INDONESIA ECONOMIC QUARTERLY

Redirecting spending

April 2012

THE WORLD BANK | BANK DUNIA

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Investing in Indonesia's Institutions

for Inclusive and Sustainable Development

Preface

The Indonesia Economic Quarterly reports on and synthesizes the past three months' key developments in Indonesia's economy. It places them in a longer-term and global context, and assesses the implications of these developments and other changes in policy for the outlook for Indonesia's economic and social welfare. Its coverage ranges from the macroeconomy to financial markets to indicators of human welfare and development. It is intended for a wide audience, including policy makers, business leaders, financial market participants, and the community of analysts and professionals engaged in Indonesia's evolving economy.

This Indonesia Economic Quarterly was prepared and compiled by the macro and fiscal policy cluster of the World Bank's Jakarta office, under the guidance of Lead Economist Shubham Chaudhuri and Senior Country Economist Enrique Blanco Armas. The team was led by Ashley Taylor and included Magda Adriani (commodity prices), Andrew Blackman (international environment, external sector and risks), Fitria Fitrani (external sector), Faya Hayati (prices and fuel subsidies), Ahya Ihsan (fiscal and 2011 Budget), David Stephan (real sector and risks) and Gonzalo Varela (external sector). Additional contributions were received from Neni Lestari (banking), The Fei Ming (corporate sector), Sandra Pranoto (Doing Business in Indonesia 2012), Jon Jellema and Rythia Afkar (Social Assistance), Dwi Endah Abriningrum (2011 Budget), Yuliya Makarova, Pedro Cerdan-Infantes and Yus Medina Pakpahan (Education), Anna I. Gueorguieva and Yulia Immajati (Gender). Arsianti, Yus Medina Pakpahan and Ashley Taylor shared the editing and production. Enrique Blanco Armas, Reena Badiani, Dini Sari Djalal, Juan Feng, Andrew Mason, Katherine Patrick, Hari Purnomo, Rubi Sagana and Djauhari Sitorus provided detailed comments and input. Farhana Asnap, Indra Irnawan, Jerry Kurniawan, Nugroho, Marcellinus Winata and Randy Salim organized the dissemination and Titi Ananto, Sylvia Njotomihardjo and Nina Herawati provided valuable administrative support.

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In order to be included on an email distribution list for this Quarterly series and related publications, please contact madriani@worldbank.org. For questions and comments relating to this publication, please contact ataylor2@worldbank.org.

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The near-term economic focus has shifted to the need to address the cost of Indonesia's fuel subsidies…

International developments continue to shape Indonesia's near-term economic outlook, but the focus of attention has shifted. In late 2011 the primary concern was the deteriorating and uncertain outlook for the global economy and financial markets. Since then there has been further evidence of the slowdown in global economic momentum but also some positive signs, such as from the US, and international financial market conditions have improved. The recent sharp rise in global oil prices has added a new dimension to the situation. In particular, it has increased the projected cost of Indonesia's fuel subsidies. With the benefits of these subsidies mainly going to the wealthier segments of the population, there is a clear need to redirect this spending to more pressing development needs.

…and Parliament has approved a revised 2012 Budget allowing for a fuel price adjustment if the oil price remains sufficiently high

Responding to the weakening external environment and higher oil price, the Government brought forward the submission of its draft revised 2012 Budget to Parliament to early March. The Government's proposal to increase the subsidized fuel price from April 2012 was a welcome move away from the quantitative restrictions in the original Budget. After much debate Parliament allowed the option of a fuel price increase of IDR 1,500 per liter to IDR 6,000 per liter subject to the condition that the average, over six months, of the Indonesian crude oil price is 15 percent above the Budget assumption of USD 105 per barrel (i.e. USD 120.8).

Without a fuel price adjustment and assuming oil prices of USD 120 per barrel, the World Bank estimates that the budget deficit could move up to just above 3 percent of GDP

The deficit in the proposed and approved revised 2012 Budget was 2.2 percent of GDP, up from 1.5 percent in the original Budget as a result primarily of higher energy subsidies. However, the World Bank estimates that if oil prices average USD 120 over the year, the deficit could rise to 3.1 percent of GDP if there is no subsidized fuel price adjustment or 2.5 percent of GDP if a fuel price rise is implemented in the third quarter of 2012.

From the perspective of fiscal sustainability a higher deficit is manageable given Indonesia's strong initial debt position. However, the risk of hitting Indonesia's three percent of GDP deficit limit may prompt a tightening in spending in key development areas. The greater uncertainty and complexity of the approach to fuel price adjustment also clouds the inflation and macro-policy outlook for investors. Furthermore, while recognizing the progress made on such a politically sensitive topic, the decision not to increase prices now represents a missed, or delayed, opportunity to redirect spending at a time when risks remain in the global environment.

A deterioration in global economic and financial developments also remains a key risk…

Previous risks persist, but are less prominent. The risk that financial market stresses originating from the Euro Zone spill over to Indonesia remains, given the exposure to foreign investors of the government bond and equity markets. Yet, global financial markets have regained ground on the back of the policy support measures taken in the Euro zone and the Greek restructuring deal. The Government of Indonesia has continued progress in strengthening crisis preparedness and management, potentially mitigating the domestic impact of any such shocks. Despite some buoyancy in the US, the momentum of the global economy has slowed over the past two quarters, and a sustained increase in oil prices poses risks to near-term global economic prospects.

…around the baseline scenario of a solid growth outlook for Indonesia

But Indonesia's economic fundamentals are solid; Fitch and Moody's recently moved Indonesia's credit rating back to investment grade, for the first time since the 1997/1998 crisis. Domestic growth came in at 6.5 percent in Q4 2011, and moved up on a seasonally-adjusted quarterly basis. The weaker international environment was reflected in the drag on growth from net exports, but domestic investment has held up well. FDI and the manufacturing sector have performed strongly over the past year. However, a number of restrictive changes to regulations regarding trade and foreign investment have been put in place or proposed, for example, relating to horticulture imports or affecting exports and investment in the mining sector. Although the policies may not have an immediate impact on growth and investment, they may have significant longer-term implications.

The baseline scenario for 2012 therefore remains for a moderation in export growth. This reflects a downward revision to Indonesia's major trading partner growth relative to the December 2011 *IEQ* but there is expected to be a continuation of support from domestic drivers of growth. A fuel price hike later in the year, and the resulting inflation, may take some edge off private consumption growth (and may also pose challenges for monetary policy). However, 2012 growth is forecast to remain robust, at 6.1 percent, and is projected to move back up to 6.4 percent in 2013 (Table 1).

Table 1: Growth of 6.1 percent is projected for 2012

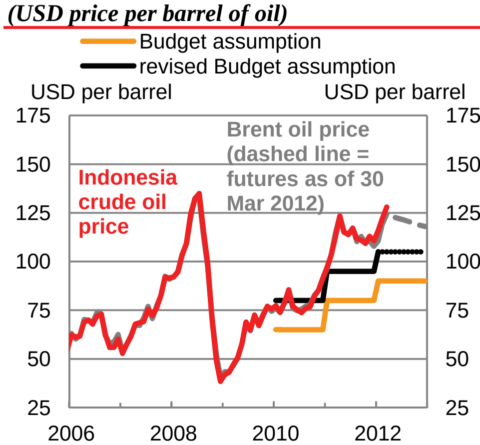
		2010	2011	2012	2013
Gross domestic product	(Annual percent change)	6.1	6.5	6.1	6.4
Consumer price index*	(Annual percent change)	6.3	4.1	8.5	5.4
Budget balance**	(Percent of GDP)	-0.6	-1.2	-2.2	n.a.
Major trading partner growth	(Annual percent change)	6.8	3.1	3.3	3.9

Note: World Bank projections for GDP and CPI assume an IDR 1,500 rise in the subsidized fuel price from Q3 2012. * Q4 on Q4 inflation rate. ** Government figures for Budget deficit - 2011 is preliminary figure and 2012 is revised Budget
Source: Ministry of Finance, BPS via CEIC, Consensus Forecasts Inc., and World Bank staff

Concern over the rising fiscal burden of energy subsidies reflects the recent sharp upward movement in international oil prices, but also the sustained rise in domestic fuel consumption, in line with Indonesia's rising domestic incomes

Supply disruptions and geo-political concerns have led to the sharp rise in international oil prices (Figure 1). The Indonesian crude oil price averaged USD 122 per barrel in the first three months of 2012. The Government's proposed revised Budget assumes a still conservative price of USD 105 per barrel. Based on the current profile of oil prices from futures contracts, and the price adjustment mechanism recently approved by Parliament, the baseline scenario of this report considers that the price of subsidized fuel is raised in Q3 2012.

Figure 1: Oil prices have moved well above the original Budget assumption
(USD price per barrel of oil)

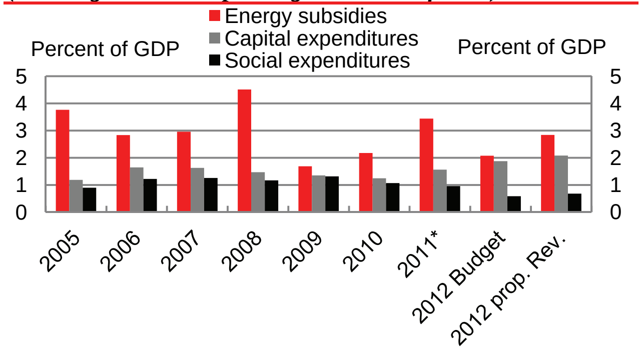


Source: EIA, ESDM, ICE, Ministry of Finance

As mentioned, a rising gap between the market price and subsidized price of fuel will inflate the fiscal burden of fuel subsidies. It is also important to note that the increased cost of fuel subsidies is in part driven by Indonesia's economic success. Fuel consumption has been rising with incomes. GDP per capita in 2010 was USD 3,000; one year later, it is USD 3,500. Vehicle ownership has boomed. In 2011 alone eight million motorbikes were sold in addition to almost 900,000 cars.

It is not only the fiscal cost of fuel subsidies that is a concern but also the opportunity cost of the spending…

Figure 2: Energy subsidy spending in recent years has significantly exceeded social and capital expenditures
(central government spending as a share of GDP)



Note: 2012 prop. Rev is proposed Revised Budget
Source: Ministry of Finance, CEIC and World Bank staff

As well as reducing fiscal risk, reducing fuel subsidies also represents a valuable opportunity to redirect government spending over the medium-term to more pressing development needs and to make this spending more efficient. For example, in 2011 Indonesia spent 3.4 percent of GDP on energy subsidies (2.2 percent on fuel and 1.2 percent on electricity subsidies), and only 1.6 percent and 1 percent of GDP on capital and social expenditures, respectively.

…along with the fact that most of the benefits of fuel subsidies go the wealthier segments of the population

Indonesia's subsidized fuel price is considerably cheaper than the price in most countries and disproportionately benefits richer households. A car owner using 50 liters per week receives around IDR 1,115,000 per month in benefits, ten times the IDR 111,000 per month received by a motorcycle owner using only 5 liters per week. A poor person without a motorbike or car would see very little direct benefit, although may benefit indirectly from lower transport costs. Indeed, according to the 2009 household survey, 40 percent of the direct benefits to households from gasoline subsidies go to the richest ten percent, and less than 1 percent to the bottom 10 percent. It is, however, important to give poorer households time to adjust to the higher prices following a hike in subsidized fuel prices, as recognized in the Government's proposed temporary cash transfer program.

Sustained efforts to remove other distortions to economic activity and improve the allocation and efficiency of government spending can help Indonesia reach its objectives of inclusive, and higher, growth…

Redirecting spending by reducing fuel subsidies is only the first step. To enable Indonesia to achieve its potential of sustained 7 percent-plus growth, while ensuring that the benefits of this growth are enjoyed by all, progress in improving the allocation and efficiency of government spending is crucial. Improvements in the business climate, and removing other economic distortions, can also help Indonesia reach these higher growth rates.

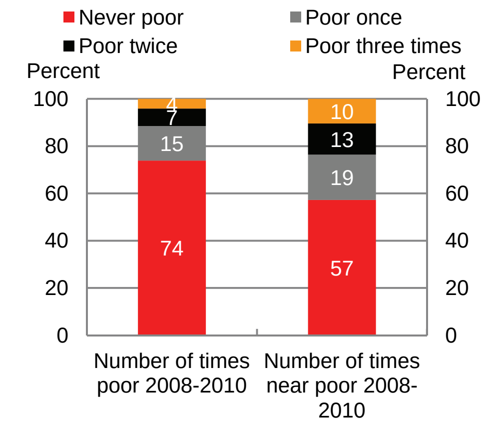
…through ensuring that the increased resources going towards education lead to the desired improvements in quality…

Education has received a substantial increase in its spending allocation, in line with the constitutional rule that the sector should receive a minimum of 20 percent of the total state expenditure. This spending, and reform efforts, have led to noted successes, such as higher enrollment rates. But there is more work to do. Access remains low for higher education and for secondary education in remote areas. Quality is a concern, and should be the next priority. Given the very low student-to-teacher ratio in Indonesia already, there is evidence that additional teachers are not associated with improved quality of education. Many reforms that could improve education quality would align spending with more prudent decision-making and more accountability, but would not increase costs. Other areas, such as expanding scholarships, require additional resources which could be freed from elsewhere. The key to this is improved teacher management and addressing the current strong incentives for hiring too many teachers. Important steps are being taken to fix these policies. Success will be essential if Indonesia is to take the next step forward towards a high quality education sector that provides competitive skills.

…through reforming and investing in integrated social assistance programs to ensure that they provide a true social safety net to the bottom 40 percent of the population that is at high risk of falling into poverty…

Policies for inclusive growth involve promoting equality of opportunity, such as through improving access and quality of education. But also vital are programs that help households escape impoverishment and protect the highly vulnerable. Indonesia's national poverty rate has fallen to 12.5 percent in 2011. This statistic masks a worrying degree of vulnerability: much of the population is clustered just above the poverty line. Nearly a quarter of Indonesians live below the official "near-poor" line (1.2 times poverty line expenditure); two-fifths live below 1.5 times the poverty line. Even relatively small shocks to vulnerable households can push them into poverty. In recent years, half of all poor households had moved into poverty that year, and were not poor the year before, while more than a quarter of all Indonesians have been in poverty at least once over 2008 to 2010 (Figure 3).

Figure 3: One quarter of Indonesians have been poor at least once in the past three years
(share of individuals by exposure to poverty, 2008-2010, percent)



Source: Susenas and World Bank staff calculations

Indonesia has the building blocks in place for a modern social welfare system. However, there is much room for improvement to ensure that these programs function as a true social safety net, so that the right benefits reach the right people at the right time. More effective spending through improving programs will be required, along with optimizing the mix of initiatives, integrating operations and access, and the scaling up of programs to protect more households from health risks, promote continuous education, and protect from adverse shocks. The cost of building the next generation of social safety assistance in Indonesia is manageable, requiring a rise in social assistance spending from 0.5 percent of GDP (2010) to roughly 1 percent of GDP, far less than the projected energy subsidy spending in 2012. Set against these costs, the benefits are sizeable. Not only can the poor be more effectively protected from shocks, but an effective social safety net can contribute to economic strength, to the benefit of the entire population, by promoting pro-poor investments in human capital and a healthy, educated, and productive workforce.

…through promoting gender equality, which is both an important objective in its own right and could also yield significant labor productivity gains …

Policies that contribute to gender quality can also play an important role in facilitating inclusive growth. There has been considerable progress toward gender equality in Indonesia, particularly in the area of education. However, persistent gender disparities remain elsewhere. Women still earn less than men in all sectors, and are more likely to work in the informal sector. Maternal mortality rates remain relatively high for Indonesia's income level, and as in other countries, women's voice in the public domain is weak. Gender equality is an important development objective in its own right; it is also smart economics. For example, a forthcoming East Asia and Pacific companion report to the World Bank's *World Development Report 2012*, finds that gender equality could lead to significant productivity growth in the region. It is estimated that if Indonesia were to allocate productive resources on the basis of people's skills and abilities, rather than by their gender, per worker productivity could increase by as much as 14 percent, with significant implications for growth and poverty reduction.

…and through supporting the development of the private sector by improving the regulatory environment

Improving the business climate for the private sector can also play an important role in raising growth levels, through stimulating investment and entrepreneurship. The recent *Doing Business in Indonesia 2012* survey of 20 cities across Indonesia illustrates the progress made in reducing red tape for local entrepreneurs. Yet, many challenges remain. However, there is scope for cities to learn from the best practices of other cities within Indonesia, some of which are already up to international standards, and internationally so as to help close the gap in performance between Indonesia and global leaders.

A. ECONOMIC AND FISCAL UPDATE

1. The global economic outlook remains fragile, oil prices have risen sharply

The outlook for the global economy and financial markets remains fragile...

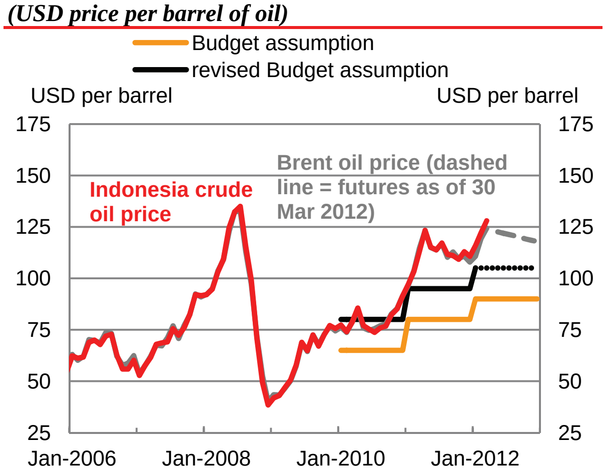
International developments continue to shape the near-term economic outlook for Indonesia, but the focus of attention has shifted. At the time of the previous *IEQ* in December 2011, the deteriorating and uncertain outlook for the global economy and financial markets was the primary concern. Since then there has been further evidence of the slowdown in global economic momentum but also some positive signs, such as from the US. Global financial markets have posted gains over the first quarter of 2012 but, also, remain sensitive to Euro zone developments and to macro data releases. The recent sharp rise in global oil prices has added a new dimension to the situation, raising concerns that, if sustained, it could dampen the growth outlook. It has also increased the fiscal risks associated with Indonesia's fuel subsidies, prompting an early revision of the 2012 Budget which foresees an increase in subsidized fuel prices under certain conditions, discussed further below.

…and oil prices have risen sharply since the start of 2012

The increase in international oil prices has been due to geo-political tensions and supply disruptions, such as related to Iran. Indonesia's crude price (ICP) averaged USD 122 per barrel in the first three months of 2012, up from USD 111 in the final quarter of 2011 (Figure 4). Currently Brent futures project prices to remain elevated but decline gradually over the year. Applying this profile to the ICP would give an average price for 2012 of just under USD 125.

Figure 4: Oil prices moved up sharply at the beginning of 2012

(USD price per barrel of oil)



Source: CEIC, ESDM, ICE, Ministry of Finance

International US dollar non-energy commodity prices have also increased recently, up 2.7 percent in February alone, although remain down on their levels of mid-2011. Metal and mineral prices showed particularly strong gains, in part due to weather-related supply losses affecting tin output in Indonesia.

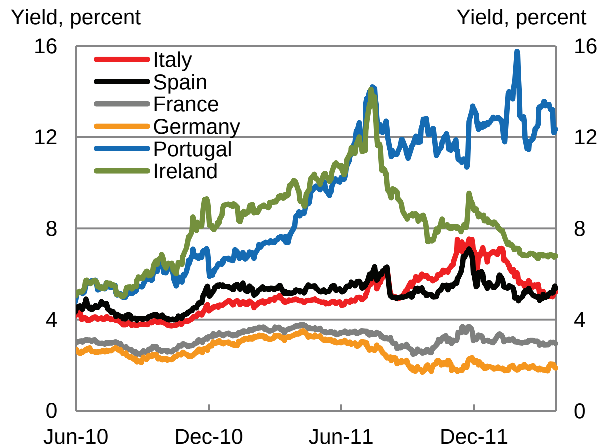
Policy measures taken in the Euro zone have supported international financial markets…

The recently agreed Greek debt restructuring plan and other policy measures in the Euro zone have provided some support for global financial markets, with core Euro zone economy bond yields narrowing since late 2011 (Figure 5). However, fiscal concerns remain for peripheral Euro zone countries, notwithstanding the revised set of fiscal deficit rules, and also for the medium-term growth outlook for the area, particularly given the need for fiscal adjustment and the challenges of implementing needed structural reforms.

…and there has been some return of risk appetite

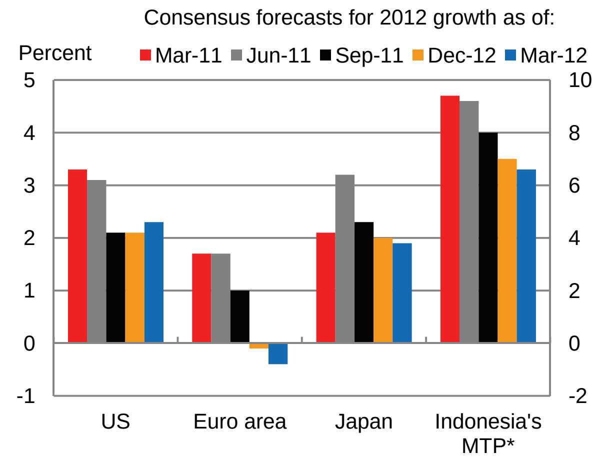
After the heightened volatility from August equity markets closed 2011 on the rise, with developed markets (in US dollars) increasing by 7.1 percent over Q4. The market recovery continued into early 2012 with a further rise of 5.6 percent for developed market equities between 1 January and 26 March 2012 (still leaving them 6.0 percent below May 2011 post-crisis highs). Emerging market equities also rose, but less strongly, up 3.6 percent over the corresponding period, remaining over 13 percent below post-crisis highs. The prospect of stronger growth in the US, and its impact on the perceptions of the likely future monetary policy stance, along with the agreement on Greece, contributed to rising yields on US and German government bonds from January lows. Consistent with returning investor risk appetite, emerging market bond spreads have fallen by over 90 basis points since January 1 and developing economy bond issuance also recovered strongly in early 2012. Other market stress indicators – such as US dollar liquidity and interbank lending – have also come down somewhat recently.

Figure 5: Financing costs for core Euro zone countries have retreated, but remain high for peripheral countries
(10-year government bond yield, percent)



Source: JP Morgan

Figure 6: The global economic outlook is mixed but has weakened on average in Indonesia's trading partners
(Mean Consensus forecasts for 2012 growth, percent)



Note: *MTP is major trading partner growth weighted by export shares (World Bank staff projection for 2012)
Source: Consensus Economics

Overall, the growth projection for 2012 in Indonesia's major trading partners has been lowered slightly

Business confidence and high frequency leading indicators, such as industrial production and exports, point to a further weakening in growth in the Euro area, major emerging market economies such as China, India and Brazil, and within Asia. Growth forecasts have been downgraded accordingly (Figure 26). The European Central Bank now expects the Euro zone to record a mild recession in the first half of 2012, before a slow recovery. The Chinese economy is experiencing a gradual slowdown and, symbolically, the Chinese government announced a growth target of 7.5 percent for 2012 – following eight successive years of an 8 percent target – although past growth out-turns have, however, regularly exceeded the target. US economic news has surprised on the upside, providing some counterbalance to the weakening global outlook, although the political debate over fiscal consolidation will continue to cloud the outlook. Overall, putting developments across the region and major markets together, forecast growth in Indonesia's major trading partners (MTP) has moved down gradually as the impact of the global downturn on economic activity has become clearer. Indonesia's MTP growth in 2012 is now forecast at 3.3 percent, down from 3.5 percent in the December 2011 IEQ.

2. Indonesia's GDP growth remained at 6.5 percent in the fourth quarter of 2011

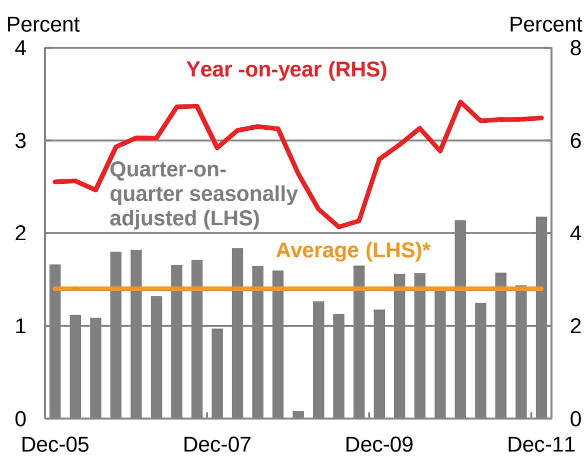
The Indonesian economy grew by a solid 6.5 percent in the fourth quarter and 6.5 percent overall in 2011

Indonesian GDP increased by 6.5 percent in Q4 2011, the third consecutive quarter of 6.5 percent growth (Q1 was revised down slightly from 6.5 percent to 6.4 percent). On a seasonally-adjusted basis the economy grew by a robust 2.2 percent, stronger than the 1.4 percent recorded in Q3 (Figure 7). Overall, the Indonesian economy grew by 6.5 percent in 2011, up from 6.1 percent in 2010 and the highest recorded growth rate since 1996. This strong real growth, combined with GDP deflator growth of 8.4 percent and the strength of the Rupiah, moved GDP per capita to USD 3,540 per capita, up from USD 3,010 in 2010.

Investment and private consumption supported activity in the quarter but the weakening in global demand was seen in the trade figures

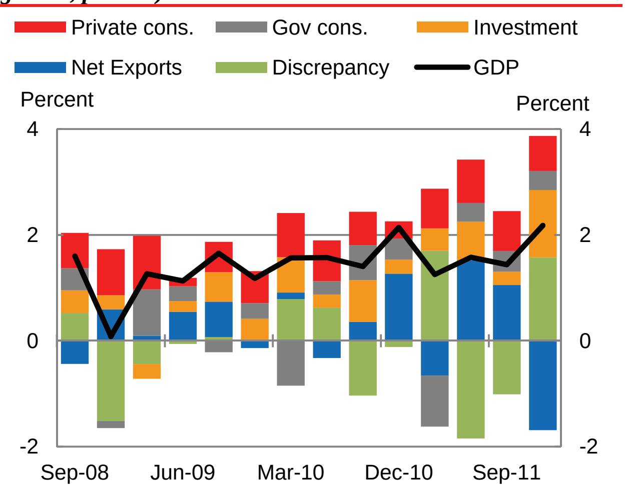
The major driver of growth in Q4 2011 was investment (Figure 8), which grew by a seasonally adjusted 5.2 percent in the quarter, the strongest growth since mid-2004. Private consumption, although slowing slightly, remained supportive. Offsetting these factors was the drag on growth from net exports, which detracted 1.7 percentage points from quarterly growth. Reflecting the weakening external environment quarterly seasonally-adjusted real export growth slowed to 0.5 percent in Q4 from 2.2 percent in Q3. This was in line with monthly trade data, discussed further below, which had shown a slowing in export growth from the middle of the year. Imports grew by 5.1 percent in the fourth quarter, recovering from the weak growth in the third quarter.

Figure 7: Quarterly GDP growth remained at 6.5 percent in the fourth quarter of 2011…
(growth in real GDP, percent)



Note: * Average quarter-on-quarter growth since Q1 2002
Source: BPS and World Bank staff seasonal adjustment

Figure 8: …with quarterly growth moving up, despite a negative contribution from net exports
(contribution to quarter-on-quarter seasonally adjusted growth, percent)



Note: Contributions may not sum to overall GDP growth due to seasonal adjustment of each individual series
Source: BPS and World Bank staff calculations

Growth in production was driven by manufacturing and trade, hotels and restaurants

On the production side, manufacturing and trade, hotels and restaurants were the main drivers of growth. Manufacturing growth was 6.2 percent in 2011, the strongest annual growth since 2004, driven by the food, beverage and tobacco and transport equipment and machinery sectors. Construction also performed well, in-line with the strong investment figures. Overall in 2011, both the trade, hotel and restaurant and services sectors recorded their highest growth rates since before 1993.

Indonesia's growth is projected to moderate in 2012 to 6.1 percent before moving up to 6.4 percent in 2013

Looking towards the rest of 2012, in line with recent data releases, the baseline scenario remains one in which there is a moderation in external demand but domestic drivers of growth are supportive. The downgrade in forecast growth in Indonesia's major trading partner economies contributes to a slight dampening of the recent strong growth in industrial sectors such as manufacturing while net exports are expected to contribute very little to growth in 2012, after a contribution of around 1.5 percentage points in 2011. Indicators of domestic activity, such as concrete sales and industrial production, all remain at elevated levels. Consumer sentiment indicators, while high, have come off slightly. This is most likely related to the potential rise in subsidized fuel prices. As discussed below, Parliament decided to allow such an adjustment if the average oil price is sufficiently high over six months reaches 15 percent above the USD 105 oil price assumption in the revised Budget. As discussed in the fiscal section below, given the profile of oil prices, the baseline scenario assumes a subsidized fuel price increase in the third quarter of 2012. The direct, and anticipatory, impact of such an increase, and the consequent increase in the level and uncertainty over inflation, could dampen consumption growth slightly, as appears to have been the case in 2005 and 2008, although cash compensation accompanying any increase may have an offsetting effect. From the supply-side perspective, the rise in crude oil prices may also be a drag on growth, to the extent that it is an important intermediate input cost for some firms.

The net impact of these factors is a growth forecast for 2012 of 6.1 percent, slightly below the December 2011 IEQ forecast of 6.2 percent. In 2013, growth is projected to move back up to 6.4 percent as external demand will likely recover, although the weakness in the Euro zone economies is set to be protracted. There remains considerable downside, as well as upside, risks around the outlook which are discussed in more detail below.

Table 2: Although risks remain high, baseline 2012 GDP growth is projected at 6.1 percent
(percentage change, unless otherwise indicated)

	Annual			Year to December quarter			Revision to Annual
	2011	2012	2013	2011	2012	2013	2012
1. Main economic indicators							
Total Consumption expenditure	4.5	4.9	5.0	4.6	4.9	5.0	-0.6
Private consumption expenditure	4.7	4.6	4.8	4.9	4.5	4.8	-0.1
Government consumption	3.2	6.8	6.0	2.8	6.9	6.1	-3.3
Gross fixed capital formation	8.8	9.8	10.0	11.5	9.8	9.9	0.2
Exports of goods and services	13.6	7.4	9.5	7.9	7.5	9.5	-0.5
Imports of goods and services	13.3	9.2	9.5	10.1	9.2	9.4	-0.5
Gross Domestic Product	**6.5**	**6.1**	**6.4**	**6.5**	**6.0**	**6.5**	**-0.1**
Agriculture	3.0	3.4	3.4	4.1	3.3	3.4	-0.3
Industry	5.3	4.9	5.3	5.3	4.8	5.1	0.1
Services	8.5	8.0	8.2	9.0	7.9	7.9	0.0
2. External indicators							
Balance of payments (USD bn)	11.9	7.9	12.6	n/a	n/a	n/a	-3.9
Current account balance (USD bn)	2.1	-4.1	-1.7	n/a	n/a	n/a	-2.4
Trade balance (USD bn)	23.5	15.4	18.7	n/a	n/a	n/a	-2.5
Financial account balance (USD bn)	14.0	11.9	14.3	n/a	n/a	n/a	-1.6
3. Other economic measures							
Consumer price index	5.4	6.4	6.8	4.1	8.5	5.4	1.5
Poverty basket Index	8.2	8.8	9.7	6.3	10.2	8.3	2.1
GDP Deflator	8.4	9.7	10.5	7.5	11.3	10.1	1.1
Nominal GDP	15.4	16.4	17.6	14	17.9	17.2	1.1
4. Economic assumptions							
Exchange rate (IDR/USD)	8773	9000	9000	9024	9000	9000	200
Indonesian crude price (USD/bl)	111.6	120.0	115.0	111.0	120.0	115.0	10.0
Major trading partner growth	3.1	3.3	3.9	2.6	4.4	4.0	-0.2

Note: Projections for 2012 and 2013 assume an IDR 1,500 rise in the price of subsidized fuel in the third quarter of 2012. Economic indicators are in real terms. Projected trade flows relate to the national accounts, which may overstate the true movement in trade volumes and understate the movement in prices due to differences in price series.
Source: MoF, BPS, BI, CEIC and World Bank projections

3. Downside fiscal risks have risen

Motivated by rising oil prices, the Government submitted its draft revised 2012 Budget to Parliament earlier than usual and it was approved on 1 April 2012

In response to the weakening external environment and sharp rise in global oil price, the Government submitted the draft revised 2012 Budget in early March ahead of the regular budget revision schedule of between July and August. After a month of deliberation process, the budget was approved by Parliament on April 1, 2012. The revised 2012 Budget allows an increase in subsidized fuel price if the average oil price over six months reaches 15 percent above the USD 105 oil price assumption in the revised Budget. This is slightly different to the Government's proposal to increase the subsidized fuel price by IDR 1,500 per liter (one-third of the current subsidized price) by early April. A proposal to increase electricity tariffs gradually in 2012 also was not approved. However, although the proposed fuel price hike was postponed, the spending levels and budget deficit in the approved budget are broadly the same as in the proposed revised budget.

The overall deficit in the 2012 revised Budget was moved up by IDR 66.1 trillion to IDR 190.1 trillion or 2.2 percent of GDP from 1.5 percent in the original Budget. This is an increase on the deficit of 1.2 percent of GDP seen in 2011 (which is discussed in more detail in Part B). The higher deficit under the revised Budget is expected to be financed mainly from domestic sources, including through increased government bond issuances and the use of an additional IDR 51.1 trillion from the Government's accumulated unspent balances (*saldo anggaran lebih,* SAL).

The macro assumptions in the revised Budget included a slight downgrade to GDP growth and a USD 15 rise in the oil price to USD 105 per barrel

The growth assumption in the revised Budget was lowered slightly, by 0.2 percentage points, due to the moderation in the global outlook. The inflation assumption was moved up to 6.8 percent, reflecting the potential increase in the subsidized fuel price. The assumed interest rate was revised down to reflect strong investor demand for government securities, backed by Indonesia's sovereign rating upgrade to investment grade. Higher inflation and uncertainty in the global economic outlook contributed to the slightly weaker exchange rate assumption. Oil lifting was revised down to 930 thousands barrel per day (bpd) from 950 thousands barrel per day. Finally, and most importantly, the assumed oil price was revised up from USD 90 to USD 105 per barrel, although this is still on the optimistic side since the average ICP price in the first three months of 2012 was USD 122 per barrel.

Table 3: The oil price assumption was revised up in the 2012 proposed revised Budget

Macroeconomic assumption	Budget	Revised budget	Change
Real growth (percent)	6.7	6.5	-0.2
Inflation (percent) year-on-year	5.3	6.8	1.5
Interest rates (percent, SPN 3mth)	6.0	5.0	-1.0
Exchange rates (IDR/USD)	8,800	9,000	200
Oil price (USD/barrel)	90.0	105.0	15.0
Oil lifting (000 bpd)	950.0	930.0	-20.0

Source: Ministry of Finance

Total revenues have been increased in the revised Budget due in particular to the rising international oil price

Under the revised 2012 Budget total projected revenues were increased by IDR 47 trillion (3.6 percent) from the original Budget level, primarily due to higher commodity-based revenues (mainly from oil, gas and CPO). Non-tax revenues were upgraded by IDR 63 trillion on the back of the higher oil price assumption, although this is somewhat offset by the lower assumed oil lifting. Revenue from tax collection has been adjusted downward by IDR 16 trillion (1.6 percent) due to the slightly lower domestic GDP growth projection and a change of basis of projection to 2011 revenue outcome from 2011 revised budget.

Spending was also increased due to rising energy subsidies, additional spending for compensation programs related to subsidized fuel price adjustment, and extra spending for infrastructure

Total expenditure was increased by 8 percent or almost IDR 113 trillion in the revised Budget relative to the original Budget. The projected spending on fuel subsidies remains significant, accounting for 13 percent of central government spending and up by IDR 14 trillion compared to the budget. This may be underestimated since it is based on the original proposal to increase subsidized fuel price in April (Box 1). As of March 2012, the effective cost of the subsidy (i.e. the economic price of fuel less the subsidized cost of fuel) was at a record high of IDR 5,600 per liter of gasoline. Without increasing subsidized fuel price, the Government spending on fuel subsidy is projected to increase by 51 percent relative to the original 2012 budget. Spending on electricity subsidies was increased by IDR 20 trillion (45 percent higher than the initial Budget), but the allocation was lower than the proposed revised Budget of IDR 93 trillion which included the proposal to gradually increase tariffs by 3 percent in Q2, Q3, and Q4. This has been rejected by Parliament, potentially leading to significant overspending in electricity subsidies as was the case in 2011.

Non-energy subsides also received a slightly higher allocation, reflecting an increase in the rice price and the allocation of 1 additional month to the *rice for the poor* (Raskin) program, to 14 months. Personnel and material expenditures have been revised down by IDR 5 trillion, reflecting cuts for line ministry spending to restrain the deficit. Capital expenditures received an 11 percent increase in their allocation, or IDR 17 trillion, to finance infrastructure development in Eastern Indonesia and domestic connectivity. "Other expenditures" also increased, by almost 50 percent, reflecting the compensation program for the poor proposed as part of the fuel price subsidy reforms. Transfers to the region remained broadly stable, with only a small proposed increase for oil and gas revenue sharing.

Box 1: The proposed fuel price increase

The Government's proposed revised Budget included an increase in the subsidized fuel price together with compensation programs. The proposal was to increase the subsidized fuel price from April 2012. Two options were under consideration: an increase of IDR 1,500 and a fix subsidy of IDR 2,000. The government proposed a combination of two schemes of compensation programs to limit the potential impact of the fuel price increase on households. The first BLSM program (*Bantuan Langsung Sementara Masyarakat* or temporary community direct assistance) was a cash transfer to be distributed to 18.5 million poor households (the poorest 30 percent of households). The proposal was for a transfer of IDR 150,000 per month for 9 months with a total budget of IDR 25.6 trillion. The second compensating program, to assist those indirectly affected by rises in transportation costs, due to the higher fuel price was an increased subsidy for public transport (public service obligation) economy class (passenger and goods) with an estimated cost of IDR 5 trillion for 9 months. As mentioned, Parliament of Indonesia approved the option of a fuel price increase of IDR 1,500 provided the ICP price is on average, over a six month period, 15 percent above the revised Budget assumption of USD 105 per barrel (i.e. USD 120.8).

Due to a higher oil price assumption, the World Bank projects a slightly higher deficit than the Government in 2012, even assuming a rise in the subsidized fuel price later in the year

The oil price and the decision on subsidized fuel price adjustment are the main drivers of the overall budget position for 2012. The World Bank ICP assumption for 2012 is USD 120, USD 15 higher than the revised Budget assumption. This reflects the price of ICP in the first three months in 2012 and the profile of prices going forward from the Brent futures market. Following Parliament's support to adjust subsidized fuel price should the ICP price meets the condition, and based on the six-month average of prices under this profile, this report assumes that there is an increase in subsidized fuel prices in Q3 2012. In this baseline "reform" scenario, the 2012 budget deficit is projected at 2.5 percent of GDP, higher than in the revised budget of 2.2 percent of GDP. This reflects fuel subsidy spending which is one-third higher due to the higher oil price assumption. Disbursements of line ministry (K/L) expenditure are assumed to be slightly below the revised Budget allocation. Revenue is projected to be slightly higher than the revised Budget, driven by higher oil price assumption although this is offset somewhat by the lower assumed oil lifting of 920 bpd.[1]

With no fuel price increase and elevated oil prices, the fiscal deficit could exceed 3 percent of GDP

However, in the absence of subsidized fuel price increase, the World Bank projects that the budget deficit would grow to IDR 269 trillion, or 3.1 percent of GDP (Table 4). This is driven primarily by spending on energy subsidies which is 60 percent higher (IDR 83 trillion) than the allocation in the revised Budget. This sensitivity analysis provides a clear indication of the fiscal risks associated with delaying subsidy reform given current levels of oil prices and potential rising opportunity cost of what is a regressive form of spending (Box 2). In addition, the risk of hitting Indonesia's three percent of GDP deficit limit may prompt a tightening in spending in key development areas..

[1] Press reports from the upstream regulator of oil and gas industry (BP-Migas) indicated that, by mid March, the average realized monthly oil lifting was only 895 bpd.

Table 4: With no fuel subsidy reform the 2012 Budget deficit could reach 3 percent of GDP
(IDR trillion, unless otherwise indicated)

	2011 Outcome (Unaudited)	**2012** Budget	**2012** Proposed Revised Budget	**2012** Revised Budget	**2012 (p)** WB Mar estimates*	**2012 (p)** WB Mar estimates*
Assumption on subsidized fuel price	No Change	No Change	IDR 1,500 increase in April	Potential for IDR 1,500 increase if average oil price over certain level**	No Change	IDR 1,500 increase in Q3
A. State revenue and grants	**1,199.5**	**1,311.4**	**1,344.5**	**1,358.2**	**1,368.5**	**1,383.3**
1. Tax revenue	**872.6**	**1,032.6**	**1,011.7**	**1,016.2**	**1,013.6**	**1,022.1**
2. Non-tax revenue	**324.2**	**278.0**	**331.9**	**341.1**	**354.1**	**360.4**
B. Expenditure	**1,289.6**	**1,435.4**	**1,534.6**	**1,548.3**	**1,637.7**	**1,600.7**
1. Central government	**949.2**	**965.0**	**1,058.3**	**1,069.5**	**1,134.8**	**1,097.8**
K/L Expenditures	**483.3**	**508.4**	**535.1**	**547.9**	**530.6**	**530.6**
Non-K/L Expenditures	**465.9**	**456.6**	**523.2**	**521.6**	**604.2**	**567.2**
o/w Energy subsidies	255.6	168.6	230.4	202.4	285.0	248.0
- Fuel subsidy	165.2	123.6	137.4	137.4	220.0	183.0
o/w Other expenditures	6.5	28.5	42.5	68.5	68.5	68.5
2. Transfers to the regions	**411.4**	**470.4**	**476.3**	**478.8**	**486.6**	**486.6**
C. Primary balance	**3.2**	**-1.8**	**-72.3**	**-72.3**	**-151.4**	**-99.6**
D. SURPLUS / DEFICIT	-90.1	-124.0	-190.1	-190.1	-269.2	-217.4
Deficit -percent of GDP	-1.2	-1.5	-2.2	-2.2	-3.1	-2.5
Key economic assumptions/outcomes						
Economic growth (percent)	6.5	6.7	6.5	6.5	6.1	6.1
CPI (percent)	5.4	5.3	7.0	6.8	5.2	8.5
Exchange rate (IDR/USD)	8,742	8,800	9,000	9,000	9,000	9,000
Crude oil price (USD/barrel)	111	90	105	105	120	120
Oil production ('000 barrels/day)	898	950	930	930	920	920

Note: *World Bank revenue estimates are based on a different methodology than the Government to derive projections for nominal GDP (see Part C of the June 2010 IEQ for a full discussion). ** the revised Budget includes the option of a IDR 1,500 fuel price increase provided the ICP price is on average, over a six month period, 15 percent above the revised Budget assumption of USD 105 per barrel
Source: MoF and World Bank staff calculations

Box 2: Fuel subsidies are highly regressive with most benefits going to wealthier households

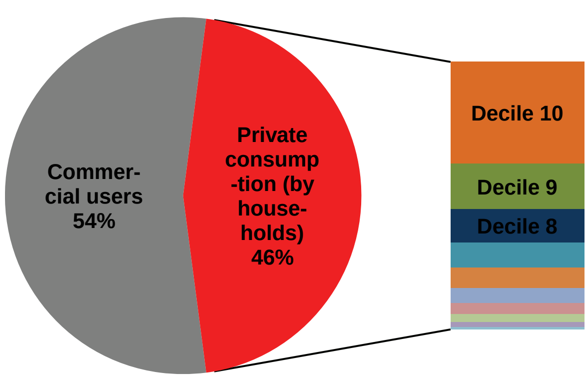
Most of the benefits of fuel subsidies in Indonesia go to commercial users and wealthier households. In addition to the fiscal burden and risks of the fuel subsidy system (see Part B and also the discussion in the March 2011 *IEQ*), there is also a concern that the current fuel subsidies do not assist the poorer segments of the population who are most in need of such support. Estimates based on data from Indonesia's National Household Socioeconomic Survey (SUSENAS, *Survei Sosial Ekonomi Nasional*) indicate that households or private users may consume as little as one-third of all subsidized fuel, which includes gasoline and diesel. The residual is potentially attributable to commercial users such as transport operators, businesses and other users.[a] With respect to individual fuels, estimates indicate that households consumed almost half of all subsidized gasoline in 2008, implying that commercial and other users consumed the remaining half (Figure 9). A breakdown of the household component of gasoline consumption by socio-economic group indicates that the top half of households accounted for 84 percent of gasoline consumption, with the highest consumption decile alone accounting for almost 40 percent (Figure 9). In contrast, the bottom 50 percent of consumers accounted for just 16 percent of total household fuel consumption, with the poorest decile accounting for less than 1 percent.

Moreover, a detailed examination of reported fuel consumption in the household survey indicates that around two-thirds of poor and near-poor households do not consume any gasoline whatsoever, and the likelihood of consuming gasoline and the actual quantity consumed rises sharply at higher income levels (Figure 10). With respect to diesel, very few households report any consumption; therefore commercial and other users are estimated to account for virtually all (98 percent) of the consumption of subsidized diesel.

The pattern of fuel consumption directly determines the distribution of fuel subsidy benefits. Thus, commercial users may have received up to two-thirds of benefits and wealthier households most of the remainder. The gasoline subsidy is the most regressive, i.e. benefits the rich disproportionately more than the poorest households, as expected given limited motorcycle and virtually no car ownership amongst poor and near-poor households.

Figure 9: Commercial users and wealthier households consume the bulk of subsidized gasoline…

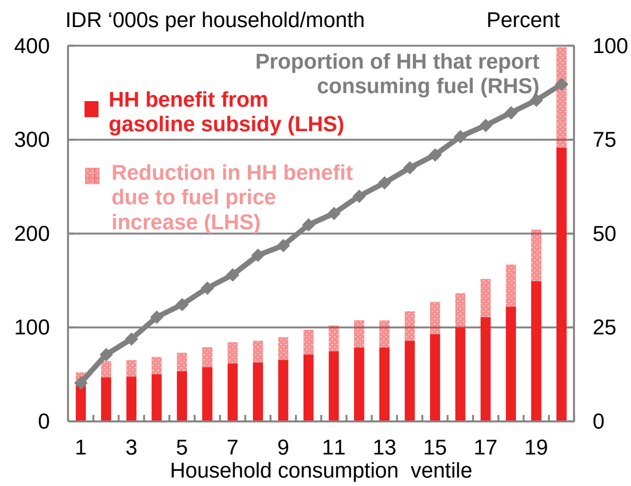
(share of subsidized gasoline consumption attributed to commercial users and private households in aggregate and by per capita consumption decile, 2008)



Source: February 2009 SUSENAS, APBN Financial Statement and World Bank staff calculations

Figure 10: …whereas most poor and near-poor households do not consume gasoline

(share of households who report consuming gasoline and average monthly benefit from gasoline subsidy of those who consume fuel, by per capita consumption ventiles, 2008)



Note: Average household benefit is the conditional mean of households who consume gasoline; i.e. households reporting zero gasoline consumption are excluded from this calculation. The benefit is based on the cost of the subsidy in March 2012

Source: February 2009 SUSENAS and World Bank staff calculations

To put it in terms of a household's budget, fuel subsidies are estimated to transfer a car owner who consumes 50 liters of gasoline a week (200 liters a month) IDR 1,115,000 per month (based on the difference between the economic price of fuel and the price of subsidized fuel as of March 2012). This is in contrast with the average motorcycle user who consumes 5 liters a week (20 liters a month) (according to SUSENAS, 2009) and only receives a transfer of IDR 111,000 per month from the fuel subsidy scheme (Figure 10). Over a year, this equates to these wealthier households which use a car receiving a transfer of IDR 13,382,000 – 10 times more than the average motorcycle user which receives IDR 1,338,240 and many times the indirect benefits from subsidized fuel that may be received from those households without a car or motorbike.

Poor households are also expected to feel the fuel price increase, despite less than 10 percent of poor households reporting they consume fuel directly, as they are the most vulnerable to changes in the prices of goods and services they consume. World Bank estimates that without any corresponding cash transfer, the poverty rate would increase by 0.7 percentage points with an IDR 1,500 per liter fuel price increase. As described above, the Government proposal in the draft revised Budget included provision for a IDR 150,000 per month cash transfer (BLSM) for 9 months to 18.5 million households (poorest 31 percent of households), which the World Bank estimates could lead to a temporary reduction in poverty, in addition to allowing poor and near-poor more time to absorb the shock once

BLSM stops. If introduced in the same form as originally proposed, the cash transfer is equivalent to about 10 percent of annual spending for a poor household in 2011.

For non-poor households there may be a temporary reduction in consumption, due to higher prices of fuel directly and other prices, but this may be mitigated by a corresponding nominal wage increase as seen in 2008 when manufacturing employee's nominal wage growth moved up in response to both the rise in fuel price and higher food price inflation. The total reduction in the cost of the fuel subsidy if the potential fuel price increase occurs in Q3 2012 is estimated to save IDR 37 trillion in 2012 and with the proposed cash transfer (IDR 26 trillion) and public transport subsidy (IDR 5 trillion) the net reduction in value for consumers would be IDR 6 trillion, or only 0.2 percent as a share of annual private consumption (using national accounts data). As such, any temporary impact to real consumption from higher inflation should be mostly offset through higher nominal wage increases and government compensation programs. Meanwhile, the fiscal savings and opportunities to redirect spending within the Government's budget would be carried over into future years.

Note: This box updates and draws from a more detailed analysis in the March 2011 *IEQ* on Indonesia's experience with fuel subsidies over the past five years (see http://go.worldbank.org/USFOQLH060)

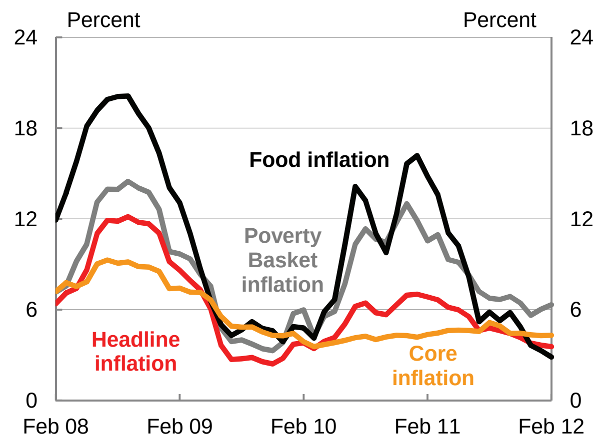
[a] Aggregate household consumption of each fuel is estimated by taking the consumption reported by nationally representative households in the SUSENAS survey and scaling up to the national level, with the residual of total consumption (as reported in budget documents) attributed to other users. However, the SUSENAS survey is believed to under represent rich households – who consume higher quantities of fuel – which may lead to underestimation of aggregate household consumption and overestimation of the consumption of other users

4. The potential for higher subsidized fuel prices dominates the inflation outlook

Headline inflation has moved down further, reaching a 2-year low of 3.6 percent in February 2012…

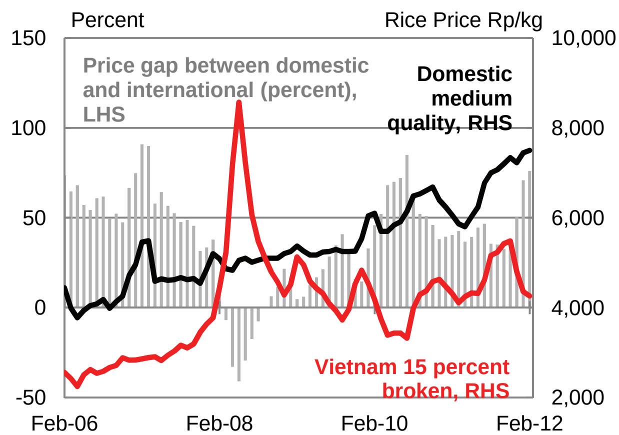
While inflation outcomes have continued to fall, the outlook is for rising inflationary pressures going forward, particularly from the potential hike in subsidized fuel prices if oil prices remain elevated above USD120 per barrel. Headline CPI inflation reached a 2-year low of 3.6 percent year-on-year in February, continuing its downward trajectory of the past six months (Figure 11). Reflecting the absence of administered price shocks, subdued commodity price shocks and improved macro policy management, this is the first time since BPS produced detailed national accounts data in 1983 that inflation has been contained below four percent and growth has been above 6 percent.

Figure 11: Headline inflation has continued to move down over the past quarter
(year-on-year growth, percent)



Source: BPS and World Bank staff calculations

Figure 12: The gap between Indonesian and international rice prices has moved up
(price of wholesale rice, IDR per kg)



Source: PIBC, FAO and World Bank

…as previous food price shocks continue to unwind

Inflation across the components of the CPI remains mixed. Food price inflation continued to decline, reaching an 8-year low of 2.9 percent in February 2012. This was due to the base effects associated with the unwinding of the spike in spice prices in early 2011. This has offset much of the steady increase in retail rice prices, up 15 percent year-on-year in February. The poverty basket inflation rate has remained steady over the quarter, falling from 6.4 percent in November 2011 to 6.3 percent in February 2012.

Looking across the other components of the CPI, clothes price inflation continues to be the highest growing component, at 8.7 percent in February. Higher gold prices have pushed up price inflation for personal effects, a subcomponent of clothing. With no changes in subsidized energy prices in more than a year transport and household energy cost inflation has been moderate, at 1.8 percent and 3.4 percent respectively in February.

Rising international supply of rice and increases in domestic prices moved the gap between Indonesian and international rice prices higher

The gap between domestic and international prices of rice has moved higher (Figure 12). In February 2012 medium-quality domestic wholesale prices were 51-76 percent higher than the comparable international price of rice (from Thailand and Vietnam respectively). Improved supply of rice onto the market, due to large production gains from Vietnam, Bangladesh, China, India and Pakistan, has pushed down international prices. For example, the US dollar price of medium quality Vietnamese rice declined by 23 percent from November 2011 to February 2012 while the price of Thai rice fell by 13 percent. Domestic wholesale prices (medium-quality) increased by 2.2 percent over this period. Domestic retail prices of rice reached a high in February with regular-quality retail rice rising by 6.6 percent since November 2011, and 15.4 percent year-on-year. Domestic rice prices did however ease in March as the harvest begun in some paddy areas (with March to April the main harvest season).

The outlook for inflation is dominated by the potential increase in subsidized fuel prices, which could add an estimated 3.2 percentage points to headline and Poverty Basket inflation…

The outlook for inflation is dominated by the impact of the potential fuel price increase, although the rice harvest in the first half of 2012 will also be critical. The World Bank estimates that an IDR 1,500 increase in gasoline and diesel subsidized fuel prices in Q3 2012 would add 3.2 percentage points to the level of both headline inflation and Poverty Basket inflation. This would move the projected headline inflation in the final quarter of the 2012 up to 8.5 percent year-on-year from 5.2 percent without the fuel price rise. The poverty basket projection would rise to 10.2 percent from 6.8 percent. The estimated impacts on the different inflation series are commensurate in scale to the effects seen during the 2008 fuel price increases although several important differences remain (see Box 3). While the fuel price subsidy reform will temporarily increase inflation, the current macroeconomic environment of historically low inflation and strong, stable economic growth provides the most favorable conditions to undertake this important reform.

The estimated impact on both headline and Poverty Basket measures of inflation is the same amount although the channels are distinctly different. The average consumer will experience the price increase both at the fuel pump and a generalized increase in prices of other goods while a poor households' consumer basket, which contains almost no direct consumption of fuel, will be affected largely through the impact of higher transportation costs on the price of food (which represents 60 percent of their consumption basket) and on public transport.

…and core inflation would also be expected to increase

Core inflation is also expected to rise by 1.3 percentage points if the fuel price increase is implemented. Although excluding administered and volatile items, services and goods within the core price basket will be affected indirectly by rising transportation or other input costs or firms taking the opportunity to reset their prices. Indeed, consumer price expectations for three and six months ahead, measured in February 2012, increased due to anticipation of higher transport costs and to a lesser extent, food costs. As uncertainty remains as to whether the fuel price increase will occur, further anticipatory inflation could build as producers start adjusting prices before any increase is undertaken. Retailers have already reported in the BI Retail Sales survey that they expect rising prices due to higher energy prices. Similar trends occurred ahead of previous fuel price increases with expectations tracking inflation movements, but with a month or two lead.

The direct inflationary impact of a potential rise in subsidized fuel prices would be temporary

The direct shock to inflation from a discrete fuel price adjustment would be temporary, falling out of the base one year from the date of introduction. Whether there is a more persistent rise in underlying inflation or expectations depends mainly on the indirect impacts, the policy response and broader economic developments (see Box 3 for a comparison of the current situation with the fuel price increases in 2005 and 2008). Overall, inflation in 2013 is expected to move down, falling to 5.4 percent in the final quarter.

GDP deflator growth is also expected to pick up

The broader level of prices growth in the economy, as measured by the GDP deflator, ended 2011 at 7.9 percent year-on-year, similar to the growth seen over the past two years. With consumer prices representing around 60 percent of the deflator, GDP deflator inflation will also be affected by the potential fuel price adjustment. Accordingly, GDP deflator inflation is projected to rise to 11.3 percent year-on-year in Q4 2012. In 2013, although the direct fuel price impact should unwind, GDP deflator growth is still expected to exceed 10 percent on the back of strengthening economic growth and credit conditions.

Box 3: Looking back to previous fuel price increases

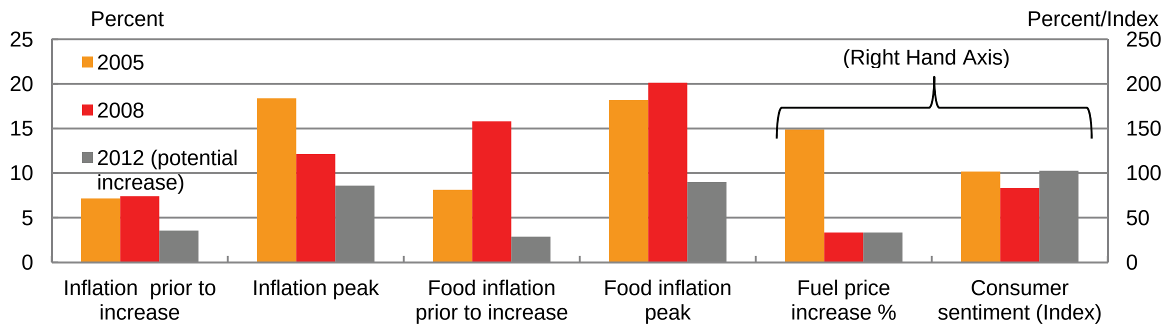
Examining the previous fuel price increases of 2005 and 2008 provides a useful starting point for exploring the potential impacts of any future fuel price increases on consumers. But there are several factors which distinguish the circumstances around the different periods of price increases, making direct comparisons less clear.

First, the level and composition of fuel price increases were different, particularly for the 2005 case compared to the 2008 case and the potential adjustment in fuel prices which may occur in 2012. In 2005, the rising cost of oil had meant the market price for fuel was close to three times the subsidized pump price of IDR 1800 per liter that Indonesian's were paying and the Government was left to pick up the difference. Subsequently, in two separate hikes within the space of 5 months in 2005, the government increased the price by 150 percent to IDR 4,500 per liter (Figure 13). This is starkly different to the 33 percent increase in fuel prices in 2008 and the potential 2012 increase should the condition for the level of the Indonesian crude oil price be met and a price increase adopted. Importantly, the increase in 2005 was also coupled with the complete deregulation of fuel prices for industrial users of fuel, which was previously also subsidized by the government. This had significant implications for large producers and manufacturers which rely on fuel as an important input in their production. As such, it is misleading to draw direct comparisons between the 2005 fuel price increases and the 2008 increase, and prospective rise in 2012. For these reasons, it is more informative to compare the price increase in 2008 and the potential 2012 one, but this exercise still has its limitations due the considerably different inflation contexts and macroeconomic backdrop.

Second, the inflation climates prior to the fuel price increases were very different. Three months following the fuel price increase in 2008, headline inflation peaked at 12.1 percent. Should an IDR 1,500 price increase be implemented in Q3 2012 inflation is projected by the World Bank to peak at 8.6 percent in 2012, well below the peaks of 2008 or 2005 (Figure 13). This is largely for two reasons; food prices are projected to remain relatively stable and inflation growth and expectations to be maintained at relatively low levels. In 2008, unrelated to fuel price increases, food price inflation had reached 16 percent in April (the month before fuel prices increased) due to rice and cooking oil shortages (Figure 13). This meant headline inflation was already 7.4 percent before the fuel price increase and food inflation continuing to build. In contrast to this, in 2012 inflation was at a two year low of 3.6 percent in February (less than half the level of 2008) and food inflation was at an eight-year low of 2.9 percent (Figure 13). While these low levels are in part due to base effects which will unwind in the next few months, and there is the risk of anticipatory price increases, it is still expected that inflation will be lower leading in to any fuel price increase this year than it was in 2008

Third, there are important macroeconomic differences between 2008 and 2012. Most of the downward movement in economic indicators in 2008 occurred not in response to the fuel price increases in mid-2008, but to the global financial crisis in late 2008. In 2012, economic activity has been robust at 6.5 percent in each of the previous four quarters and, while there remain risks to the outlook from the ongoing fragility of international markets and weakening of external demand, it is expected that growth will remain above 6 percent for the year. Additionally, because inflation was high and above BI's annual target in 2005 and 2008, even before the introduction of the fuel price increases, BI had to rapidly increase interest rates to keep inflation within their target band, with the policy rate peaking at 12.75 percent in 2005 and 9.5 percent in 2008, adding further drag to economic growth. In 2012, the inflation rate, with no subsidized price increase, would be expected to remain within BI's inflation target band of 4.5±1 percent. The policy rate is currently at the lowest it has ever been at 5.75 percent, with the lower bound of the benchmark corridor a further 200 basis points below. This leaves plenty of scope to tighten policy, if required, through coordinated usage of liquidity management and macro prudential tools along with the policy rate. This will be particularly important should other inflationary pressures start to emerge such as from the impact of higher international oil prices or continued strong domestic activity.

Figure 13: A comparison of macro variables around the 2005 and 2008 fuel price increases and potential 2012 increase
(inflation year-on-year, percent, LHS; fuel price increase, percent RHS; Consumer Sentiment Index, RHS)



Notes: 2012 inflation and food inflation peaks are World Bank projections. Consumer sentiment is a simple average of the BI Consumer Confidence Index and Danareksa Consumer Confidence Index and are taken two months prior to the fuel price increases in each year in order to gauge the level before the decision of the increases were made public. The dates of the fuel price increases were March 2005, October 2005, May 2008, and provided oil prices remain elevated above USD 120 per barrel it is assumed there will be an increase in Q3 2012. For 2005, 'prior to increase' is measured at February 2005 and peak is Nov 2005. For 2008, 'prior to increase' is April 2008 and peak is September 2008. For 2012, 'prior to increase' is Feb 2012 (latest data point available) and, for a Q3 2012 increase, the peak is projected to be November 2012.
Source: BPS, BI Consumer Confidence, Danareksa Consumer Confidence and World Bank projections

5. Further balance of payment outflows were seen in the fourth quarter of 2011

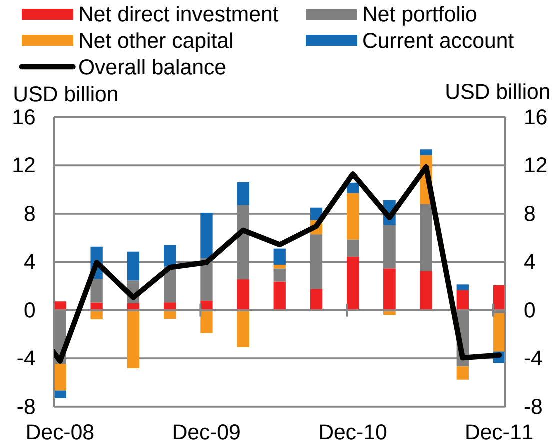
Indonesia's overall balance of payments recorded a second consecutive outflow in Q4 2011, as the uncertain global environment impacted capital flows

Spillovers from global financial market volatility and the weaker external environment have been seen most markedly in the balance of payments deficits of the second half of 2011. Following strong inflows in the first half of 2011, the balance of payments saw overall outflows in the third quarter - the first quarterly deficit since the fourth quarter of 2008 - and this continued into the final quarter of the year. These outflows were driven largely by financial account outflows although the current account also returned to a small deficit at the end of the year. After USD 3.7 billion in outflows in Q4, the overall balance of payment inflows in 2011 reached USD 11.9 billion (down from USD 31.8 billion in 2010).

Banking outflows were the main source of financial account outflows in Q4 2011, along with net sales of government bonds, while foreign investors returned strongly to private assets and FDI inflows also rebounded

Net financial account outflows fell to USD 1.4 billion in Q4 from USD 4.1 billion in Q3 (Figure 14). The outflows in Q3 had been driven primarily by portfolio outflows on the heightened international risk aversion associated with concerns over the Euro zone. In Q4, the outflows were mainly on the banking side as the domestic private sector increased their currency and deposits overseas by USD 3 billion. Foreign investor inflows to private share and bonds returned strongly. FDI inflows also rebounded to USD 4.4 billion in Q4 from USD 3 billion in Q3. These inflows were predominantly to the transport, storage, and communication sectors. For 2011 as a whole, FDI inflows reached USD 18.2 billion, 30 percent higher than 2010 inflows.

Figure 14: The balance of payments recorded a second consecutive deficit in Q4 2011
(USD billion)



Note: Errors and omissions not shown
Source: BI

In Q4 2011 the current account recorded its first deficit since the height of the 2008 financial crisis…

The trend decline in the current account continued into the final quarter of the year and a current account deficit was registered (USD 0.9 billion, 0.4 percent of GDP) for the first time since the height of the global financial crisis in the final quarter of 2008. Inflows from the declining surplus on goods trade (USD 7.4 billion versus USD 9.6 billion in Q3) and stable current transfers (USD 1.2 billion) were offset by the largest services trade deficit in eight years (USD 3.5 billion) and a still-high income deficit (USD 6.1 billion). While freight service imports continue to be important, the rise in the services deficit was driven by an increase in residents traveling overseas and in their spending.

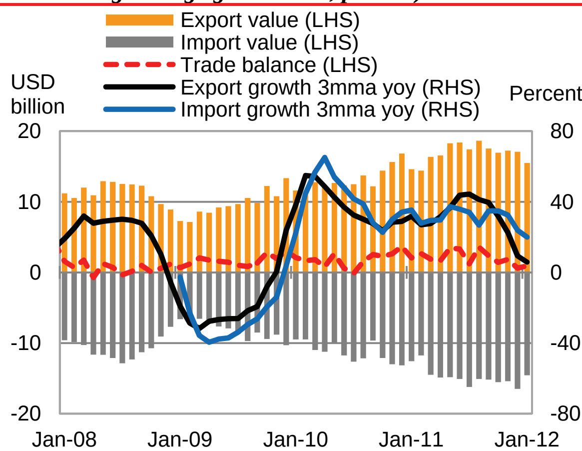
…as Indonesia's exports showed signs of being impacted by the slowing global economy

The weakening in global demand combined with lower commodity prices resulted in slower growth in both real and nominal exports in Q4 2011. The falls were sizeable across all sectors. However, the slowdown for the growth in manufacturing exports has been notable relative to that seen during previous periods with similar declines in global demand (but clearly much less than during the height of the global financial crisis). Measures such as improving electricity and transport infrastructure and improving the business climate could help domestic manufacturers improve their competitiveness to be able to weather such downturns in external demand (for detail see Part C in the December 2011 *IEQ*). By trading partner, the recent fall off in growth in manufacturing exports has been most prominent for China and Singapore while US and Europe have seen a gradual trend down in growth since mid-2011. On the imports side, growth in real and nominal imports has also slowed in year-on-year terms, but remains higher than for exports, contributing to the shrinking trade surplus (Figure 15). Imports of capital goods, machinery and airplanes remain firm, consistent with still-strong domestic demand.

Recently proposed changes to trade and investment regulations are aimed at supporting local producers and investors but could impact growth and investment over the medium-term

The Government has recently put in place, or proposed, a number of restrictive changes to regulations regarding trade and foreign investment. Some examples include a regulation which prohibits exports of raw rattan to ensure the availability of inputs for domestic furniture manufacturers and a proposed regulation to implement administered import quotas and a non-automatic licensing system for imports of horticulture products, to address a perceived influx of horticulture imports. Other regulatory changes include a requirement for new mining permits that foreign mining firms divest 51 percent of ownership to local entities by the tenth year of operation. It is also proposed that exports of raw metals including copper, iron, nickel and bauxite might be prohibited from 2014, to encourage the development of the domestic manufacturing sector for material processing. While aimed at supporting domestic investors or demand for local products they may also reduce trade, raise domestic prices and create uncertainty in the investment climate, particularly for foreign investors. Although the policies may not have an immediate impact on growth and investment, as reflected in record high FDI inflows in recent years, they may have significant longer term implications.

Figure 15: Trade values have softened in recent months
(value of goods trade, USD billion; year-on-year growth of 3-month moving average goods value, percent)



Note: The coverage of imports data was modified in January 2008 to include imports to Special Economic Zones, inducing a level-shift up in imports. Year-on-year calculations are thus taken from January 2009
Source: BPS and World Bank staff calculations

Table 5: The current account is projected to move into a small deficit in 2012 and financial inflows to come down
(USD billion)

	2009	2010	2011	2012	2013
Overall Balance of Payments	**12.5**	**30.3**	**11.9**	**7.9**	**12.6**
Current Account	10.6	5.6	2.1	-4.1	-1.7
Trade	*21.2*	*21.3*	*23.5*	*15.4*	*18.7*
Income	*-15.1*	*-20.3*	*-25.7*	*-24.2*	*-25.3*
Transfers	*4.6*	*4.6*	*4.2*	*4.7*	*4.9*
Capital & Financial Accounts	4.9	26.6	14.0	11.9	14.3
FDI	*2.6*	*11.1*	*10.4*	*9.3*	*10.6*
Portfolio	*10.3*	*13.2*	*4.2*	*7.8*	*8.5*
Other	*-8.1*	*2.3*	*-0.6*	*-5.2*	*-4.8*
Reserves[(a)]	**66.1**	**96.2**	**110.1**	**112.2**	

Note: Errors and omissions not shown. [(a)] 2012 reserves as of end-February
Source: BI and World Bank staff projections

Baseline projections are for the overall balance of payments to register healthy surpluses in 2012 and 2013 – however financial inflows remain highly sensitive to global market conditions

The outlook for external flows balances a number of dynamics. On the trade side, the weak global outlook is expected to weigh on export earnings in 2012, narrowing the trade surplus (Table 5). On the financial account-side, the prospect of improved risk appetite, combined with the recent upgrade by Fitch (in December 2011) and Moody's (in January 2012) of Indonesia's sovereign long-term debt back to investment grade, augurs well for increased portfolio investment inflows, in the absence of renewed financial market turbulence. FDI inflows are expected to remain solid. Foreign companies continue to be attracted by Indonesia's resources, growing domestic market and source of inexpensive labor, for example. Indeed, a recent survey by the Japanese Bank for International Cooperation on overseas business operations by Japanese manufacturing companies indicates a steady rise in the share of companies who view Indonesia as among the top five economies for medium-term business opportunities.

Nevertheless, balance of payment risks remain firmly weighted to the downside. Further downward revisions to external demand, renewed weakness in commodity prices and additional shocks to global financial markets, are all key external risks to the outlook over the forecast horizon. In terms of domestic factors, it is unclear at this stage how or to what extent portfolio flows will react to the revised 2012 Budget and the uncertainty regarding an adjustment to subsidized fuel prices. It depends in part on the interplay of changing investor perceptions of fiscal risk should oil prices remain high and no price adjustment occur and also the risks to the inflation outlook.

Indonesia's current account is projected to move into an annual deficit in 2012

The annual current account is projected to move into deficit in 2012, for the first time since the Asian financial crisis, reflecting the combination of weaker global demand for Indonesia's exports, strong local demand for industrial, capital and transportation imports and continued solid profit repatriations consistent with increasing FDI in Indonesia. To the extent that the rising imports of capital and intermediate inputs are associated with increased domestic and foreign direct investment, particularly FDI, the decline in the current account deficit can be viewed as a signal of confidence in the future growth potential of the economy. It reflects the fact that domestic investment exceeds domestic savings with the difference financed by a country borrowing abroad. The investment that is financed can increase the productive capacity of the economy, and future ability to pay off this external borrowing. However, particularly in the current fragile external environment, any sharp further widening of the deficit could lead to greater external financing risks, if portfolio and banking flows suddenly reversed. The rising share of FDI in capital inflows helps to mitigate this risk. Furthermore, the current account deficit is forecast to remain a relatively low fraction of Indonesia's overall external financing needs (i.e. external debt amortization plus current account deficit, estimated by the IMF at USD 96.5 billion for 2012).

6. Financial markets are likely to remain sensitive to fuel price developments

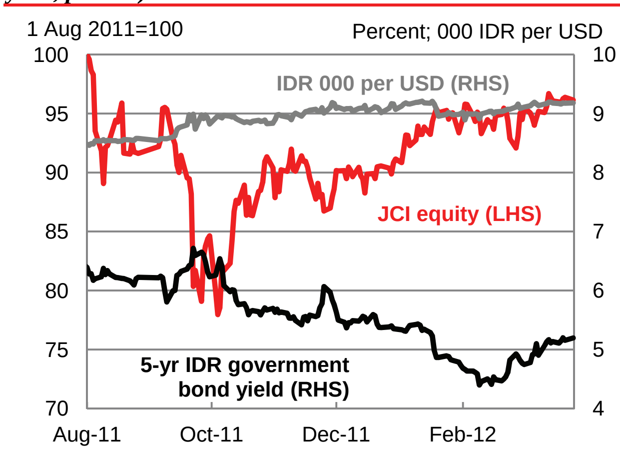
Local currency government bond yields have recently picked up, in part reflecting expectations of higher inflation due to the proposal to increase fuel prices, but remain near historically low levels

Domestic financial market movements since the December 2011 *IEQ* can be split into two segments, first driven primarily by international and then by domestic factors. From December through to early February, in line with the global trends discussed above, equity market gains were seen (Figure 16). Local-currency government bond yields continued to decline, supported by the upgrade of Indonesia to investment grade mentioned above, and non-resident investors increased their holdings of Indonesia's government securities and equities (Figure 17).

Since mid-February local currency government bond yields have moved up, with the five-year yield increasing by 70 basis points from 14 February to 5.2 percent on 26 March (still remaining 1 percentage point lower than in August 2011). Non-resident investor holdings of tradable IDR-denominated government securities declined by IDR 9.2 trillion to IDR 225.4 trillion over this period. Concerns of rising inflation related to the Government's announcement of a hike in subsidized fuel prices in its draft revised Budget have played a role in these movements, although in the longer-term reducing the burden of fuel subsidies should reduce Indonesia's fiscal, and suppressed inflation, risk. The Rupiah has gradually fallen against the USD dollar over this period, down 1.6 percent since mid-February, reflecting the moderation of capital inflows and declining trade balance.

Figure 16: Bond yields have recently picked up and the Rupiah has depreciated gradually against the US dollar

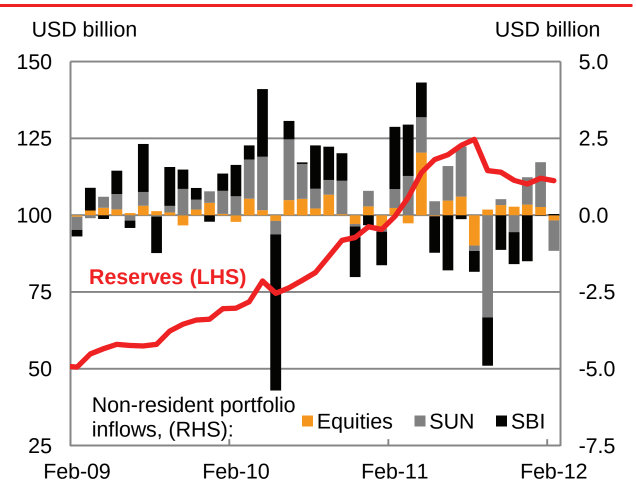
(equity index, 1 August 2011=100; IDR per USD; yield, percent)



Source: CEIC and World Bank staff calculations

Figure 17: February saw a reduction in non-resident investor holdings of Indonesian government bonds

(USD billion)



Note: "Flows" for SUN (IDR government securities) and SBI (BI certificates) indicate changes in holdings

Source: BI, CEIC and World Bank staff calculations

After a loosening in stance in late 2011, BI now faces the challenge of responding to emerging inflationary pressures, particularly related to any adjustment in the price of subsidized fuel

Bank Indonesia, in anticipation of a worsening external environment, and with core inflation low and stable, loosened monetary policy at the end of 2011 and the beginning of 2012. Following total rate cuts of 75 basis points in October and November, BI made an additional 25 basis point cut in February 2012. This followed its announcement a month earlier of a further 50 basis point reduction in the lower bound of its operational corridor (the overnight deposit facility rate), moving it to 200 basis points below the policy rate.

Following the announcement of the Government's proposal to increase subsidized fuel prices, BI maintained its policy rate in March. The central bank also indicated its intention to manage short-term inflationary pressures through liquidity management and macro-prudential tools, while interest rates would "continue to be directed to control inflation pressure from fundamentals" based on the macro outlook. Indeed, BI recently announced maximum loan-to-value ratios for housing loans and minimum down payments on vehicle loans. The challenge will be to use the various policy instruments at BI's disposal in a consistent way to ensure that temporary inflation pressures do not translate into sustained rises in inflation and inflation expectations. This is made more difficult by the uncertainty over when any rise in the subsidized fuel price might happen and by the relative weakness of the monetary policy transmission mechanisms in Indonesia, as seen, for example, in the limited impact of recent policy rate cuts on commercial bank lending rates.

New regulations cap loan-to-value ratios for housing loans and impose minimum down payments for car and motorbike loans

The new regulations announced by BI would cap the loan-to-value (LTV) ratio for commercial banks' housing loans (for properties above a certain size) at 70 percent, effective mid-June 2012. Vehicle loans from banks are also to be subject to a minimum down payment, for example, of 25 percent for a motorcycle or 30 percent for a private car. The Ministry of Finance also issued a similar regulation for multi-finance companies, mandating minimum down payments for cars and motorbikes 5 percentage points lower than the respective levels for the commercial banks.

These macro-prudential measures come at a time when overall loan growth is around 25 percent year-on-year. However, around two-thirds of recent loan growth has come from working capital and investment loans rather than consumer loans (and it is also unclear to what extent the new restrictions will be binding). System-wide banking sector indicators have remained solid over the quarter to January. Gross non-performing loans moved down slightly to 2.8 percent while the capital adequacy ratio moved up to 18.4 percent.

7. Uncertainty over the future path of fuel prices adds to Indonesia's near-term risks

External risks remain prominent, including adverse shocks to investor sentiment…

Indonesia's economic outlook remains sensitive to adverse shocks to international investor sentiment, global commodity prices and external demand. The baseline international outlook remains that of continued market turbulence, outlined in the October 2011 *IEQ*. Although international financial markets have stabilized in recent months, with borrowing costs and spreads falling, there remains considerable uncertainty over the resolution of the Euro zone debt crisis and related banking sector difficulties.

… to commodity prices and global demand

While energy and non-energy prices have recently both moved up, a particularly concern would be a scenario where their paths de-couple and oil prices continue to rise, due to geo-political or supply problems, but non-energy prices, such as for minerals, decline on the back of a decline in global demand. Higher oil prices would put pressure on Indonesia's fiscal situation, and also could dampen global activity and increase import costs, while revenues and exports would be hit by a fall in non-energy prices.

Indonesia's recent declines in export growth show that it is not immune from trade spillovers from weakening global growth. If there were to be a further deterioration in external demand this could quickly impact trade volumes, widening further the recently emerged current account deficit. There is, however, also potential upside risk to external demand, particularly if key markets such as the US or China outperform expectations, pulling upwards the growth performance of Indonesia's regional trading partners.

Domestically, the main uncertainties relate to the future adjustment of fuel prices

Domestically, there remains uncertainty over if, or when, there will be an increase in subsidized fuel prices over this year. Relative to the Government's proposal of an increase in April 2012, the decision by Parliament to allow an increase only if the oil price remains sufficiently high represents a missed, or delayed, opportunity to improve the efficiency of spending and reduce the burden of this spending, which adds risk to the fiscal outlook and increases the complexity of the approach to fuel price adjustment.

The fiscal risks of delaying a fuel price increase have risen with higher oil prices…

The baseline scenario described in this section assumes there is a price increase in Q3 2012. However, if oil prices remain high and there is no price adjustment, either because the oil price threshold foreseen in the 2012 Budget to allow an adjustment is not reached or it is breached but the adjustment does not occur, the Government will face an expansion of the budget deficit. The higher oil price will push up energy subsidies, transfer to the regions and education spending (which as discussed in Part C is mandated at 20 percent of total spending), more than offsetting increased oil and gas-related tax and non-tax revenues. The World Bank analysis described above suggests that if oil prices average USD 120 in 2012 then the deficit, with no reform could rise to 3.1 percent of GDP. Although imposing an opportunity cost, this burden is manageable from the perspective of debt sustainability given Indonesia's low government debt and the baseline continued robust growth outlook. However, the risk of hitting the 3 percent deficit limit due to high fuel subsidies may motivate offsetting reductions in line ministry spending, to the detriment of key development spending areas.

…and the uncertainty over the path for domestic inflation has also increased

There are, of course, notable risks around the inflation projection. Most clearly these relate to whether a price rise is indeed implemented and when. The degree, and stickiness, of any anticipatory price increases is also unclear. Higher international oil prices may also feed into imported inflation, and through input costs, into general prices. The increased uncertainty over the inflation outlook is likely to present challenges for the appropriate setting of monetary policy, given the lags and uncertainties for the impact of policy adjustment on economic conditions. The inflation uncertainty may also affect the consumption and investment decisions of domestic households and firms. The impact of this inflation uncertainty and changing fiscal outlook on investors' demand for Indonesian assets is unclear at this stage but it does pose an additional risk to the outlook.

B. SOME RECENT DEVELOPMENTS IN INDONESIA'S ECONOMY

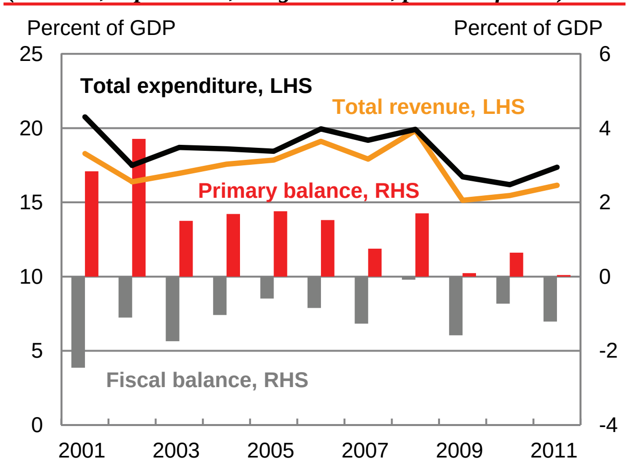
1. 2011 budget performance – a brief review

Indonesia's fiscal position continued to be prudent in 2011 with the deficit coming in at 1.2 percent of GDP, well below the revised Budget target of 2.1 percent

Delivering the level and quality of public services required for Indonesia to meet its objectives for growth and inclusive development requires further improvements in the allocation and efficiency, as well as the execution of government spending. This section provides insights into these issues, along with recent trends in revenue performance, through a review of the 2011 Budget outcome.

Looking at the headline numbers, total revenue moved up to 16.2 percent of GDP from 15.5 percent of GDP in 2010 (Table 6). Total expenditure stood at 17.4 percent of GDP, an increase of 1.2 percent of GDP relative to 2010 (Figure 18). As a result, the realized 2011 budget deficit (based on unaudited figures as of 30 December) was 1.2 percent of GDP or IDR 90.1 trillion. This is well below the revised Budget level of 2.1 percent of GDP or IDR 151 trillion and also the World Bank's December 2011 *IEQ* deficit projection of IDR 116 trillion or 1.6 percent of GDP. Stronger revenue collection and weak spending of core government programs more than offset higher spending on energy subsidies. The lower fiscal deficit than planned resulted in a substantial financing surplus of IDR 39 trillion which lifted the government's accumulated unspent balance (SAL or *Sisa Anggaran Lebih*) to around IDR 96.6 trillion by end 2011.

Figure 18: Indonesia's Budget deficit has remained low
(Revenue, expenditure, budget balance, percent of GDP)



Source: MoF and World Bank

Continuing conservative fiscal policy contributed to further reduction in Indonesia's debt to GDP ratio to 24 percent of GDP by the end of 2011.

Table 6: Despite high energy subsidy spending the deficit in 2011 came in well below the revised Budget level
(IDR trillion, unless otherwise indicated)

	2010 Outcome	2011 Revised budget	2011 Outcome (unaudited)	Nominal growth on 2010, percent*	Difference relative to revised Budget, percent
A. State revenue and grants	**995.3**	**1,169.8**	**1,199.5**	**20.5**	**2.5**
1. Tax revenue	723.3	878.6	872.6	20.6	-0.7
a. Domestic tax	694.4	831.7	818.6	17.9	-1.6
i. Income tax	357.0	431.9	430.8	20.7	-0.3
- Oil and gas	58.9	65.2	73.1	24.1	12.1
- Non oil and gas	298.2	366.7	357.7	20.0	-2.5
ii. Other domestic taxes	337.3	399.8	387.8	15.0	-3.0
b. International trade tax	28.9	46.9	54.0	86.9	15.1
i. Import duties	20.0	21.5	25.2	26.0	17.2
ii. Export duties	8.9	25.4	28.8	223.6	13.4
2. Non-tax revenue	268.9	286.5	324.3	20.6	13.2
o/w natural resources	168.8	192.0	215.3	27.5	12.1
i. Oil and gas	152.7	173.2	194.7	27.5	12.4
ii. Non oil and gas	16.1	18.8	20.6	28.0	9.6
B. Expenditure	**1,042.1**	**1,320.8**	**1,289.7**	**23.8**	**-2.4**
1. Central government	697.4	908.3	878.3	25.9	-3.3
- Personnel	148.1	182.9	175.5	18.5	-4.0
- Material expenditure	97.6	142.8	121.0	24.0	-15.3
- Capital expenditure	80.3	141.0	115.9	44.3	-17.8
- Interest payments	88.4	106.6	93.3	5.5	-12.5
- Subsidies	192.7	237.2	294.9	53.0	24.3
Fuel	82.4	129.7	165.2	100.5	27.4
Electricity	57.6	65.6	90.5	57.1	38.0
- Social expenditure	68.6	81.8	70.9	3.4	-13.3
2. Transfers to the regions	344.7	412.5	411.4	19.4	-0.3
C. Primary balance	41.5	-44.4	3.1		
D. SURPLUS / DEFICIT	-46.9	-151.0	-90.2		
- as percent of GDP	-0.7	-2.1	-1.2		
E. Net financing	91.6	150.8	129.3		
1. Net domestic banking	22.2	48.8	49.0		
2. Net debt financing	73.9	123.9	100.7		
- Debt securities	91.1	126.7	119.9		
- Official loans	-4.6	-2.8	-19.2		
3. Other net financing	-17.7	-21.8	-20.4		
Economic assumptions/outcomes					
Gross domestic product (GDP)	6,423	7,227	7,427		
Economic growth (percent)	6.1	6.5	6.5		
CPI (percent)	5.1	5.7	5.4		
Exchange rate (IDR/USD)	9,074	8,700	8,742		
Interest rate (average percent)*	6.4	5.6	6.6		
Crude oil price (USD/barrel)	79	95	111		
Oil production ('000 barrels/day)	954	945	898		

Note: * 2011 outcome is to 30 December
Source: MoF, World Bank staff calculations

a. Revenues came in strong although tax collection was slightly below target…

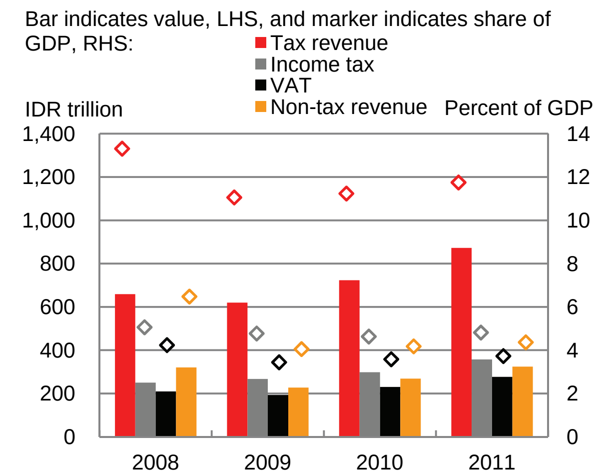
Revenue outturns in 2011 were slightly higher than targeted in the revised budget…

The realization of revenue was IDR 1,199.5 trillion, slightly exceeding the target set in the revised budget (by 2.6 percent) or up by 21 percent in nominal terms compared to 2010 levels. Both tax and non-tax revenues grew by 21 percent on the back of strong nominal GDP growth and increasing commodity prices, primarily for crude oil and crude palm oil (CPO). Tax and non-tax revenues increased slightly as a percentage share of GDP compared to 2010. The tax-to-GDP ratio was up by 0.5 percentage points on 2010 to 11.7 percent (excluding taxes collected by sub-national government), but came in below the initial target in the Budget of 12.1 percent of GDP. Non-tax revenues rose to 4.4 percent of GDP in 2011, slightly higher than the 2010 level of 4.2 percent of GDP (Figure 19).

…driven by higher commodity prices

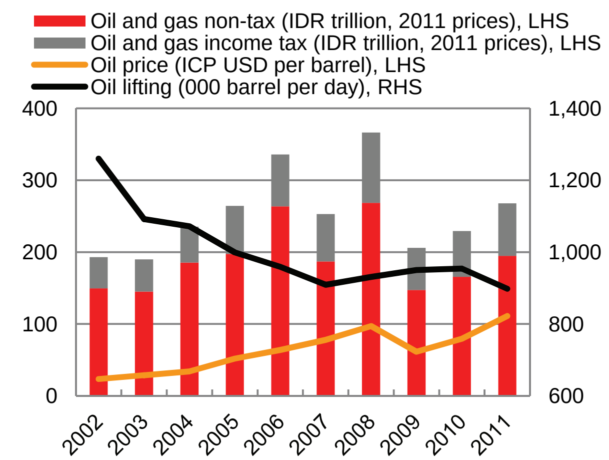
By type of tax, income tax (non-oil and gas) and value added tax also saw significant nominal growth of 20 percent, although came in slightly below the revised Budget. While a relatively small contribution to total revenue, export taxes more than doubled from their 2010 levels in nominal terms in line with increasing CPO prices. Oil and gas non-tax revenues rose by 27 percent in nominal terms in 2011 (up 18 percent in real terms) while oil and gas tax revenues rose by 24 percent in nominal terms (up 15 percent in real terms), coming in 12 percent higher than the revised Budget projection. This was driven by a higher average Indonesia crude oil price (ICP), which reached USD 111 per barrel in 2011, up 40 percent from USD 79 per barrel in 2010. However, offsetting this boost to revenues was the continued decline in oil lifting numbers, with production in 2011 averaging 898,500 barrels per day (bpd), 5 percent lower than the revised Budget's assumption of 945,000 bpd (Figure 20).

Figure 19: Revenue collection in 2011 was relatively strong…
(IDR trillion)



Source: Ministry of Finance

Figure 20: Oil lifting has trended downwards, dampening the rise in related revenues from higher oil prices
(revenues in 2011 prices, IDR trillion; Indonesia crude oil price per barrel, USD; oil lifting, 000 barrel per day)



Note: Lifting for 2011 is December 2010-November 2011
Source: MoF, CEIC and World Bank

As in previous years, year-end strength in revenues were seen across major types of revenue

As in previous years there was significant year-end strength in revenues. The monthly revenue realization in December was IDR 176.6 trillion, almost double the average monthly outcome between January and November and equal to 15 percent of total revenues for the year. This back loading of revenues was partly driven by strength in oil and gas revenues, and strong corporate income tax and VAT collection due to end of year tax payment deadlines and administration and verification procedures.

The Government launched a tax census to register additional tax payers, although the numbers registered were below the target

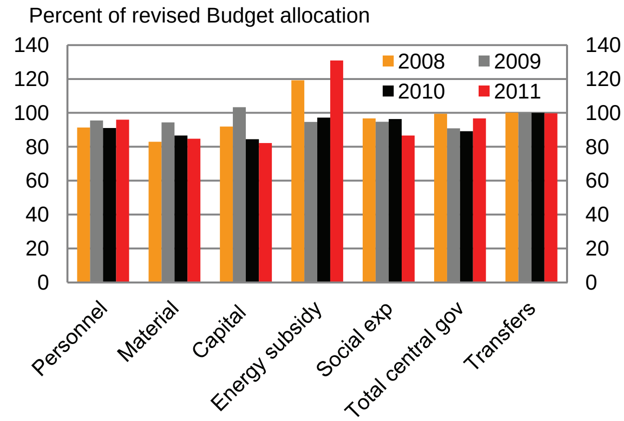
To improve its tax payer database, reduce tax evasion, and broaden the tax base, the Government launched a National Tax Census Program on September 30, 2011 simultaneously in 37 cities throughout Indonesia, including Jakarta. The tax census was able to register 646,000 new census forms/tax payers from the prime central business districts and luxury residential areas in the targeted cities, but this was around one-third below the target of slightly over 1 million new forms/tax payers. A number of challenges were reportedly faced by tax officials during the implementation of the census, such as the non-availability of shop owners on site when the census was conducted and a shorter effective census period (only two months) than expected. The Government is reviewing its strategy and approach, and plans to conduct another round of tax census in April 2012, as part of the objective to improve income tax revenue collection.

b. Rising subsidy spending and weak budget execution continued until year end

Total realized expenditure was slightly below the revised Budget level but spending on energy subsidies, once again, significantly overshot the revised Budget allocation

Total expenditure realization in 2011 was IDR 1,289.6 trillion, around 2.5 percent below the revised Budget allocation. However, in nominal terms spending in 2011 was 24 percent higher than 2010. Energy subsidy spending and weak disbursement on core programs, particularly on materials and expenditures, were again key drivers of the expenditure patterns in 2011 (Figure 21).

Figure 21: Energy subsidy spending significantly overshoots the revised Budget allocation
(share of actual of the revised budget, percent)



Source: MoF and World Bank

Spending on energy subsidy substantially exceeded the allocated budget in 2011 by IDR 60 trillion, or 31 percent higher than in the revised budget. Fuel subsidy spending reached IDR 165.2 trillion or 27 percent higher than in the revised Budget driven by the large and growing gap between the regulated and market fuel prices and an increase in the volume of subsidized fuel consumed. As discussed above, the oil price in 2011 came in significantly above the revised Budget assumption. The price differential between market and subsidized fuel, along with rising incomes and vehicle usage, contributed to subsidized fuel consumption moving up to 41.69 million kilo liter, 3 percent higher than the revised Budget level of 40.36 million kilo liter[2]. The Government postponed an earlier plan to restrict the sale of subsidized fuel for private car users in April 2011, which was planned to be piloted in Jakarta and surrounding areas. The electricity subsidy also substantially exceeded the allocated budget (by IDR 25 trillion) due to rising oil prices and a shortage of gas supply. As described in Part A, parliament has approved the 2012 revised Budget that allows the Government to increase subsidized fuel prices if for 6 months the average oil price is 15 percent higher than the revised Budget assumption, combined with cash transfers to the poor.

Spending on capital expenditures rose markedly in nominal terms in 2011, but still came in well below Budget targets

The execution of capital and material expenditures slightly improved in 2011. The disbursement rates of both capital and material were slightly higher than 2010 levels but still below the revised budget at 82 percent and 85 percent. However, both spending have risen markedly in nominal terms by 22 percent and 44 percent respectively between 2010 and 2011. Capital spending moved up to 1.6 percent of GDP and is expected to increase to 2 percent of GDP in 2012.

Social expenditure, which consist of social programs such as health insurance for the poor (Jamkesmas), school operational fee (BOS) and scholarships for the poor, and national community development programs (PNPM), was disbursed at 87 percent of the revised budget due to delays in the verification process of beneficiaries. Salary and transfers to the region were disbursed as expected. “Other expenditures” came in significantly lower than budgeted as most contingency expenditures were not realized.

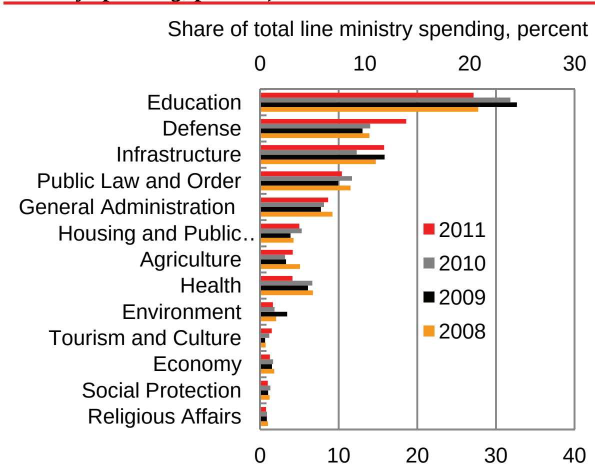
[2] http://ekonomi.inilah.com/read/detail/1815941/konsumsi-bbm-subsidi-2011-capai-4169-juta-kl

Education, defense, and infrastructure were the three biggest sectors by spending in 2011

Reflecting the rise in capital expenditures, and the mandated 20 percent of spending on education (see Part C for a discussion), education, defense, and infrastructure together accounted for 62 percent of total line ministries spending in 2011 (Figure 22). Education spending increased by 5 percent in nominal terms in 2011 while defense spending rose 63 percent, mainly to finance the modernization and improvement of military equipment. Infrastructure also received a significant spending boost in 2011, up by 57 percent in nominal terms relative to 2010. As a share of GDP, central government infrastructure spending moved to 0.8 percent of GDP from 0.6 percent of GDP in 2010 (Figure 23). The significant budget increase reflected the government priority of supporting domestic connectivity through expansion and improvement of national roads, airport development and rehabilitation and extension of the electricity network. Spending on government administration also increased by 30 percent in 2011, reflecting the on-going process of bureaucratic reform and a nominal 10 percent salary increase for civil servants.

Figure 22: Education, defense, and infrastructure accounted for 62 percent of 2011 line ministry spending

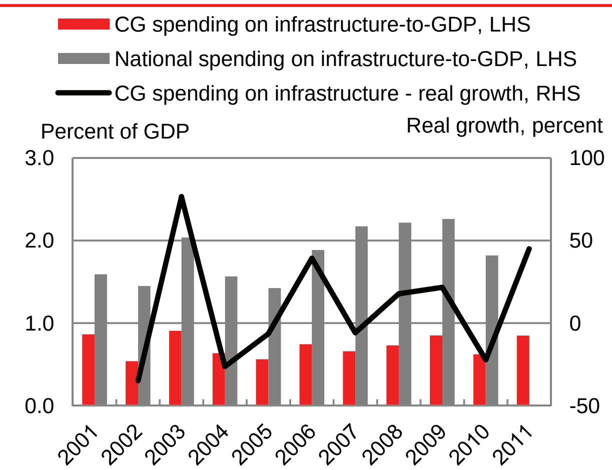
(Line ministry spending by function, share of total line ministry spending, percent)



Source: MoF and World Bank staff calculations

Figure 23: Central government spending on infrastructure increased markedly in 2011

(percent of GDP, and growth)



Note: GDP deflator used to calculate real growth

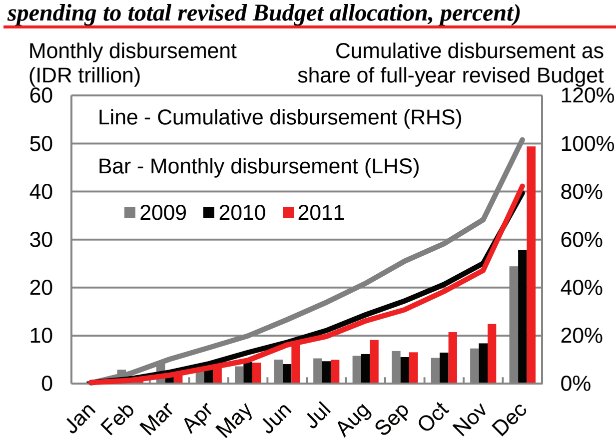
Source: MoF and World Bank staff calculations

Spending continued to be skewed towards the end of the year…

As in previous years, spending in 2011 was bunched at the end of the year. About 22 percent of total expenditure (IDR 288 trillion) was spent in December alone, tripling the average monthly spending between January and November. By type of expenditure, 30 percent of material expenditures, 43 percent of capital expenditures, and 33 percent of spending on energy subsidies were disbursed in December. The weight of capital spending in December was worse in 2011 than in 2010 (Figure 24). As discussed in the December 2010 *IEQ,* this back loading of spending can undermine the effectiveness and quality of spending.

Figure 24: …and capital expenditures continue to be back-loaded towards the end of the year

(monthly capital spending, IDR trillion; cumulative capital spending to total revised Budget allocation, percent)



Source: MoF

…reflecting on-going challenges in budget execution

Budget execution, particularly for capital spending, remains challenging. Some persistent constraints remain such as the complicated land acquisition process and the lengthy budget revision and procurement processes. Some of the reforms introduced to accelerate budget execution in 2010, such as early procurement and the multi-year appointment of implementing unit managers (Satker), have had limited impact due to a lack of dissemination and the necessary technical regulations, or inconsistencies with other regulations. In addition, the policy of budget efficiency (spending cuts) implemented within the fiscal year (from April 2011) affected budget execution through revision of the budget warrant (*Daftar Isian Pelaksanaan Anggaran* or DIPA).

The Government has introduced measures to improve execution

The Government is aware of the ongoing problems with budget execution and has introduced measures to improve it. The President has established a Budget Execution Task Force (*Tim Evaluasi dan Pengawasan Pelaksanaan Anggaran*, TEPPA) led by the Presidential Working Unit for Supervision and Management of Development (UKP4) to closely monitor and accelerate budget execution in 2012. The Ministry of Finance has also issued a regulation on multi-year contracts that allows big and complex infrastructure projects to be implemented simultaneously with construction activities. Prior to that, all projects that required multiyear warrant from the Ministry of Finance needed to complete the land acquisition process before starting activities. The recently passed Land Acquisition Law is expected to accelerate the land acquisition process (Box 4). However, the effectiveness of this Law is subject to the issuance of implementing regulations which are expected later in the year. In addition, the Government is preparing a government regulation on budget execution that is also expected to improve budget implementation.

Box 4: Key features of Indonesia's new Land Acquisition Law

To accelerate the land acquisition process, which is critical for infrastructure project, the Government and Parliament approved the new Land Acquisition Law (UU No.2/2012) at the end of 2011. This new law is expected to expedite the land acquisition process, which has been the major constraint for infrastructure development in Indonesia. The new law clarifies roles, imposes time limits on each phase of procedures, and ensures safeguards for land-right holders. Most importantly, the law provides a clear mechanism for enforcing the principle of eminent domain, or revocation of land rights, to prevent small minorities from blocking projects that fulfill the public interest, such as expressway projects. However, the crucial power of revoking land rights will rest with provincial governors. Therefore, the feasibility of projects will vary somewhat, depending on the province and the inclination of the governor involved. Moreover, projects that cross provincial boundaries (i.e. expressways) will be more cumbersome than those contained within one province. Once the land acquisition plan is approved by the governor, the execution will rest with the National Land Agency (*Badan Pertanahan Nasional* – BPN) a change from local government led execution in the old law. Overall, the new law should significantly increase the feasibility of land acquisition for projects.

Source: Law No.2/2012 and World Bank staff analysis

c. Looking forward

Commodity prices will remain a key driver of the budget outlook for Indonesia

Commodity prices continue to be a major driver of both revenues and expenditures in Indonesia. Revenues related to the oil and gas and CPO sectors account for one quarter of total revenue. Improving the income tax take from other non-oil and gas sectors can reduce this fiscal sensitivity to commodity price movements. Improving tax administration and expanding the tax base, such as through the next steps in the tax census, have an important role to play. On the expenditure side, the fiscal burden, risk and opportunity cost of energy subsidies has been discussed in Part A. Reducing the fuel subsidy, with compensating mechanisms for poor and vulnerable households, can play a role in improving the allocation of spending, freeing up fiscal space in the future for more productive spending such as on infrastructure and, as discussed in Part C, programs of integrated social assistance. Further improvements in budget execution are also important to effectively deliver the significant increases in budget allocations planned for key sectors, particularly infrastructure. Improving allocation and execution of public spending can help Indonesia achieve its growth and development targets.

2. Doing Business in Indonesia 2012

Despite Indonesia's strong recent economic performance, it faces challenges that hold back private-sector development

Despite its recent strong growth performance, Indonesia continues to face challenges that stifle private-sector development, including infrastructure weaknesses, access to skilled labor and the burden and uncertainty of the regulatory framework. This regulatory burden is also an important determinant of the high rates of informality in the economy. According to the World Bank's 2009 Enterprise Survey, nearly 30 percent of firms in Indonesia start operations without being formally registered. Over half the workforce remains in the informal sector, whose lower income security and benefits coverage can make households more vulnerable to adverse economic and health shocks, for example.

Effective and harmonious policy design and implementation at the local government level are crucial for the development of small to medium size domestic firms

Creating a more favorable business climate and making it easier to do business can facilitate start-ups, encourage investments, boost employment and improve economic competitiveness. It can also promote the expansion of the formal sector helping to provide more opportunities for workers to move into higher quality jobs. However, the regulatory environment for businesses, and reform progress, can vary markedly across locations within an economy. In a country as decentralized as Indonesia, effective and harmonious policy design and implementation at the local level are crucial for the development of small to medium-size domestic firms – the backbone of the economy. Looking at business regulations at the sub-national level can therefore provide important insights into the overall business environment and, more importantly, allow Indonesian cities to compare their regulations among themselves and with other economies and cities globally.

Doing Business in Indonesia 2012 is the second in a series analyzing business regulations beyond Jakarta

The recent Doing Business in Indonesia 2012 report is the second such report analyzing business regulations at the sub-national level.[3] It updates the information in the 2010 report and tracks progress in implementing reforms in three areas: starting a business, dealing with construction permits and registering property. The sample is expanded to 6 additional cities on top of the original 14. This section provides an overview of the key findings, highlighting the reform progress that has been made, the continued dispersion seen across cities, and how this benchmarking exercise can be used. Box 5 provides a brief background to the report and the broader Doing Business global survey.

a. Cities across Indonesia are improving commercial regulations…

Business reforms at the local level are making it easier for local entrepreneurs to start and operate a business

Between August 2009 and July 2011, national and local governments carried out twenty-two business reforms at the local level that made it easier to do business for local entrepreneurs in all 14 cities measured for the second time. All these cities improved the business start-up process, while 10 out of 14 improved dealing with construction permits (as measured by the requirements to build a warehouse and connect it to utilities ranges). While the economic impact has yet to be measured, these efforts by both the national and local governments have already resulted in time and cost savings for local entrepreneurs.

Simplifying local licensing requirements, establishing one-stop-shops, introducing statutory time limits, and eliminating or reducing fees for local licenses are some of the key local reforms that took place since 2010. The national government also issued legislation mandating the simplification of local licensing requirements for the required business trading license and the company registration certificate including setting statutory time limits and the elimination or reduction of associated fees. However, implementation of the new regulations still varies across the cities.

The time and cost it takes to start a business has fallen on average by one quarter since the 2010 report…

In the area of starting a business, all Indonesian cities benefited from the nationwide reintroduction in 2010 of a computerized system for company registration and the creation of standard incorporation forms for limited liability companies. Improved efficiency at local branches of national agencies also reduced the time needed for tax, labor and social security registrations in several cities. The average time and cost to start a business in cities measured for the second time were reduced by one quarter since the 2010 report (down 13 days and 8 percentage points of gross national income per capita respectively).

[3] For more details see http://www.doingbusiness.org/ indonesia. The Doing Business in Indonesia 2012 project was funded by the governments of Australia, Finland, the Kingdom of the Netherlands, New Zealand, Switzerland, and the International Finance Corporation Funding Mechanism for Technical Assistance and Advisory Service.

Box 5: About Doing Business and Doing Business in Indonesia 2012

Doing Business is an annual global survey conducted by the World Bank Group which gathers and analyzes comprehensive quantitative data based on a specific set of assumptions and indicators to compare business regulation environments across economies and over time. The indicators look at domestic small and medium-size companies and measure the regulations applying to them through their life cycle. Since the first global Doing Business report in 2003 the survey has grown from 133 economies and 5 sets of indicators to 183 countries and 11 sets of indicators in 2012. With the objective of promoting growth through a vibrant private sector, the Doing Business survey encourages countries to compete towards more efficient regulation; offers measurable benchmarks for reform; and serves as a resource for academics, private sector researchers and others interested in the business climate of each country. While providing a valuable set of benchmark indicators, there are a range of limitations of the Doing Business data which must be kept in mind when interpreting the data, such as the limited coverage, usage of standardized cases and focus on the formal sector.

Table 7: The Doing Business methodology allows an objective but limited global comparison

Advantages	Caveats
Transparent as based on factual information about laws and regulations (with inputs from the local respondents that includes lawyers, notaries and government agencies with respect to the on the ground implementation reality of such laws and regulations based on statistical data and experience)	**Limited in scope** with a focus on 11 areas of regulation affecting local business; does not measure all aspects of business environment or all areas of regulation
Comparison and benchmarking valid due to **standard assumptions**	Based on **standardized case**: transactions described in case scenario refer to specific set of issues and type of company
Inexpensive and easily replicable	Focuses on **formal sector**
Actionable data which highlight extent of specific obstacles, identify the source and point to what might be changed	**Only reforms related to indicators** can be tracked
Multiple interactions with local respondents to clarify potential misinterpretation	**Assumes that business has full information** on what is required and does not waste time when completing procedures
Nearly complete country coverage	Part of data obtained refer to an economy's **largest business city only,** although sub-national reports, such as for Indonesia, cover other major cities

Doing Business also offers detailed sub-national reports, covering business regulation and reform in different cities and regions within a nation. Doing Business in Indonesia 2012 is the second such sub-national report for Indonesia and limits its analyses to three sets of indicators that are most sensitive to local level implementation – starting a business, dealing with construction permits, and registering property – instead of the 11 indicators covered in the global survey. It is not meant to be a full reflection of the investment climate in Indonesia or an absolute measure of attractiveness for investment. The purpose is not the rankings in themselves but rather using the survey results to uncover potential challenges and to draw the attention, particularly of local government decision makers, to the fact that there are many options for them to improve their investment climate through their own local actions. The data in the report are based on the national and local laws and regulations as well as administrative requirements for a standardized case. Respondents filled out written surveys and provide references to the relevant laws, regulations, and schedules. Data checking and quality assurance are aided by working closely with legal practitioners and professionals who regularly undertake the cases involved.

Source: Law No.2/2012 and World Bank staff analysis

Note: For more details see www.doingbusiness.org

…with the average time and cost required to deal with construction permits also declining

Improvements in the construction permit process included the creation of one-stop shops, improved administrative efficiency of involved agencies, the simplification of requirements for commercial buildings, and the reduction or elimination of fees. Some cities, such as Banda Aceh, Surabaya and Surakarta, completely overhauled their building permit process. As a result, the average time required to deal with construction permits decreased by one month from 106 days in 2010 to 77 days in 2012. The average cost dropped from IDR 22.1 million (USD 2,123) to IDR 19.3 million (USD 1,850). In the area of registering property, the government continues to encourage entrepreneurs to formally register their lands by raising the tax-free limit on properties as their market values increased across Indonesia. Eleven of the 14 cities previously measured raised the tax-free value, nine of these only up to the minimum mandated in the national law.

b. …but there remain significant differences in performance across cities

There are large variations among the different cities benchmarked – both in local regulations and in the implementation of the

The decentralization process initiated in Indonesia a decade ago provided regional governments with the authority to administer business licenses. As a result, local governments apply their own license practices and implement national regulations differently. For example, the number of procedures to formally open a business ranges

same national laws pointing to ample room for improvement

from 8 to 11, of which 7 are required by national-level legislation. Yet, starting a business is fastest in Gorontalo and Palangka Raya at 27 days but takes 44 days in Jambi (Table 8). The same 6 procedures are required to register property in all 18 cities, with the exceptions of Batam and Semarang, but different local practices and levels of administrative efficiency still lead to wide differences in time across cities.

No single city performs best across the different indicators

There is no single city which is a top performer across all three sets of indicators examined in the report. It is easiest to start a business in Yogyakarta, deal with construction permits in Balikpapan, and register property in Bandung and Jakarta. It is most difficult to start a business in Manado and register property in Batam. Dealing with construction permits is most burdensome in Jakarta, while no building permits for commercial warehouses had been issued in Gorontalo since 2008.

Table 8: Where is it easier to start a business, deal with construction permits or register property?

Key = No. of proc is number of procedures; time is in days; cost is as percentage of gross national income per capita; paid in min. capital is minimum paid in capital as percentage of gross national income per capita (2010 Indo GDP=US$ 2,580)

	Starting a Business					Dealing with Construction Permits				Registering Property			
	Rank	No. of proc.	Time	Cost	Paid in Min. Capital	**Rank**	No. of proc.	Time	Cost	**Rank**	No. of proc.	Time	Cost
Balikpapan	**7**	8	28	26.3	46.6	**1**	8	52	62.8	**12**	6	39	10.9
Banda Aceh	**5**	9	29	19.3	46.6	**4**	10	42	66.5	**12**	6	39	10.9
Bandung	**12**	9	30	24.3	46.6	**8**	10	44	76.5	**1**	6	19	10.9
Batam*	**15**	9	39	22.6	46.6	**10**	9	45	127.3	**20**	7	54	13.3
Denpasar	**9**	8	31	22.9	46.6	**17**	12	94	71.4	**12**	6	39	10.9
Gorontalo*	**6**	9	27	22.2	46.6	**n.a.**	n.a.	n.a.	n.a.	**5**	6	31	10.9
Jakarta	**8**	8	45	17.9	46.6	**19**	13	158	105.3	**1**	6	22	10.8
Jambi*	**18**	10	44	20.2	46.6	**2**	10	68	32.0	**7**	6	37	10.9
Makassar	**17**	10	35	22.0	46.6	**11**	8	51	131.5	**9**	6	38	10.9
Manado	**20**	11	34	30.8	46.6	**18**	14	107	100.1	**15**	6	12	11.0
Mataram*	**10**	9	31	22.4	46.6	**12**	10	83	58.4	**4**	6	25	10.9
Medan*	**19**	11	39	21.2	46.6	**6**	7	71	70.3	**7**	6	37	10.9
Palangka Raya	**2**	8	27	22.0	46.6	**14**	11	82	37.5	**16**	6	15	11.0
Palembang	**11**	10	34	19.0	46.6	**3**	9	57	50.5	**3**	6	21	10.9
Pekanbaru	**16**	10	29	26.5	46.6	**15**	10	83	64.5	**18**	6	29	10.9
Pontianak*	**13**	10	42	17.8	46.6	**7**	11	59	32.3	**9**	6	38	10.9
Semarang	**4**	9	28	19.7	46.6	**8**	10	72	38.6	**19**	7	43	10.9
Surabaya	**14**	9	32	23.5	46.6	**16**	11	116	71.2	**11**	6	39	10.8
Surakarta	**3**	8	29	20.5	46.6	**12**	11	71	41.9	**17**	6	54	10.9
Yogyakarta	**1**	8	29	18.5	46.6	**5**	7	51	85.5	**6**	6	36	10.9

Note: The ranking on each topic is based on the simple average of the percentile rankings on its component indicators.
* indicates cities not benchmarked in Doing Business in Indonesia 2010. n.a. indicates no practice in Gorontalo
Source: Doing Business in Indonesia 2012

The costs of starting a business range from 18 to 31 percent of income per capita and takes from 27 to 45 days

Starting a business takes, on average, 9 procedures and 33 days. The differences in time and cost across cities reflect in part local licensing requirements. In Yogyakarta and Palangka Raya, where the business licensing process was consolidated at one-stop shops, complying with local requirements is fast - just 1 procedure over 5 days to obtain the business trading license, the company registration certificate and the location permit. In addition, the local branches of national agencies are not equally efficient in all locations. The average start-up cost is 22 percent of income per capita but varies from 18 percent in Pontianak to 31 percent in Manado with local licensing fees varying among cities.

The performance on the construction permits is relatively strong, although there remain sizeable variations across cities

The number of requirements to build a warehouse and connect it to utilities ranges from 7 in Medan and Yogyakarta to 14 in Manado. Although the average time required to deal with construction permits is 74 days (3.5 times faster than Malaysia and twice as fast as in Thailand) there are again considerable variations among cities. All necessary clearances and permits can be obtained in just 42 days in Banda Aceh while in Jakarta it takes 158 days. Variations mainly reflect time required to obtain municipal clearances and permits. It is cheapest to deal with construction permits in Jambi (32 percent of income per capita) whereas in Makassar the relative cost is four times higher.

Registering property continues to be expensive

At 11 percent of the property value, the average cost to register property in Indonesia is about triple the East Asia and the Pacific average of 4.1 percent. Eighteen of the 20 cities measured require 6 standard procedures to register property, but Semarang and Batam require 1 additional procedure in the process. While it takes almost 2 months to transfer a property title in Batam and Surakarta, it can be done in less than 2 weeks in Manado.

c. Learning from each other

Cities in Indonesia can learn from each other and adopt good practices that are already working within the country…

Despite the progress that has been made, the relatively high burden of business regulations continues to be a challenge for Indonesian entrepreneurs. However, cities in Indonesia can learn from each other and adopt good practices already working within the country. In particular, when compared internationally, some Indonesian cities already perform up to international standards on construction permits and do relatively well on time to transfer property. Indeed, cutting the number of procedures to build a warehouse to that of Yogyakarta or Medan or reducing the time needed to deal with these permits to the 42 days of Banda Aceh would put Indonesia in the top 10 rank globally on these indicators (Table 9). Adopting the time to register property from Manado would cut the time to 12 days, as in the United States, and put Indonesia into position 27 worldwide.

Table 9: Some cities within Indonesia already perform to international best practice

Indicator	Best performing city within Indonesia	Performance	Indonesia's global rank (out of 183 countries) if based on best performing city within Indonesia
Number of procedures to deal with construction permits	Medan, Yogyakarta	7 procedures	4
Days to deal with construction permits	Banda Aceh	42 days	5
Days to register property	Manado	12 days	27
Cost to deal with construction permits	Jambi	32 percent of income per capita	42
Number of procedures to register property	All cities except Batam, Semarang	6 procedures	83
Number of procedures to start a business	Balikpapan, Denpasar, Jakarta, Palangka Raya, Surakarta, Yogyakarta	8 procedures	109
Cost to start a business	Jakarta, Pontianak, Yogyakarta	18 percent of income per capita	111
Days to start a business	Gorontalo, Palangka Raya	27 days	117
Cost to register property	Jakarta	11 percent of property value	151

Source: Doing Business in Indonesia 2012

…and also look internationally to improve practices that could help close the gap between cities in Indonesia and the global leaders on other indicators where domestic performance is not as strong

However, Indonesia's performance on starting a business remains relatively weak, taking about 1 month longer than in Malaysia and costing 4 times as much as in Thailand, for example. Adoption of the good practices within Indonesia would still leave the country lagging behind more than 100 other economies globally. The same is true for the cost of registering property. Looking to regional and global good practices can help close the gap between Indonesia and the global leaders on these indicators. For example, neighboring countries such as Malaysia; Taiwan, China; Thailand and Vietnam, have formed regulatory reform committees, which can involve private sector and government members, to inform and monitor implementation of the national business climate reform agenda.

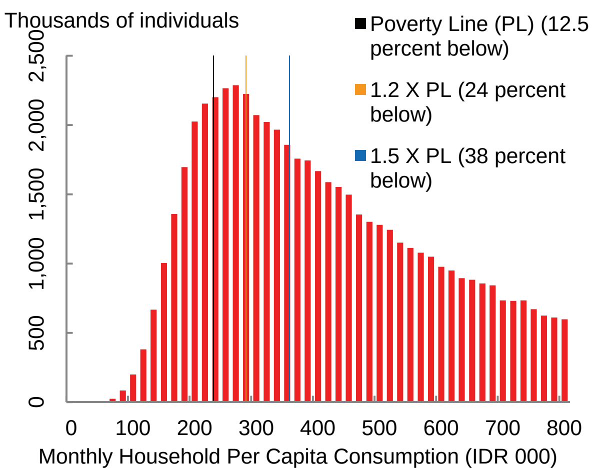
C. INDONESIA 2014 AND BEYOND: A SELECTIVE LOOK

1. Building Indonesia's social safety net

Though absolute poverty is declining, 40 percent of Indonesia's population remains highly vulnerable to shocks that threaten to push them into poverty…

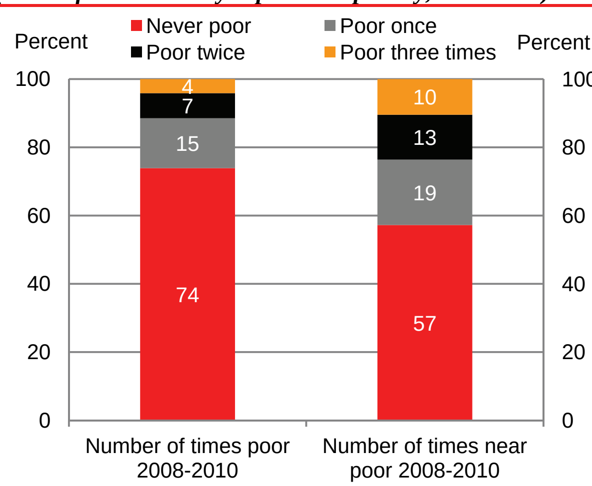
Indonesia's robust economic growth and sound macro policy management have contributed to a reduction in the national poverty rate from 23.4 percent in 1999 to 12.5 percent in 2011. However, declining poverty partially masks a worrying degree of vulnerability: much of Indonesia's population is clustered just above the 2011 poverty line of IDR 233,000 per month (about USD 27 at 2011 nominal exchange rates). Around 24 percent of Indonesians live below the official "near-poor" line (1.2 times poverty line expenditure), while 38 percent of the population lives below 1.5 times the poverty line and are highly exposed to poverty-inducing events (Figure 25). Even relatively small shocks to these vulnerable households can be enough to push them into poverty: in recent years, half of all poor households were not poor the year before while more than a quarter of all Indonesians have been in poverty at least once over 2008 to 2010 (Figure 26).

Figure 25: Much of Indonesia's population live just above the poverty time…
(2011 monthly household per capita consumption, Rupiah)



Note: The national poverty line was set at approximately IDR 234,000 per person per month in 2011
Source: Susenas and World Bank staff calculations

Figure 26: … and approximately 25 percent of Indonesians have been poor at least once in the past three years.
(share of individuals by exposure to poverty, 2008-2010)



Source: Susenas and World Bank staff calculations

…raising the question of whether Indonesia's current social assistance programs can provide an effective social safety net

Indonesia's double challenge – helping households escape impoverishment and protecting the highly vulnerable – can be addressed with a social safety net. Social safety nets, which consist of non- contributory cash or in-kind transfer programs targeting the poor and vulnerable, are one component in a social protection suite, which typically also includes social insurance, active labor market programs, and provision of high-quality, low-cost education and health services accessible to all.

Drawing on recently released World Bank analysis, this section asks to what extent Indonesia's current social assistance programs provide an effective social safety net. In order to answer this question it considers six intermediate questions: Does Indonesia allocate the right level of resources to household social assistance? Do programs provide the right benefits? Are benefits reaching the right people? Do people receive the benefits at the right time? Are programs implemented in the right way? Does Indonesia have the right programs and system in place?[4]

Social safety nets help to protect households from the impact of negative shocks, promote opportunities to move out of poverty and facilitate the implementation of government reforms, for example on subsidies

Safety nets serve three main functions. The first is to protect households from impacts of negative economic shocks. They can provide income or in-kind support and subsequently reduce inequality. By protecting consumption, they can also reduce the likelihood of poor and vulnerable households resorting to negative coping strategies in the face of shocks, such as pulling children prematurely from school to enter the workforce.

Social safety nets can also be used to enhance the future opportunities and livelihoods of poor and vulnerable families by promoting their investments in productive assets, including in human capital like education and health. These investments not only help to sever the transmission of poverty to future generations but can leave households better prepared in terms of *ex ante* strategies to reduce their risk of falling back into poverty, for example, through building up savings or using other financial management products.

Finally, safety nets may help governments to implement reforms to address inefficient redistributive policies in other sectors or to put in place policies or investments to improve growth. Most topically, for example, reorienting spending towards progressive transfers and providing consumption support during the acute inflationary environment that follows a subsidy reduction can help sustain pro-poor, and pro-growth, reforms and investments.

a. The building blocks exist, but better construction and engineering are needed

The Government of Indonesia has developed a number of household-based social assistance (SA) programs targeting the poor and near-poor

Indonesia has rapidly introduced a range of social assistance (SA) programs forming the potential foundation of a true social safety net. The first generation of programs was borne of the 1997/98 crisis when the Government introduced a number of temporary initiatives to protect the poor from large negative shocks. A second generation of more permanent programs was introduced in 2005 to help usher in fuel subsidy cuts, and more recently, the Government has piloted and expanded programs that have a greater emphasis on the promotion of health and education services for poor and vulnerable families. Today, social assistance is concentrated in eight household-based programs which are all primarily designed, funded, and executed by the central government (Box 6).

Indonesia needs to go beyond program reform to build a social safety net providing consistent, high-quality, and comprehensive coverage

Indonesia's current range of SA programs does not go far enough in protecting populations with the greatest exposure to poverty. These programs have been limited in their effectiveness due to (a) an insufficient ability to find and prioritize poor or vulnerable households; (b) a total benefit package that is sometimes underfunded, sometimes inadequate for addressing the particular household need or risk, and sometimes delivered with less-than-optimal timing; (c) a passive and implicit reliance on poorly-equipped local implementation partners combined with little explicit financial or technical support; (d) weakly-monitored and insufficiently-detailed implementation procedures; or in many cases a combination of all four reasons. The likelihood that an eligible household will consistently receive all benefits is small, while the facilitation, outreach, and information dissemination that are necessary to ensure households with any type of background use programs effectively are not consistently provided. So the current range of SA programs provides partial and non-guaranteed protection to the poor and vulnerable from some, but not all, of the risks faced, but there are risks that are not yet covered by any program – e.g., risks due to sudden job loss or underinvestment in early childhood education. A true social safety net will involve system-wide planning and coordination between programs and agencies in order to ensure that all types of eligible households are reliably protected for all important risks.

[4] This section draws on the recently released World Bank (2012) report on *Protecting Poor and Vulnerable Households in Indonesia,* available at http://go.worldbank.org/5BWH4ZCQM0. Support for this report was generously provided by the Australian Agency for International Development and the Embassy of the Kingdom of the Netherlands in Indonesia.

Box 6: Indonesia's household-based social assistance programs

Indonesia's main household-based social assistance programs are summarized in Table 10. A temporary unconditional cash transfer program (*Bantuan Langsung Tunai*, BLT) was deployed in 2005-06 to mitigate the inflationary impact caused by fuel price adjustments and again in 2008-09 to protect vulnerable households from the effects of the global financial and food price crises. Raskin distributes subsidized rice to 17.5 million families across the country. Jamkesmas provides health service fee waivers for 18.2 million poor and vulnerable households. A scholarship program (*Bantuan Siswa Miskin*, BSM) provides cash assistance to approximately 4.6 million students across the country. PKH – a conditional cash transfer – provides income support and investment in health and education services for over 800,000 extremely poor households in pilot areas. Finally, there are cash transfers with facilitated services for highly vulnerable groups including at-risk children (*Program Kesejahteraan Sosial Anak*, PKSA), the disabled (*Jaminan Social Penyandang Cacat Berat*, JSPACA) and vulnerable elderly (*Jaminan Sosial Lanjut Usia*, JSLU). Indonesia also has a range of complementary programs and policies that extend beyond the household to "protect and promote" the poor and vulnerable, including community-driven development programs, job creation and employment strategies, and plans for social security.

Table 10: Indonesia's social assistance program is concentrated in eight household-centered programs

Name	Transfer type	Risk covered	Target group	Target number of beneficiaries	Population coverage	Benefit level (average)	Key executing agency
1. BLT*	Cash	Acute consumption difficulty	Poor & near-poor households (HH)	18.5 million HH	National	IDR 100,000 per month for 9 months	M. of Social Affairs (*Kemensos*)
2. Raskin	Subsidized rice	Consumption difficulty	Poor & near-poor HH	17.5 million HH	National	14 kg rice per month	Bureau of Logistics (*Bulog*)
3. Jamkesmas	Health service fees waived	Health shocks; low health utilization	Poor & near-poor HH	18.2 million HH	National	Varies depending on utilization	Ministry of Health (*Kemenkes*)
4. BSM**	Cash & conditions	Cost of education; low education	Students from poor HH	4.6 million students	National, but not full scale	IDR 561,759 per year	Ministry of Education & Culture (*Kemdikbud*) & Ministry of Religious Affairs (*Kemenag*)
5. PKH	Cash & conditions	Low incomes; low health & education utilization	Very poor HH	810,000 HH	Pilot	IDR 1,287,000 per year	*Kemensos*
6. PKSA	Cash, conditions & Services	Quality of life; low education; exclusion	Vulnerable children	4,187	Pilot	IDR 1,300,000-1,800,000 per year	*Kemensos*
7. JSPACA	Cash & services	Quality of life; exclusion	Vulnerable disabled	17,000	Pilot	IDR 3,600,000 per year	*Kemensos*
8. JSLU	Cash & services	Quality of life; exclusion	Vulnerable elderly	10,000	Pilot	IDR 3,600,000 per year	*Kemensos*

Note: BLT details are for last usage in 2008. BSM detail on target number of beneficiaries and benefit level based on 2009 data.
Source: Program manuals, regulations, staff reports, and World Bank staff calculations based on 2010 information.

b. Is the appropriate level of resources allocated to household social assistance?

Social assistance expenditures rose markedly between 2000 and 2005 …

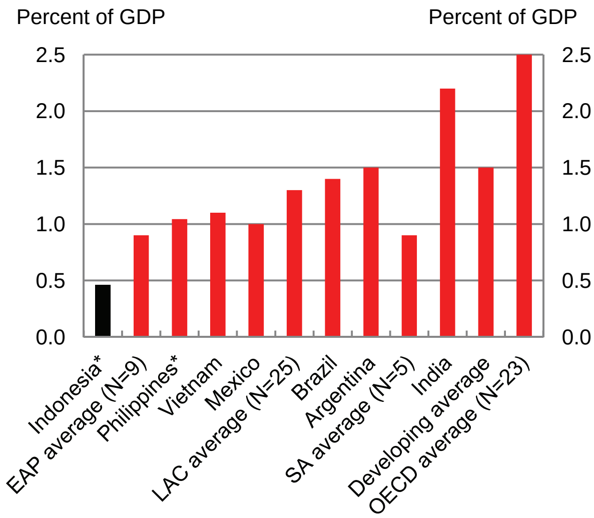
From a low base in the early 2000s, Indonesia's aggregate national public expenditures on SA programs permanently increased in line with the proliferation of individual initiatives beginning then. Since 2005, non-emergency SA spending has remained flat relative to total expenditures (Table 11). Central government spending accounts for almost 90 percent of total Indonesia-wide public SA expenditures. National expenditures on SA programs are estimated at almost IDR 30 trillion (USD 3.3 billion) in 2010, equivalent to 2.9 percent of total national expenditure. Indonesia spends 0.5 percent of GDP on SA, which is low in comparison to regional peers and middle income developing countries: the average for East Asian developing countries is 1 percent of GDP while the average developing country spends around 1.5 percent of GDP on social assistance (Figure 27).

Table 11: After rising to 2005, spending on household SA has stayed roughly constant in real terms
(sector's share in total national spending, percent)

	2005		2010	
Sector	**Share of total national spending (percent)**	**Rank**	**Share of total national spending (percent)**	**Rank**
Energy and other subsidies (excl. SA)	22.1	1	15.7	3
Government administration	17.6	2	19.1	2
Education (excl. SA)	15.5	3	20.4	1
Interest payments	13.7	4	8.5	5
Infrastructure	8.3	5	10.3	4
Health (excl. SA)	3.6	6	4.6	6
Household SA	**3.3**	**7**	**2.9**	**7**
Agriculture	1.0	8	1.3	8

Note: Sub-national spending shares in 2010 are projections
Source: Ministry of Finance and World Bank staff calculations

Figure 27: Indonesia spends relatively little on social assistance relative to regional and middle income peers
(spending on social assistance relative to GDP, percent)



Note: * World Bank staff estimates. EAP is developing East Asia and Pacific, LAC is developing Latin America and Caribbean and SA is South Asia (N represent number of countries in the regional group with available data). Most recent available data, year varies by country
Source: Adapted from Weigand and Grosh (2008), "Levels and Patterns of Safety Net Spending in Developing and Transition Countries"

…but current SA expenditures seem low given the Indonesian risk and vulnerability profile

The majority of SA spending goes to consumption protection and smaller amounts are spent promoting productive behavior and human capital investment. Raskin, the single largest program, accounts for 53 percent of total SA expenditures while both Jamkesmas and BSM scholarships – the next two largest programs, together accounting for one-third of all SA expenditures – protect by providing income (BSM) or no-cost healthcare services (Jamkesmas). Cash transfers designed to promote livelihoods and investments in human capital are allocated much smaller resource shares: PKH is allocated 4 percent and programs for marginal groups 2 percent of total national SA expenditures.

Resources dedicated to SA expenditures are not commensurate with the Indonesian risk and vulnerability profile described previously. Most social assistance programs do not yet have the mandate or resources to reach all eligible beneficiaries. Programs officially target only poor and near-poor households (and PKH targets only the "extreme poor"), not the additional vulnerable households that are at risk of falling into poverty. Each program prioritizes beneficiaries idiosyncratically (see below), meaning many beneficiaries of one program will not receive other programs and few households are transferred benefits from all available programs and interventions.

c. Do programs provide the right benefits at the right time?

While the benefits of some social assistance programs have had an impact…

Some programs are delivering benefits that make a difference. For example, Indonesia continues to lag neighboring and middle income countries in important mother and child health indicators (see the June 2010 *IEQ*). The PKH program was developed to tackle these deficiencies by conditioning a cash benefit on household consumption of certain health and education services. At least for the health side, PKH benefits did indeed change behavior: pregnant mothers and their young children did consume more of a variety of health services, including those that can make meaningful changes to lagging health indicators. As discussed in Box 7, the unconditional cash transfer (BLT), provided in 2005/6 for 12 months and 2008/9 for 9 months, also appeared to be effective in providing temporary protection from the impact of fuel price increases (notwithstanding obvious implementation weaknesses).

…the main SA programs deliver only a fraction of the benefits needed and only some are delivered when needed

Other programs struggle to deliver meaningful benefits. For example, in 2010, Raskin promised beneficiaries 14 kilograms per month but only delivered an average of 3.8 kilograms per month (Figure 28). These amounts, when purchased at actual Raskin prices, represent a benefit valued at 2 to 3 percent of the household poverty line expenditure, the lowest benefit level provided by any Indonesian SA program. Raskin is continuously delivered every month, but local-level implementation practices – with rotation and sharing of rice amongst households regardless of strict eligibility – negatively impact Raskin's dependability for poor and vulnerable households.

Jamkesmas is generous by design, offering a fee waiver for nearly all medical services available at public hospitals and primary care centers, and is always available to households when needed. However, as outlined in the December 2010 *IEQ,* the program does not provide enough facilitation and outreach that could make the benefit packages effective for poor households. For example, it cannot address costs, such as transport or lost wages, which households identify as serious impediments in accessing health services.

Neither scholarship programs nor conditional cash transfers provide sufficient benefits for the education needs of target households: secondary education expenditures (including placement fees, transportation, and uniforms among others) can be as high as 20 percent of a poor household's annual income, which puts it well beyond the reach of beneficiary households even after BSM or PKH education transfers, which are less than half the amount of total per-child expenditures on education. A household receiving both PKH and BSM might find the total transfer almost adequate, but separate implementing agencies have in the past prioritized different households and students.

Design and implementation characteristics can reduce timeliness

The timeliness of the benefits provided can be less than optimal when program design reinforces the negative effects of slow implementation. For example, BSM is delivered in one lump-sum payment that arrives more than one year after enrollment and thus is not available to students in the final year at each level of schooling. The cash transfers, therefore, are absent at the beginning of the school year and during primary-to-secondary or within- secondary transition years, which is precisely when the greatest risk to, and sharpest increases in the costs of, continued education occur.

d. Are benefits reaching the right people?

Overall, the distribution of SA benefits is pro-poor, but inclusion and exclusion errors show much room for improvement

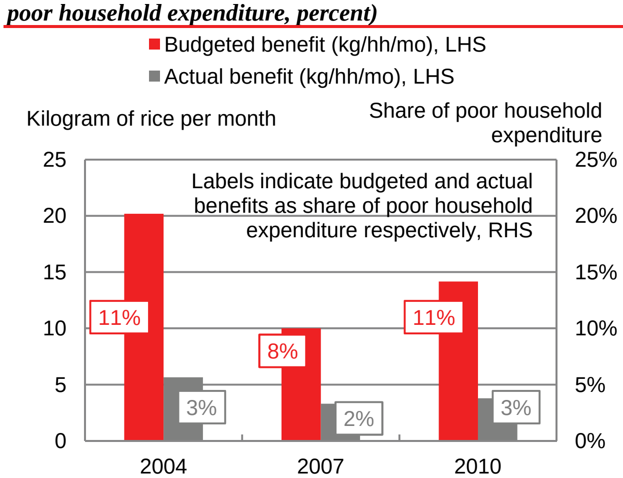
Overall, the targeting of Indonesia's social assistance programs, as measured by coverage of the poor, is pro-poor and in line with international benchmarks. However, also relative to international benchmarks, a large share of benefits accumulates in non-poor households. Less than half of the poorest and most vulnerable 40 percent of households receive BLT and Jamkesmas, while 20 to 25 percent of total benefits from both programs go to the richest 40 percent. Over 70 percent of the vulnerable receive Raskin, but the program also has high coverage of the non-vulnerable, a result of local-level sharing of the subsidized rice among all households (Figure 28). In a comparison of targeting outcomes, and with 100 percent representing perfect targeting according to program design, BLT performs the best at 24 percent better than random, with Jamkesmas and Raskin at 16 and 13 percent respectively. BSM targeting is neither progressive nor regressive: the share of total BSM benefits in the bottom 40 percent of households is equal to the share in the top 60 percent.

Rationalizing and coordinating the many different targeting procedures could produce more consistency and less risk for potentially eligible households

Each program has developed its own beneficiary eligibility rules and targeting in practice has often strayed from these official guidelines.[5] For example, BLT was meant to use a mix of data collection methods, but each step in the data collection procedure was carried out with significant revisions: statistical assessment of poverty status was not done according to international best practice while community-based assessment was in most cases neither consultative nor transparent. Raskin is meant to use official lists of the poor to select beneficiaries, but, as mentioned above, in practice communities distribute the rice as they see fit, often sharing it out amongst many or all households. Jamkesmas is also meant to use official lists of the poor but there is considerable variation in beneficiary identities at the local level, with local health officials sometimes choosing beneficiaries, or households selecting themselves based on previous healthcare use. Different targeting approaches mean different beneficiaries for each program while poor socialization and mistargeting have undermined support for SA programs. The percent of communities experiencing protests over the programs ranged from 25 percent for Askeskin (now Jamkesmas), to 56 percent for BLT, with those not receiving assistance being the most likely to complain. Mistargeting and a lack of transparency in, and poor socialization of, beneficiary selection were the main sources of complaints.

Figure 28: In practice the Raskin program delivers fewer benefits to the poor than budgeted for…

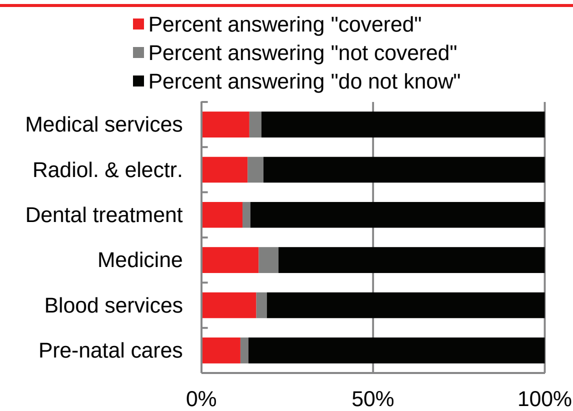
(kilogram of rice per household per month; benefit as share of poor household expenditure, percent)



Source: Bulog budget reporting documents, Susenas (various years) and World Bank staff calculations

Figure 29: …while awareness of Jamkesmas benefits levels is low

(share of sample, percent)



Note: All treatments, services, diagnostics, and medicines listed above are officially covered according to Jamkesmas technical manuals and regulations. Radiol. & electr. Is radiology & electromedic
Source: Indonesia Corruption Watch (2008)

e. Are programs implemented in the right way?

Most SA initiatives do not benefit from administration and support operations that enhance efficiency and effectiveness

The larger programs – BLT, Raskin, Jamkesmas, BSM – spend too little on administration and support operations and weak socialization and lack of accountability are the result. The smaller cash transfer programs have higher administrative costs which seem reasonable given the pilot status and small scale of those programs. Raskin – like most food delivery programs around the world – has high non-benefit spending overall, but these expenditures are for physical transportation, distribution and packaging of rice rather than on support operations for beneficiaries.

[5] For a detailed review and discussion of targeting practices in Indonesia see *Targeting Poor and Vulnerable Households in Indonesia*, available at http://go.worldbank.org/5BWH4ZCQM0

Weak socialization has translated into a lack of bottom-up accountability and misunderstanding of SA goals and objectives

All programs suffer from inadequate socialization guidelines, leading to reduced program transparency and legitimacy and heightened potential for corruption. Knowledge on eligibility rules, program objectives, and beneficiary rights and responsibilities is usually spread thinly among beneficiaries, eligible households, communities, and local-level program implementers (Figure 29). Therefore, bottom-up monitoring of the targeting and benefit distribution process is limited while intra-community jealousy and misunderstanding are often high. SA programs – with the exception of the pilot Kemensos (Kementerian Sosial, Ministry of Social Affairs) cash transfers – do not include an explicit facilitation or outreach process. This limits beneficiaries' effective access and leads to increased capture by those already familiar with the services offered, especially for Jamkesmas and BSM.

Program monitoring – especially on household outcomes – is also underprovided and does not feed into a continuous program improvement cycle

Monitoring and evaluation, complaint resolution mechanisms, and budget execution are all underdeveloped. All programs have descriptions (in regulations and manuals) of program monitoring arrangements and some details regarding the content of monitoring procedures and reports. However, program monitoring and reporting is most often carried out by local-level implementers and delegated with very little financial support, technical support, or systems for quality control. Monitoring and reporting does not always produce information useful for evaluating service delivery performance or household outcomes. Likewise, complaints and grievances processes are usually described but remain only weakly functioning and they are mostly unfamiliar to households and front-line providers. Most SA programs exhibit slow and unsmooth budget disbursement: benefit payments are often "bunched" in the second-half of the fiscal year making them less useful for consumption smoothing. Such delays often stem from lengthy, bottom-up beneficiary identification/verification procedures.

Local-level implementation and delivery partners are common, but weak incentives mean highly-variable SA delivery performance

Implementation is also affected by local-level politics and capacities. Local governments, agencies, service providers, and broader communities are asked to support various stages of most programs. Targeting, beneficiary verification, socialization, funds channeling, facilitation, monitoring and evaluation, and the complaints and appeals process are all areas where these actors may be involved. However, weak socialization and inconsistent follow-up mean that local actors are free to revise implementation procedures to suit what they feel is needed or desired by the community. This often means minimum service standards in each of the above-mentioned processes cannot be guaranteed and both implementation and outcomes will vary widely from region to region.

f. Are the right programs and system in place?

Some SA programs are well- designed, address a frequent and serious risk, and have demonstrated positive results…

Conditional and unconditional cash transfer programs have effectively protected households from shocks, promoted good health and education behaviors and facilitated reforms. As described in Box 7, BLT effectively protected households from the shock of increases in fuel prices and helped facilitate much needed subsidy reforms by delivering cash transfers at the right time. The PKH pilot program has also produced positive impacts. For example, monthly household consumption increased by 10 percent (over and above initial levels); the largest shares of this increase went to food, especially high-protein foods, and health care. PKH's presence even produced more pre-natal visits and child weighings in non-beneficiary households living in PKH areas. However, PKH did not have an effect on drawing more children into school, encouraging them to stay, or encouraging them to continue due to poor timing, relatively small benefits, and lack of outreach to school-leavers.

Box 7: BLT and BLSM

As discussed in Part A, Parliament recently approved a revised Budget including conditions under which the Government could increase the subsidized fuel price. Some of the resulting budgetary savings in the event of a price increase are proposed to fund a variety of targeted pro-poor initiatives, including a one-time, emergency, unconditional direct cash transfer to the poorest 30 percent of households called *Bantuan Langsung Sementara Masyarakat*, or BLSM (roughly translated as "Temporary Direct Assistance for the People").

In 2005 and again in 2008, Indonesia achieved a similar reorientation of regressive fuel subsidy spending towards pro-poor initiatives and social sector spending. On both occasions part of the budgetary savings funded a large-scale, direct, unconditional BLT cash transfer to poor and near-poor households. An assessment of the experiences and impacts of the BLT can help to inform assessments of which might be expected under a potential BLSM.

Government expenditures were noticeably more "pro-poor" during both BLTs. During the first 12-month BLT in 2005/6, total household SA spending rose to approximately 1 percent of GDP, or more than double previous levels. During the second 9-month BLT in 2008/9 total household SA spending rose to approximately 0.8 percent of GDP. Combined with the decrease in spending on regressive fuel subsidies, BLT significantly shifted the national expenditure profile towards pro-poor initiatives while it was delivered.

BLT was delivered when it was most needed and allowed households to continue spending regularly. BLT reached households in all provinces and districts in Indonesia and added cash amounts of approximately 10 to 15 percent of regular expenditures at the time when fuel prices were increasing fastest. The transfer levels (of IDR 100,000 per household per month) were more than enough to cover increased expenditure on fuels and lasted long enough (12 months in 2005/6 and 9 months in 2008/9) for households to adjust spending patterns to new relative prices. Households with BLT did not change their previous consumption patterns noticeably, spending just as much as prior to BLT on nearly all goods and services.

BLT households did not resort to negative coping strategies when prices were rising fastest. Household expenditure was protected for BLT households, especially in regions where local economies were weakest and not generating noticeable community-wide growth, while communities with more BLT recipients (whether economically strong or weak) saw increased consumption gains for non-BLT households. BLT households removed their children from labor at increased rates while overall health service utilization also increased more for BLT than non-BLT households. In 2008/9, when a BLT payment coincided with due dates for school enrolment and registration fees, households with BLT reported using it to pay these fees and keep their children in school.

BLT helped households find work and did not create dependency. In fact, households who received BLT were more likely (by a significant margin) to find new jobs than households without BLT. And there was no difference between non-BLT and BLT households in the rate at which they left or were dismissed from jobs. In other words, BLT was responsible for a net increase in employment. Likewise, the number of hours worked (for adults) was essentially the same in both BLT and non-BLT households. BLT beneficiary households as well as other community observers noted that BLT amounts were nowhere near enough to live on and that employment continued to be essential and desirable for maintaining even poverty-level living standards.

BLT support operations – from targeting through to complaint resolution – were carried out under severe constraints… Compressed delivery schedules, insufficient guidelines and incentives, a lack of clear accountability between BLT agencies and operational bodies, poor technology, and a difficult and varied poverty environment made implementation problematic. As there was a very short "incubation" period for BLT, a monitoring and evaluation program, a complaint and grievances mechanism, and an audit system were not included. This prevented any serious implementation improvements in real time or between the 2005 and 2008 BLTs. BLT has a very light administrative footprint and does not consume many resources in operation, but BLT was not efficient in terms of safeguarding program expenditures (see below).

…and these pressures led to most of the ground-level confusion surrounding BLT. The allocation of BLT to poor, near-poor, and vulnerable households proved better than in Raskin, Jamkesmas, or BSM (for example). However, the hurried manner in which targeting procedures were socialized and implemented led to tremendous frustration in the majority of communities. Nearly all BLT-related complaints and protest activity focused on the prioritization, allocation, and distribution of benefits, as well as irregularities and malfeasance in that process. Furthermore, most complaints were made by non-beneficiaries who considered the actual allocation of benefits inequitable. Relatedly, informal deductions of BLT benefits increased markedly between rounds. These deductions and the redistribution of benefits to a wider population were common strategies that local-level administrators pursued to "keep the peace" in areas where confusion and envy regarding BLT, its prioritization of some households over others, and its objectives were elevated. The rush to distribute BLT – and lack of time spent developing proper support systems – meant that benefit deductions were not recorded, monitored, evaluated or remedied while insufficient socialization kept beneficiary households from interrupting, reporting, or acting on these unexpected modifications.

Moving forward to BLSM, several home-grown innovations in direct cash transfers are worth noting. Most importantly, the recent introduction of a Unified Database for Social Protection Programs (*Basis Data Terpadu untuk Program Perlindungan Sosial*) based on PPLS11 data will improve the prioritization of BLSM (and other social programs) in targeting the poor and vulnerable. This new database covers 40 percent of the population, which is a significant improvement on the previous databases, while a more technical and transparent approach, based on lessons learned in Indonesia and other countries, should result in improved targeting. A responsive grievance mechanism can enhance overall coverage of the poor and vulnerable while leading to better understanding of the goals behind the prioritization to the poorest and most vulnerable. An improved socialization campaign will deepen public awareness of program goals and facilitate smooth implementation while continuing improvements in ongoing social assistance programs in health, education, and food security will ensure that BLSM cash benefits can be allocated to high return investments in human capital and nutrition. Lastly, simple and transparent administrative procedures with low overhead will maintain the program's cost effectiveness for the GOI. All of these improvements should enhance the objectivity and integrity of the BLSM system.

A temporary cash transfer can perform modest protection functions, but it alone is not a poverty reduction system. BLT provided temporary protection to poor households in a more pro-poor manner than the fuel subsidies it replaced. But for long-term poverty reduction goals, BLT or BLSM will not be appropriate. Continuing investments in health, education, and business development, all of which can help disrupt the intergenerational transmission of poverty, are better encouraged by programs like conditional cash transfers, free health insurance, secondary and university scholarships, and micro-loans for entrepreneurs.

Note: For more details see the background reports to World Bank (2012), *Protecting Poor and Vulnerable Households in Indonesia* (at http://go.worldbank.org/5BWH4ZCQM0) and the summary of the BLT evaluation in the December 2010 *IEQ*

…while others are logically designed and *could* address frequent and serious risks but have not been effective

The remaining SA programs are struggling to meet their overarching objectives and are likely not cost-effective initiatives. For example, Jamkesmas has increased utilization of health services, but the effects are much larger for non-poor households and households with previous experience with the healthcare system. Poor beneficiaries are not taking advantage of Jamkesmas' nearly unlimited benefits due to lack of awareness of services provided and inability to meet supplemental costs of access. BSM and Raskin are not likely to significantly protect households or promote good behaviors because of design and implementation weaknesses. While BSM delivery looks efficient – i.e., with minimal overheads – the program is less well-known and less used by target groups. Raskin spends the most to deliver rice, but beneficiaries end up with a very small transfer, making Raskin the least cost-effective program when considering actual benefits delivered.

Overall, the current collection of SA programs in Indonesia do not constitute a true social safety net: many gaps still remain…

The current SA system leaves vulnerable groups uncovered and risks unaddressed. There is currently no program that anticipates risks from, and prevents negative coping behaviors during, household-idiosyncratic risks such as temporary unemployment. Indonesia also does not have an automatic safety net that kicks in to protect households in response to global, macro, regional or micro shocks. Large numbers from marginalized groups such as destitute elderly and disabled remain unprotected. Promotion on a large scale is also underprovided. PKH is a relative success story but is confined to a small subset of very poor households. BSM serves a larger proportion of the population with a valuable protection-and-promotion benefit, but is not effective.

…and fragmentation in SA policy and implementation has prevented the construction of a logical and efficient social safety net system

These programs operate in isolation creating a fragmented approach to social protection. The eight major SA programs are spread across five different implementing agencies while many additional institutions are involved in support operations, disbursing and delivering benefit packages, and policy planning. Fragmentation also occurs within agencies: the scholarships program is actually comprised of 10 different independent initiatives spread across the Ministry of Education and Culture and Ministry of Religious Affairs with little inter-connectivity between them. The PKH, JSLU, JSPACA, and PKSA programs are run independently out of four different administrative clusters within the Ministry of Social Affairs, which means many common processes are needlessly duplicated. Implementing agencies do not realize economies of scale or scope in their operations and households cannot be inducted into the entire array of initiatives available.

g. Building a true social safety net in Indonesia

The creation of an effective social safety net system in Indonesia will require more effective spending through improving programs and optimizing the mix of initiatives…

This assessment points to a number of important steps are necessary for the creation of an effective social safety net system in Indonesia. The first is to spend better by improving programs and achieving a more optimal mix of initiatives. This includes increasing the benefit level and delivery schedule of the cost-effective PKH conditional cash transfer program; instituting a package of radical reforms for stopping leakage and improving targeting in Raskin's subsidized rice program; upgrading capacity for the pilot cash transfers targeting highly vulnerable groups; re-engineering the BSM scholarship program; and redefining an appropriate benefit package for Jamkesmas in order to provide financially sustainable and reliable health care utilized by all poor households.

…scaling up programs to protect all vulnerable households,…

The second step is to scale up programs to protect more households from health risks, promote continuous education and protect from shocks threatening welfare. This includes expanding Jamkesmas and BSM to reach all vulnerable households, and introducing a pilot early childhood education program. The PKH program and the collection of programs that target marginalized populations can be scaled up to reach all chronically poor households. Raskin should be right-sized to cover only poor households. Finally, existing gaps in the safety net can be filled by adding a coordinated emergency response system, featuring a revised version of the BLT unconditional cash transfer.

…and integrating the programs of a social safety net by consolidating support operations and encouraging a single window of access

The third step is to integrate the social safety net programs. This includes consolidating program support operations, such as socialization, complaints handling and monitoring and evaluation, under a single roof and developing a single National Targeting System (NTS). Creating a reliable public face for the social safety net under a single agency with employees that perform outreach and socialization activities can encourage and facilitate single window access to all initiatives available in the social safety net.

The costs of building the next generation of social safety assistance in Indonesia are manageable

The next generation of social assistance in Indonesia is affordable. With increases in coverage for most current programs; with the addition of a public works program; with increases in benefit levels for most current programs; increases in administrative costs and spending on support operations for approximately half of the current programs; and in a year during which an emergency, temporary, unconditional cash transfer was used, SA spending would double from around 0.5 percent of GDP (2010) to approximately 1 percent of GDP. This is still far less than Indonesia spent on energy subsidies in 2011 (3.4 percent of GDP), for example, or is projected to in the 2012 Revised Budget.

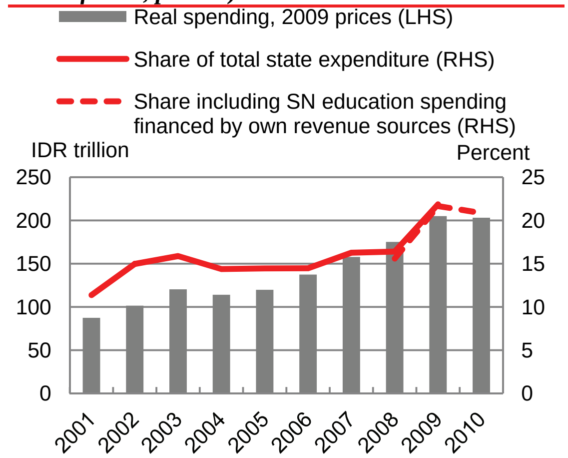
2. Turning quantity into quality in education

The constitutional mandate to provide 20 percent of the national budget for education has resulted in a significant increase in education resources

Over the past few years, education has become a bigger priority in Indonesia, which was reflected in a constitutional mandate to allocate a minimum of 20 percent of the total state expenditure towards the education sector.[6] The "20 percent rule" was originally introduced in a 2002 Amendment to the Constitution but, after the Constitutional Court finally defined and clarified the rule, it was met for the first time in 2009, triggering an increase in education resources by over 20 percent in real terms relative to the previous year (Figure 30). In light of the significant implications of the rule for education resources, this section examines where additional resources have gone and why, despite the increase in resources, the quality of education remains an issue. Our analysis in particular focuses on the challenges associated with the allocation of spending and inefficiency in teacher management processes.

Figure 30: The " 20 percent rule" triggered a significant increase in education spending starting 2009

(education spending in 2009 prices, IDR trillion; as share of GDP, percent)



Source: World Bank staff estimates based on state budget data and Regional Financial information system data (Sistem Informasi Keuangan Daerah,SIKD), Ministry of Finance

a. Access to education has improved but quality remains an issue

The improvement in educational access and equity has been impressive, but enrollment rates are still low in higher education

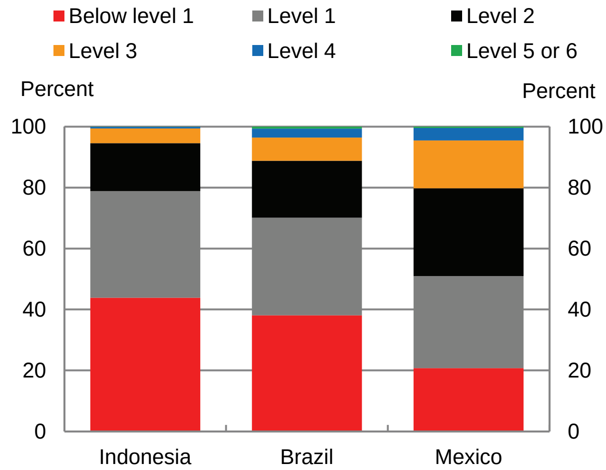
The progress in enrollment rates has been impressive. Indonesia has achieved universal primary education and has advanced significantly in secondary and higher education, with an increase of 10 percentage points and 7 percentage points in their gross enrollment rates (GER) respectively from 2001 to 2009. Perhaps the most impressive achievement has been in early childhood education (ECD), which now reaches half of 3 to 5 year-olds (up from 25 percent a decade earlier). Most importantly, the biggest improvements in access at all levels have been for poorer segments of the population and in rural areas, leading to a big improvement in equity. There is, however, room for further progress since it is still the case that only about 4 percent of 18-20 year olds from the lowest income quintile are enrolled in higher education.

Despite the increase in access, quality of education is still an issue

While access has improved, the quality of education remains an issue. Indonesia's performance in standardized international exams is lower than those of students in most other middle income countries. In the OECD Programme for International Student Assessment (PISA), which tests a representative sample of 15 year old students in the country, half of Indonesian students scored below level 1 in mathematics (the most basic level out of 6. No Indonesian students achieved levels 5 or 6, which measure creative problem solving and students' complex reasoning (Figure 31). The results are similar when looking at 8th grade students tested in the Trends in Mathematics and Science Study (TIMSS). When gross enrollment rates of grade 8 students in several East Asian countries are adjusted for "some knowledge of whole numbers, operations, and basic graphs", the gross enrollment rates of Indonesia drop more dramatically than in other countries in the region, with the exception of Philippines (Figure 32).

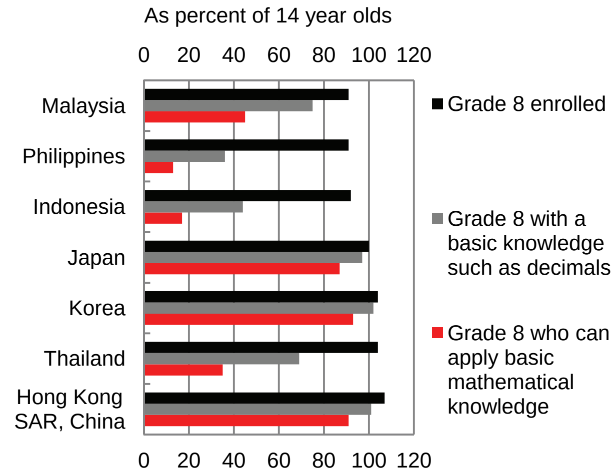
[6] The 20% rule requires the allocation of minimum 20% of total state budget (central government expenditure and transfers to regions) to education (Ministry of Finance Decree 86, 2009).

Figure 31: Comparable measures of the quality of educational outcomes are relatively weak in Indonesia…
(share of students by level of PISA math scores, percent)



Note: Higher score indicates better performance
Source: OECD, PISA 2009

Figure 32: …resulting in a reduction in gross enrollment rates, adjusted for quality
(gross enrollment rates in secondary education)



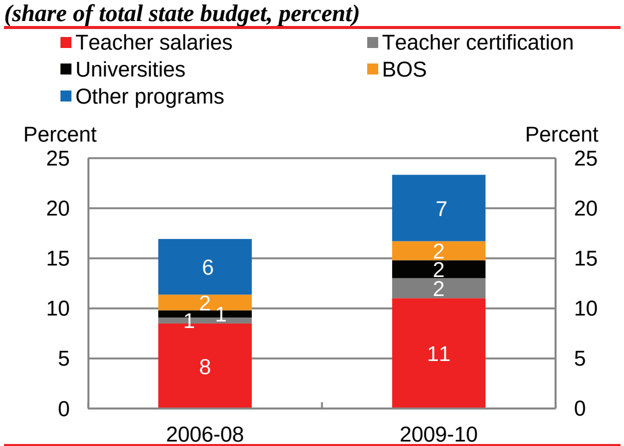
Source: UNESCO Institute of Statistics, World Bank Edstats, and *TIMSS Advanced 2008 International Report* Mullis, Martin, and Foy 2008

b. Inefficient spending, particularly on teachers, may explain why increases in resources have not translated into improved education quality

Part of the reason for low performance in educational outcomes is inefficiency in spending, particularly overstaffing

When the "20 percent rule" was implemented in 2009, the share of the total stage budget going to education increased by 6 percentage points, a majority of which went to teacher's salaries and teacher certification. More concretely, about 4 percentage points was allocated to teachers' salaries and teacher certification subsidies, with 1 percentage point each in additional resources for higher education programs and for all other programs (Figure 33). As a result, about half of the education budget in 2009 was spent on teacher salaries – and this does not yet take into account the 30 percent of the School Operational Assistance Program (*Bantuan Operasional Sekolah*, BOS) funds spent on school-hired teachers. This share is not extraordinarily high by international standards. In fact, many high performing countries spend a higher share of the budget in salaries. The problem lies in how the salary bill is spent: high performing countries spend a large share of the budget because attracting and retaining the best performers into teaching is expensive. In Indonesia, the high salary bill is due to an exceptionally low student teacher ratio (STR).

Figure 33: Most of the recent rise in education spending went to teachers' salaries and certification program subsidies
(share of total state budget, percent)

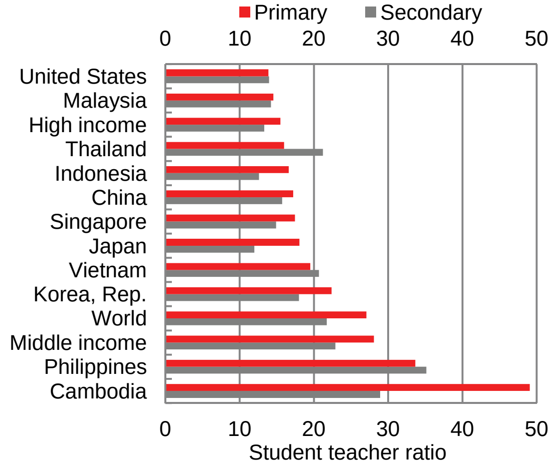


Source: World Bank staff estimates based on SIKD-MoF data

Indonesia has one of the lowest student teacher ratios in the world and it continues to decline

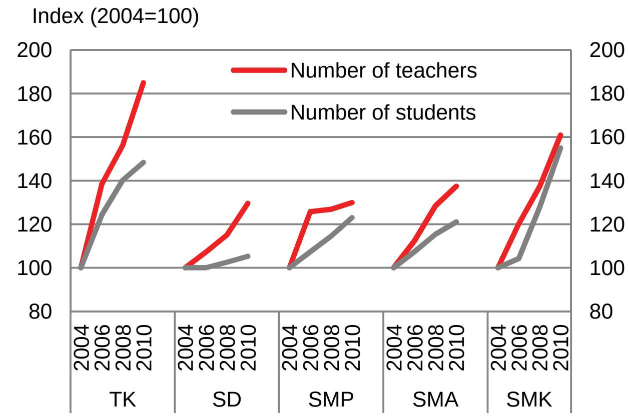
At 20:1, Indonesia already has one of the lowest STR in the world at the primary school level; the global average is 31:1. At the secondary school level, comparisons are even more striking, with the average Indonesian STR at 12:1 – the lowest ratio in the East Asia region. (Figure 34). Moreover, the STR in Indonesia continues to decline, with the number of teachers increasing at a faster pace than students at all levels of education (Figure 35).

Figure 34: Indonesia already has one of the lowest STR in the world
(Student Teacher Ratio in primary and secondary schools)



Source: UNESCO Institute for Statistics, 2009

Figure 35: The growth in teachers has outstripped that of students across different levels of education
(index of numbers by education level, 2004=100)

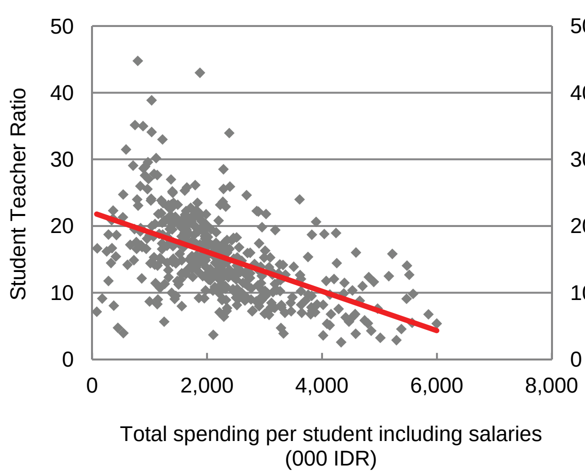


Note: TK: Pre-School, SD: Primary School, SMP: Junior Secondary school, SMA: Senior Secondary School, SMK: Vocational school
Source: Ministry of Education & Culture

The low student teacher ratio appears to be the main driver of inefficiency in spending and is not associated with better outcomes

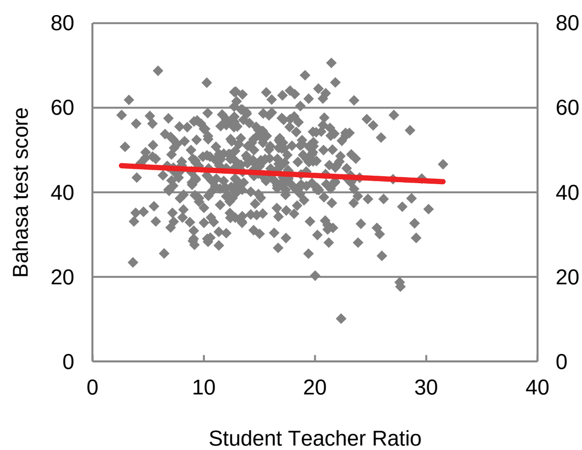
At the school level, STR is highly correlated with per student spending, and the effect is large. Using school-level data of a nationally representative sample of primary schools, the World Bank estimates that a rise in the STR by 5 students per teacher is associated with a one-third reduction in spending (Figure 36). More importantly, with the current distribution of teachers, the STR shows no correlation with learning outcomes (Figure 37) – more teachers do not result in more learning.

Figure 36: The relationship between the Student Teacher Ratio and spending per student is very strong
(Student Teacher Ratio; spending per student, IDR 000)



Note: Test is for a representative sample of public primary schools in Indonesia. Line indicates linear regression fit (coefficient statistically significant at 1 percent significance level)
Sources: World Bank School Based Management Survey, 2010

Figure 37: The STR is not correlated with learning outcomes if the class size is below the regulatory maximum of 32
(Bahasa test score; Student Teacher Ratio)



Note: Test is for a representative sample of public primary schools in Indonesia. Score is out of 100 and a higher test score indicates better performance. Line indicates linear regression fit (coefficient statistically insignificant). Schools with more than 32 students per teacher (the maximum allowed by Ministry regulations) are excluded (if included, the relationship turns negative)
Source: World Bank School Based Management Survey, 2010

The current transfer mechanism to districts (DAU) is the main reason for the overstaffing

So why does Indonesia have such a high number of teachers? To a large extent, overstaffing is the result of the current financing system of intergovernmental transfers (see September 2011 *IEQ*). Although local governments are responsible for hiring teachers, they do not bare the majority of the costs, as the central government pays the salaries of civil servants through funds that are transferred to the districts in the form of *Dana Alokasi Umum* (DAU) or a general block grant. The formula for this largest central government transfer includes the number of civil servants (Basic Allocation), which creates a perverse incentive for overstaffing - local governments with more civil servants receive a larger transfer. Delinking the basic allocation part of the day from staffing would ensure that districts hire teachers more rationally. In addition, having districts cover some of the costs of teacher allowances, such as the functional allowance, and assume part of the financial burden of hiring additional teachers, would further increase incentives for districts to control teacher hiring.

There has also been a large rise in contract teachers, in part due to the large inequality in teacher distribution

In addition to civil servant teachers, the number of contract teachers hired by districts or schools has also increased significantly. For example, about 30 percent of BOS funds are spent on honoraria for contract teachers. How these teachers affect learning is unclear, but the long term consequences of these practices for the budget are concerning. There is an expectation that contract teachers will one day be converted to civil servant teachers and be entitled to salary and subsidy increases. The very large inequality in civil servant teacher distribution, characterized by many schools being severely understaffed while others enjoy extremely low STR, is the reason why understaffed schools use BOS funds for contract teachers. The reason for the inequalities in teacher distribution is in part geographical: in a country like Indonesia one would expect problems in staffing schools in remote, low population density areas. However, the inequality of teacher distribution is not unique to remote rural areas – some districts and provinces in Java also suffer from it.

To address this problem, the Government is trying to put in place mechanisms to improve teacher management. A recently issued decree signed by the 5 ministries involved in teacher hiring will provide guidelines to districts for teacher management, but its implementation will not be easy. Moving teachers across schools within a district is the responsibility of the district, so while these transfers may come at a cost (unclear in the regulation), they are feasible. But movement across districts and across provinces will likely prove more difficult. The preliminary analysis of the magnitude of the redeployment needed to ensure equitable allocation of teachers shows that about 15 percent of the teaching force would need to be redeployed, at least half of them across districts or provinces.

c. Improving the quality of the teaching force in Indonesia is critical for improving the quality of education

Improving the quality of the existing teaching force can include further improvements in the process of teacher certification…

In addition to improving teacher distribution, improving learning outcomes will depend on improving the quality of the teaching force. The introduction of the teacher certification program in 2005 was meant to do just that, improve and recognize teacher competencies and professionalism. While it was a well intentioned and well developed program in its inception, the implementation gave space for ineffective paths for certification. More concretely, the "portfolio certification" allowed teachers with certain years of work experience and previous completion of training or workshops programs to receive a waiver to fulfill other certification training requirements. While there is no definitive evidence of the impact of the certification yet, early evidence suggests this was not an effective method of certification. The pass rate for these teachers is nearly 100 percent. A process of assessment and targeted training, as well as periodic re-certification or review might provide options to improve the program.

…and the re-design of teaching practices

Teaching practices may also need to be re-designed. A pioneering 2007 video study conducted by the World Bank[7] provided cross-country comparison on teacher and student behavior in classrooms, including during comparative TIMMS examinations. The study found that the traditional teaching method of rote learning, which is used extensively in Indonesia, tends to have a negative relationship with test scores. It also found a strong

[7] World Bank (2010), *Inside Indonesia's mathematics classrooms: a TIMSS video study of teaching practices and student achievement.*

relationship between classes with high student involvement (such as student presentations and problem-solving and teacher-student interaction) and higher scores. Key preparatory activities, such as lesson planning, were strongly positively related to student outcomes.[8]

But, no one policy can improve teacher quality

International experience in teacher management shows that no one policy can improve teacher quality. Top-ranking countries in the 2009 and 2003 PISA scores, including China, Singapore and the Republic of Korea, have attributed great importance to improving teaching quality assurance, including through raising the quality of initial teacher training, attracting top candidates into teaching, providing comprehensive but cost-effective professional development programs to teachers, and creating teacher appraisal systems that promote improvement.[9]

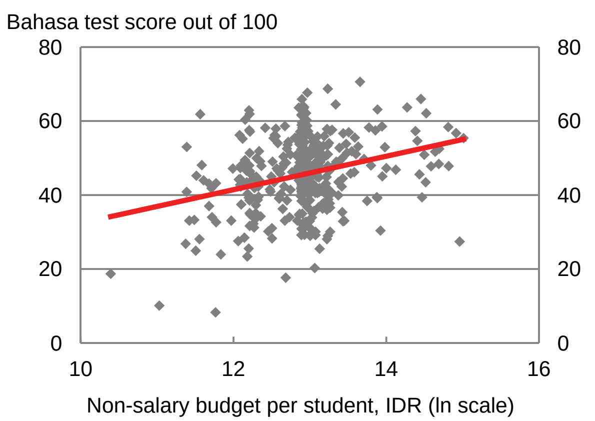
In addition to teacher quality, there is room for additional cost-neutral reforms to improve quality of education…

Another strategy that has shown positive impacts on learning in other countries is increasing the role of schools in managing the education budget, and increasing parental participation in schools. Indonesia has taken steps in that direction, increasing discretion at the school level and decentralizing education management. Since 2005, Indonesia has had a school grants program (*Bantuan Operational Sekolah*, BOS) that provides schools with a per student amount to cover operational costs, and many local governments have decided to increase the amount transferred to schools through district block grants for school operational assistance (*Bantuan Operasional Sekolah Daerah*, BOSDA).

…such as greater discretion and grant funding to schools

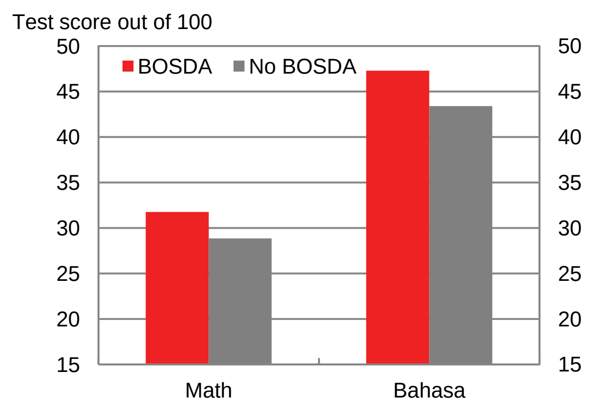
These reforms show some promising results. BOSDA funds tend to be spent mostly on students and materials and are correlated with higher achievement (Figure 38). Whether it is only the additional discretionary funds that lead to better results or the combination of funds and stronger involvement of the local government in supporting schools, the BOSDA programs have shown positive relationships with learning outcomes (Figure 39). This suggests that these types of programs should be supported in the future, perhaps through performance based transfers or matching grants schemes that provide incentives for districts to provide funds to schools while improving accountability.

Figure 38: Discretionary budget at the school level is associated with higher student test scores
(Bahasa test score; non-salary school budget per student, IDR, ln scale)



Sources: World Bank School-Based Management Survey, 2010

Figure 39: Students in schools with BOSDA perform better, even controlling for other factors
(Math and Bahasa test score out of 100)



Note: Differences in performance between BOSDA and no BOSDA schools are significantly different at 1 percent level
Source: World Bank School-Based Management Survey, (2010)

[8] World Bank (2010), *Transforming Indonesia's teaching force.*
[9] World Bank (2011), *Systems Assessment and Benchmarking for Education Results (SABER): What are the Different Profiles of Successful Teacher Policy Systems?*

Continuing to expand access for students, especially at secondary and higher education, will require a refocus in the allocation of spending and improvements in spending efficiency

Secondary and higher education should also be given a greater share of resources. More classrooms will be needed to expand access to senior secondary education. Scholarship programs for poor students was only 1 percent of the total education budget in 2009 and the existing program (*Bantuan Siswa Miskin*, BSM) does not cover the full cost of education for many poor students and does not provide the right incentives to continue education in transitions between levels. Taking into account recent substantial increase in the education public spending and pressing demands for the government to allocate more resources to the currently underfunded sectors, including infrastructure, health and social assistance programs, it is unlikely that the education budget will continue to increase at the same rate in the next decade. It is important for Indonesia to assess the quality and efficiency of spending of its education resources to create room for policies and programs that can improve education quality.

Indonesia is ready for a qualitative jump of its education sector, it is time to translate the strong commitment to education into higher quality

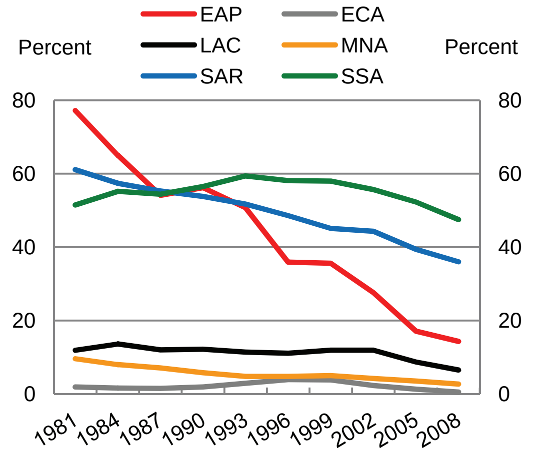
Indonesia has made an important commitment to expanding education opportunities and has implemented important reforms to improve the quality of education. But not all the work is done. While access has improved, it is still low in higher education, and even at senior secondary level poor students and students in remote areas face difficulties in accessing education. Quality is a concern, and should be the next priority. With the large amount of resources devoted to education, many of the reforms that would improve education quality would not increase costs; by better aligning spending with discretion and decision making, and increasing accountability, existing funds can result in better outcomes. Others, such as expanding scholarships or senior secondary education, will require resources. For those, freeing up resources will be crucial, and the key to this is improving teacher management. The current inefficiencies in teacher numbers and teacher allocations are the result of years of policies that incentivize hiring and prevented careful management of teachers at the district level. Important steps are being taken to fix those policies, and their success will be essential to ensure that Indonesia takes the next step towards a high quality education sector that prepares the country to meet its future economic and development challenges.

3. Gender equality is smart economics

Similar to the rest of the East Asia and Pacific region, Indonesia's significant economic growth and development has been associated with reduced gender inequalities in a number of areas

Indonesia, and the rest of the East Asia and Pacific (EAP) region, has experienced significant economic growth, structural transformation, and poverty reduction in the last few decades. The shift away from agriculture toward manufacturing and services has contributed to significant growth and poverty reduction; the region grew at 7 percent on average between 2000 and 2008, faster than any other developing region. High and sustained growth has translated into higher living standards for the vast majority of the region's inhabitants; extreme poverty – the share of the population living below USD 1.25 per day (measured at purchasing power parity, PPP) – in EAP countries has fallen by over 50 percent since 1990 and its incidence declined from the highest in the world to among the lowest (Figure 40). These trends of growth, structural change, and poverty reduction in Indonesia and other regional economies have been accompanied by considerable progress toward gender equality in several key areas, particularly in education and health.

Figure 40: East Asia and Pacific has experienced historic rates of poverty reduction
(poverty headcount ratio of per capital daily household consumption below PPP USD 1.25, by region)



Note: EAP – East Asia and Pacific; ECA – Europe and Central Asia; LAC – Latin America and Caribbean; MNA – Middle East and North Africa; SAR – South Asia; SSA – Sub-Saharan Africa
Source: PovcalNet World Bank

But economic growth and development have not been enough to attain gender equality in all its dimensions

There are, however, a number of dimensions where regional gender inequalities are "stickier", where the above trends have not been sufficient to overcome persistent gender disparities. Women still have less access than men to a range of productive assets and services, including land, financial capital, agricultural extension services and new information technologies. There remains substantial employment segregation, by gender, across industries and occupations. As a result, women are less likely than men to work in formal sector jobs and more likely to work in poorly remunerated occupations and enterprises. Despite education gaps closing, women continue to be paid less than men for similar work. Moreover, women in EAP countries still have weaker voice and influence than men, whether in household decision-making, in the private sector, in civil society or in politics. Women across the region also remain vulnerable to gender-based violence, often at the hand of an intimate partner.

Working toward gender equality is both a development objective in its own right and is smart economics, potentially increasing productivity per worker in Indonesia by as much as 14 percent

Gender equality and women's empowerment are development objectives in their own right. In addition, a growing body of empirical literature from around the world demonstrates that promoting gender equality is also a good development policy – or as stated in the World Bank's *World Development Report (WDR) 2012*, "Gender equality… is smart economics." Promoting gender equality in access to productive resources and economic opportunity can contribute to higher economic productivity benefitting women and men alike. If Indonesia's society were to allocate resources on the basis of people's skills and abilities, rather than by gender, per worker productivity could increase by as much as 14 percent, with important implications for growth and poverty reduction. Across countries in the region the increase could be 7 to 18 percent. [10] Promoting gender equality is also an investment in the next generation. Healthier, better educated mothers

[10] These estimates are from World Bank (2012, forthcoming) *Toward Gender Equality in East Asia and the Pacific*, Regional Companion Piece to *WDR* 2012. The *WDR* 2012 report can be accessed at http://wwwr.worldbank.org/wdr2012. The estimates for Indonesia are from D. Cuberes and M. Teignier Baqué (2011), "Gender Inequality and Economic Growth" Background paper for WDR 2012.

have healthier, better educated children; greater female earnings and assets are also associated with greater investments in children. The effects begin before child birth and are long-lasting, contributing to improved economic prospects for the next generation. Promoting gender equality in voice and influence in society contributes not only to more representative but also higher quality development decision making. When more women participate in policymaking, decisions better reflect both women's and men's preference. Recent evidence shows that greater female participation in government also improves the provision of public goods.

The following overview of recent progress and pending challenges in achieving gender equality is structured around *endowments, economic opportunity* and *agency*

Drawing on the World Bank's forthcoming *WDR 2012* regional companion piece, *Toward Gender Equality in East Asia and the Pacific*, this section surveys Indonesia's recent progress and pending challenges in achieving gender equality in endowments (human capital, such as education and health as well as productive capital, such as land and credit), in economic opportunity (economic participation and returns) and in agency (women's voice and influence).

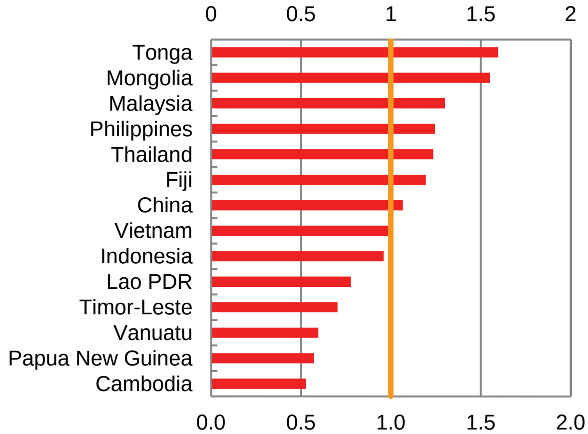
a. Gender equality in endowments has increased, however some disparities remain

While gender disparities in enrollment have closed, gaps in education quality and choice of academic streams persist

As described in the preceding piece on education, economic growth and poverty reduction in Indonesia, and the region as a whole, has been associated with rapid increases in school enrollment and closing of gender gaps at all levels of education (Figure 41). In fact, in several countries in the region, including Indonesia at the basic education level, there is now a reverse gender gap, where many more girls are attending school than boys. There are indications of "gender streaming" in education, however, which contributes to persistent inequalities between women and men in the types of jobs they do. Data from Indonesia, Thailand and Vietnam indicates that the fields of engineering and law are heavily dominated by males while the fields of education, health and business administration are dominated by females.[11] TIMSS and PISA test scores from Indonesia, Malaysia, Philippines, and Thailand suggest, however, that there are no systematic differences between males and females in math and science scores (Figure 42). Moreover, consistent with the global findings, women in East Asia outperform men in reading assessments (Schleicher, 2008). Nonetheless, different norms and expectations for males and females, including those promoted from an early age through school curricula, are likely to influence preferences by gender and, therefore, affect the choice of education streams.

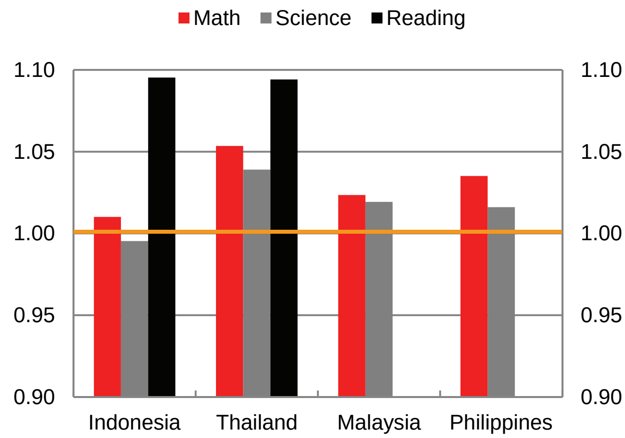
[11] In OECD countries men are also more likely to be found among mathematics and computer science graduates than women and have been found to outperform women in mathematics (Schleicher, A., 2008 "Student Learning Outcomes in Mathematics from a Gender Perspective : What does the International PISA Assessment Tell us?" In M. Tembon and L. Fort, eds, *Girls' Education in the 21st Century)*.

Figure 41: Enrollment rate gaps for tertiary education have closed and are reversed in some countries
(ratio of female to male tertiary school gross enrollment)



Note: Data is 2008 or 2009, except the following: Fiji 2005, Papua New Guinea 1999, Tonga 2004, and Vanuatu 2004
Source: Global Education Digest 2009 and 2011, UNESCO Institute for Statistics

Figure 42: There are no systematic differences between males and females in mathematics and science scores
(ratio of female to male performance)

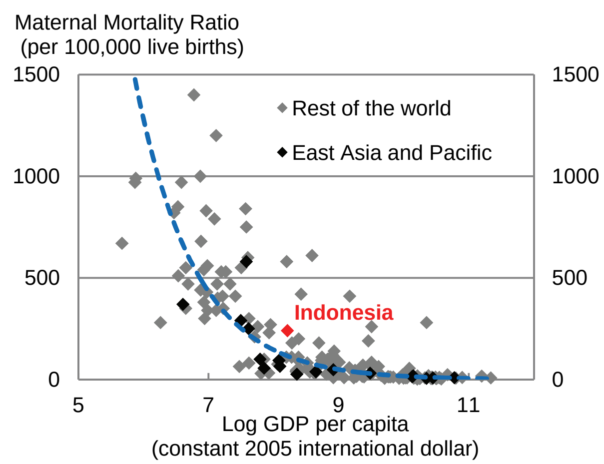


Note: Most recent year is 2003 for Philippines, and 2007 for all other countries. Philippines is not a participant in PISA. Malaysia 2010 PISA data not available online yet
Source: Mathematics and science scales for 8th graders are from TIMSS. Reading scale is from PISA, 2009

Indonesia's maternal mortality rate remains high compared to other countries in the region at similar levels of development

Although maternal mortality rate declines with higher incomes (Figure 43), Indonesia's maternal mortality rate remains high compared to other countries at similar levels of development, and progress in reducing maternal mortality has been slow. Indonesia's rate is as high as in low income neighbors such as Cambodia. Recent analysis by the World Bank highlights that the current approach in Indonesia, which emphasizes the use of a midwife for delivery and community-based interventions, has not had the anticipated impact.[12] Health centers and hospitals, which are key elements of a referral system designed to address emergency complications, are also still not performing at an optimal level. The continued use of traditional birth attendants and delivering at home are some of the contributory factors to the levels of maternal mortality in Indonesia. Acknowledging its risks, the Government for the last two years has discouraged home delivery and promoted institutional or facility delivery, including through a program paying for costs of delivery in *Puskemas* (community health centers) and in those other facilities which have a Memorandum of Understanding with the District Health Office.

Figure 43: Maternal mortality in Indonesia is high for its income level
(maternal mortality ratio per 100,000 live births; GDP per capita, in logs)



Note: Data are for 2008. Maternal mortality ratios are modeled estimates. Dashed line is exponential trend line
Source: World Health Organization and WDI 2011

[12] World Bank (2010a), *Indonesia* Maternal *Health Assessment: and Then She Died.*

Gender disparities in the access to and control of productive assets, such as land and capital, are pervasive in Indonesia and around the world and remain challenges despite significant growth and development

In most countries, women remain less likely to own land (or hold formal land titles) than men. Moreover, data from Indonesia as well as China, Lao PDR, Mongolia, Timor-Leste, and Vietnam indicate that when women – or, specifically female-headed households – do own land, they typically have smaller holdings. A recent study of women's land holdings in post-Tsunami Aceh similarly found that women's land holdings were considerably lower than men's.[13] Women have traditionally also had systematically less access to capital than men; this has been compounded by their poorer access to land, an important source of collateral. While gender differences in access to capital remain, data suggest that obtaining credit can remain a challenge to both male and female entrepreneurs. Among micro and small firms in Indonesia, both female-and male-run enterprises cite access to finance as the most significant business constraint, with the share of female-run firms reporting this constraint is only slightly higher than the share of male-run firms (30 vs. 25 percent, respectively).

b. On economic opportunity, female labor participation rates has risen but lags the region

The female labor force participation rate is lagging behind that of the region and women are mostly found in the informal sector and account for the majority of unskilled migrant labors

While Indonesia's female labor force participation rate increased from around 45 percent in 1980 to about 55 percent in 2008 (Figure 44), it still remained below the average for the region of 70 percent (even though it is at about average, worldwide, for Indonesia's income level). In Indonesia, women are mostly found in informal sector and are the majority of unskilled migrant labors. The participation in the agriculture and industry sectors by women was fairly similar between 1980 and 2007. The bulk of the increase in female labor force participation came from the entry of women into the service sector. There remains employment segregation, by gender, in the Indonesian economy. For example, 2009 survey data indicates that over half of the female labor force in Indonesia is employed in the commerce sector, compared with just over a quarter of male workers. Female workers are also relatively more likely to be employed in the education, health and social sector, for example.

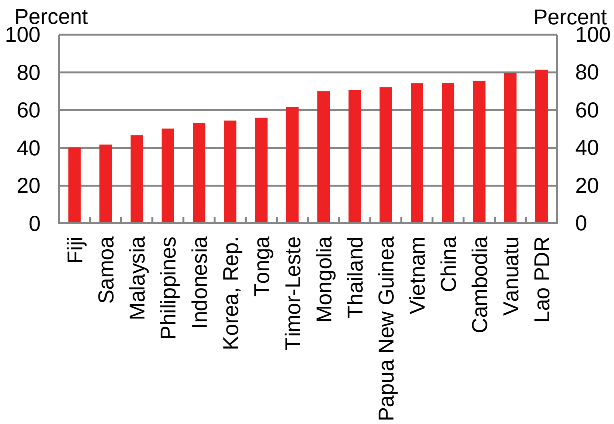
Returns to work for women tend to be lower region-wide, including in Indonesia, where female-led enterprises also tend to be smaller and more precarious

Women still earn less than men in all sectors in Indonesia and in all countries in the region. Earnings in the government sector seem to be the most equal, but gender gaps in wages in the service, industry and agriculture sectors in Indonesia are among the largest in the region (Figure 45). The important socioeconomic variations in Indonesia are that urban educated women have higher returns than men with the same education, while women at the bottom end of the wage distribution (i.e. among the lowest educated individuals) face the biggest wage gap.[14] Enterprise surveys also suggest that, within the same firms, women are more likely than men to be temporary workers – around 25 and 17.5 percent of women workers in exporting and non-exporting firms compared to less than 10 percent of male workers are on temporary contracts in Indonesia.[15]

Female-led enterprises across the region tend to be smaller and more precarious than male-led enterprises, operate in the informal sector, be home-based or operate out of non-permanent premises. While female-owned and managed enterprises are not inherently less productive, they tend to be less capitalized and operate in less-remunerative sectors. For instance, in Indonesia, the Indonesia Family Life Survey indicates that female-led enterprises are relatively more likely to locate in the food, retail and garment manufacturing sectors – among the least capital intensive and productive sectors – while male-led entrepreneurs are relatively more likely to locate in sectors such as transportation – among the most capital intensive, highest productivity sectors.

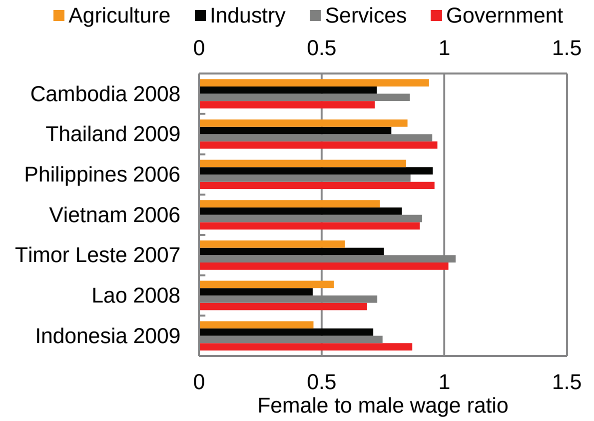
[13] World Bank (2010), *Indonesia - Reconstruction of Aceh Land Administration System Project*. Evidence from other parts of Indonesia suggests that land ownership patterns, by gender, can differ in important ways, depending on local norms and customs. In matrilineal region of West Sumatra, Indonesia, for example, at the time of marriage, husbands commonly own more forest land than their wives, while wives commonly own more paddy land (Quisumbing, A.R., and J. Maluccio. 2003, "Resources at Marriage and Intra-household Allocation: Evidence from Bangladesh, Ethiopia, Indonesia, and South Africa", *Oxford Bulletin of Economics and Statistics* 65, pp. 283-327).
[14] World Bank (2011). *Indonesia Job Report: Towards Better Jobs and Security for All.*
[15] World Bank staff estimates using Enterprise Survey, 2006-2011.

Figure 44: Indonesia's female labor force participation rate is lower than the regional average of 70 percent
(female labor force participation in 2008, percent)



Source: WDI 2010, Gender Statistics, World Bank.

Figure 45: Women still earn less than men across all sectors, but with less divergence in government
(ratio of female to male wages)



Source: World Bank staff estimates using Household Surveys, 2006-2011

c. Women's agency – voice and influence – can be strengthened in both the private and public spheres

Women still face challenges in exercising voice and influence, whether in the home or in society

Agency – that is women's voice and influence – can be looked at in two main dimensions. The first is the ability of men and women to make choices related to themselves and to their households. This could be proxied through control over own earnings, ability to travel without husband's permission, and the gap between desired and actual fertility. The second is the ability of men and women to make choices and be represented in the political and economic spheres. This is usually measured by women's activity in the public domain such as their share of parliamentary seats. While there has been some progress in raising women's voices with development, there is substantial work that remains to be done in strengthening the voice of women in both private and public spheres.

Some indicators suggest that women's voice in personal and household decisions is relatively balanced in Indonesia

Women in Indonesia have a relatively good control over their own income, compared to other countries in the region, including several Pacific Island countries, the Philippines and Timor-Leste (Figure 46). Greater influence in personal and household decisions could be a function of several factors, including recent increases in female education and access to economic opportunities. Region-wide, East Asia and the Pacific, and Indonesia in particular, seems to perform well on several indicators of women's autonomy, such as control over household purchases and the ability to travel.

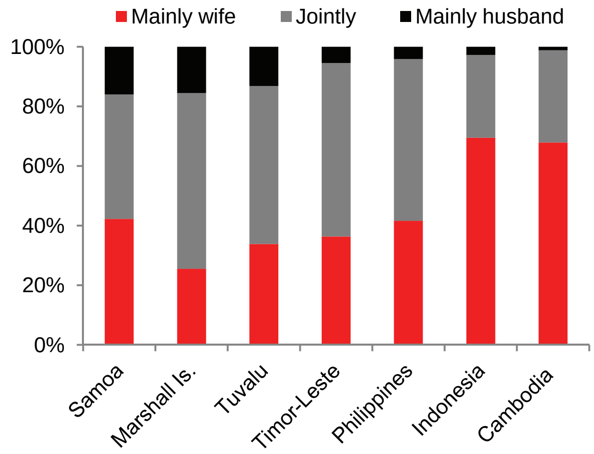
Women's voice in the public domain – as measured by political representation – remains weak

Women have relatively low levels of representation in political assemblies, whether at the national or local levels. For example, women make up just over 19 percent of national parliamentarians worldwide. The share of female parliamentarians in East Asian and Pacific countries is slightly lower, at approximately 18 percent in 2011, barely changed since 1990. This stands in contrast to other developing regions, where levels of female political representation have tended to increase, at least since 2000.[16] In Indonesia in 2009 18 percent of parliament seats were held by women, around the regional average, and up from 13 percent in 2004. Women also continue to be seriously under-represented in the top echelon in government. Furthermore, decentralization in Indonesia, which should have provided more opportunities for women, has led to a proliferation of discriminatory legislation at the local level. Discriminatory local government policies against women increased from 154 in 2009 to 189 in 2010.[17]

[16] In the Europe and Central Asia region, female representation in national assemblies fell substantially falling the dissolution of the Soviet Union, although levels increased again between 2000 and 2008.
[17] Komnas Perempuan (Indonesia's National Commission on Violence Against Women), *Terror and Violence Against Women: The Loss of Control by the State. A Note on Violence Against Women 2010*, March 2011, revised version.

Figure 46: Strength of women's voice in personal household is relatively high…

(wives' control of own earnings, percent of sample)

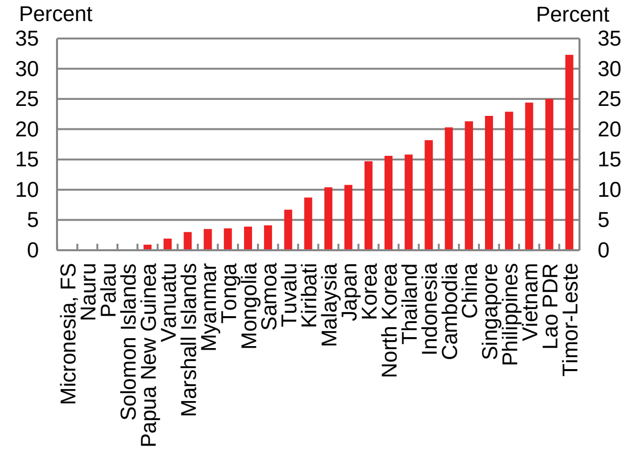


Note: Wives include currently married women aged 15-49 who receive cash earnings for employment

Source: Demographic and Health surveys, various years

Figure 47: …but remains weak in the public domain

(shares of parliamentary seats held by women as of December 2011, percent)



Source: Inter-Parliamentary Union www.ipu.org

Gender-based violence – defined here as the extreme deprivation of female agency – remains pervasive in the region

The incidence of gender-based violence in the region remains high. Its prevalence reflects several factors, including societal norms, the socio-economic characteristics of the victim and perpetrator, the extent of legal protections against violence, and women's access to justice. A recent study in Indonesia indicates that the most common forms of violence against women in Indonesia include psychological, economic, physical and sexual, violence against women by their husbands.[18] While the factors that enable gender-based violence are multiple and complex, the phenomena is exacerbated by a lack of adequate legal protections in many countries in the region. In this context, it is worth noting that Indonesia has put in place several legal and institutional measures to address domestic abuse in recent years.

d. Priority areas for action

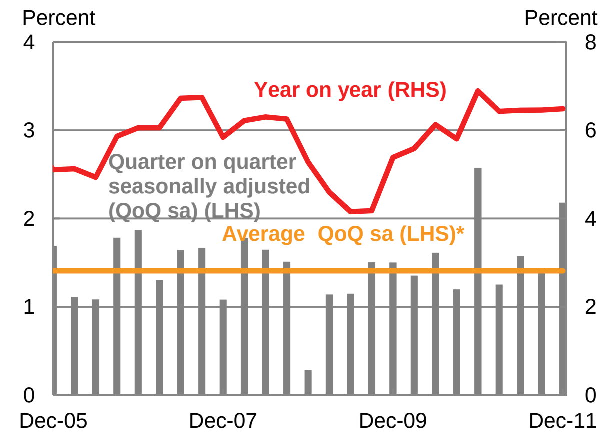
Some of the priority areas for action to promote gender equality in Indonesia include reducing gender silos in education and labor markets while promoting affirmative action in the public domain

This brief review of gender equality by endowment, opportunity and agency indicators points to a number of areas for further improvement within Indonesia. For example, in education, with the gender gap in access eliminated, Indonesia's education system could concentrate on addressing gender stereotypes in school curricula and in reducing "gender streaming" in education. In the health sector, maternal mortality rate needs to be strongly targeted through better institutional management of pregnancy care and child birth. Reducing gender wage gaps in the labor market could also be addressed through positive action to eliminate discrimination such as enforcement of existing legal measures for equal employment opportunities. . Enhancing women's voice and influence, especially in the political sphere, seems to remain a particular challenge. Specific steps to strengthen women's agency will need to be taken, including better enforcement of existing affirmative action policies for female representation in parliament.

[18] See above study by Komnas Perempuan.

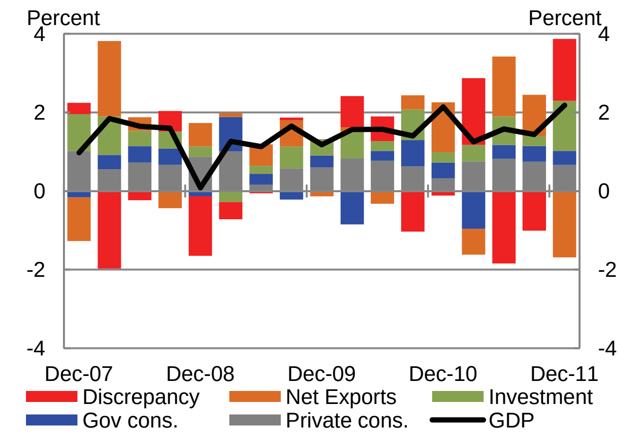
APPENDIX: A SNAPSHOT OF INDONESIAN ECONOMIC INDICATORS

Appendix Figure 1: Quarterly and annual GDP growth
(percent growth)



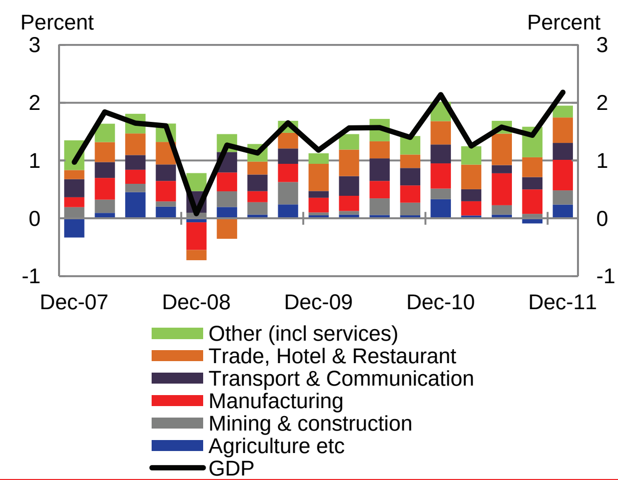
Note: *Average QoQ growth between Q4 2005 – Q4 2011
Sources: BPS, World Bank seasonal adjustment

Appendix Figure 2: Contributions to GDP expenditures
(quarter-on-quarter, seasonally adjusted)



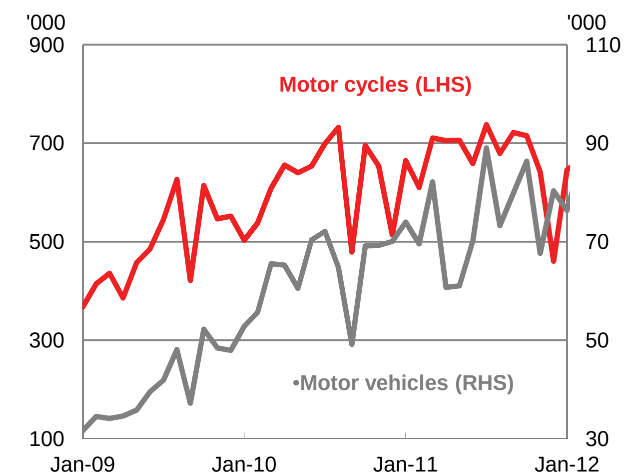
Source: BPS via CEIC and World Bank

Appendix Figure 3: Contributions to GDP production
(quarter-on-quarter, seasonally adjusted)



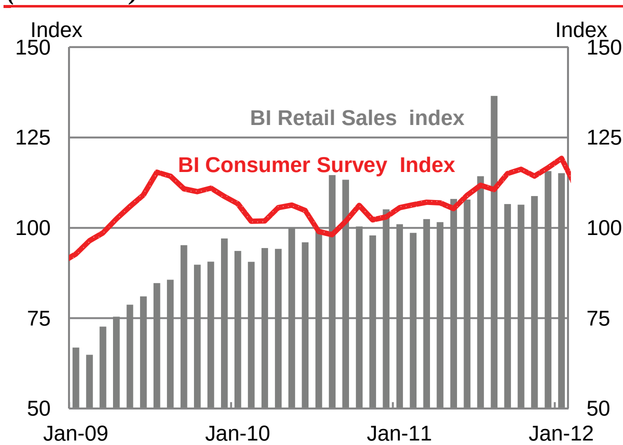
Source: BPS via CEIC

Appendix Figure 4: Motor cycle and motor vehicle sales
(monthly sales)



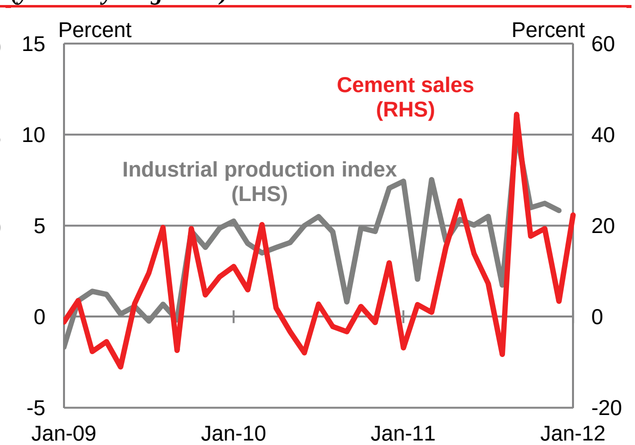
Source: CEIC

Appendix Figure 5: Consumer indicators
(index levels)



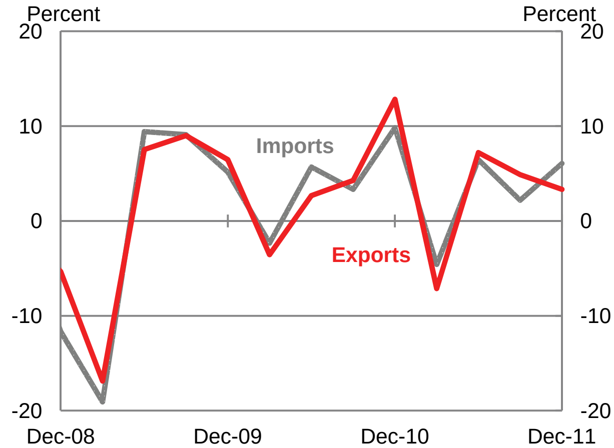
Source: BI via CEIC

Appendix Figure 6: Industrial production indicators
(year-on-year growth)



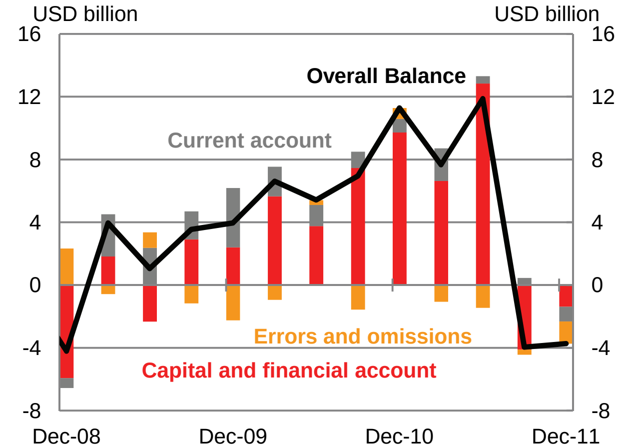
Source: CEIC

Appendix Figure 7: Real trade flows
(quarter-on-quarter real growth, nsa)



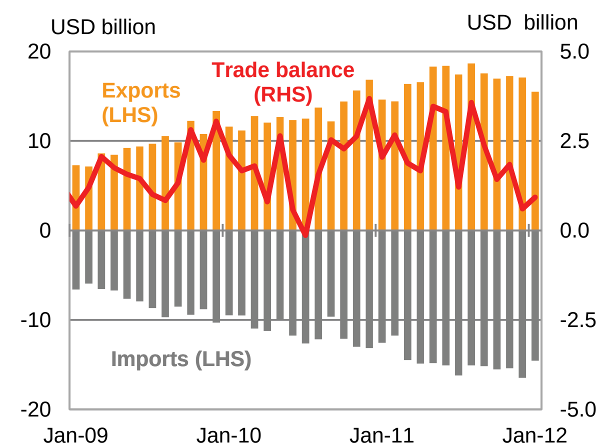
Source: BPS (National Accounts) and World Bank

Appendix Figure 8: Balance of Payments
(USD billion)



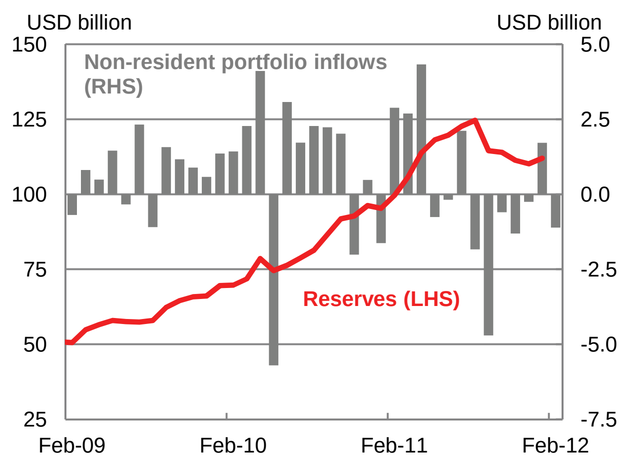
Source: BI and World Bank

Appendix Figure 9: Trade balance
(USD billion)



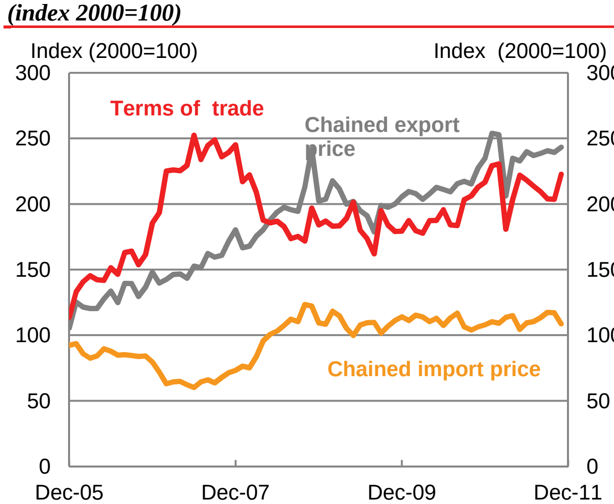
Source: BPS and World Bank

Appendix Figure 10: Reserves and capital inflows
(USD billion)



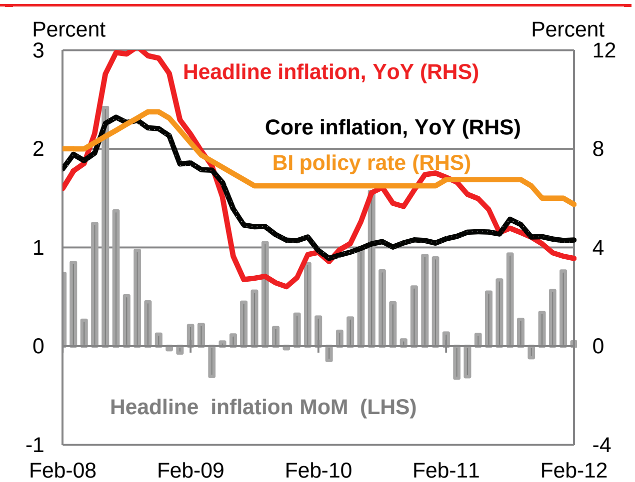
Source: BI and World Bank

Appendix Figure 11: Term of trade and monthly export & import chained Fisher price indices
(index 2000=100)



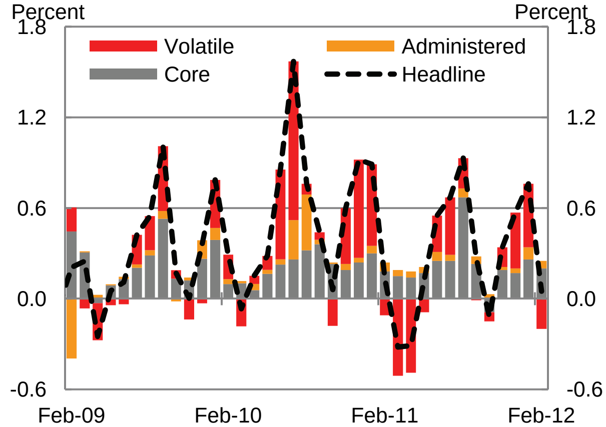
Source: BPS and World Bank

Appendix Figure 12: Inflation and monetary policy
(month-on-month and year-on-year growth, percent)



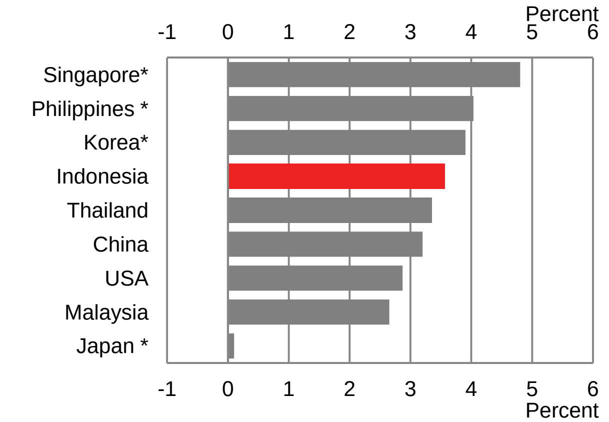
Source: BPS and World Bank

Appendix Figure 13: Monthly breakdown of CPI
(percentage point contributions to monthly growth)



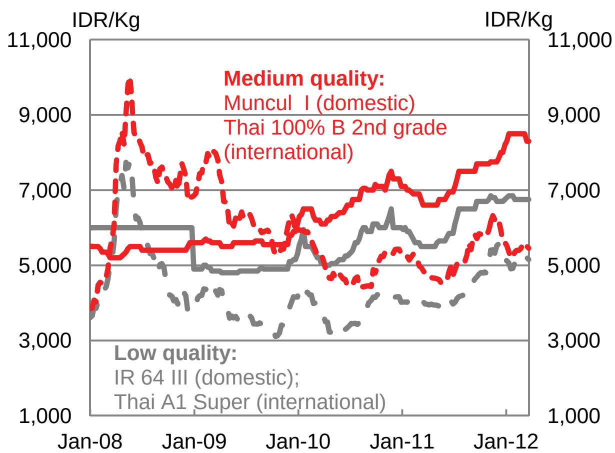
Sources: BPS and World Bank

Appendix Figure 14: Inflation among neighboring countries
(year-on-year, February 2012)



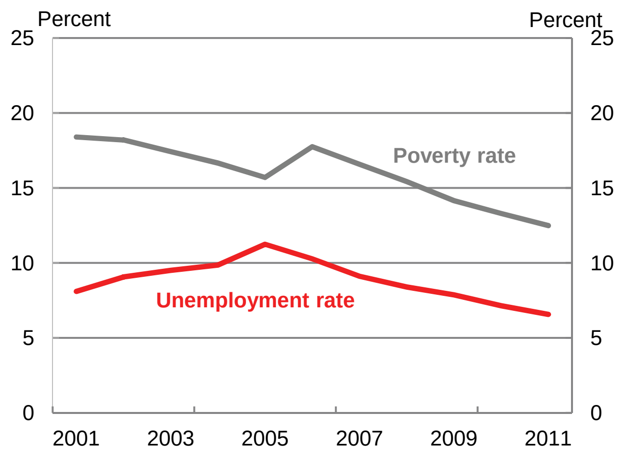
*January is latest available month
Sources: National statistical agencies via CEIC, and BPS

Appendix Figure 15: Domestic and international rice prices
(in IDR per kg)



Note: Dashed: international Thai rice (cif) prices. Solid: domestic wholesale rice
Sources: PIBC, FAO and World Bank

Appendix Figure 16: Poverty and unemployment rate
(percent)

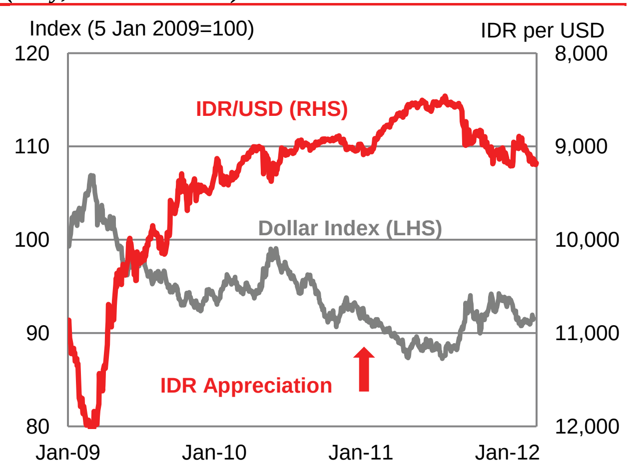


Note: Labor data from August Sakernas
Sources: BPS, and World Bank

Appendix Figure 17: Regional equity indices
(daily, index January 2009=100)

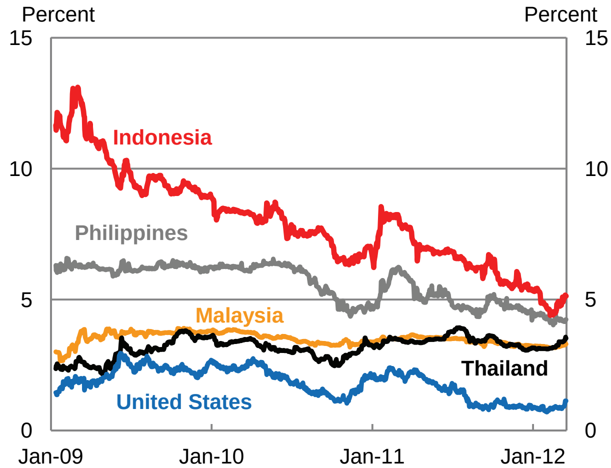
Sources: World Bank and CEIC

Appendix Figure 18: Dollar index and Rupiah exchange rate
(daily, index and levels)



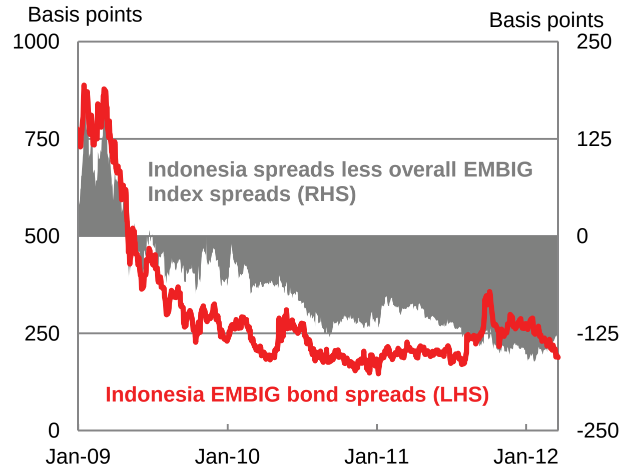
Sources: World Bank and CEIC

Appendix Figure 19: 5 year local currency government bond yields
(daily, percent)



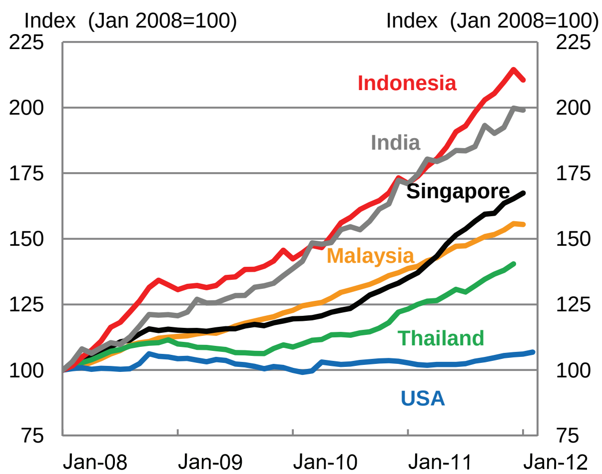
Sources: World Bank

Appendix Figure 20: Sovereign USD Bond EMBI spreads
(daily, basis points)



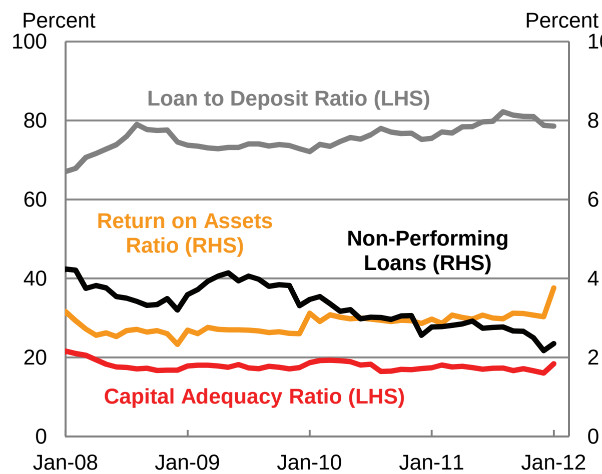
Sources: World Bank and CEIC

Appendix Figure 21: International commercial bank lending
(monthly, index January 2008=100)



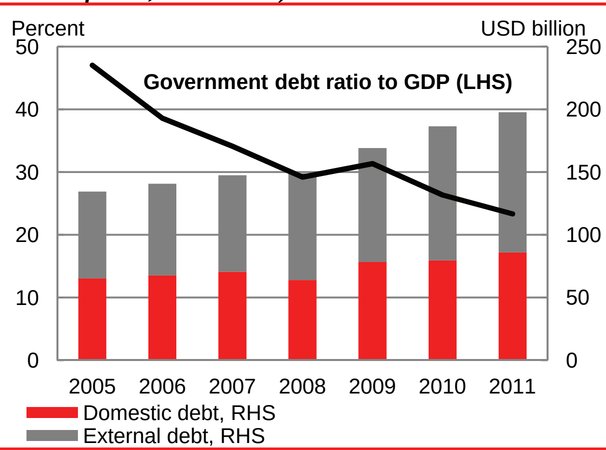
Sources: CEIC and World Bank

Appendix Figure 22: Banking sector indicators
(monthly, percent)



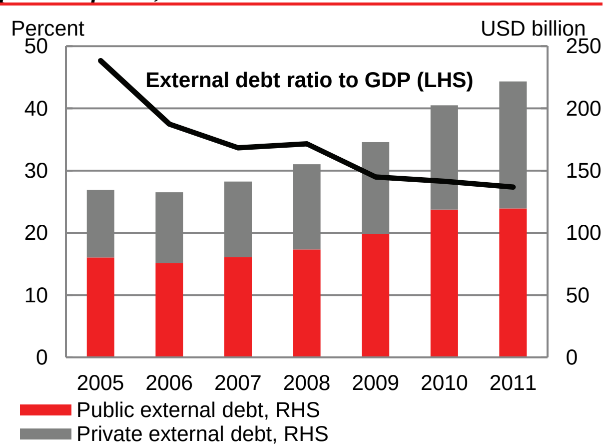
Sources: BI and World Bank

Appendix Figure 23: Government debt
(percent of GDP; USD billion)



Sources: BI and World Bank

Appendix Figure 24: External debt
(percent of GDP; USD billion



Sources: BI and World Bank

Appendix Table 1: Budget outcomes and proposed budget
(IDR trillion)

	2008 Outcome	2009 Outcome	2010 Outcome	2011 Outcome (Unaudited)	2012 Budget	2012 Revised Budget
A. State revenue and grants	**981.6**	**848.8**	**995.3**	**1,199.5**	**1,311.4**	**1,358.2**
1. Tax revenue	658.7	619.9	723.3	872.6	1,032.6	1,016.2
2. Non-tax revenue	320.6	227.2	268.9	324.3	278.0	341.1
B. Expenditure	**985.7**	**937.4**	**1,042.1**	**1,289.6**	**1,435.4**	**1,548.3**
1. Central government	693.4	628.8	697.4	878.3	965.0	1,069.5
2. Transfers to the regions	292.4	308.6	344.7	411.4	470.4	478.8
C. Primary balance	**84.3**	**5.2**	**41.5**	**3.2**	**-1.8**	**-72.3**
D. SURPLUS / DEFICIT	-4.1	-88.6	-46.9	-90.1	-124.0	-190.1
(percent of GDP)	-0.1	-1.6	-0.7	-1.2	-1.5	-2.2

Source: MoF

Appendix Table 2: Balance of Payments
(USD billion)

	2008	2009	2010	2011	2010				2011			
					Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Overall Balance of Payments	**-1.9**	**12.5**	**30.3**	**11.9**	**6.6**	**5.4**	**7.0**	**11.3**	**7.7**	**11.9**	**-4.0**	**-3.7**
As percent of GDP	-0.4	2.3	4.3	1.4	4.1	3.1	3.7	6.0	3.9	5.6	-1.8	-1.8
Current Account	**0.1**	**10.6**	**5.1**	**2.1**	**1.9**	**1.3**	**1.0**	**0.9**	**2.1**	**0.5**	**0.5**	**-0.9**
As percent of GDP	0.0	2.0	0.7	0.2	1.2	0.8	0.6	0.5	1.0	0.2	0.2	-0.4
Trade balance	9.9	21.2	21.3	23.5	4.8	4.6	5.4	6.4	6.6	6.3	6.8	3.9
Net income & transfers	-9.8	-10.6	-16.2	-21.5	-3.0	-3.2	-4.4	-5.6	-4.5	-5.8	-6.3	-4.9
Capital & Financial Account	**-1.8**	**4.9**	**26.6**	**14.0**	**5.7**	**3.8**	**7.5**	**9.7**	**6.6**	**12.8**	**-4.1**	**-1.4**
As percent of GDP	-0.4	0.9	3.8	1.7	3.5	2.2	4.0	5.2	3.4	6.0	-1.8	-0.6
FDI	3.4	2.6	11.1	10.4	2.6	2.4	1.8	4.4	3.5	3.2	1.7	2.1
Portfolio	1.8	10.3	13.2	4.2	6.2	1.1	4.5	1.4	3.6	5.5	-4.7	-0.3
Other	-7.3	-8.2	2.3	-0.6	-3.1	0.3	1.2	3.8	-0.4	4.1	-1.1	-3.2
Errors & omissions	**-0.2**	**-3.0**	**-1.5**	**-4.2**	**-0.9**	**0.3**	**-1.6**	**0.7**	**-1.1**	**-1.4**	**-0.3**	**-1.4**
Reserves[a]	**51.6**	**66.1**	**96.2**	**110.1**	**71.8**	**76.3**	**86.6**	**96.2**	**105.7**	**119.7**	**114.5**	**110.1**

Note: * Reserves at end-period
Source: BI and BPS

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