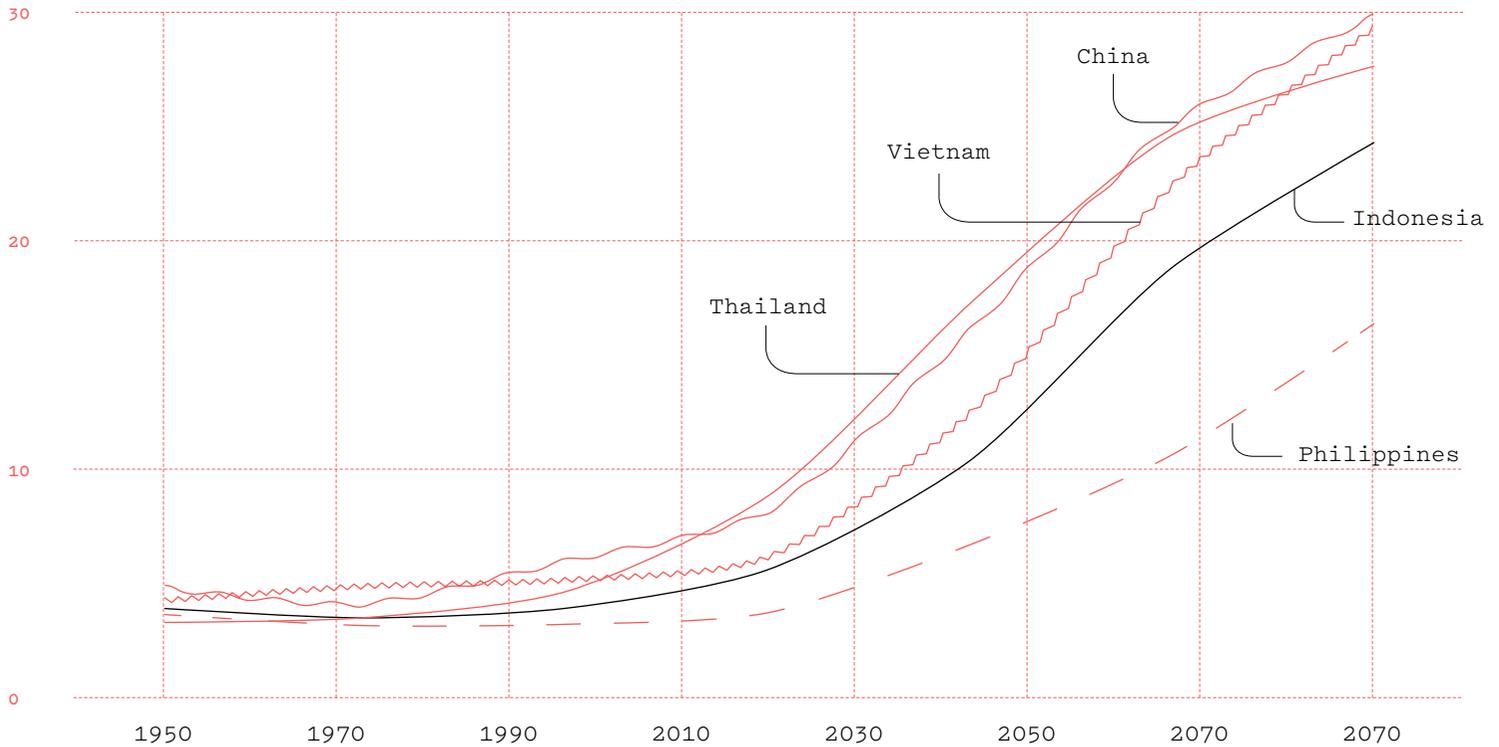
However, with Indonesia now at middle-income status, the development challenge is increasingly becoming less one of poverty reduction and more one of escaping the middle-income trap. In earlier stages of de-

velopment, countries could benefit from both investment and the transfer of technology from developed countries. This enabled some countries, such as Brazil, China, India, Indonesia, Malaysia, the Philippines, Thailand and Vietnam, to sustain strong growth for 20 to 30 years, largely eradicating poverty and achieving middle-income status. However, only a few countries managed to sustain growth for longer and become high-income countries. These success stories include Japan, Singapore, the Rep. of Korea, and Taiwan, China.

FIGURE 7.2

Share of population aged 65 and above, 1950-2070 (percent)

Only 5 percent of Indonesia's population is aged over 65 years old, but just over a decade this will double, and by 2050 it will reach 20 percent, bringing Indonesia into line with other countries in the region.



Source: UN population projections in World Bank (2016).

At the same time, Indonesia, as well as East Asia, is aging much faster than the rest of the developing world. Currently, a little over 5 percent of the Indonesian population is aged over 65 years old. In little over a decade, this will double, and by 2050 it will reach 20 percent. This will bring Indonesia's aging in line with other countries in the region, including China, Thailand and Vietnam (Figure 7.2). In fact, in 2010, the East Asia and Pacific region had about 36 percent of the global population of the ages 65 and above, and by 2060, its average share of older population (22 percent) is expected to approach that of the OECD countries

(24 percent).¹¹⁵ The fast pace of aging will lead to a steep drop in the size of the workforce and sharp increases in public spending (China alone will have around 90 million fewer workers). Without reforms, pension spending is projected to increase by 8 to 10 percent of GDP by 2070. Furthermore, the developing East Asia Pacific region is getting old before getting rich. In particular, largely middle-income countries, such as China, Indonesia, Thailand and Vietnam, have been aging rapidly at much lower per-capita income levels than did high-income countries.

¹¹⁵ This paragraph draws from World Bank (2016); see the report for a comprehensive discussion of aging in the East Asia Pacific and policy recommendations.

Addressing the middle-income trap, as well as an aging population, will mean significantly greater public investments. The transition from a middle-income to a high-income country requires significant increases in public investment. In Indonesia, the World Bank (2014a) has identified a need for an increase in productivity and competitiveness through improved functioning of product, labor, capital and land markets; and increased or redirected public spending toward key development policies, such as closing infrastructure and skill gaps, strengthening health and social assistance system, and improving public service

delivery as critical in avoiding the middle-income trap. At the same time, tackling aging in Indonesia will require increased labor force participation by women, establishing a comprehensive and sustainable social protection system including pensions, and controlling health costs through a switch in strategy (Box 7.2). Funding these investments will likely mean raising new revenues through personal income taxes, currently very low in Indonesia relative to both the region and developed countries. But at present, Indonesia still relies heavily for public revenue streams on corporate taxes, consumption taxes (such as VAT and

tobacco excise) and resource rents (either as royalties or through corporate taxes). Therefore, increased investments will call for greater public revenues from personal income taxes, which are relatively low as a percentage of GDP compared with developed countries throughout East Asia (Figure 7.4). However, greater revenues from income taxes will be largely paid for by the middle class, which already provides 42 percent of indirect taxes (Figure 7.3) and contributed to almost all of Indonesia’s 11.8 million income taxpayers in 2016.



BOX 7.2

Policy options to tackle aging in the East Asia & Pacific

Many high- and middle-income countries in the East Asia and Pacific (EAP) region are already aging quickly and face pressing challenges in managing their aging societies. The EAP region’s demographic and epidemiological transitions require proactive policy responses on pensions, health care and labor markets. They will need to mitigate the labor supply and fiscal effects of rapid aging through ongoing reforms of pension and health systems, and labor policies to extend the working lives of their urban and formal sector workers as they undergo rapid urbanization.

1

In the labor market, countries can encourage more women to join the labor force, especially through childcare reforms. Meanwhile, countries such as China, Vietnam and Thailand can remove incentives in pension systems that have encouraged some workers, especially urban women, to retire too early. Countries at all income levels will also need to keep improving the quality of their workforces by strengthening education and lifelong learning.

2

Developing countries in EAP can take steps to reform their existing pension schemes, including considering gradual increases in retirement age. Such changes would also make it possible to expand currently low pension coverage to include those working in the informal economy. For countries with relatively young populations, governments need to prepare for the future rapid aging and put in place sustainable pension systems.

3

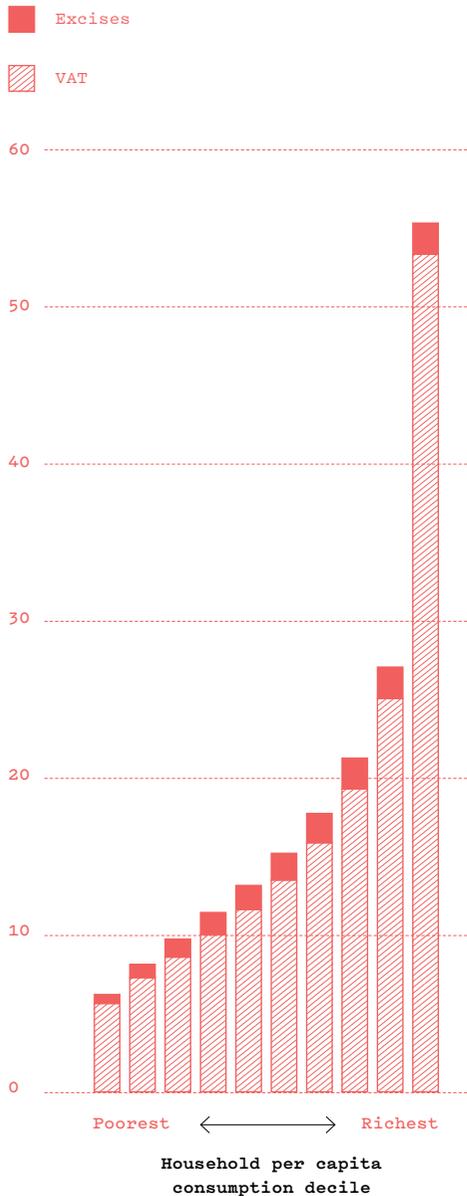
To meet the higher demands on health and long-term care systems in a financially sustainable way, health systems should shift their focus from hospital-centric care to primary care and promote more efficient management of patients with multiple chronic conditions. This structural shift will require changes in pharmaceutical and technology procurement, and how health providers are paid. It also will require a new health workforce that can provide good-quality primary care. The challenge in long-term care is to develop affordable models that combine family support with community- and home-based approaches.

Source : World Bank (2015b) *Live Long and Prosper: Aging in East Asia East Asia and Pacific*.

FIGURE 7.3

**Incidence of indirect taxes, 2015
(Rp trillion)**

The middle class—the richest two consumption deciles—already pays nearly half of all indirect taxes, and almost all direct taxes.



Note: Excises are those on tobacco, which make up 95 percent of total excises.

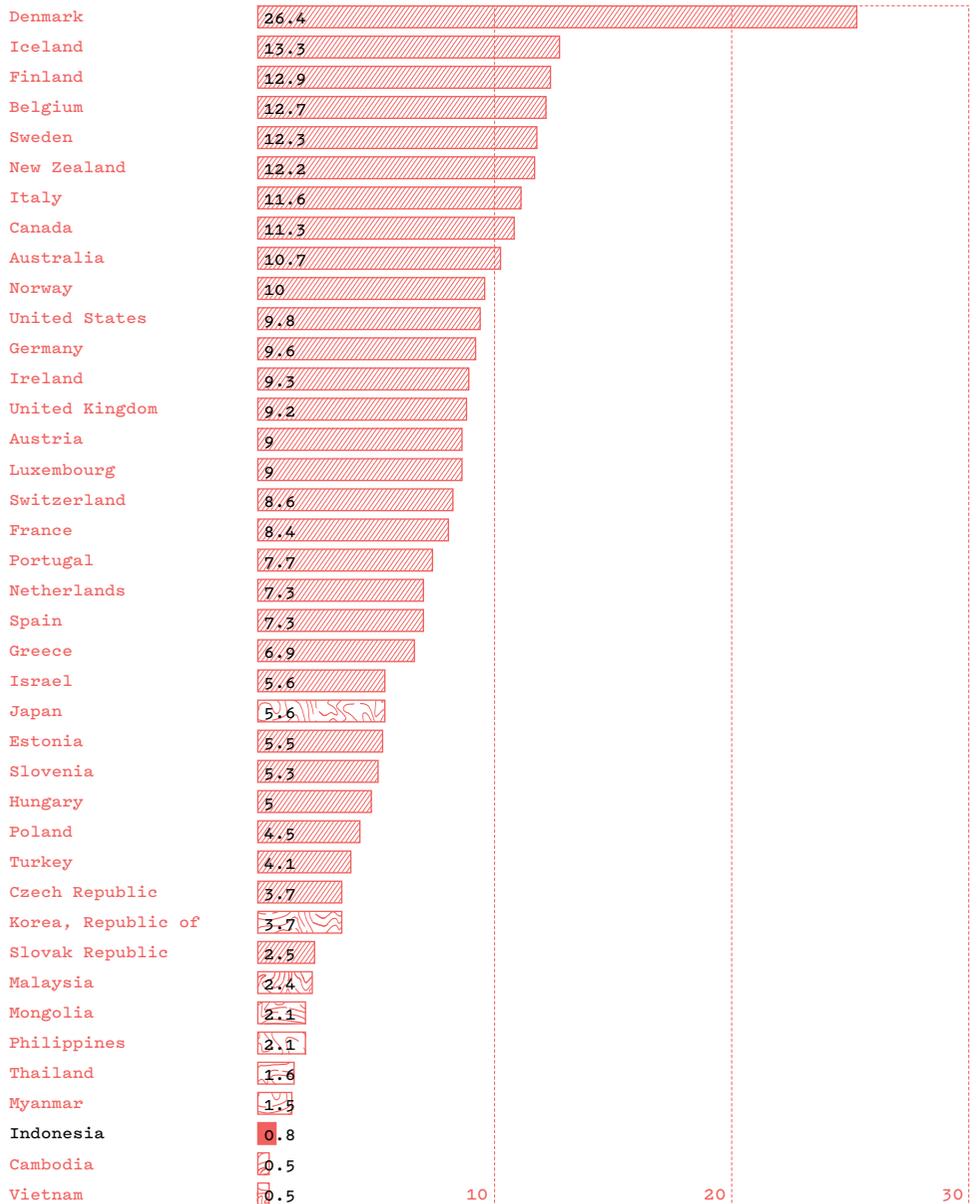
Source: Susenas and World Bank calculations.¹¹⁶

¹¹⁶ See the forthcoming World Bank update to the 2015 report *Revisiting the Distributional Impact of Fiscal Policy in Indonesia: Who Benefits, Why Pays?*

FIGURE 7.4

Personal income tax revenue as a percentage of GDP

Indonesia achieves relatively low public revenues from personal income taxes.



Source: IMF Government Finance Statistics in Wai-Poi et al. (2016).

Right Government policy can play an instrumental role in expanding the middle class.

The main payers of these taxes will be those in the middle class. What will they expect in return, and what does this mean for a new social contract? Unlike consumption taxes, which are at best neutral and often regressive, personal income taxes are usually very progressive and the majority are paid for by the wealthier citizens in a country.¹¹⁷ However, the interests of those in the middle class will increasingly focus on protect-

ing the economic gains they have made and using their newfound income to enjoy better health, education and other social services. Consequently, it seems possible that a new social contract will begin to be negotiated in Indonesia. This section examines the role of a rising middle class in developing a new social contract, considering the economic and social discussions earlier:

1	2
Economic	Social
Growing economic numbers & influence	Sometimes unmet non-monetary needs with respect to services and amenities, growing aspirations of the economically secure to be global middle class, possible opting out of public services when their quality is inadequate and middle-class consumers can afford private provision.

¹¹⁷ See the discussion on different taxes in World Bank and Indonesian Ministry of Finance (2015c) and Jellema et al. (2017). However, note that while consumption taxes are often regressive in terms of relative incidence, that is, tax collection as a percentage of the income/consumption, the middle class accounts for a disproportionately large share of total consumption, and would therefore account for most of the consumption taxes collected.





7.3



Driving *the* social contract: votes & money¹¹⁸

Above There are risks that the middle class favors policies that benefit only those in the middle class, but not others, resulting in a more polarized and fractious society.

¹¹⁸ This section summarizes Wai-Poi et al. (2016).

¹¹⁹ See Wai-Poi et al. (2016).

FIGURE 7.5 Political salience indicators, 2002 and 2016 (percent/points)

The aspiring middle class and the middle class have the size and economic influence to be politically salient.



Which classes will have more political influence depends on the country context. In poorer countries with a very small middle class, it may be the aspiring middle class with larger numbers and a greater consumption share that will be more influential. In richer countries where the middle class has grown to sufficient size, and whose consumption share will be even larger, middle-class consumers may wield more influence. One way to assess which class may be more influential is to consider each class’s political saliency.

The political saliency of a class of people depends on their size, their economic clout and their homogeneity. In examining the Latin American middle class, Birdsall (2014) identifies a number of factors required for a class to have ‘political saliency’: (i) enough

people (measured by population share); (ii) enough income (measured by income or consumption share); and (iii) shared class identity (measured by within-class Gini coefficient; that is, all of the class have similar economic means). We look at this combination of factors for Indonesia and compare it with other countries in the region. Birdsall discusses the importance of economic homogeneity for political saliency and looks at the within-class Gini as a proxy. On this basis, the aspiring middle class has greater homogeneity than the middle class, with a Gini of 13 compared with 26 (Figure 7.5). However, this is by construction: by bounding the classes between narrower consumption levels for the poor, vulnerable and the aspiring middle class, the within-class Ginis are by definition going to be smaller than that of the middle class, which includes households

with consumption unbounded from above. To the extent that the aspiring middle class really does just aspire to be middle class, as the Malaysian example (Box 7.1) shows it does, its members are unlikely to really represent a category of people with a distinct economic class consciousness. Thus, we focus on the number of people and the share of consumption that each class represents when considering whether they are potentially catalytic classes with political voice.

In Indonesia, currently both the aspiring middle class and the middle class have the potential for political saliency. The aspiring middle class and the middle class have the size (numbers) and economic influence (share of total consumption) to be politically salient (Figure 7.5). Currently, the aspiring middle class has a smaller but still significant economic clout, with a consumption share 38 percent compared with the middle class’s 47 percent, and there are more than twice as many aspiring middle class (44 percent of all Indonesians) as there are middle class (21 percent). At the same time, while the middle class has only half as many voters, it represents half of all consumption.

However, in the future, as the middle class grows, so will its number of voters, while it will come to dominate national consumption. Growing in numbers much more quickly than the aspiring middle class (10 percent per year between 2002 and 2016, compared with only 2 percent for the AMC), the middle class will approach the AMC in size. However, the middle class will quickly dominate national consumption, having more than doubled its share of consumption from 22 percent to 47 percent over the same period, while the AMC actually fell from 48 percent to 38 percent. This combination of a large number of voters commanding most of the economic resources will make the middle class the most influential group of the future. In this respect, Indonesia will come to look more like Thailand and Malaysia do now.¹¹⁹

Middle-class influence: benefiting or harming others?¹²⁰

How the middle class uses this growing political saliency could affect the rest of Indonesia in both positive and negative ways, as the example of the Chinese middle class shows. Will Indonesia's growing middle class be a positive or negative force? There are both positive and negative examples from China.

Food safety has become a major concern for the Chinese middle class, which will benefit all segments of society through stronger regulations. The 2000s saw a number of food safety scandals: the sale of illegal cooking oil that recycles waste animal oil (*China Daily*, 2011); sick children and infants from powdered milk containing melamine, a chemical from plastics production (*US News*, 2008); and deaths at Ramadan due to vinegar contaminated with antifreeze (*Guardian*, 2011). In response to these scandals and an outcry from the Chinese middle class, tough new laws were introduced in 2015 that mean tougher safety standards, tighter approvals and licensing, and heavier civil and criminal sanctions (Balzano, 2015).

Furthermore, the middle class's willingness to pay for safer products could also improve domestic supply for all. It is estimated that 83 percent of Chinese middle-class consumers are willing to pay more for safe food products as a result of increased awareness of potential health hazards (AT Kearney, 2007). The China Market Research Group finds that shoppers who are mothers are willing to spend about 20 percent more for food products, clothing and related toiletry items for their babies if they were fully confident that those products are safe. Such consumption preferences and concerns could stimulate domestic industry—which also serves poorer consumers—to produce better quality products

for this large potential market; if industry does not respond in time, it risks losing the middle-class market to foreign products that are perceived to benefit from higher production and quality control processes (Rein, 2009).

The Chinese middle class, particularly the young and middle aged in urban areas, is increasingly concerned with some issues related to non-excludable goods, such as environmental degradation and pollution, particularly those that may directly affect living standards (Ekman, 2015a). Recently, more than one thousand people took to the streets of Shanghai to protest against the construction of a new chemical plant. A similar number gathered in the suburbs of the northern industrial city of Tianjin claiming that pollution from a nearby steel plant was carcinogenic. Residents in Wuchuan, a city in southern Guangdong, marched on government offices to oppose plans to build a waste incinerator near their homes. Such protests have successfully triggered President Xi Jinping's response, who pledged that the Chinese government would "punish with an iron hand any violators who destroy China's ecology or environment". Since the beginning of this year, pollution fines were imposed on 26 companies, plants belonging to 527 companies were closed, and a further 207 businesses were ordered to suspend operations.

However, polluting or problematic projects are often not canceled but simply moved to areas with poorer households and less voice. Middle-class protests have often been moderately effective in stopping local projects, but not yet so in reforming overall environmental policies. Controversial projects are rarely canceled and are instead simply relocated to areas with a more submissive population. For instance,

7.4

thousands of people in Xiamen, an affluent wealthy city on the eastern coast, forced the Chinese government to suspend the proposed construction of a chemical factory producing paraxylene. Faced with unprecedented numbers of protesters from among the urban middle class, the provincial government reallocated the plant to poorer, smaller Zhangzhou, the site of a recent accident with disenfranchised farmers (Hoffman and Sullivan, 2015).

Moreover, in the case of China it is unclear whether the middle class will push for reforms or be concerned that change will threaten its economic interests (Box 7.3). The existing political literature points out the close traditional connection be-

tween the middle class and the Chinese Communist Party, and a conservatism among the older generation of the middle class that may make it unlikely to push for change. At the same time, a more confident and modern younger generation of the middle class is finding opportunities to express its views. The degree to which this younger generation feels that the current political regime is listening to its opinions may influence the degree to which it looks to reform the system from within, or to challenge it. Moreover, while those in the middle class are more likely believe that growth in personal wealth does not come at the expense of others, when their economic interests are threatened, as in the case of the *hukou* reform,¹²¹ they may be resistant to change.

Below 83 percent of Chinese middle-class consumers are willing to pay more for safe food products as a result of increased awareness of potential health hazards.



¹²⁰ Taken from Wai-Poi et al. (2016).

¹²¹ The *hukou* system designates a resident's status as being either rural or urban based on their registered birthplace. This means a migrant worker from the countryside is not entitled to public services in a city, despite working and living in a city. China's government has announced a goal of expanding urban *hukou* or residency permits to 100 million migrant workers by 2020 as part of its plan to rebalance the economy.

BOX 7.3

China's middle class: reformers or co-opted?



The Chinese middle class traditionally has a strong connection with the Chinese Communist Party and may not be the group most inclined to support some forms of political change. Glassman (1997), on an early assessment of the economic restructuring in China, argues that democratic change will follow from the emergence of new entrepreneurial classes. Subsequent research, however, shows the intertwined relationship between the new entrepreneurs and the Communist Party (Pearson, 1997; Chen and Goodman, 2013). According to some non-official estimates, around 40 percent of entrepreneurs are members of the Party (Chen and Goodman, 2013). This is partly because those in the middle class have more desire for political participation than their less well-off counterparts (Fewsmith, 2007). We see in the WVS data that the financially secure Chinese are slightly more likely to belong to a political party than the non-financially secure (9 to 7 percent). In addition, since Jiang Zemin's leadership, the Communist Party has opened its doors to the private sector with the aim of ensuring the loyalty of all segments of society. Many of middle class are therefore generally connected in one way or another to the Party, especially when Party connections and membership are perceived as signs of success. However, political connections and participation do not necessarily translate into a demand for political change. Ekman (2015a) argues that the majority of China's middle class is unlikely to demand change or question the current political

order. If there is criticism, it is more as a desire for greater efficiency and social justice within the current system (Goodman, 2013) and, despite social policy reform, the force of democratization is unlikely to become strong (Jing, 2010).

However, a younger generation may look to influence policy from within the Party. The older generation of the Chinese middle class holds relatively conservative political views and is more likely to support state authoritarianism for fear of losing its own socioeconomic stability, while the younger Chinese middle class prioritizes career advancement and household prosperity over political participation (Ekman, 2015b). However, while the older middle class tends to be more mindful of its financial situation and less conscious of social inequality, the new middle class shows a more democratic consciousness and its members are often recruited into think-tanks or invited to join consultation committees to advise or voice opinions (So, 2013). While its opinions may not be accepted by the Party-State, the new middle class feels that it has a chance to participate in the decision-making process and believes it can influence policymaking through the existing political channels (So, 2013). Whether the rising middle class continues as a supporter or a challenger to the political regime will depend on whether the political system is able to accommodate its political demands (Li, 2008).

The middle class appears to be more open-minded regarding the pursuit of profit to sustain economic growth but may be resistant to reforms that threaten its interests. Utilizing the 2006 China General Society Survey (CGSS), Jing (2010) finds that the middle class supports imposing taxes on the rich to help the poor (the WVS data also show broad support for this, but not more so than among the non-secure). Nevertheless, since most of those in the Chinese middle class hope to benefit from economic growth and maintain their current lifestyles, they tend to be more submissive to an authoritarian state for economic security and socio-political stability. Based on survey data from three major cities (Beijing, Chengdu and Xi'an), Chen and Lu (2011) find that, while most of those in the middle class are in favor of the individual rights of a democratic system, they are not supportive of political liberties and democratic institutions, particularly if these could disturb social order. At the same time, while the majority of the middle-class survey respondents support competitive, multicandidate elections of government leaders, they do not support multiparty competition, suggesting consent to the current one-party dominance and controlled election system. Moreover, the Chinese middle class appears to be reluctant to accept some of the ongoing socioeconomic reforms, such as making the *hukou* system more flexible, especially when its position will be less favorable as a result (Solinger, 2005).

Below It is unclear whether China's middle class will push for reforms or be concerned that change will threaten its economic interests.



7.5

A new social contract

Right Effective and sustainable health, employment and old-age insurance can provide the safety net that the aspiring middle class needs to enter the middle class, and can protect the economic gains that the middle class has already achieved.

An arrangement for all Indonesians is one where public investments drive growth, such growth is inclusive, and social insurance protects the gains of all. For the non-middle class, access to high quality public services and good jobs can provide opportunities to achieve economic security and become middle class. At the same time, upward mobility of the non-middle class and investments in productivity and infrastructure will drive greater economic growth, benefiting the middle class. Furthermore, stronger social insurance to provide employment and health protection, as well as pensions, means that the economic gains of both the current middle class and those entering it (from the AMC) can be secured from the shocks that can affect everyone. Finally, strengthening income-tax compliance from the current middle class and boosting new collections from an expanding middle class mean that everyone is paying their fair share.

Thus, a social contract that focuses on quality public services, economic mobility and social security for all both helps to

expand the middle class and to protect those already there. A relationship between the government and its people could focus on three areas. First, quality public services, especially in health and education, but also water and sanitation, are necessary so that aspiring middle-class children can develop the health and skills they need to succeed later in life. Better quality services may also mean that the middle class uses and appreciates such services more widely, generating broader support for financing them. Second, access to livelihoods that allows the middle class to prosper and those below to enter can help ensure economic mobility for all. This means a focus not only on better education, as discussed earlier, but also on making it easier to become an entrepreneur, which increases the prosperity of the middle class and creates new jobs for others. Finally, effective and sustainable health, employment and old-age insurance can provide the safety net the aspiring middle class needs to become middle class and, at the same time, protect the economic gains that the middle class has already achieved.



A Common Cause *for* All Indonesians



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8.1
Quality public services:
linking financing &
performance

8.2
Enhancing economic
mobility through
entrepreneurism

8.3
Economic security
through effective &
comprehensive social
insurance

Quality public services: linking financing & performance¹²²

Below Indonesia's public spending on health is well below regional and lower middle-income country averages, with a recommended benchmark of US\$86 per capita needed for low and middle-income countries to be able to deliver a limited set of key health services.

8.1



“Unlike education, there is insufficient spending to ensure supply-side readiness in the Indonesian health system”

Despite significant investments in education, an increased number of teachers, and higher teachers’ salaries, student learning outcomes have not been improving. Education spending in Indonesia quadrupled between 2001 and 2016 in real terms and now represents 20 percent of all public spending and 3.3 percent of GDP. The number of teachers has increased dramatically since 2005, with 15 percent more civil servant teachers and 40 percent more temporary teachers by 2015. Indonesia’s student-to-teacher ratio (STR) of 17 far exceeds the average for other lower middle-income countries of 29 and is nearing the high-income country average of 14. At the same time, a teacher certification program has expanded sharply and is reflected in greatly increased teacher allowances. However, despite increased spending on educational inputs, learning outcomes have not improved, with little change in international PISA scores, and no relationship between lower STRs and test scores.

Increasing the focus on professional development and linking performance to rewards, both at the teacher and local government level, could improve the quality of teaching and education. There is a lack of continuous professional development (CPD) and the School Operational Fund (BOS) spends three times more on honorariums (17 percent) than professional development (5 percent). At the same time, there is no link between teachers’ performance and their allowances and professional progression, so quality is neither developed nor rewarded. Moreover, funding and spending are not linked to performance either. Local governments are responsible for spending their education budgets to achieve minimum service standards, but spending is only weakly correlated with these achievements, while BOS allocations are generally not allocated based on school performance. The World Bank is piloting tying teacher allowances with teacher performance through the KIAM Guru project. In remote pilot schools under the project, payment of the remote area allowance is tied with either teacher presence or service performance, with inputs from parents and broader community members. Initial findings indicate significant improvements in teacher presence and service performance. Another example of how reforms

could tie spending to performance is the reform introduced by the Jakarta Provincial Government in 2015.¹²³

Unlike education, there is insufficient spending to ensure supply-side readiness in the Indonesian health system.¹²⁴ Total health spending in Indonesia is low relative to other countries in the region and much of it comes from consumers themselves. Despite increases in recent years, public spending on health is one of the lowest in the world, at 5.9 percent of total public expenditures, and represents only 1.1 percent of GDP, far lower than the 3.3 percent average for countries of similar income levels. Consequently, many health facilities lack the equipment and training needed to provide key services. Moreover, central government spending represents only one-third of total health spending, and this is compounded by a disconnect between local government spending and supply-side readiness.

In addition to increasing health spending, Indonesia needs to focus on spending better. More spending on health could help to reduce gaps in access. However, only one-third of public spending comes from the central government; improving the efficiency of hospitals and health centers is also important. Moreover, the priority is improving the *quality* of health services. Specific actions include targeted public investments with built-in incentives for performance to equip local health facilities to deliver results; producing sufficient competent health workers and ensuring they are deployed to where they are needed; and scaling up and enforcing the accreditation system. Moreover, public health spending can be made more efficient, with Indonesia’s relative technical efficiency in transforming inputs into outputs lagging other countries such as Sri Lanka and Vietnam.

More broadly, improvements are needed in the way local governments deliver public services. In a decentralized Indonesia, local governments are critical for delivering public services, not just in health and education, but also in areas such as water and roads. And in an urbanizing Indonesia, service delivery in cities is failing, where only 33 percent of urban households have access to clean water, only 12 cities have piped sewerage networks serving 2 percent of the urban population, and 40 percent of urban residents do not have access to proper sanitation

¹²² This discussion on public service delivery and quality is expanded significantly in the main report and draws heavily on World Bank (forthcoming) *Spending Better: Indonesia Public Expenditure Review 2016-18*.

¹²³ World Bank (forthcoming) *Spending Better: Indonesia Public Expenditure Review 2016-18*.

¹²⁴ See World Bank (2016) *Health Financing System Assessment: Spend More, Right, and Better*.

Five strategies have been identified to maximize the effectiveness of local governments' spending of transfers.¹²⁵ To improve local government spending on service delivery, the government should consider implementing the following:

1

Build a robust system to measure performance



Relate inputs, processes and outputs to outcomes; invest in higher quality data; combine finance and performance data for a more meaningful picture; and utilize the Central Bureau of Statistics (BPS) and the Financial and Development Supervision Agency (BPKP) in monitoring.

2

Make the most of incentives



Remove bad incentives, such as the general allocation fund (DAU) basic share that encourages the hiring of more district staff; use financial incentives in different ways, such as rewarding process compliance and paying for outputs; use matching funding to drive ownership; and encourage positive competition, by publicizing local performance data

3

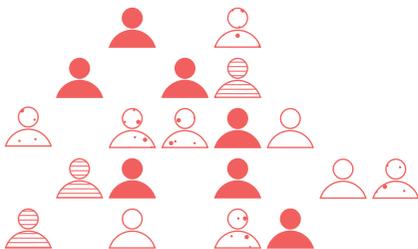
Address poor performance in graduated ways



Issue letters to improve; provide technical support; require performance action plans; and reduce funding allocations.

4

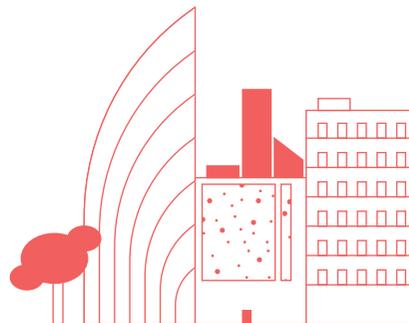
Use citizens to provide incentives for better performance



Make budget and spending data public; involve citizens in the local decision-making and development; and provide feedback mechanisms.

5

Fix systems & capacity



Streamline subnational public financial management (PFM) systems; measure the performance of subnational PFM systems to targeting capacity building; modernize district financial management accounting software; and develop a comprehensive capacity-building program for subnational governments.

¹²⁵ World Bank (forthcoming) *Spending Better: Indonesia Public Expenditure Review 2016-18*.

In addition, reforming Law No. 33/2004 on Fiscal Decentralization's comprehensive intergovernmental financing framework could make decentralization more effective. Two core changes would help. First,

conditional transfers to regions (DAK) should address national priority outcomes, not administrative functions. Second, getting the general allocation fund (DAU) right matters. Current DAU allocations are per district, not per

person. This not only encourages districts to split, it also means large urban populations—where most of the middle class live—lack sufficient financing for their local infrastructure needs, undermining local service delivery.

Right There is broad support across all classes for a social contract that benefits all Indonesians.



Enhancing economic mobility through entrepreneurship

Most business owners who employ others are from the middle class. While most middle-class workers find well-paid productive jobs in the formal sector, a significant number own their own businesses and employ others (Figure 4.12). Policies that support these entrepreneurs will increase their own economic mobility, help drive economic growth, and create more jobs for the aspiring middle class. Two key areas are the regulatory environment and access to credit.

Recent improvements in the ease of doing business need to be sustained and deepened. The investment climate and ease of doing business have long been identified as a constraint on firms in Indonesia.¹²⁶ As recently as 2013, Indonesia ranked 120th out of 185 countries in the World Bank Group's Doing Business rankings. However, a series of reforms implemented by the current administration has seen significant improvements and Indonesia has seen one of the greatest gains in the rankings in recent years, improving from 106th in the 2016 rankings to 91st in 2017 to 72nd in the just released Doing Business 2018 rankings. The World Bank credits positive reforms in the areas of: starting a business, getting electricity, registering property, getting credit, paying taxes, trading across borders, and en-

forcing contracts. However, with a goal of 40th by 2019, the government now needs to move beyond "quick-win" reforms and implement medium-term structural reforms to further improve Indonesia's business environment. To this end, it is important that the government continues with its plan for coordinating and monitoring the reform process.¹²⁷

In addition, more needs to be done to make Indonesian firms less credit-constrained.¹²⁸ There is ample evidence that firms in Indonesia are credit constrained, with firms relying more on retained earnings than bank credit for expansion. The credit constraint faced by firms reflects the lack of depth of Indonesia's financial markets. Public policy could help nudge the system toward greater financial depth, through easing strict investment requirements, building a more credible legal system that allows for the effective enforcement of contracts and property rights, and provides greater investor protection. The recent reforms of the social security regime further present an opportunity to deepen financial markets, with the new body expected to cover 10 times the number of workers it had previously, multiplying assets under management and presenting an opportunity to widen the choice of eligible investments.

Right While just over one-third of middle-class workers continue to be self-employed or own their own business, more and more of them run productive businesses that are capable of employing other paid workers.

2
•
8

¹²⁶ World Bank (2014a).

¹²⁷ World Bank (2017) *Indonesia Economic Quarterly: Sustaining Reform Momentum*.

¹²⁸ See World Bank (2014a).







Economic security through effective & comprehensive social insurance

The final component in ensuring millions of Indonesians can enter the middle class and remain there is social insurance. We have looked at the investments and policies needed to strengthen the opportunities for the non-middle class to increase their incomes and move into the middle class, achieving their aspirations and driving greater growth. However, protecting the economic gains as households enter the middle class is just as important. This means establishing a social insurance system that protects households from health and employment shocks, and provides income in old age, while providing the right mix of benefits in a fiscally sustainable manner. It also means providing social assistance to poorer households that cannot afford to pay the premiums themselves, so that they have a better chance to climb into the middle class.¹²⁹

There are many shocks that can erode household resources and incomes; many Indonesians rely on friends and family to cope rather than formal mechanisms.

Households can be affected by economic, health, and social and political shocks, as well as natural disasters. Civil servants and some of the middle class have access to health and employment insurance that they can rely on during shocks. While the government covers health insurance premiums for the poor and vulnerable, for many workers from the aspiring middle class who work in the informal sector, the expansion of health and especially employment insurance coverage to these households may be many years away. When people do not have access to formal coping mechanisms in times of shock, they usually turn to family and friends. However, this typically does not provide enough support to fully cope and does not work when a shock such as a natural disaster hits an entire community. When informal borrowing is not enough, households may resort to steps that reduce their future income, such as selling productive assets or pulling children out of school. Thus, shocks can reduce household income by either destroying or impairing the underlying assets that generate income (productive assets such as equipment or human assets such as labor), or by forcing households to use or sell these assets (savings or productive assets) to cope with the shock.

Shocks hurt the incomes of all Indonesians, but the middle class is more resilient.¹³⁰ With vulnerability high in Indonesia, small shocks can easily reduce incomes; around half of the poor each year were not poor the year before. Those in the aspiring middle class can also be badly affected by shocks such as illness and disease or unemployment if they do not have access to insurance or other coping mechanisms. As a consequence, over a 14-year period, most Indonesians have experienced considerable ups and downs in terms of their income. In contrast to this common situation, the majority of the middle class have been able to remain middle class over the same period of time.

¹²⁹ See World Bank (2015a) and World Bank (2017b).

¹³⁰ World Bank (2015a).

¹³¹ World Bank (forthcoming) *Spending Better: Indonesia Public Expenditure Review 2016-18*.



Left Indonesia is also rapidly aging—with the share of population aged 65 years and older expected to double from 5 to 10 percent between 2015 and 2030.

Therefore, expanding the middle class also requires expanding and strengthening Indonesia's social insurance system. In recent years, Indonesia has been implementing a massive social insurance framework, which covers both health (JKN) and employment and retirement (SJSN Employment). The policy goal is universal coverage of the two schemes, which includes both contributing (from non-poor workers) and non-contributing (premiums subsidized by the government) members.

The national health insurance scheme (JKN) is the largest single payer system in the world but it is far from universal and does not cover its costs. JKN now covers 163 million people, or over 60 percent of the population. In practice, premiums are paid both by formal workers and by the government on behalf of the poor and vulnerable; government subsidies make up half of all JKN revenues. However, JKN does not cover the full costs of care, meaning that central and local governments have to make up the difference.¹³¹

Extending coverage to informal workers, many of whom come from the aspiring middle class, has proven difficult, and the long-term sustainability of JKN is under threat. While many of the poor and vulnerable have premiums paid by the government, and civil servants and formal workers have contribu-

tions deducted by their employers from their salaries, enrolling and collecting from informal workers—who largely represent the aspiring middle class—has proven difficult. Those informal workers who do enroll are those with an incentive to do so, meaning adverse selection threatens JKN sustainability; there is little barrier to enrolling when sick and no way to bring informal workers in ex ante. Moreover, the cost of the benefits package exceeds the cost of contributions, further compromising long-term sustainability, which affects both the middle class and those who aspire to join it.

Improvements in sustainability, accountability, efficiency and effectiveness are required for JKN to provide true security to the middle class and beyond. To address sustainability, the basic benefit package needs to be commensurate with the financing and moving to strategic purchasing of services (from passive purchasing) could improve value for money. A lack of checks and balances in the implementation of JKN means inefficiency and a lack of accountability, which needs to be addressed. Furthermore, JKN payments can be used as incentives for district-level health performance. Finally, there is a need to clarify the roles and responsibility of different agencies implementing JKN, including the Ministry of Health and BPJS.

60%

The national health insurance scheme (JKN) is the largest single payer system in the world but it is far from universal and does not cover its costs. JKN now covers 163 million people, or over 60 percent of the population.



Chapter 9

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Conclusion

Indonesia aspires to move from middle- to high-income country status. Meeting these aspirations will mean meeting the aspirations of its people and becoming a middle-class society. The emergence of a prosperous middle class in Indonesia has been a key driver of recent economic growth. However, to sustain and even accelerate economic growth and the public investments needed to transition to a high-income country, it will need to substantially expand the middle class, beginning with the two-fifths of its citizens who have successfully escaped poverty and vulnerability, and who now aspire to join the economic security and prosperity of the middle class. Achieving this means ensuring that they stay in school longer and develop the skills they need

for better jobs. It also means expanding social insurance so that their newfound prosperity is protected from shocks. At the same time, tax revenues from the growing middle class will be critical to fund the investments in health and education, infrastructure and productivity necessary for Indonesia to keep developing. In return, those in the middle class will want to see higher-quality public services and continued upward mobility if they are not to start to resent the tax burden that will fall increasingly and substantially on them.

Transforming Indonesia into a middle-class society is also vital to prevent political and social polarization. As we have discussed, escaping the middle-income trap will require

greater public investments, funded by taxes built on a new social contract that provides protection and higher-quality services for all. Moreover, not only is a new contract required for a brighter future, without one even today's prosperity may become vulnerable if Indonesia's growing inequality and middle-class opting out result in a socially and politically polarized country that cannot agree on a vision for shared prosperity. Nowhere has this been more dramatically illustrated than in Thailand over the past decade. After the strongly re-elected Thaksin Shinawatra was forced from power in 2006, Thai politics have stumbled through a decade of a deeply divided electorate, inflamed by the actions on both sides, snap elections, the ejection of popularly elected prime ministers,

“Indonesia aspires to move from middle- to high-income country status. Meeting these aspirations will mean meeting the aspirations of its people & becoming a middle-class society”

FIGURE 9.1 “How urgent is it for the government to reduce inequality?”



Source: Lembaga Survei Indonesia Inequality Perceptions Survey and World Bank calculations. See World Bank (2015c) for details.

widespread and persistent street demonstrations and violence, culminating in a military coup. Thailand remains trapped in a political impasse between the emerging rural economically secure and the Bangkok-based urban global middle class and elites. This impasse has many roots,¹³² but is in part due to a failure to establish a broad social contract that benefits all.

There is broad support across all classes for a social contract that benefits all Indonesians. A recent survey asked Indonesians how important it was to address

inequality. Nearly 90 percent said “very urgent” or “quite urgent”, a figure that was constant across all consumption classes, including the middle class (Figure 9.1). They were also asked what the most important policies were. All classes agreed on jobs, credit for small businesses, education and health care for all, social protection and eradicating corruption. While support for higher taxes on the rich is low, this can be addressed with a strong communications strategy explaining what these taxes buy and sustained commitment to delivering these policies.

¹³² See Box 15, Wai-Poi et al. (2016).

TABLE 9.1 Three most important policies for addressing inequality by class (percent)

Regardless of economic class, all Indonesians agree that the best way to address inequality is through social assistance, better jobs and less corruption.

	Poor	Vulnerable	Aspiring Middle Class	Middle Class
Social assistance	54	52	48	40
More jobs	43	46	50	49
Eradicating corruption	34	33	38	44
Free education	30	30	30	31
SME credit	27	27	27	25
Free health care	18	18	17	18
Infrastructure	16	14	12	17
More subsidies	13	14	15	11
Raising minimum wages	12	16	19	22
Village grants	10	9	6	6
Improving school quality	9	11	10	10
Non-business loans for the poor	8	8	8	5
Equitable asset ownership	3	1	3	2
Unemployment insurance	2	3	2	4
Taxes on the rich	2	3	3	4

Source: Lembaga Survei Indonesia Inequality Perceptions Survey and World Bank calculations. See World Bank (2015c) for details.

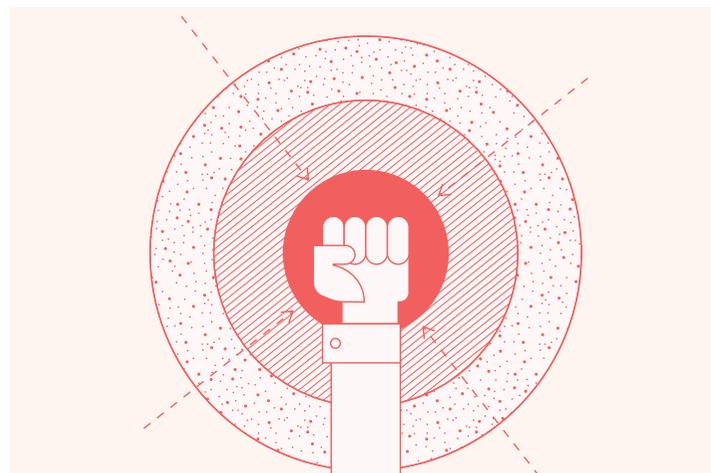
HOW TO EXPAND *the* MIDDLE CLASS:

Sectoral Diagnoses & Recommendations



10.1

Improving *the* quality of education



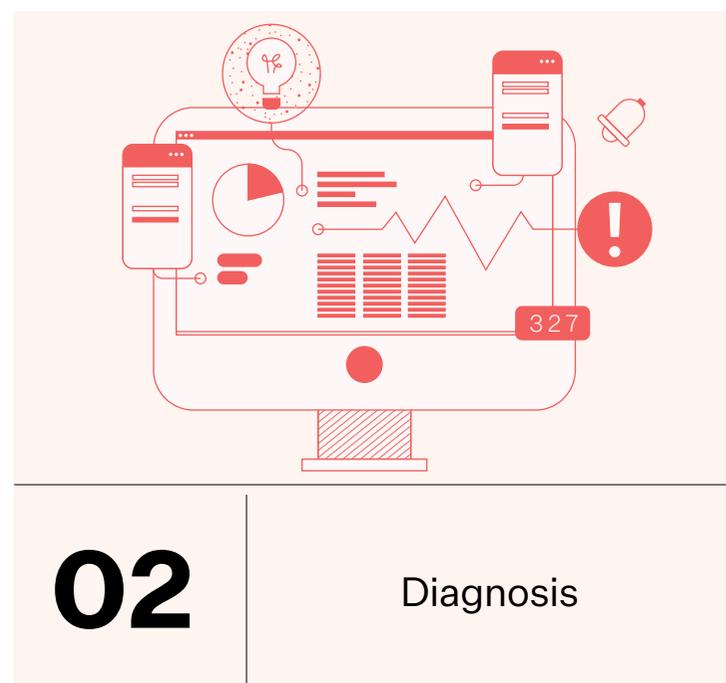
01

Motivation

Evidence of the importance of education in improving the wellbeing of individuals and helping to boost economic growth is overwhelming. Through education, individuals increase their productivity, earn higher wages in the labor market, and become more fully developed citizens better able to make a contribution to society, among other desirable outcomes. At the aggregate level, countries with higher levels of education post higher rates of economic growth over the long term. Nonetheless, for education to deliver on its promise, two elements are crucial: first, individuals must be able to enroll in the education system and, second, once in the education system, students need to acquire the necessary cognitive and socioemotional skills to allow them to join the labor force and make their full contribution.

Over the past 15 years, Indonesia has launched several major reforms to improve the educational outcomes of its population, aiming to increase school attendance and the quality of learning. In 2002, Indonesia amended its Constitution to make it mandatory for all Indonesian children to follow elementary education and requiring the government to fund this by allocating 20 percent of the budget to education. Following this constitutional amendment, two important laws were enacted, namely Law No. 20/2003 on National Education and Law No. 14/2005 on Teachers and Lecturers, to improve access and quality of education to all Indonesians. In addition, two major programs were launched by the government to reduce the financial constraints limiting the access of aspiring middle-class Indonesians to the education system: starting in 2005, the *Bantuan Operasional Sekolah* (BOS) program, which provides schools with resources on a per-capita basis and reduces the need of schools to charge fees and, starting in 2009, the *Program Indonesia Pintar* (PIP), which provides financial support to students from low-income families to help cover the costs related to participating in school, such as transport, uniforms and books, were implemented.

Indonesia has made important progress in enabling aspiring middle-class Indonesians to access the education system, successfully closing enrolment gaps. Total enrolment expanded by about 25 per-



02

Diagnosis

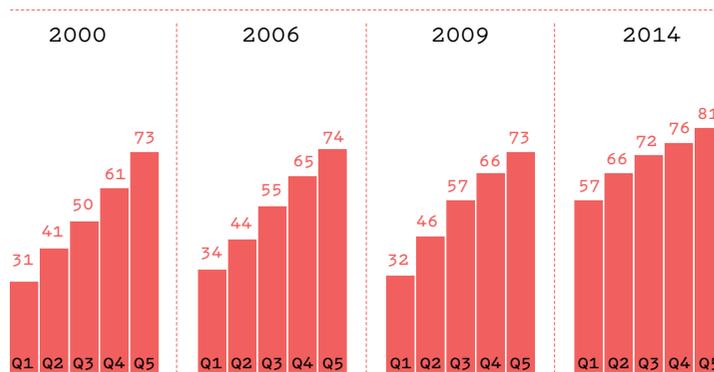
cent between 2001 and 2015, from 43.3 million to 53.3 million students, mostly at the lower- and upper-secondary education level. As a result, educational attainment of students grew from an average 6.8 years of schooling in 2000 to 11.0 years of schooling in 2017. However, student learning outcomes are lagging and still low by international and national standards. While learning outcomes have seen a modest improvement in recent years, nonetheless, at the current rate of progress, it will take Indonesia 48 years to reach the OECD average level in mathematics and 78 years to reach the average OECD rate in reading (although the OECD average level can be expected to improve in the interim). On average, most of the youngest cohorts of Indonesian students now finish upper-secondary education. However, once this level of educational attainment is adjusted to take into account Indonesia's low education quality, these students' learning outcomes are only equivalent to completing lower-secondary education.

For education to deliver its full promise to Indonesian students, especially those in the aspiring middle class, the necessary and successful expansion of enrolment must also be accompanied by improvements in student learning outcomes. Unless schools succeed in delivering significant improvements in student cognitive and socioemotional skills, they will be failing to serve their purpose. Improvements in student learning outcomes are linked to many elements, the most important of which is teaching quality.

Between 2001 and 2015, Indonesia's education system expanded rapidly. In 2001, total enrolment was 43.3 million students, comprising 29 million and 14 million in primary and secondary education, respectively. By 2015, while enrolment in primary education remained relatively static at about 29 million students, there was a significant expansion in secondary education to 24 million students, giving a total of 53 million students in all—a 22.4 percent increase over 15 years.

Improvements in access to education have been focused on the poorer segments of the population. Between 2000 and 2014, enrolment of 16- to 18-year-olds increased for all socioeconomic groups, growing on average by between 50 and 73 percent. Students in the lowest quintile saw the largest increase in enrolment, almost doubling their participation from 30 to 57 percent in the period. Meanwhile, student enrolment in the wealthiest quintile rose from 73 to 81 percent. As a consequence, the gap in enrolment between the poorest and wealthiest quintiles decreased from 43 to 24 percent over the same period—an impressive and important achievement.

FIGURE 10.1 School enrolment rate of population aged 16-18 years old by family expenditure group, 2000-14



Source: Susenas, several years.

In the context of the rapid expansion of educational attainment, Indonesia increased its PISA math score between 2003 and 2015 by about 25 points, equivalent to almost one year of learning. This is an important achievement, as countries often experience a decrease in learning scores as access to education increases. Among the PISA 2003 and 2015 participants, Indonesia registered the second-largest increase in enrolment of 15-year-olds. Moreover, Indonesia is the only PISA participant country in the 2003 and 2015 PISA tests to see an increase in enrolment for students from the poorest households.

The improvements in PISA scores differ markedly depending on socioeconomic group. For math and reading, there are significant differences in the evolution of the wealthiest four deciles compared with those in the poorest four deciles.

These unequal results in student learning outcomes linked to socioeconomic status indicate that, despite equal access to the education system,

Indonesian students do not have equal access to learning opportunities. Comparison of the characteristics of schools attended by poorer and wealthier students in Indonesia (proxied by the number of students who are eligible for PIP attending a school) shows important differences in the quality of service delivery. In basic education, although poorer and wealthier students have teachers with similar qualifications in terms of a bachelor's degree (S1), poorer students enjoy a lower share of classrooms that are in good condition (19 vs. 36 percent) and their schools are less likely to be accredited (13 vs. 35 percent). These differences across socioeconomic groups increase as students reach upper-secondary education: the share of classrooms in good condition is 31 vs. 52 percent, respectively, while accreditation is 14 vs. 55 percent, respectively. Schools attended by poorer students tend to be smaller, probably reflecting the geographic location of the school, making it more challenging to have larger class sizes. Likely reflecting the former, student-teacher ratios tend to be lower in schools attended by poorer students.

FIGURE 10.2 Evolution of PISA math scores and student enrolment, 2003-15

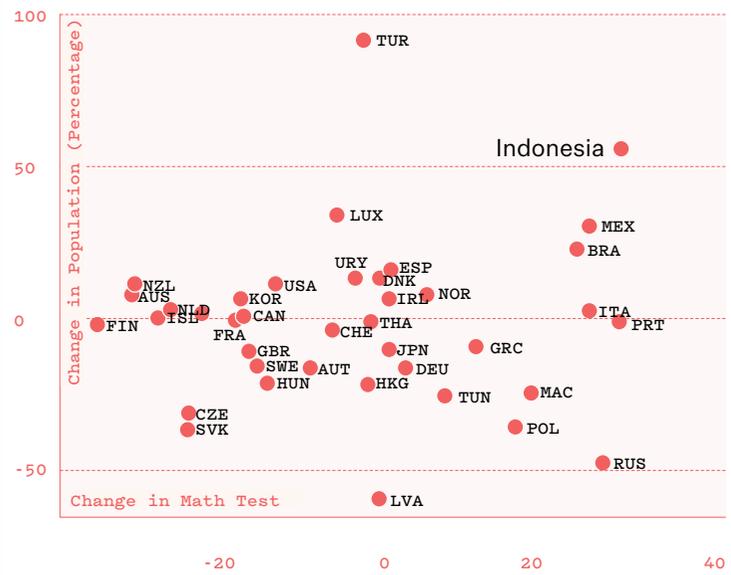
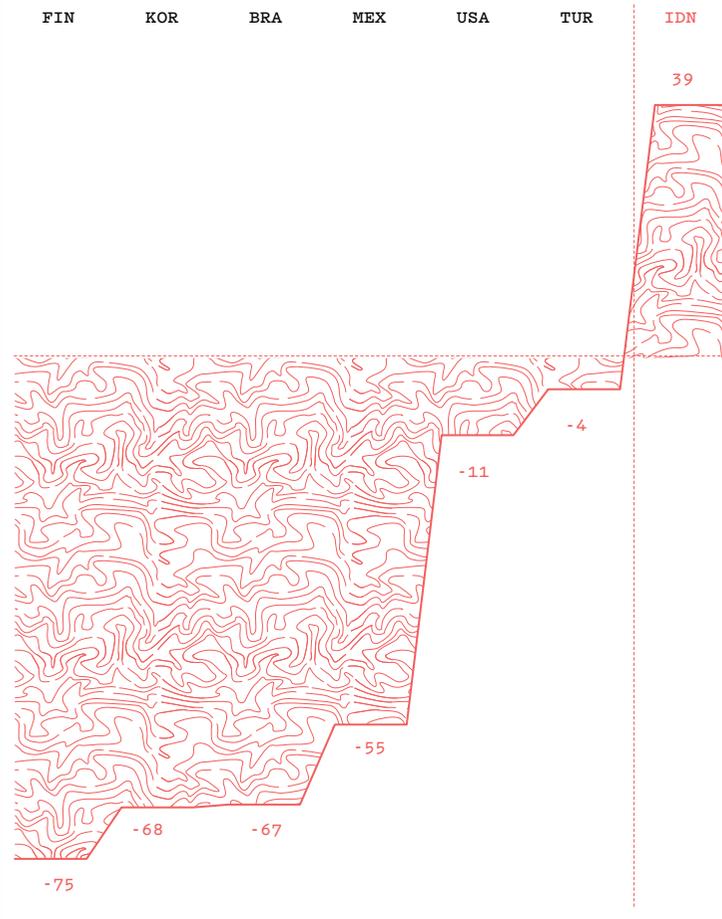


FIGURE 10.3 Evolution of enrolment among the poorest decile across selected PISA countries, 2003-15



Source: www.pisa.oecd.org

FIGURE 10.4

Math PISA scores by socioeconomic decile

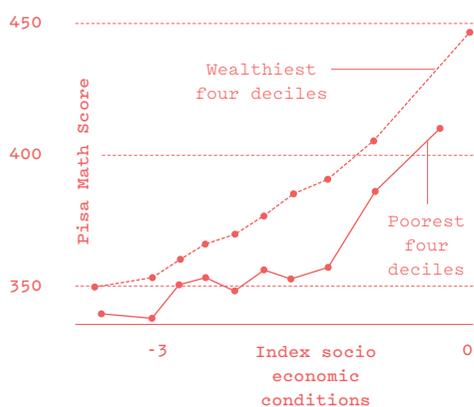
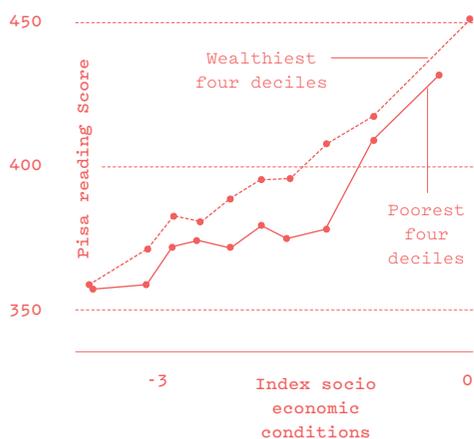


FIGURE 10.5

Reading PISA scores by socioeconomic decile

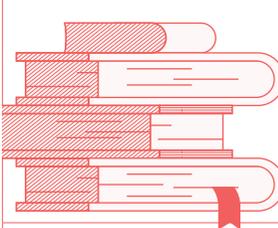


In the context of the rapid expansion of educational attainment, Indonesia increased its PISA math score between 2003 and 2015 by about 25 points, equivalent to almost one year of learning.

25 PTS

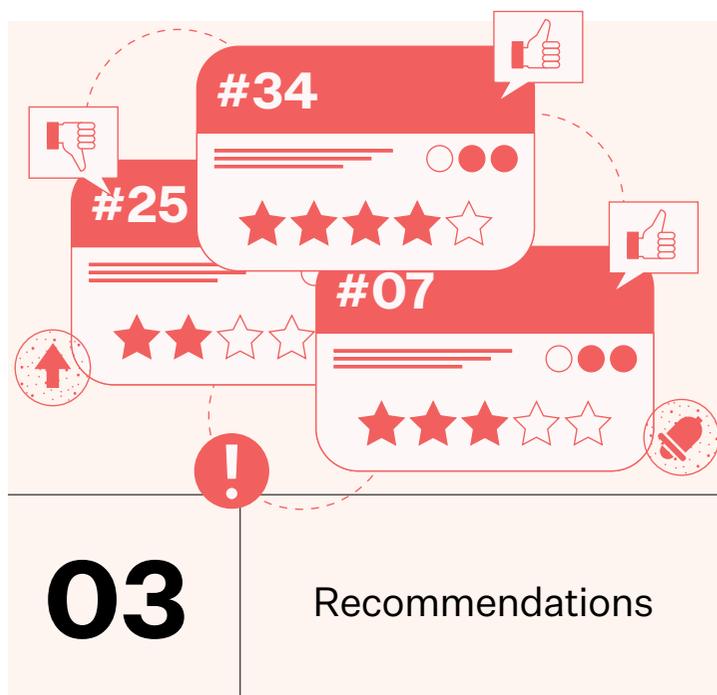
TABLE 10.1

School characteristics by socioeconomic conditions

	SD - SMP				SMA - SMK		
	Top quintile	Bottom quintile	Total		Top quintile	Bottom quintile	Total
 Size	277	124	191		499	183	368
Good classrooms (%)	36%	19%	25%		52%	31%	40%
Teachers with bachelor degree (%)	86%	84%	86%		94%	93%	94%
Student-teacher ratio	19	15	17		19	14	17
District size (students)	155,521	111,966	127,728		60,924	32,238	41,293
'A' accreditation (%)	35%	13%	21%		55%	14%	34%

Source: www.unesco.org

Source: Dapodik 2017.



Indonesia's education system has seen significant improvements over the past 15 years, mostly in expanding access to secondary education. However, for the education system to deliver its full promise to Indonesian students, especially those in the aspiring middle class, and fulfill the requirements of a growing and modernizing economy, major improvements in student learning outcomes will be essential.

As mandated by the Constitution, while the government now allocates 20 percent of its budget to education, there is evidence that the efficiency in the use of these resources is low.¹³³ The following recommendations would help to improve the overall efficiency of the education system and thereby help to provide better opportunities to all Indonesians, especially those in the aspiring middle class.

1

Improving the available information to allow for more comprehensive analysis and informed decision-making.

Better decision-making in the education sector requires better information on resources used in the sector and data on the results posted by students. The quality of data on spending (by levels of government, by education function and level, and by type of spending) should also be improved. Meanwhile, performance data, for example student results from the national test, should be socialized to local governments and then used subsequently to set education sector priorities.

2

Spending on teachers' salaries and allowances has risen sharply in recent years but this has not been associated with similar gains in learning outcomes.

Overall, teacher compensation, including teacher base salaries and special allowances, represents about 49 percent of the total education budget, but the relationship between teacher payments and student results is weak. It will therefore be important for the MoEC:

To update the existing Teacher Performance Management System to more directly link teachers' allowances (*DAK-Profesi Guru*) with competency achievements, continuous professional development (CPD) and classroom performance.

To commence a rigorous teacher re-certification process to ensure that certification is more directly linked to the achievement of key professional competencies, and that periodic re-certification becomes a condition for teachers to continue to receive professional allowances and opportunities for further career progression.

To provide greater support for teachers to benefit from CPD.

To leverage and explore the opportunities for the scaling-up of existing initiatives. For example, *KIAT Guru* is a promising initiative that promotes community empowerment and pay-for-performance. Another example is the Regional Performance Allowance (*Tunjangan Kinerja Daerah*, or TKD) for teachers in DKI Jakarta. This enables teachers to receive an extra allowance that has a fixed allocation (70 percent) that is affected by presence, and a variable allocation (30 percent) that is affected by job functions and related variables.

¹³³ World Bank (forthcoming). *Spending Better: Indonesia Public Expenditure Review 2016-18*.

3

Student-teacher ratios in Indonesia are too low, reducing the resources available for other quality-improving interventions.

The deployment of the teacher workforce should be maximized by redistributing teachers within districts, and also across districts and provinces. In order to do so:

Redistribute teachers across schools within districts. Districts should identify oversupply and undersupply of teachers in their areas of jurisdiction and create a redistribution plan.

Redistribute teachers across districts and provinces. Develop and implement a mechanism to enable such a redistribution to take place.

Standardize the recruitment process for non-permanent teachers. The MoEC and MenPAN should develop national guidelines for recruiting non-permanent teachers who can teach the main subjects and extracurricular activities. These guidelines should cover the selection process, selection criteria, payment (payroll, budget source), contract terms and other requirements.

4

Resources to schools should be distributed based on equity, need and performance.

Currently, the BOS program provides about Rp 40 trillion (roughly US\$3 billion) to schools, but most schools do not achieve their minimum services standards (MSS). Looking ahead, it will be important to link BOS allocations to equity, need and performance. One methodology used to achieve this has been applied by DKI Jakarta since 2015, based on a formula comprising three components (Pergub No.59/2016):

Basic allocation Based on the number of students.

Equity allocation Based on the school location/special needs.

Performance allocation Based on the improvement in results in the national exams.



5

Early childhood education and development (ECED) should be improved and expanded.

This will require the MoEC to increase the budget for ECED to allow for an expansion in the coverage and unit cost of BOP (School Operational Assistance Grants for ECED) based on Dapodik data linking the use of BOP to meeting national ECED standards.

Strengthening support to deliver quality early childhood education will involve the following:

National level	01	Issue MSS as a basis for districts to allocate and manage resources.
	02	Build district capacity to manage services based on ECED MSS.
District level	01	Establish ECED units in Dinas and provide funding for staffing support.
	02	Build the capacity of supervisors (Penilik PAUD) to conduct quality assurance visits to ECED centers.
	03	Support the provision of incentives and training for community teachers.

Leverage Dana Desa as an alternative funding source

Include ECED in the annual *Dana Desa* prioritization regulation (Ministerial Regulation No. 22/2016, as amended by Ministerial Regulation No. 4/2017) to support village planning to identify early childhood education centers as priority programs for investment from *Dana Desa*.

6

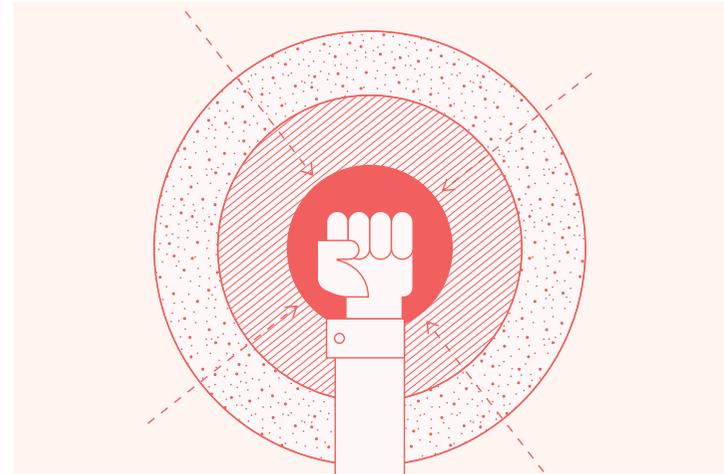
To ensure that all aspiring middle-class Indonesians that reach secondary education have the necessary conditions to learn, the mechanisms to guarantee education quality should be strengthened. In particular, school accreditation should be accelerated.

10.2

Indonesia is undergoing rapid demographic, epidemiological and health-financing transitions that have major implications for the government's ambitions of achieving universal health coverage (UHC), providing greater financial risk protection from health shocks, and promoting inclusive and sustainable economic growth.

Achieving universal health coverage

134 In general terms, the demographic transition is a shift from high levels of mortality and fertility to low levels of mortality and fertility in a population.



01

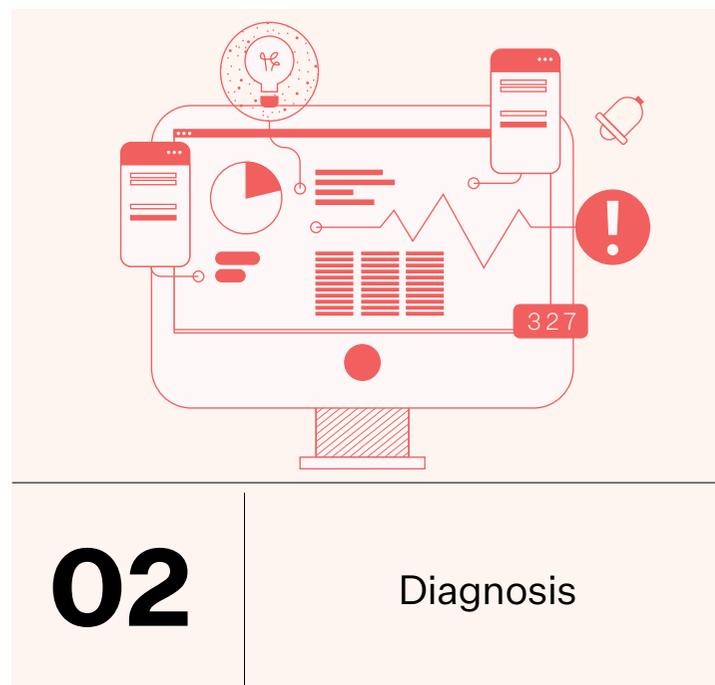
Motivation

Demographic transition¹³⁴

As the fourth-most-populous country in the world, and one that has yet to complete its demographic transition, Indonesia's human capital potential is substantial, with about 28 million new entrants expected to join the workforce between 2015 and 2030. In the “economic miracle” countries of East Asia in the period 1960-90, the demographic dividend—the period of economic growth driven primarily by the increase in the share of the working-age population—contributed between one-third and 44 percent of economic growth (Bloom & Williamson, 1998). However, these benefits are not automatic. They are dependent upon substantial investments in expanding the delivery of education and health-care services to produce a healthy, educated and productive workforce. A second important feature of the demographic transition is that Indonesia is also rapidly aging—with the share of population aged 65 years and older expected to double from 5 to 10 percent between 2015 and 2030 (United Nations, 2015). Attaining and sustaining UHC in the context of such rapid aging will also put pressure on public budgets trying to deepen coverage and transform a health-care system that is ill-equipped to deal with the long-term health-care needs of older patients.

Epidemiological transition

Non-communicable diseases (NCDs), including complicated co-morbidities, are now exploding among middle-aged Indonesians, due to unhealthy lifestyle choices and health systems that are underfinanced, and unprepared to diagnose, treat or adequately manage chronic conditions. Whereas in 1990 only 37 percent of morbidity and mortality in Indonesia was due to NCDs, they now account for the largest share of the burden of disease (67 percent in 2016), with strokes, heart disease, depression and diabetes among the most prevalent conditions. The 2016 Indonesia Quantitative Service Delivery Survey reported low service readiness for NCD services at primary health-care facilities, particularly for cardiovascular and chronic respiratory diseases. Only 5 percent of Puskesmas (public primary health-care facilities) and 3 percent of private primary health-care facilities met all cardiovascular



02

Diagnosis

disease service readiness tracers (guidelines and training, equipment and medicine), while for chronic respiratory diseases, only 1 percent of Puskesmas and not a single private primary health-care facility met all tracers. Estimates of lost GDP from NCD deaths, absenteeism and loss of productivity due to illness in Indonesia is expected to rise from US\$34.1 billion (4.8 percent of GDP) in 2010 to US\$113.6 billion (5.5 percent of GDP) in 2030 (Sweeney, Rasmussen, & Sheehan, 2015).

Health financing transition

In nearly all countries, growth in incomes is accompanied by growth in total health expenditure—particularly through pre-paid or pooled mechanisms—and a decrease in out-of-pocket (OOP) spending as a share of total health expenditure. This is usually accompanied by an increase in government health expenditures as a share of total health expenditures, and as a share of GDP. Meanwhile, access to development assistance falls as eligibility criteria are frequently tied to income thresholds. These two trends are sometimes referred to as the “health financing transition”. However, Indonesia has struggled to manage this transition smoothly and build health-care financing systems that provide UHC—that is, affordable access for all to quality health-care services. In 2014, it introduced *Jaminan Kesehatan Nasional* (JKN)—the single-payer social health insurance scheme providing a generous benefits package—and committed to fully rolling out UHC by 2019. However, despite rapidly expanding coverage to more than 70 percent of the population, OOP expenditures remain significant (Table 10.2). There are also wide variations in health outcomes across districts, especially in hard-to-reach areas.

Out-of-pocket health expenditures remain a dominant source of health financing because the generous benefits provided under JKN are unaligned with the level of resources available. In 2015, government health expenditure was 1.1 percent as a share of GDP and 5.7 percent as a share of government expenditure, amounting to just US\$38 per capita. This level of government spending on health is well below regional and lower middle-income country averages, with a recommended benchmark of US\$86 per capita needed for low and middle-income countries to be able to deliver a limited set of key health services (Table 10.2). This low level of health spending in Indonesia contributes to facilities often lacking trained staff, equipment, diagnostic capacity and the medicines needed to deliver basic services. This, along with an open-ended benefits package, has limited the expansion of cost-effective interventions with the universal health service coverage index—defined as the average coverage of tracer interventions for essential UHC—at just 49 percent (Figure 10.6).

TABLE 10.2 Health expenditure in Indonesia and selected countries, 2015

	Govt. health expenditure as % GDP	Govt. health expenditure as % of budget	Govt. health expenditure per capita (US\$)	Govt. health expenditure as % of THE	Social Health Insurance as % of THE	External financing as %THE	OOP expenditure as % of THE
China	3.1	10.4	234	55.8	12.2	0.0	32.0
Indonesia	1.1	5.7	38	37.8	15.2	1.1	47.0
Lao PDR	0.9	3.4	16	50.5	10.5	31.8	39.0
Malaysia	2.3	6.5	252	55.2	9.8	0.0	35.0
Philippines	1.6	10	46	34.3	11.7	1.4	54.0
Thailand	5.6	23.3	310	86.0	6.0	0.0	8.0
Vietnam	3.8	14.2	77	54.1	8.9	2.7	37.0
EAP	5.1	12.5	674	69.3	6.7	20.7	24.0
LMIC	3.3	10.1	81	54.4	7.6	14.4	38.0

Source: World Bank (2017). World Development Indicators.

Notes: THE=total health expenditure; OOP=out-of-pocket; EAP=East Asia Pacific; LMIC=Low and Middle Income Countries

Underinvestment in health is further compounded by weak governance and accountability, as well as JKN design issues that significantly undermine service delivery. Persistent regional inequalities in access to primary health care, poor quality of care at Puskesmas and private sector primary health-care facilities, and a ballooning *Badan Penyelenggara Jaminan Sosial* (BPJS) deficit—the JKN fund administrator—all find root in system-wide weaknesses in governance and accountability, as well as JKN design issues that handicap performance on the ground. In particular, these systemic weaknesses comprise the following:

01 Fragmented health information systems and the absence of a formal mechanism to coordinate and consolidate information on health resources, the cost and use of health services, and health outcomes across the tiers of government (i.e., central, provincial and district) and the various ministries, departments, and agencies (i.e., the Ministries of Health, Home Affairs, National Development Planning [Bappenas] and Finance, as well as BPJS Health) responsible for the delivery of health services. This fragmentation limits the ability of the Ministry of Health (MoH) to effectively oversee the sector as a whole and target limited resources to the interventions and populations that would benefit the most.

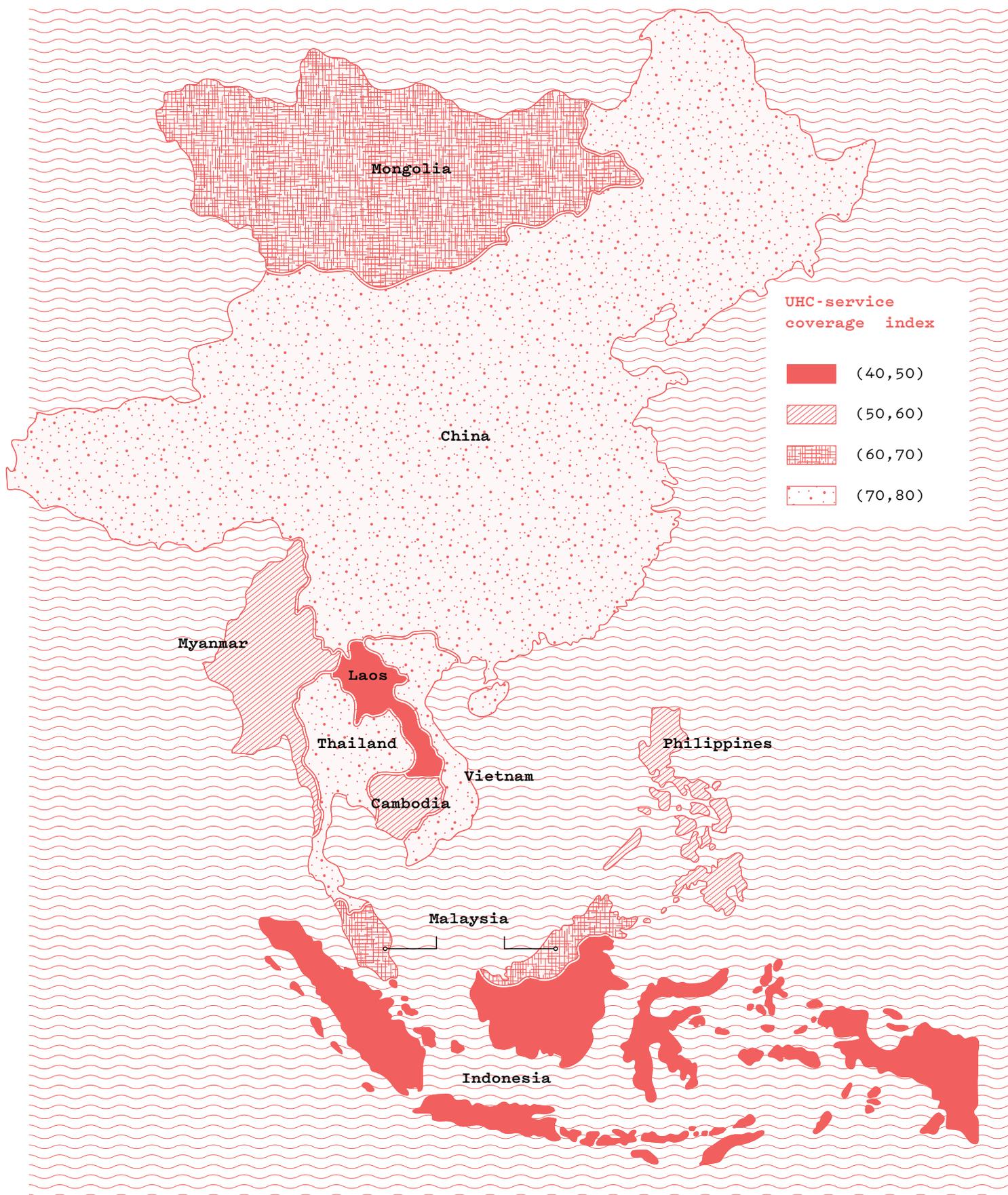
02 The lack of performance-orientation in health-care financing makes accountability difficult. On the supply side, *Dana Alokasi Khusus* (DAK)—the main supply side inter-governmental fiscal transfer that is earmarked for health—is linked partly to need but not performance, resulting in a wide variation in facilities’ ability to deliver services. On the demand side, the current provider payment arrangements and infrequent supervision under JKN give little incentive to increase the quantity and quality of care. In the absence of a strongly enforced or monitored ‘gatekeeping’ system, primary care providers have an incentive to refer patients unnecessarily to the hospital sector and under-deliver outreach services, avoiding expensive treatment that would come out of their fixed or ‘close-ended’ operating budgets. In a weakly monitored hospital sector, and a lack of a ‘close-ended’ hospital budget, hospitals are incentivized to both treat more patients as well as ‘up-code’ to charge codes that have higher payment rates and discharge patients early for later re-admission. This has important policy implications, not only because the cost of treating simple cases in hospital settings is significantly higher, but also because primary health-care services become under-utilized and tertiary hospitals overburdened, not to mention the avoidable disease progression in individuals due to a lack of early diagnosis and treatment at the primary care level.

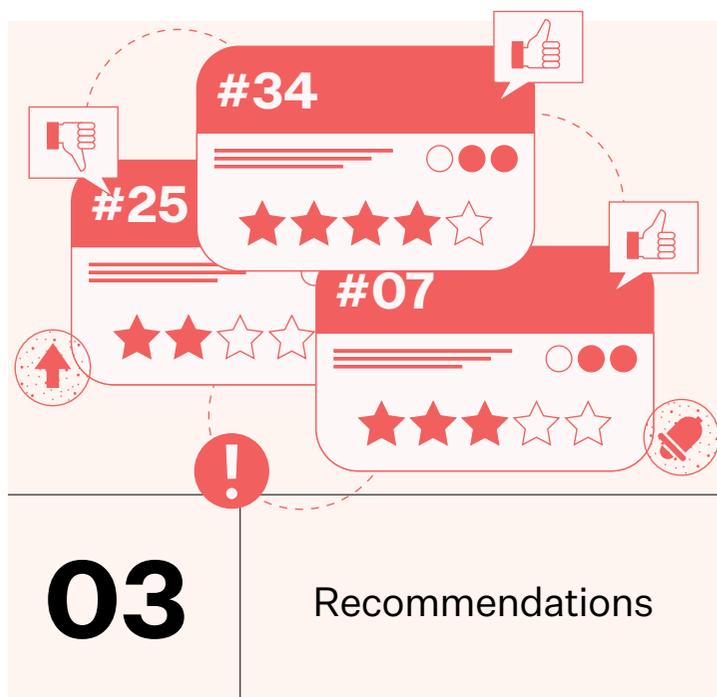
03 Poor coordination among key institutions also leads to the duplication of tasks and a lack of overall accountability for the sector. On the one hand, there are conflicting guidelines for service delivery, quality standards and referral protocols set separately by the MoH and BPJS. On the other hand, there is no clarity from either institution on who is responsible for monitoring and ensuring provider performance. As a result, health workers often find themselves without the means, skills and incentives to deliver health services to the population.

04 JKN design features hinder the quality of health expenditures. A comprehensive benefits package with no caps or co-payments, short waiting periods to access services following enrolment, low collectability of premiums among the informal sector, and provider payment rates that do not cover the full cost of services, have led to the implicit rationing of health services, adverse selection among the informal sector, and a growing budgetary deficit that threatens the financial sustainability of the JKN scheme.

FIGURE 10.6

Coverage of key cost-effective interventions





Achieving UHC, providing greater financial protection, and promoting inclusive economic growth will require not only that the government spends more on health but also spends it on the right interventions, and in a more effective way. The most impactful combination would be if it does this together, i.e., increase government spending on health in combination with health systems reform. In particular, this could be achieved through the following:

Right While access may be high, most local health centers struggle to provide basic care facilities.

1

Increasing and diversifying the sources of revenue for a sustainable and equitable system.

The government needs to increase government health expenditures to benchmark itself against countries of similar economic status, especially those that have progressed further along the path to achieving UHC. This would depend upon tax system reforms to raise tax revenue as a percentage of GDP and further prioritization of health in the overall budget. New revenue sources from increased taxation of tobacco and alcohol products, specifically earmarked for the health sector, should be pursued. While voluntary contributions to social health insurance (SHI) can provide a large and stable revenue base, the expansion path is slow and also dependent on the capacity to enforce contributions from the informal sector universal (Cotlear, Nagpal, Smith, Tandon, & Cortez, 2015). Typically, countries similar to Indonesia that have chosen a voluntary contributory path (as opposed to non-contributory tax-financed systems) have needed to supplement insurance contributions with tax-based financing that pays for poor and vulnerable groups, and heavily subsidize contributions from the informal sector.

2

Targeting limited resources to cost-effective health services and underserved populations, improving the quality of service delivery, and introducing integrated care.

Indonesia will need to focus its limited resources on targeting the most cost-effective interventions, such as preventive and promotive interventions delivered at the primary health-care level (promoting healthy behaviors, strengthening primary prevention, such as immunization, and early diagnosis, management and treatment of risk factors and diseases). In addition, there is a need to improve the quality of service delivery, both in public and private facilities. There is also an urgent need to strengthen the preparation and implementation of national procedures, guidelines and standards to reduce inappropriate or low-value care, prevent avoidable costly adverse effects, decrease operational waste, and improve clinical and managerial performance. The recently introduced primary care accreditation system is a first step in this direction. There is also a need to ensure equitable access to quality services across Indonesia, especially in the eastern islands of Indonesia. Finally, with the increased burden of chronic diseases such as NCDs, compared with the episodic care required for acute illnesses, this will also require transforming service delivery models that integrate and coordinate care across different care providers (such as hospitals, single specialty centers, diagnostic facilities and home-based care), while placing primary care in a central 'gate-keeping' role that connects all these various providers.



3

Improving JKN design and implementation to ensure fiscal sustainability of JKN and improve provider performance.

First, this will entail defining an explicit benefits package and target population that is commensurate with available resources, through a systematic and transparent process for prioritizing interventions. Second, it will also involve building government capacity to identify the incentives that encourage private sector engagement, while also ensuring public sector interests. Third, it will require designing provider payment systems that incentivize and reward performance. This will need to include inter-fiscal transfers from the national to subnational governments, for example through designing DAK *fisik* and DAK *non-fisik* to be more results-oriented. Fourth, strengthening the purchasing functions of BPJS, such as contracting (especially those that link the payment of individual providers or institutions to improved performance—coverage, quality of care, and efficiency), performance monitoring, the processing and payment of claims, and auditing, will be required. Finally, similar incentives that reward institutional and provider performance should be introduced in the DAK.

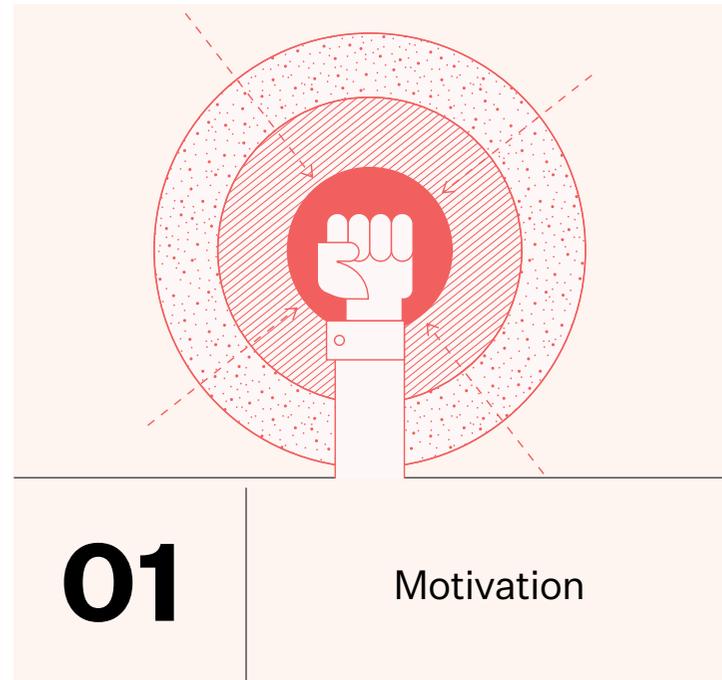
4

Investing in the institutions, systems and processes that hold the health-care system together.

This will include strengthening of the public sector management functions for health, including encouraging planning and budgeting that link inputs to outcomes, strengthening health management information systems that could be used to benchmark performance, and improving budget execution and other financial management functions, such as procurement, financial reporting, internal controls, and audits. There is also a need for better human resource management for the public sector, including improvement of managerial and clinical competencies and skills, as well as enabling a more equitable distribution of human resources for health.

10.3

Undertaking taxation reform



Indonesia's level of central government public expenditure is insufficient to build and serve a growing middle class. At 14.6 percent of GDP in 2017, central government spending is less than half the average of other emerging markets, which was 35.4 percent in 2016 (Figure 10.7).¹³⁵ Without increasing the level of spending and improving the quality of that spending, Indonesia will struggle to provide the services that are necessary to build and serve a growing middle class, namely health, education, housing and social insurance (Figure 10.8).

Tax reform will require the middle class to pay more taxes and this will need to be in exchange for wider access to better quality services. Tax reform will mean that the aspiring middle class and the middle class will be required to pay more taxes, but the premise of raising more revenues is to allow the government to spend more on priority services that will build and serve the growing middle class. To use Albert Hirschman's categories, two outcomes are possible: voice or exit.¹³⁶ If the middle class trusts the government to work for it, then it will *voice* its demands and agree to pay taxes in exchange for better-quality services. If the middle class distrusts the government, it will seek to *exit* from government services, and also taxation, at great cost to the large population segments of poor and those who aspire to join the middle class but who need good quality government services to do so. Indonesia can collect more and spend more and better in order to build trust in government and give a growing voice to its middle class.

¹³⁵ IMF Fiscal Monitor: October, International Monetary Fund. The average is calculated using 39 emerging markets excluding Indonesia. For more analysis on how Indonesia can spend more and better to support growth, see "Collecting more and spending better for inclusive growth," *Indonesia Economic Quarterly: Towards Inclusive Growth*, World Bank (March 2018)

¹³⁶ Albert O. Hirschman, *Exit, Voice and Loyalty: Responses to Decline in Firms, Organizations and States*, Harvard University Press (1972)

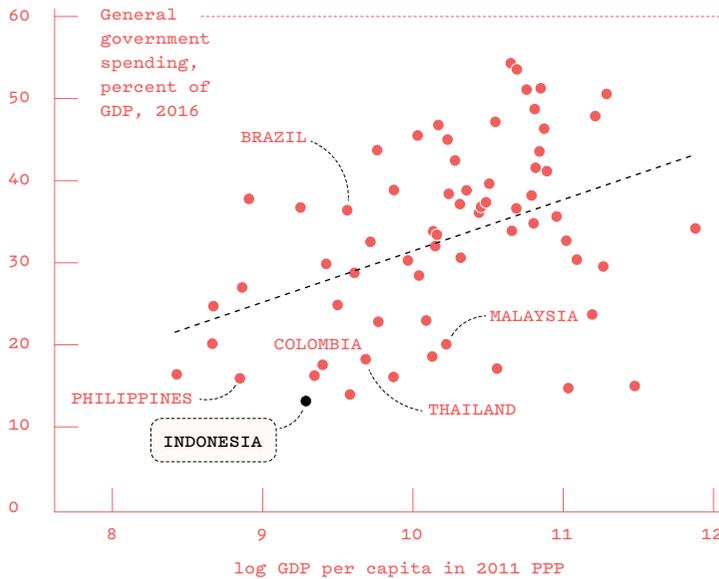
¹³⁷ IMF Fiscal Monitor: October, International Monetary Fund. The average is calculated in the same way as above.

¹³⁸ Total revenues fell by about 1.6 percentage points of GDP in 2014-15 due to the oil price collapse. For more, see Box 4, *Indonesia Economic Quarterly: Decentralization that delivers*, World Bank (December 2017).

¹³⁹ Prior to January 2014, this threshold was at Rp 600 million.

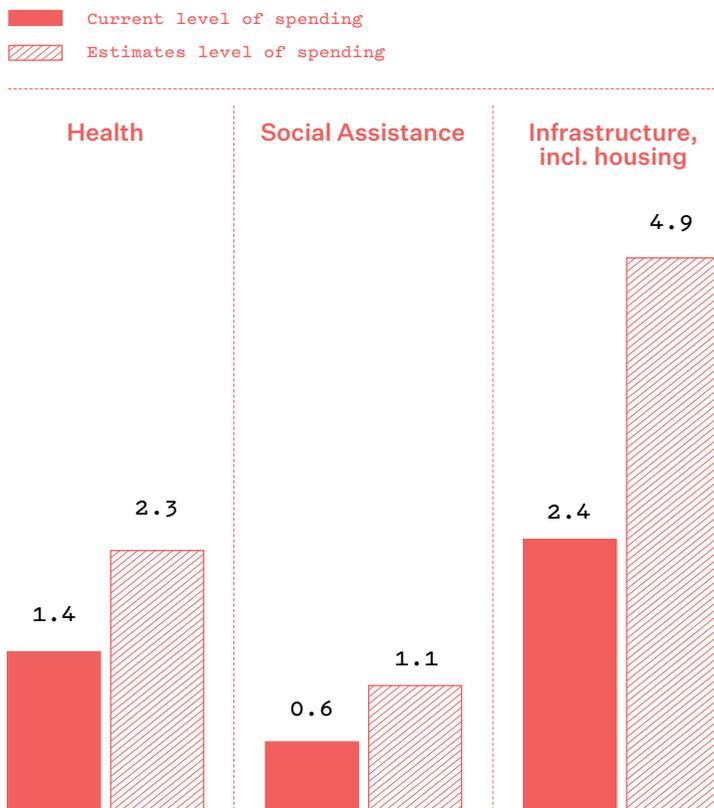
¹⁴⁰ For more, see "Policy Brief: The Economics of Tobacco Taxation and Employment in Indonesia," The World Bank (2018, forthcoming).

FIGURE 10.7 Indonesia's level of public expenditure is relatively low...

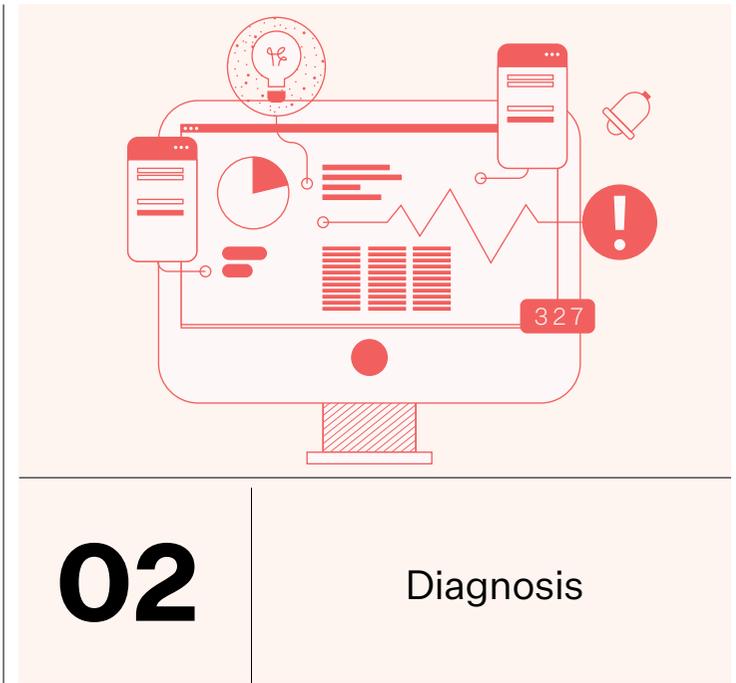


Source: Indonesia Economic Quarterly, World Bank (March 2018); Data from IMF Fiscal Monitor.

FIGURE 10.8 ...which means spending on priority areas does not meet government needs (Percent of GDP)



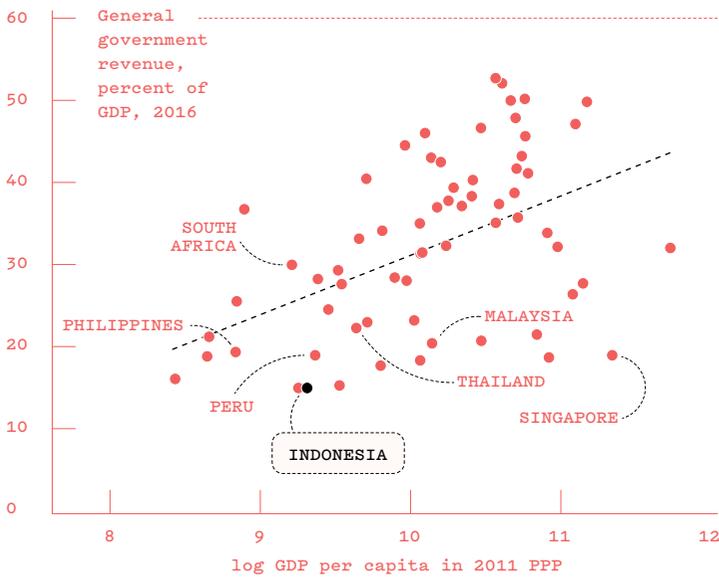
Source: Indonesia Economic Quarterly, World Bank (March 2018); Data from Ministry of Finance.



Insufficient spending is primarily due to low government revenues, which are driven by low tax collections. Although higher spending on areas that build and serve the middle class can be financed by reallocating expenditures from lower priority areas, notably subsidies, such reallocation will not be sufficient to meet the needs of a growing middle class. Indonesia will simply need to collect more. Indonesia's revenue-to-GDP ratio is low, at just 12.2 percent in 2017, compared with an emerging economy average of 27.8 percent¹³⁷ (Figure 10.9). Tax collections are lower than both regional peers and countries with similar levels of GDP per capita (Figure 10.10). Moreover, annual tax collections as a share of GDP have declined every year since 2013, reaching 9.9 percent in 2017 (according to preliminary realization data). The declines are partly due to cyclical factors, most notably the fall in commodity-related revenues after the oil price collapse in 2014.¹³⁸

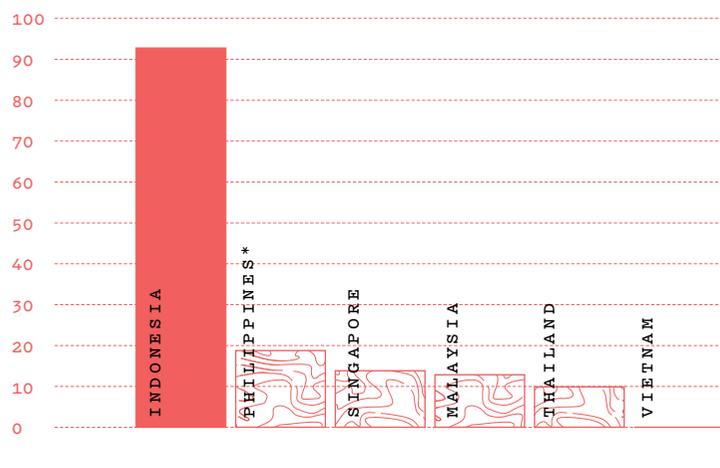
To increase revenue collections, Indonesia can collect more taxes on goods and services. Indonesia collects about the same share of GDP in VAT as Thailand and Malaysia, despite having a rate that is 30 and 40 percent higher, respectively. This is in part because too few firms have to pay VAT. According to government regulations, mandatory filing for the purposes of charging value-added tax (VAT) is only required for businesses with annual gross turnover in excess of Rp 4.8 billion.¹³⁹ For businesses with turnover below this threshold, registration and filing is voluntary. Compared with international standards, this threshold relative to real GDP per capita is the highest in the world (Figure 10.11). This high VAT threshold is combined with a policy of allowing many goods and services to be exempt from the VAT regime. Moreover, some goods and services consumed by Indonesians that have negative externalities on both health and the environment are taxed at lower rates than in many other countries. A stark example is tobacco, where Indonesians consume more cigarettes than in most countries in the world (Figure 10.12). While taxes on tobacco have increased incrementally in recent years, the current tax burden on tobacco is still lower than many countries and is insufficient to have any significant impact on consumption levels.¹⁴⁰

FIGURE 10.9 Indonesia suffers from low revenues



Source: Indonesia Economic Quarterly, World Bank (March 2018); Data from IMF Fiscal Monitor.

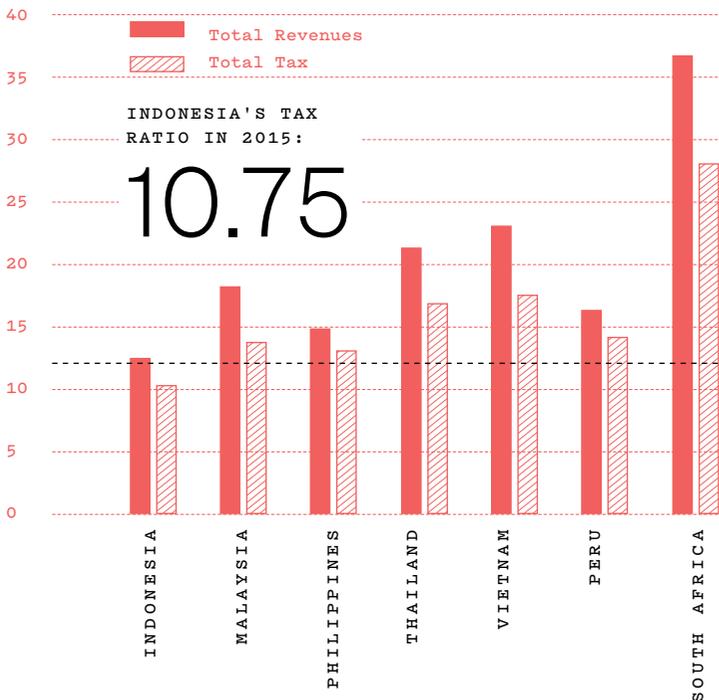
FIGURE 10.11 Indonesia's VAT registration threshold as a share of real per capita GDP is the highest in the world (VAT threshold as a share of GDP per capita)



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

Source: Indonesia Economic Quarterly, World Bank (March 2018); information on VAT thresholds from vatllive.com.

FIGURE 10.10 Tax collections are lower than both regional peers and countries with similar GDP per capital (Percent of GDP)



Notes: Data are for 2015. Total revenues include social security contributions. Total tax excludes social security contributions but includes taxes from resources.

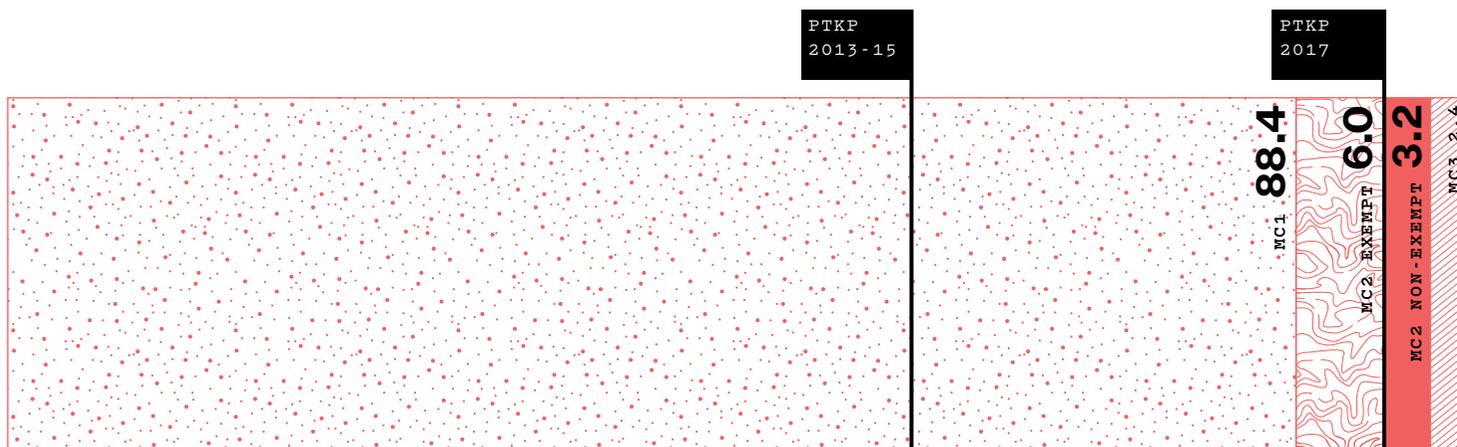
Source: ICTD GRD.

FIGURE 10.12 Indonesia has one of the highest cigarette consumption levels in the world, with the highest smoking prevalence for adult males

Country	Adult male smoking prevalence (%)
Indonesia	67% (68.1% in 2016)
Russian Federation	61%
Bangladesh	58%
China	53%
Greece	51%
Ukraine	50%
Philippines	49%
Turkey	48%
India	48%

Source: Table from "The Economics of Tobacco Taxation and Employment in Indonesia: Policy Implications A Technical Brief", World Bank (May 2018). Data sources used in table: Asma S, Mackay J, Song SY, Zhao L, Morton J, Palipudi KM, et al. 2015. The GATS Atlas. CDC Foundation, Atlanta, GA.

FIGURE 10.13 Most of the middle class is exempt from paying PIT...(Percent)



Notes: PTKP refers to the non-taxable income tax threshold. For 2017, this was set at Rp 54 million, whereas in 2015, it was Rp 24.3 million.

Source: World Bank staff calculations.

The government has an opportunity to collect more taxes and significantly broaden the personal income tax regime, which currently excludes about 98.8 percent of citizens. In 2015, the annual non-taxable income (PTKP) threshold for personal income tax (PIT) was Rp 24.3 million. This threshold implies that about 66.2 percent of the middle class were exempt from paying any PIT, although this threshold was increased by 48.1 percent YoY in 2016 to Rp 36.0 million, and by a further 50.0 percent YoY in 2017, to reach Rp 54.0 million. A high PTKP threshold narrows the tax base of the income tax regime. As a result, only about 15 percent of employed workers have an obligation to file income tax returns, compared with rates of 50 percent or higher in many advanced economies.¹⁴¹ For the middle class, the high PTKP threshold means that 94.4 percent of them are exempt from paying PIT: the entire AMC and MC 1, and 65.4 percent of MC 2 (Figure 10.13). This, in turn, is one factor behind the lower contribution of PIT to total income taxes in Indonesia relative to other countries (Figure 10.14).

Adding more taxpayers to the tax base will not only generate greater revenues but will also have the benefit of increasing accountability and the demand for services by the middle class, as more of those in the middle class start paying taxes. The link between taxes, increased accountability and better services is well-established in the academic literature.¹⁴² A conventional political-economy explanation is that tax-reliant governments are compelled to bargain with citizens, buying quasi-voluntary tax compliance in return for more accountable and democratic institutions, and/or policy concessions, such as increased services.

As the size of the middle class grows and as more middle-class citizens grow wealthier, so will their capacity to pay taxes. Expanding the tax base to include more of the MC and the AMC encourages citizens who will not contribute much tax revenue today to grow accustomed to, and develop a *habit* of, paying taxes. As these citizens grow wealthier in line with the continued growth of the Indonesian economy, so will their contributions to tax revenues in the future.

FIGURE 10.14 leading to low personal income tax revenues (Share of income taxes coming from taxes on income, profits and capital gains of individuals, percent)



Notes: The percent of income taxes coming from income, profits and capital gains of corporates is 100 percent, less the shares depicted in this chart.

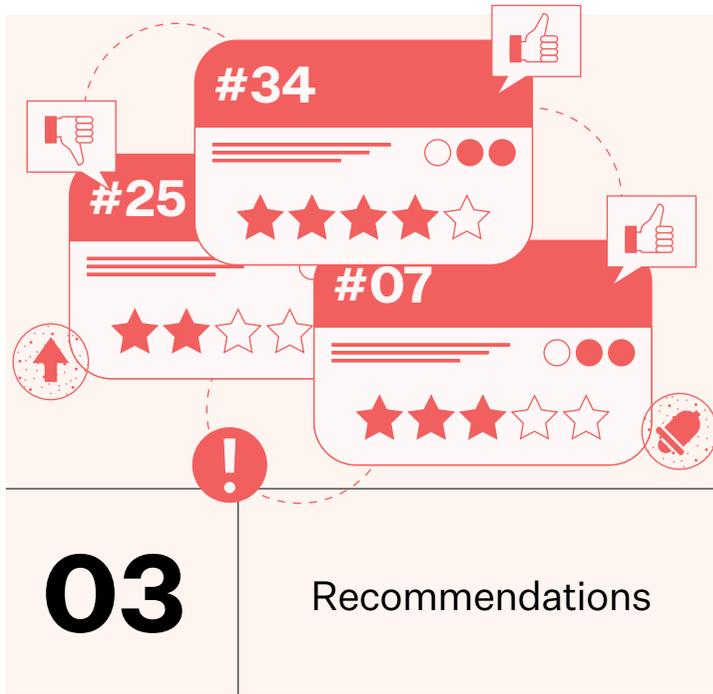
Source: OECD; World Bank staff analysis.

¹⁴¹ Data on the number of Indonesians with obligation to file come from the Directorate General of Taxes for 2016; data on the number of employed workers in 2016 come from the National Socio-Economic Survey (Susenas). In the UK, as one example of comparison, 56.2 percent of the adult population (that is, both workers and non-workers) paid tax in 2015-16. See "The changing

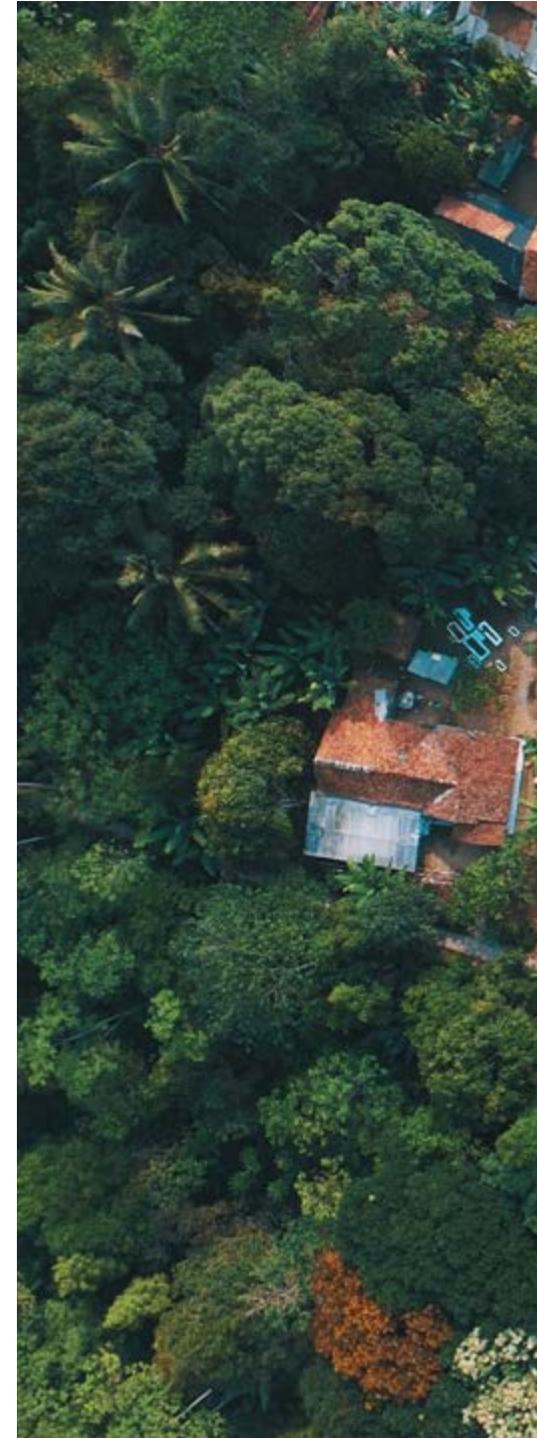
composition of UK tax revenues," Institute of Fiscal Studies Briefing Note BN182, 2016.

¹⁴² Notable work in this area includes: Douglass C. North and Barry R. Weingast, "Constitutions and Commitment: The Evolution of Institutions Governing Public Choice in Seventeenth-Century England," *The Journal of Economic History* (Vol. XLIX, No. 4, December

1989); and Richard A. Musgrave, "Schumpeter's crisis of the tax state: an essay in fiscal sociology," *Journal of Evolutionary Economics* (Vol. 2, Issue 2, June 1992). For more recent literature, see for example: Lucy Martin, "Taxation and Accountability: Experimental Evidence for Taxation's Effect on Citizen Behavior," *Yale University* (May 12, 2013).



Reform of the Indonesian tax system should focus on broadening the tax base and raising rates for select taxes. However, these policy reforms will also require significant investments in tax administration capacity. Plausible tax-broadening measures include lowering the VAT registration threshold and replacing the non-taxable income threshold (PTKP) with tax credits for taxpayers who are poor or vulnerable. Other needed tax policy reforms include increasing taxes on alcohol, tobacco and vehicles, and introducing more environmental taxes, such as on plastic bag consumption. The enabling factor for successful policy reforms will be improving the tax administration capacity of the Directorate General of Taxes (DGT) and facilitating a high degree of voluntary compliance.¹⁴³ Currently, DGT continues to rely heavily on paper filing due to limited IT capacity and staff expertise, while business processes for registration, filing and payment remain too complex. Moreover, current regulations require that all business requests for VAT refunds are audited, creating an undue burden on DGT and delays for businesses receiving back their VAT refunds.¹⁴⁴ To increase tax administration capacity, DGT requires significant investment in IT capacity, as well as reforms of human resources and business processes.¹⁴⁵ Moving to a risk-based approach for auditing VAT refunds is a critical component.¹⁴⁶ A major cultural shift at DGT will also be needed—one that entails treating taxpayers as consumers and setting targets on regular improvements in the ease with which citizens can pay their taxes.¹⁴⁷



¹⁴³ It is recommended that a comprehensive compliance improvement plan be designed that includes all these features. For more on this, see Russell (2010).

¹⁴⁴ For more on rules regarding VAT audits, see: 'Tax Audits and Tax Assessments' chapter

in "Indonesian Pocket Tax Book 2017" *PricewaterhouseCoopers* (2017) pp 91-97

¹⁴⁵ DGT's existing IT systems are out of date and much of the revenue administration remains reliant on paper. To address this, the government plans to procure a commercial off-the-shelf (COTS) IT

system, as part of a broader transformation of business processes and organizational reform.

¹⁴⁶ For more on this, see Khwaja, M. S., R. Awasthi and J. Loeprick. 2011, "Risk-Based Tax Audits: Approaches and Country Experiences," *The World Bank* (2011)

¹⁴⁷ Efforts to shift behavior of citizens through 'nudges' - small changes in how governments operate - will help, as evidence from other countries show. For more on the impact of behavioral initiatives on improving tax compliance, see Kettle, Hernandez, Ruda and Sanders (June 2016).

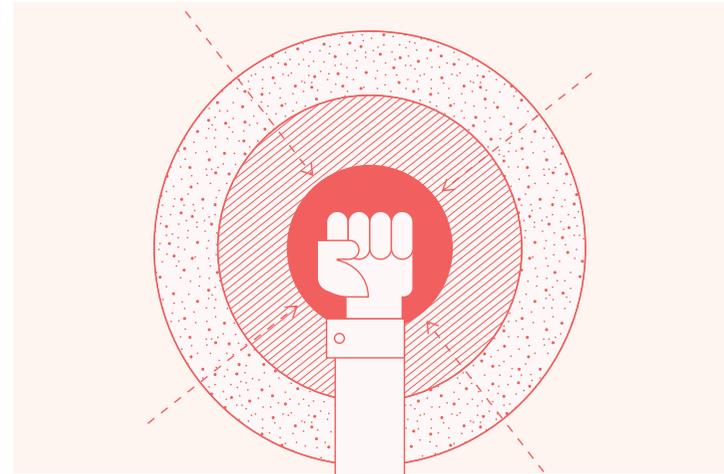


Above Regional governments are responsible for delivering many of the key public services that affect the quality of life of Indonesia's aspiring middle class, including health, education, and water and sanitation.

10.4

Strengthening regional government service delivery

Right Many local health facilities do not have the necessary equipment or training to provide basic care or key services, even in urban areas where most of the middle class live.

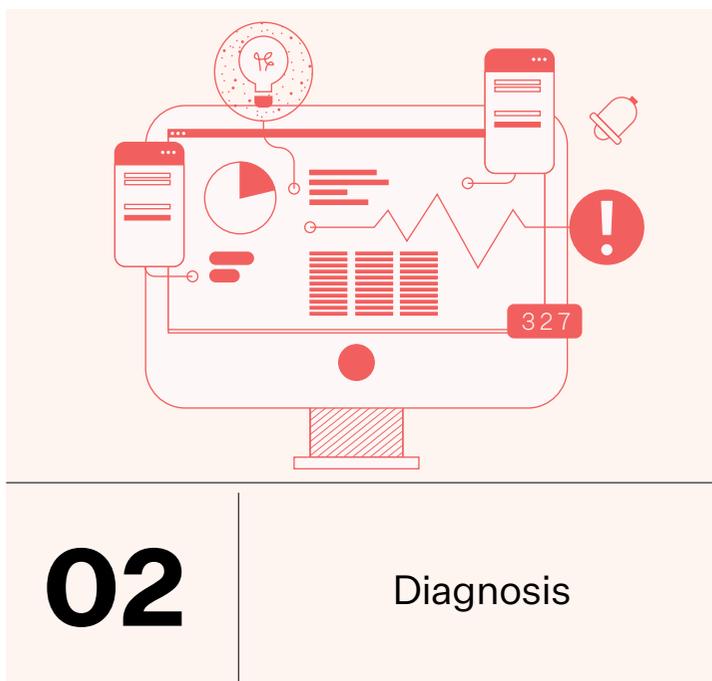


01

Motivation

Regional governments are responsible for delivering many of the key public services that affect the quality of life of Indonesia's aspiring middle class, including health, education, and water and sanitation. This is especially so in rapidly expanding urban areas, where those in the middle class and aspiring middle class are most likely to live. The quality of regional government service delivery, and the ability of regional governments to meet the changing needs of an aspiring middle class, depend in very large measure on central government policies. These policies are, in particular, related to the financing of subnational governments, the regulatory framework that enables and constrains them, and the incentive framework for encouraging better service delivery performance by regional governments.





02

Diagnosis

Rebalance the allocation of fiscal transfers to address growing needs in urban areas

The fiscal capacity of district governments to address service delivery can be measured by the per-capita revenues available to them from all sources to deliver services. In almost all countries, the per-capita fiscal need of different local government jurisdictions is affected by factors including the demand for public services, and the diseconomies of scale involved in delivering services in more remote and sparsely populated locations. The purpose of fiscal equalization arrangements is to ensure that different subnational jurisdictions are in a similar fiscal position—taking into account their different per-capita needs—to deliver a similar range and quality of public services to their citizens. However, the spread of per-capita total revenues across districts in Indonesia varies much more than is the case in other countries—even countries with highly variable per-capita needs across jurisdictions. To take an example, Australia has what is considered one of the most equalizing intergovernmental financing systems in the world, and the spread of per-capita revenues varies 2.5 times between Victoria—a geographically small, mainly urban state with a large population—and the Northern Territory—a very small population spread over a large and remote land area, and significant social needs among its population. By comparison, across Indonesia’s districts the spread of per-capita revenues is almost 40 times. Meanwhile, Nigeria—considered a highly unequal country—has a spread of 17 times, and Peru—an international outlier—is 21 times.

The main reason for these imbalances in Indonesia is the formula for the distribution of the *Dana Alokasi Umum* (DAU), the main equalizing intergovernmental transfer that is supposed to equalize these biases. The formula is based on an assumption that all districts have the same absolute needs to provide services to their citizens, regardless of the size of their populations. The effect of the formula is that total per-capita revenues are highly correlated with total district

population—districts with large populations have significantly lower revenues per-capita than districts with smaller populations.

The largest districts population-wise in Indonesia are the ‘dormitory *kabupaten*’—districts that are being absorbed into rapidly growing metropolitan cities. These districts are absorbing most of the population increase that rapid urbanization brings and they also have the largest infrastructure gaps. This is because they started with a relatively low stock of urban infrastructure when they were still rural areas, but now need to provide urban standard infrastructure to address the agglomeration effects of their rapidly expanding populations.

Addressing the imbalance in distribution of per-capita revenues will require fundamental changes to several formulae embedded in intergovernmental financing arrangements. The most important of these will be changing the DAU formula. This formula should be revised to remove the basic allocation—which funds the district governments’ wage bills and encourages fiscally unsustainable district hiring practices—and to shift to a ‘per client’ norm as the basis for equalization. Other formulas based on similar ‘per region’ norms include the formula for distributing the village fund (*Dana Desa*) and the formula for measuring the relative fiscal capacity of districts. These changes pose political-economy challenges because increasing the transfers of some districts axiomatically involves reducing transfers to other districts. These challenges need to be managed with a carefully designed transition strategy.

Ensure that institutional and financing mechanisms facilitate regional governments to address infrastructure gaps

Today’s Indonesia is a highly decentralized country, in which most urban infrastructure is the responsibility of regional governments. As Indonesia’s urban areas expand, infrastructure needs (roads, water,

sanitation and flood mitigation, in particular) become more complex, while connective infrastructure such as public transport becomes increasingly important. It falls to regional governments—and mainly to district governments—to address these challenges.

Three impediments undermine the capacity of Indonesia’s regional governments to respond adequately to address infrastructure gaps: (i) sustainable sources of financing for medium-sized infrastructure projects; (ii) mechanisms for cross-regional collaboration in service provision; and (iii) planning and asset management systems suitable for the needs of large cities.

01 Sustainable financing for medium-sized infrastructure

Around the world, the recurrent revenues of local governments are rarely sufficient to address the financing needs for medium-sized infrastructure. In most countries, city governments meet these needs by borrowing, allowing the costs of infrastructure provision to be spread over the lifetime of the asset. In the absence of sufficient access to debt, or if the infrastructure gap is too large, central government needs a more targeted financing mechanism to selectively finance medium-sized infrastructure projects.

Two factors limit access to borrowing by regional governments.

First, under Indonesia’s conservative subnational borrowing framework, subnational borrowing is limited to a low multiple of untied revenues. Low per-capita revenues not only hamper Indonesia’s regional governments from providing an adequate level of services, but they also compromise the ability of regional governments to borrow to finance medium-sized infrastructure projects that are more critical in urban settings. Second, annual total public-sector borrowing is limited to 3 percent of GDP, which is distributed between the three levels of government. Central government borrowing leaves little scope for regional governments to finance their infrastructure needs through additional borrowing.

In the absence of local debt as a source of financing for medium-sized infrastructure, central government will need to finance this infrastructure itself. One option is to finance projects directly from the central government’s budget through line ministries, transferring

the asset to regional government control after it has been constructed. This is the model that has been preferred up to now. This approach has the advantage of mobilizing central government line-ministry capacity to design and procure complex infrastructure, but it has very significant drawbacks in terms of sustainable management of the infrastructure. In the case of solid waste projects, for example, the lengthy delay in the transfer of assets to regional government control means that regional governments cannot properly finance the recurrent operational costs from their own budgets, resulting in expensive infrastructure lying unused.

A preferable approach is to gradually shift responsibility for implementing infrastructure projects to local responsibility, financed through large selective transfers. *Dana Alokasi Khusus* (DAK) has not proven to be a suitable vehicle for larger infrastructure provision, not least because of the limited mechanisms for holding regional governments properly accountable for how they implement projects. *Hibah*, which is designed as an output-based grant, provides more flexibility and accountability. At present, the incentives for line ministries to shift resources off their budgets and into the *hibah* mechanism are not well-aligned. The need for pre-financing by regional governments and the challenges of obtaining local parliamentary approval for pre-financing limits the take-up of *hibah* by local governments.

02 Mechanisms for cross-regional service provision

Since decentralization in 2001, a process of *pemakaran*, or district splitting, has resulted in the sub-division of districts from the original 348 to 514 districts in 2014. Meanwhile, the number of provinces expanded from 28 to 34. At the same time, urbanization is driving a process of agglomeration, where districts increasingly function as multi-district metropolitan areas. To achieve more efficient and effective service provision, it should be possible to provide larger infrastructure for purposes such as water treatment, sewerage treatment, solid waste treatment, flood mitigation and mass transport across multiple districts.

Although Law No. 23/2014 on Regional Autonomy authorizes cross-regional collaboration, it is not clear how this might be operationalized. Since all regional governments are financed on the as-

sumption that they have identical responsibilities, financing of cross-regional infrastructure provision is a particular concern. This could be addressed through arrangements that allow cross-charging of operating costs to those regional governments whose citizens receive the benefits of the infrastructure, or by improving tariff frameworks to allow some or all of the costs of infrastructure provision to be recovered directly from users through tariffs.

03 Public financial management systems suitable for implementing and managing complex assets

Cities have very specific needs in terms of public financial management (PFM) systems. Spatial planning to ensure orderly development is critical and helps to identify the need for investment in public infrastructure. Infrastructure in cities is usually larger, more complex and has a longer lifespan, which in turn means more complex multi-year planning for capital investments, multi-year project implementation, more complex procurement, and the need for multi-year asset management planning.

One-size-fits-all subnational PFM systems are not addressing these needs. Regulatory reform is needed, as well as developing the capacity of district (and city) governments to implement these more complex management systems. Capacity-building of third-tier governments in PFM is the responsibility of the provinces, which in turn raises issues about the capacity of provincial governments themselves.

Build systems to align regional incentives to improve, and robustly measure, district government performance

Managing across levels of government is a challenge for all multi-level governments.

The conventional approach to managing across levels of government is dominated by a top-down approach in which highly prescribed centrally-designed programs are specified in lengthy regulations and introduced to the level of implementing staff through cascaded socialization programs. This top-down compliance-oriented approach is no longer a good fit—either with the political design of decentralized government, or with the complex and increasingly heterogenous challenges of development across Indonesia's regions.

A more effective approach to managing across levels of government would be not only to hold district governments more accountable for the results they deliver, but also ensure that they have sufficient responsibility and flexibility to deliver those results. Achieving this transformation would involve six sets of reforms: (i) better defining district governments' expected performance

so they can be held accountable; (ii) streamlining the regulatory framework to enable rather than constrain them to deliver effectively; (iii) providing effective capacity-building to support them to improve their performance; (iv) providing rewards as incentives to improve; (v) increasing constructive interventions in cases of poor performance; and (vi) stimulating more effective functioning of political markets, in which citizens choose leaders in a robust contest based on full information, with more transparency focused on performance. Central to an improved focus on results (in place of upstream controls focused on inputs and compliance) is more robust ways of measuring performance.

01 Measuring performance

The focus of performance measurement in fiscal transfers is currently limited to performance in terms of inputs. These are measured in terms of the absorption of funds. However, performance should be more comprehensively defined and measured, not just in

terms of inputs but also in terms of processes, outputs and outcomes. District governments should be held accountable for results they control. Independent survey data provide the best source of credible data, but only through proxy indicators (for example, measures of enrolment may indicate how effectively education services are delivered but might also reflect the take-up of private education services). Ultimately, administrative data systems need to be improved, which will depend on higher standards of data governance and improved mechanisms for independent verification.

02 Reinforcing incentives through positive rewards

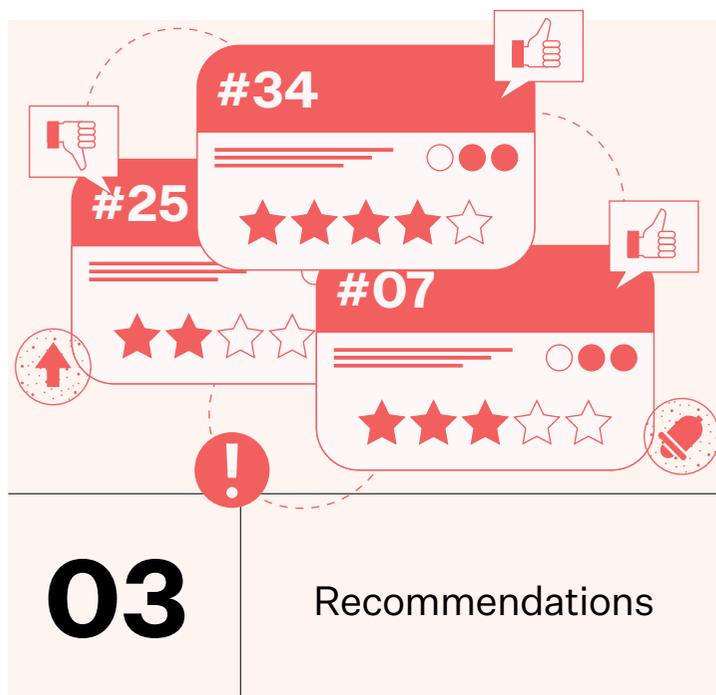
Fiscal transfers provide the most obvious mechanism for rewarding well-performing district governments, but not the only one. Matching-funding conditions stimulate local commitment and crowd in local funding. Output-based grants, such as *hibah*, pay on the basis of verified performance. The publication of comparative performance achievements offers incentives for improvement and also provides citizens with evidence of their leaders' effectiveness.

03 Responding to poor performance

While a great deal of information is now being collected on local government performance, it is less clear how this information is being used to drive better performance.

The Ministry of Home Affairs' performance measurement system (*Evaluasi Kinerja Penyelenggaraan Pemerintahan Daerah*, or EKPPD) allows action to be taken against local leaders who fail to perform, but this only focuses on elected leaders and not on specific sectors. As the World Development Report 2004 identifies, long-route accountability mechanisms (via electoral systems) should be complemented by short-route accountability that strengthens the clients' ability to hold service providers accountable.¹⁴⁸ In many countries, a range of graduated responses, including the imposition of a performance improvement plan (identifying areas of performance weakness, possible ways to improve, and monitorable actions by the local government to strengthen performance), is available to central government authorities, as a way to respond to poor performance.

¹⁴⁸ World Bank. 2003. *World Development Report 2004: Making services work for poor people - Overview (English)*. World Development Report. Washington, DC: World Bank Group. Page 49. <http://documents.worldbank.org/curated/en/527371468166770790/World-Development-Report-2004-Making-services-work-for-poor-people-Overview>



03

Recommendations

1

Rebalancing fiscal transfers

In the short term, this should involve: (i) revising the formula for fiscal capacity (which informs allocation of DAK and allocation of *hibah*) to one that uses a per-capita transfer norm; (ii) developing and disseminating advocacy materials on the impact of the current DAU formula on the equity of fiscal transfers; and increasing the proportion of the *Dana Desa* that is allocated on the basis of the formula. In the longer term, more challenging reforms might include: (i) revising Law No. 33/2014 to include a shift to a 'per-client' norm for the DAU formula; and (ii) incorporating into those revisions a more comprehensive approach toward transition that is better aligned with regional government incentives

2

Financing urban infrastructure

In the short term, this should involve: (i) reforming *hibah* as a more flexible instrument for selective financing of larger, multi-year infrastructure projects by regional governments, including better aligning *hibah* with the incentives of both central ministries and regional governments; (ii) developing a new government regulation to operationalize cross-regional service provision, including addressing the challenges of financing; (iii) building the capacity of provincial governments to supervise and support the development of subnational PFM capacity in larger urban areas; and (iv) introducing a PFM regulatory framework to address the asset planning and management challenges of larger cities. In the longer term, more challenging reforms might include: (i) addressing limits on subnational borrowing through a more equitable distribution of the annual limit on public sector borrowing; (ii) expanding the scope for cities to raise revenue, including through additional sources of revenue;

(iii) setting timelines in the next RPJMN for transition to full regional government implementation of larger urban infrastructure projects, including solid waste, wastewater treatment and mass transport; and (iv) revising and reforming subnational PFM arrangements to provide simpler, more streamlined approaches that are adapted to the different needs of large, medium and small district governments.

3

Incentive framework

In the short term, this should involve: (i) mandating the use of standard data sources and indicators, and building in verification to address the incentives to 'game' the data; (ii) establishing rewards and sanctions for districts' collection of accurate data, and using data to inform decision-making; (iii) rationalizing the reporting requirements by local governments to minimize the transaction burden and to ensure that data are not only useful but used; (iv) setting timelines in the next RPJMN for transition to full regional government implementation of larger urban infrastructure projects, including solid waste, wastewater treatment and mass transport; and (v) developing scope for greater results orientation in monitoring of DAK and Dana Desa. In the longer term, more challenging reforms might include: (i) developing a framework for subnational data governance to improve the management and dissemination of data on district service delivery that incorporates data quality assurance; and (ii) as part of the next RPJMN, developing a framework for managing across levels of government that includes supervision, support, capacity-building, and rewards and interventions to address poor performance.

Annex

A

Defining the Middle Class

B

The Indonesian Poverty, Vulnerability
and Economic Security Lines

Defining the Middle Class¹⁴⁹

ANNEX A

There Are Different Approaches to Defining the Middle Class

The size of the middle class, its characteristics and the roles it plays depends on how it is defined. There are many ways of thinking about the middle class, in terms of income, consumption patterns, occupational status, or even by using self-identification. Furthermore, there are different approaches to defining the middle class, namely the use of absolute income/consumption definitions, relative income/consumption definitions, behavioral-based definitions and vulnerability/economic security-based definitions. This section reviews each approach and proposes an income/consumption-based definition grounded in the concept of economic security.

In this section we consider four different approaches to defining the middle class:

- 1 Arbitrary: based on arbitrary income or consumption levels in absolute or relative terms.
- 2 Global Benchmark: measured by looking at the cross-country distribution of income or consumption, often with respect to developed country poverty lines.
- 3 Behavioral: based either on occupational status, or on household socioeconomic profile: consumption behavior, leisure activity, saving and investment, employment, asset ownership, housing status, education and health utilization, use of social media, and so forth.
- 4 Vulnerability: taking vulnerability as economic insecurity, the middle class as those who are safe from falling into poverty and vulnerability.

The rest of the section discusses the literature on each in more depth, and Table A.1.1 summarizes these approaches.

Defining the Middle Class in Absolute Income Terms

Absolute and relative definitions are often used when the middle class is defined in terms of its income or consumption. Much of the existing literature defines the middle class in absolute terms. This could be globally, across developing countries, or specific to a country. Kharas and Gertz (2010) provide an example of a globally defined and arbitrary middle class. They define “the global middle class as those households with daily expenditures between US\$10 and US\$100 per person in purchasing power parity terms” (p.3) and estimate the size of the middle class in 145 countries which account for 98 percent of global population. Using this definition, they estimate the world’s middle class as around 28 percent, with the poor and the rich at 70 percent and 2 percent respectively.

Other use global benchmarks to set absolute middle-class thresholds. As Kharas and Gertz (2010) do, Milanovic and Yitzhaki (2002) divided the world population into the rich, the middle class, and the poor. The middle class here is between US\$4,000 (Brazilian average income, or US\$11, which is also around the poverty line in the US and Germany) and US\$17,000 (Italy’s average income) in 2000 PPP terms. They estimate that 11 percent of the world is rich, 78 percent poor, and only 11 percent of people are ‘world middle class’.

The Asian Development Bank (ADB) sets middle-class thresholds for the developing East Asia region using both arbitrary and global benchmarks. The ADB (2010) defines the middle class as “those with per capita daily consumption of US\$2-20 in 2005 PPP US\$” (p5). Under this definition, in 2008, 56 percent of developing Asia’s population, or nearly 1.9 billion people, were considered to be part of the middle class.¹⁵⁰ Meanwhile, the poor, defined as those living under US\$2 per person per day represented 43 percent, and the high class, defined as those with per capita daily consumption more than US\$20 per day only represented 1 percent of the Developing Asian population. The ADB further divides the middle class into three different groups: the lower-middle class, who consume between US\$2 to US\$4 per day and are very vulnerable to slipping back into poverty; the middle-middle class (US\$4 to US\$10), who live above subsistence and have some disposable income; and the upper-middle class, who consume between US\$10 and US\$20 per day, or roughly the poverty lines of Brazil and Italy, respectively.

Ravallion (2010) proposes two middle-class definitions for developing countries, based on global benchmarks, examining 116 developing countries throughout the East Asia and Pacific, Eastern Europe, Central Asia, Latin America, the Caribbean, Middle East, North Africa, South Asia, and Sub-Saharan Africa. He broadly defines the middle class as those who are not poor by developing country standards (household per capita consumption above the median poverty line of 70 developing countries, or US\$2 a day at 2005 purchasing power parity) but still poor by developed country standards (below the US poverty line of US\$13 a day). Under this definition, Ravallion finds one in three people in developing countries was middle class in 1990, rising to one in two by 2005; most of the additional 1.2 billion people joining the middle class over this period came from Asia generally (four-fifths) and China in particular (half). Ravallion also adopts a narrower definition which increases the lower bound to US\$9, meaning a middle-class person would not be below the poverty line in any developing country. Under much

stricter definition, only 100 million of the 1.2 billion additional middle class broadly defined would still be considered newly middle class.

Banerjee and Duflo (2008) examine absolute measures across countries and associate them with relative measures in developing countries. They use two alternative absolute measures of the middle class, those with daily per-capita expenditures between US\$2 and US\$4 and those with daily per capita expenditures between US\$6 and US\$10. In all 13 of countries that they analyzed, “except for the rural parts of India, Pakistan, and Panama, the US\$2 to US\$4 per day category comprises between 23 and 40 percent of the population, and is primarily composed of those between the 20th and the 80th percentile of income” (p.5), while the US\$6 to US\$10 group is smaller in most countries, and “those belonging to this group are above the 80th percentile of incomes” (p.6).

Within Indonesia, management consultancies have defined the middle classes in absolute terms based on market size potential. BCG (2013) divides the population into seven categories, three of which are considered to be “middle”. The upper middle comprises those whose expenditure is between Rp 3 and Rp 5 million per month (around US\$600-1,000 adjusted for purchasing power), the middle between Rp 2 and Rp 3 million (US\$400-600), and the emerging middle between Rp 1.5 and 2 million (US\$300-400).¹⁵¹ In 2012, the combined total of the population of these three groups was approximately 109.2 million people. The richest four categories are called the Middle Class and Affluent Customer (MAC) group, which consists of middle, upper-middle, affluent, and elite consumers. They expect that the MAC population in Indonesia will increase from 74 million in 2012 to 141 million in 2020, driven mostly by the growth in the middle and upper-middle population. Meanwhile, McKinsey (2012) defines a ‘consuming class’ “with enough income to purchase not just basic necessities such as food and clothing but

also discretionary goods and services” (p27) as those with annual net income of more than US\$3,600 in 2005 PPP, having 45 million members in 2010, potentially rising to 135 million by 2030. This increase of 90 million would be the largest increase in the world outside of China and India. Moreover, they find “the global consuming class will increase by 1.8 billion in the next 15 years, of whom more than 75 percent are likely to be in Asia” (p.4).

Finally, an absolute threshold can also be based not on global poverty line benchmarks but grounded in the concept of economic security. The World Bank (2013) report on *Economic Mobility and the Rise of the Latin American Middle Class* sets an income threshold of PPP US\$10 per day as a lower-bound per capita household income, and an upper bound at PPP US\$50 for the middle class. Thus, “according to these thresholds, a family of four would be considered middle class if its annual household income ranged between US\$14,600 and US\$73,000” (p.2). The lower bound was set by examining panel data in selected Latin American countries and determining a household’s probability of being poor next period based on their income this period. The income level at which a household was safe from falling into poverty next period was averaged across countries to develop the US\$10 lower bound. The report then used self-perceptions of class membership in five countries (Brazil, Chile, Colombia, Mexico, and Peru) to validate this lower income threshold. Using this measure, the size of middle class in the countries studied increased by half between 2003 and 2009, from 103 million people to around 152 million, so that the middle class now accounts for around a third of the region’s population, around the same as the poor.

149 Taken from Wai-Poi et al. (2016).

150 Developing Asia includes: Armenia, Azerbaijan, Bangladesh, Cambodia, People’s Republic of China, Georgia, India, Indonesia, Kazakhstan, Kyrgyz Republic, Lao PDR, Malaysia, Mongolia, Nepal, Pakistan, Philippines, Sri Lanka, Tajikistan, Thailand, Turkmenistan, Uzbekistan, and Vietnam.

151 Expenditure includes: food, utilities, transportation, communication, and regular household supplies. Discretionary spending such as entertainment, restaurant dining, and similar categories are excluded.

Defining the Middle Class in Relative Terms

One set of relative approaches to defining the middle class is based on a fixed middle proportion of the distribution.

For example, Easterly (2001) defines the “middle class” as those lying between the 20th and 80th percentile on the income or consumption distribution. He then conducts a cross-country analysis on 175 countries to understand the impact of the total income share of the middle three quintiles on various dependent variables of interest.

Others have defined the middle class relative to the median income. Birdsall, Graham, and Pettinato (2000) define as those between 75 and 125 percent of median per capita income, focus-

ing on Latin America. The OECD (2011) defines ‘middle sectors’ “as households with income per capita between 50 percent and 150 percent of the national median” (p.11), meanwhile referring to “those with income below 50 percent of the median household as ‘disadvantaged’, and those with incomes higher than 150 percent of median income as ‘affluent’” (p.17). This definition, often used for the analysis of the middle class in OECD countries, was applied to 11 Latin American countries.¹⁵² They argue that this definition has “important advantages in terms of comparability and consistency across countries, and between the middle sectors and the relatively more disadvantaged and affluent groups of society” (p.17).

Absolute-Relative Hybrids

A hybrid definition combines absolute and relative definitions, which allows it to set a minimum global threshold, while at the same time consider differences in welfare across countries. Birdsall (2007) combines absolute and the relative approaches, by defining the middle class as those individuals who consume the equivalent of US\$10 or more per day, but who fall below the 90th percentile in the income distribution in their own country (she later revised this upper bound to be those who fall below the 95th

percentile in their own country (2010). She justifies the absolute and global lower bound on the basis that people with consumption below this level are too poor to be considered middle class in any society, while the relative and local upper bound is to exclude people who are considered rich in their own society. Among the countries studied, “only Russia, Mexico and Brazil have more than 25 million people in the middle class, urban China has not quite 20 million” (Table 7).¹⁵³

¹⁵² Uruguay, Mexico, Chile, Brazil, Peru, Costa Rica, Ecuador, Argentina, Columbia, Bolivia, Venezuela

¹⁵³ Countries studied are: Ghana, India (Rural and Urban), Indonesia (Rural and

Urban), Morocco, China (rural and urban), Thailand (rural and urban), Turkey (rural and urban), South Africa, Mexico, the Russian Federation, Honduras, Bolivia, Paraguay, Columbia, Ecuador, Brazil, Venezuela, Argentina, Chile, Sweden and

the United States.

¹⁵⁴ This chapter also uses the WVS data to look at opinions and values, but it constructs a more objective class category.

Defining the Middle Class in Terms of Its Behavior and Perceptions

Some studies looking at middle class values in emerging countries classify people based on self-perception of either status or position in the income distribution (PRC, 2008; Amoranto et al., 2010)., even though self-reported status may be a poor predictor of someone's income, education, or occupation. Amoranto et al. (2010) utilizes the World Values Survey (WVS) data to examine different perspectives on class status based on self-perceptions rather than income or expenditure measures.¹⁵⁴ In the countries they studied, 2 percent see themselves as coming from an upper class, 45 percent from the lower class and 53 percent from the middle class. They find that “there is generally a wide range of variation in what people consider middle class, but perceived class status is largely related to higher education, more skilled and stable jobs, and the ability to ‘save’, which are all characteristics of people with higher incomes” (p.1).

There are also some who define the middle class as those who exhibit certain behaviors. A concern with this approach is that it often makes it very difficult to objectively measure the middle class, as most of the analysis conducted using this approach often uses self-reporting mechanisms or subjective observations. Currently, there are no cross-country analysis that have been able to conclude what general behavior identifies the middle class.

Occupation is a key behavior used by some to define the middle class. Lawrence James

(2006), looking at Elizabethan England, defines the middle class as those who live by their wits rather than manual labor. In a more modern sense, Adelman and Morris (1967), were among the first scholars to highlight the importance of the middle class, specifically the indigenous middle class, and occupation. They define the middle class as those working in particular occupation as evident in the way in which they construct the indicator of the importance of the indigenous middle class. To construct this indicator, they divide countries into five categories. A country categorized as having a relatively important indigenous middle class is one with at least 20 percent of the active male population working in commercial banking, insurance, or in technical, professional, managerial, administrative, or clerical employments. Countries fulfilling this criterion but which are largely dominated by expatriates are excluded from this category.

Nonetheless, income and behavioral definitions do not necessarily result in very different people being identified as middle class. Despite adopting an absolute definition, some scholars such as Kharas and Gertz (2010) acknowledge that “the middle class is an ambiguous social classification, broadly reflecting the ability to lead a comfortable life” (p.2), and recognize that “the middle class usually enjoy stable housing, health care, educational opportunities (including college) for their children, reasonable retirement and job security, and discretionary income that can be spent on vacation and leisure pursuits” (p.2).

Defining the Middle Class in Indonesia and East Asia and Pacific: Economic Security

This report adopts an economic security-based definition of the middle class, as is done regionally for East Asia and the Pacific (World Bank, 2017). There are a number of advantages to defining the middle-class threshold as free from economic vulnerability. First, it is conceptually grounded in the notion of economic security, unlike arbitrary thresholds which have no basis. Second, what counts as economic security is developed in the East Asian regional context, rather than global benchmarks, which may be less relevant. Third, it allows behaviors and characteristics of the middle class to be explored empirically, rather than being pre-determined to define them, as behavioral definitions do. Fourth, the definition can be held constant in conceptual terms over time, allowing a line which increases over time with inflation and growth but can be compared consistently over time.

However, as countries become upper-middle-income and most of the population are economically secure or better, ‘middle class’ may come to be more of a relative notion. When countries are still lower income and most of the population are still poor, then the economically secure are among the richest. However, as a country becomes richer, the poorer end of the distribution may have become economically secure, but may not consider themselves middle class at all, as they aspire to the greater wealth they see at the richer end of the distribution. We examine this later in the case of Malaysia.

TABLE A.1.1

Summary of Middle-Class Definitions

Source	Original Range (all PPP are 2005)	US\$ PPP Range (2005) (daily per capita)	
Absolute definitions - Global			
Kharas and Gertz (2010)	US\$10-US\$100 PPP (daily)	US\$10-US\$100 PPP	
Milanovic and Yitzhaki (2002)	US\$4,000-US\$17,000 PPP (annual)	US\$11-US\$47 PPP	
Absolute definitions – Developing Countries			
ADB (2010)	US\$2-US\$20 PPP (daily) (1) Lower MC: US\$2-US\$4, (2) Middle MC: US\$4-US\$10 (3) Upper MC: US\$10-US\$20	US\$2-US\$20 PPP	
Ravallion (2010)	US\$2-US\$13 PPP (daily)	US\$2-US\$13 PPP	
Banerjee and Duflo (2008)	(1) US\$2-US\$4 PPP and (2) US\$6-US\$10 PPP (daily)	(1) US\$2-US\$4 PPP and (2) US\$6-US\$10 PPP	
Absolute definitions – Indonesia			
BCG (2013)	(1) Emerging MC: Rp 1.5-2 mil (2) MC: Rp 2-3 mil, (3) Upper MC: Rp 3-5 mil (monthly HH)	(1) Emerging MC US\$1.9-US\$2.5 (2) MC US\$2.5-US\$3.8 (3) Upper MC US\$3.8-US\$6.3 PPP*	
McKinsey (2012)	> US\$3,600 PPP (annual)	> US\$10 PPP	
Tempo (2012)	US\$2 - US\$20 PPP (daily)	US\$2 - US\$20 PPP	
Relative definitions			
Easterly (2001)	20 th -80 th percentile	N/A	
Birdsall et al. (2000)	0.75 to 1.25 times of the median per capita income	N/A	
Hybrid definition (Absolute + Relative definition)			
Birdsall (2007)	US\$ 10 per capita consumption - 90 th percentile in the income distribution	N/A	
World Bank (2013)	US\$10-US\$50 PPP (daily)	US\$10-US\$50 PPP	
Behavior Definitions (Middle class characteristics)			
Amoranto et al. (2010)	Self-reported perception of class status from the World Values Survey data.		
Adelman and Morris (1967)	Middle class as those working in commercial banking, insurance, or in technical, professional, managerial, administrative, or clerical employments.		
Kharas and Gertz (2010)	Use an absolute definition, but also acknowledge that “the middle class is an ambiguous social classification, broadly reflecting the ability to lead a comfortable life” (p.2) and recognize that “the middle class usually enjoy stable housing, health care, educational opportunities (including college) for their children, reasonable retirement and job security, and discretionary income that can be spent on vacation and leisure pursuits”.		

	Income/ Expenditure	Rationale
	Expenditure	Global benchmark: The lower band reflects the average poverty line in Portugal and Italy, while upper band is chosen as twice of median income of Luxemburg
	Income	Global benchmark: Range between the average annual income in Brazil and Italy in 2000 PPP. Brazilian average income (US\$11) is almost equal to the poverty line of US & Germany
	Expenditure	Semi-arbitrary: US\$4-US\$10 is living above subsistence and able to save and consume nonessential goods. US\$10-US\$20 is roughly poverty lines of Brazil and Italy, respectively
	Expenditure	Global benchmark: Range between the median poverty line (US\$2) from a sample of 70 developing countries to the US poverty line (US\$13) in 2005
	Expenditure	Semi-arbitrary: Based on their estimates of a lower and upper middle class from 13 developing countries. Those living on more than US\$2 have a base amount of consumption that can contribute economically to growth
	Expenditure excluding discretionary spending	Semi-arbitrary + Behavioral: Based on BCG consumption survey and middle-class definitions from precedent works
	Income	Arbitrary
	Income	Arbitrary
	Expenditure	Arbitrary in relative terms
	Income	Arbitrary in relative terms
	Expenditure & Income	Arbitrary: Exclude people who are too poor to be middle class in any society and some people who are, at least in their own society, "rich"
	Income	Regional benchmark: The lower band reflects the average economic security line in countries such as Argentina, Columbia, and Costa Rica, at which Latin American households have only a small probability of being poor next period based on this period's income, while the upper band separates the middle class from the top 2% of the Latin American population.

The Indonesian Poverty, Vulnerability & Economic Security Lines

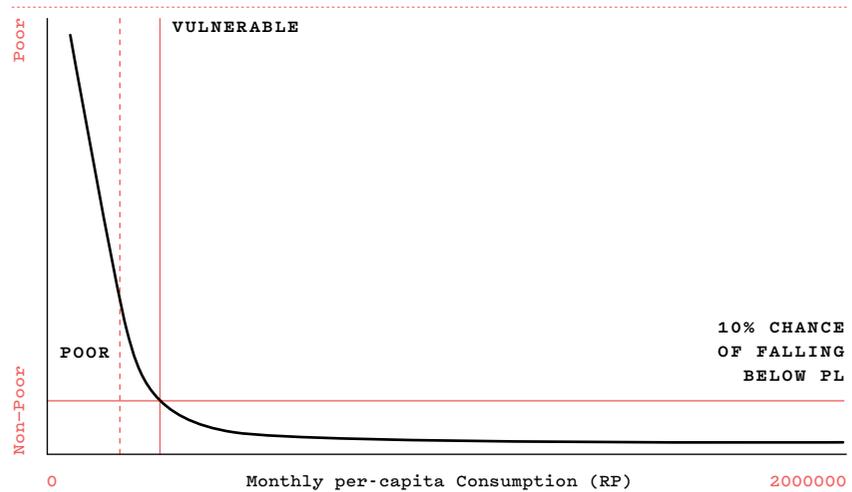
ANNEX B

Indonesia sets separate urban and rural poverty lines for each province. The national average in 2016 was Rp 355,000. Each poverty line is based on the cost in that location of obtaining 2,100 calories, based on prices and food types eaten by a reference group of the poor. A non-food component is included to cover basic non-food subsistence items such as health and housing.

The probability of falling into poverty is then used to set the vulnerability and economic security lines. Panel data track the same households for multiple periods. A probabilistic function can be estimated that represents the chance of a household falling below the poverty line next period based on their per capita consumption this period (following Lopez-Calva and Ortiz-Juarez, 2014). Our approach differs slightly in that we use a lowess smoothing method to estimate the probability curve, rather than the logistic regression used in Lopez-Calva and Ortiz-Juarez. The result is similar using either method. The first period consumption level which corresponds to a 10 percent chance of being poor next year is taken as the vulnerability line (Figure A.2.1), while the first period consumption level which corresponds to a 10 percent chance of being poor or vulnerable is taken as the economic security line (Figure A.2.2).

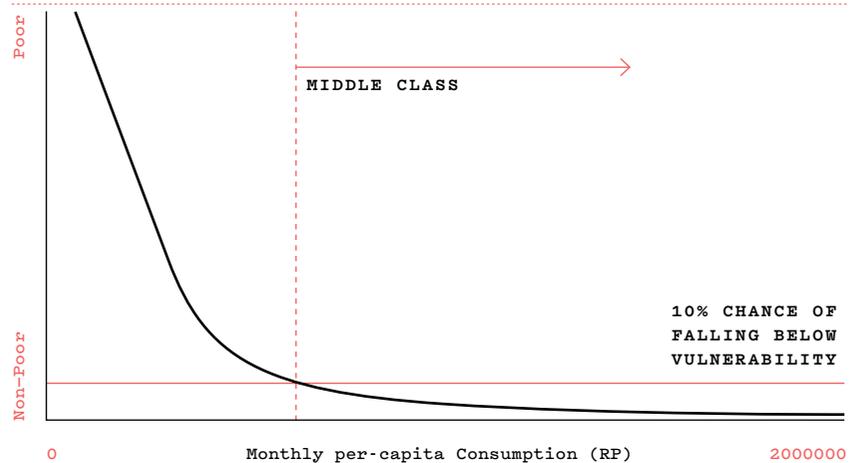
The Susenas 2008-10 panel data are used to determine a vulnerability line of Rp 530,000 in 2016 and an economic security line of Rp 1.2 million. The 2008-10 panel data indicated a greater than 10 percent chance of being poor next year if this year's consumption was below 1.5 times the poverty line (Rp 530,000). Similarly, households above the vulnerability line but below 3.5 times the poverty line (Rp 1.2 million) had a greater than 10 percent chance of being below the vulnerability line next year.

FIGURE A.2.1 Probability curve of being poor next year given this year's consumption



Source: Susenas 2008-10 Panel and World Bank calculations.

FIGURE A.2.2 Probability curve of being vulnerable next year given this year's consumption



Source: Susenas 2008-10 Panel and World Bank calculations.

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