Fostering formal sector job creation to further improve living standards in Indonesia

By Christine Lewis, Head of Indonesia Desk, OECD Economics Department

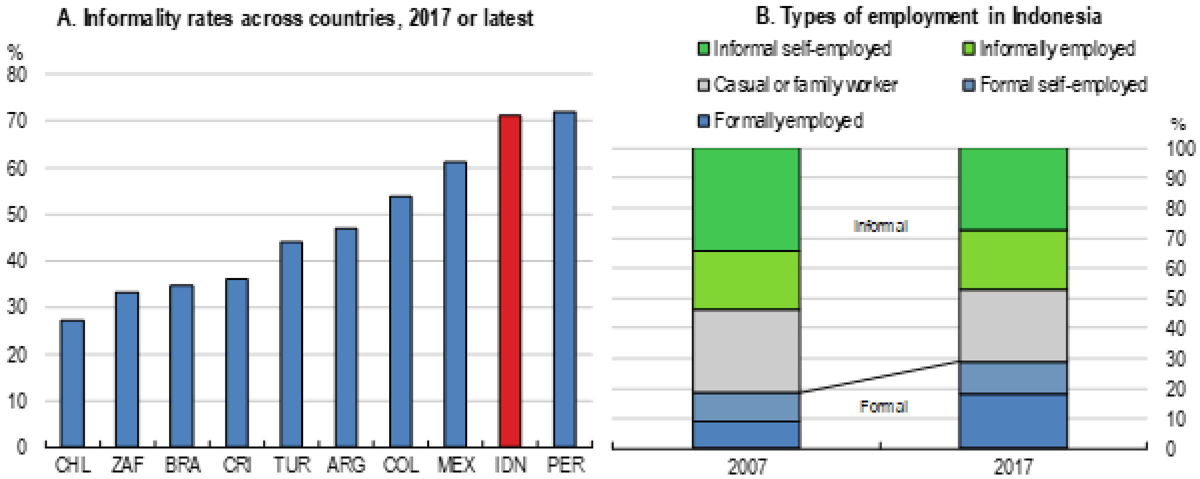
The Indonesian economy has grown solidly in recent years, which together with helpful government policies has raised incomes and brought down poverty rates to record lows, as highlighted in the latest OECD Economic Survey of Indonesia (OECD, 2018). Prudent macroeconomic policies have contributed to economic stability, muted inflation and limited government debt. Even with the more challenging external environment, GDP growth is expected to remain around 5¼ per cent in 2018 and 2019.

Indonesia's youthful population represents an opportunity to lift future growth and living standards. In contrast with higher-income countries, the working-age population share is rising and will likely continue doing so for another decade (United Nations, 2017). OECD estimates suggest that over the next decade this demographic change alone is expected to boost trend GDP growth by around 0.3% on average (OECD, 2018; Guillemette and Turner, 2018).

Indonesia's favourable demographics could provide a bigger boost to growth if a larger share of employment consisted of high-quality jobs in the formal sector. Informality is usually associated with insecure jobs with lower pay and fewer training opportunities (OECD, 2015; Allen, 2016). Although the rate of informality has fallen in Indonesia, it remains pervasive. The OECD estimates that around half of all dependent employees and 70% of all workers are informally employed, compared to 35% in Brazil or around 55% in Colombia

(Figure 1). Growing the share of formal sector jobs would increase incomes and, by raising government revenues, would allow better services to be provided for future generations.

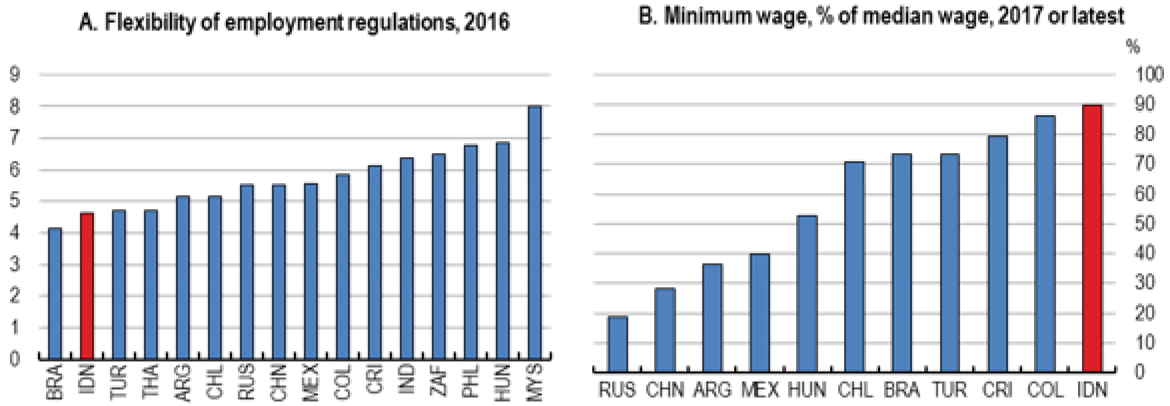
Figure 1. The rate of informality is still relatively high



Note: Estimates are based on the ILO definition of informality and may differ from national sources due to definitional differences. In general informality is defined as employees without social security and self-employed who do not pay social security contributions or whose business is not registered (depending on data availability). For Indonesia, informality is based on the ILO definition for employees and the Statistics Indonesia proxy for identifying informal self-employed workers (based on employment type and occupation) due to data availability for the self-employed. The estimate of informality in Indonesia published by Statistics Indonesia is based on employment status. By this estimate informal employment is 58% of total.
Source: OECD calculations based on the EPH for Argentina, the PNAD for Brazil, the CASEN for Chile, the GEIH for Colombia, the ECE for Costa Rica, the SAKERNAS for Indonesia, the ENOE for Mexico, the ENAHO for Peru, the QLFS for South Africa and the HLFS for Turkey.

There are different reasons for informal employment so tackling it requires a multi-pronged approach. Stringent employment regulations, including high dismissal costs and minimum wages, limit firms’ ability and incentive to hire formal employees (Figure 2). The *Survey* recommends trialling easier employment regulations and a discounted wage for youth in special economic zones and extending these reforms if they are successful. Continuing to simplify business regulations and to improve the new online submission system for licensing would help reduce barriers to businesses operating formally.

Figure 2. Employment regulations are relatively strict



Note: Flexibility of employment regulation is from the Economic Freedom Indices calculated by the Fraser Institute and ranges from 0 (low economic freedom) to 10 (high economic freedom).
Source: Fraser Institute, *Economic Freedom of the World Index*; OECD, *Going for Growth Database*; Statistics Indonesia, *SAKERNAS*; OECD calculations.

Low skill levels combined with a relatively high minimum wage also limit the growth of formal sector employment. Only half of all Indonesians aged 25-35 have completed upper secondary school. The OECD PISA test results show that many 15 year-olds still lack basic skills in maths and reading. Improving the quality of education can be difficult but it is crucial for improving the prospects of future generations. Reforms should focus on improving teacher quality in schools and better linking vocational education with employers to ensure students graduate with the skills they need to find good jobs and continue developing over their career.

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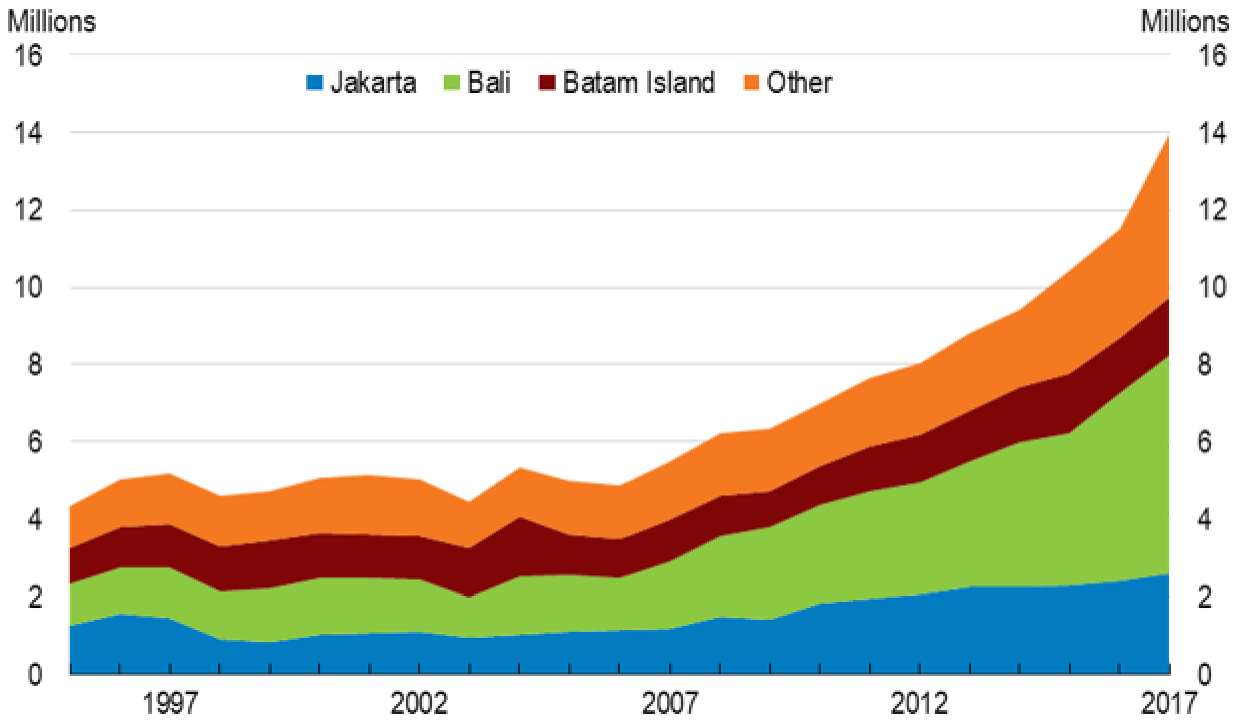
How best to keep up rapid tourism growth in Indonesia

by Patrice Ollivaud, Economist, Indonesia Desk, OECD Economics Department

Bali, where the 2018 OECD Economic Survey of Indonesia is being released, is emblematic of Indonesia’s success in creating a popular tourism brand. The number of foreign tourists arriving in Bali soared from 2.5 million in 2010 to 5.7 million in 2017. In 2014, the authorities committed to replicate this success in “10 new Balis” with the aim of doubling tourist numbers to 20 million by 2019. To reach that target, the government accelerated transport infrastructure development and stepped up its promotion efforts. In 2017, tourist arrivals reached 14 million and other destinations are becoming popular, such as Borobudur.

So far, Bali has attracted the lion's share of the increase in tourist arrivals



Source: CEIC.

However, success in numbers also poses challenges. Environmental infrastructure such as water and waste treatment remains insufficient in most of Indonesia. Growing numbers of foreign tourists are widening the infrastructure gap because their consumption is higher than that of a typical Indonesian. To wit, the increased use of plastic bottles, since tap water is typically not potable. Improperly disposed waste from land largely contributes to Indonesia's position as the second-largest contributor to plastic marine pollution in the world. Indonesia has also the most plastic-ridden coral reefs in the Asia-Pacific (Lamb et al., 2018). In Bali, the ocean carries waste onto beaches that need to be regularly cleaned.

Addressing infrastructure gaps would allow more sustainable development of tourism, and development of tourism to be sustained. Better planning, especially at the destination level, can help accommodate tourist inflows (OECD, 2018). Focusing more on attracting high-spending visitors could also limit the burden without reducing the economic benefits. The involvement of local government and stakeholders is crucial so that plans address local needs and have the population's acceptance.

Preserving the environment and developing tourism can be mutually reinforcing. Visitors are attracted by the richness of Indonesia's environmental assets. Preservation of those assets is essential for sustaining Indonesia's brand and attracting tourists. For example, forests need protection as deforestation is destroying more than just trees and wildlife but also the economic returns from properly using them for tourism. Protecting more areas would contribute to preserving those assets (OECD, 2018). More of those areas could also be opened to the tourism industry, when it is environmentally viable. Imposing fees will help control the number of visitors and contribute to the cost of maintenance.

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The business climate has improved in Indonesia, but this is no time for complacency

by Patrice Ollivaud and Petar Vujanovic, OECD Economics Department

The government has put a heavy emphasis on improving the business climate, thereby promoting a competitive, innovative and dynamic private business sector. Traditionally Indonesia has relied heavily on commodities, but the recent focus of policy has been on facilitating economic development and structural change by diversifying the economy, supporting the development of the manufacturing sector and promoting downstream local value added.

Global competitiveness rankings illustrate the challenges faced by Indonesia. In terms of competitiveness, according to the World Economic Forum, Indonesia's overall ranking in 2016 slipped to 41st and would be even lower (52nd) if market size is excluded from the calculation (Figure 1). As pointed out in the *2016 OECD Economic Survey of Indonesia*, poor infrastructure is one factor holding back structural transformation. The government has recently committed a large amount of funding to fill some of the gaps. However a lot remains to be done, for instance regarding labour market regulation and health and education outcomes.

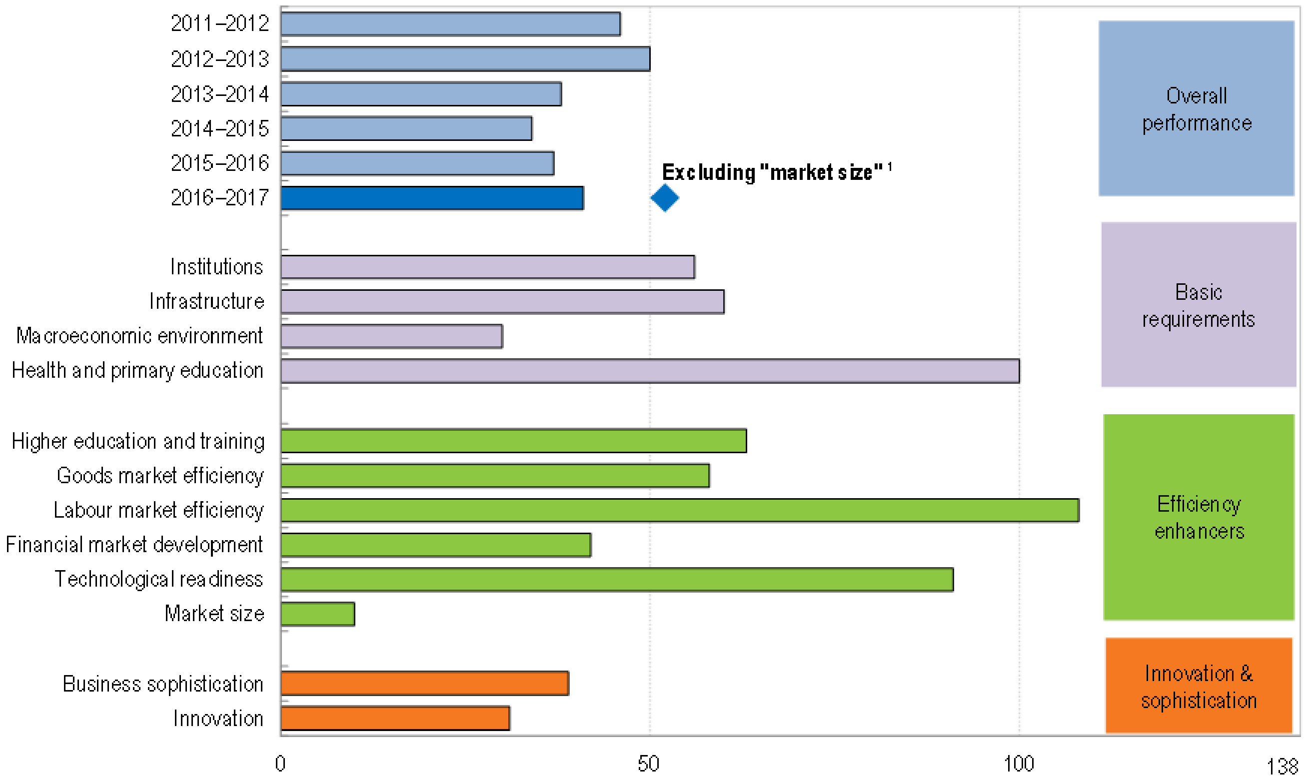
The authorities have released 13 reform packages since September 2015, focusing notably on deregulating and improving the business environment. And the President has set a target of boosting Indonesia to at least 40th place among 189 economies in the World Bank's Doing Business rankings. Indonesia has recently made good progress in that exercise, moving from 120th to 91st between 2015 and 2017 (World Bank, 2016). The bulk of this improvement came from changes to corporate tax rules. For example, the average number of annual tax payments a firm is required to make fell from 65 in 2015 to 43 in 2017, but it remains well above Singapore (6), Malaysia (9) and Thailand (21) and Indonesia still ranks 160th in this subcategory. In its 12th reform package the government stated its intention to reduce the number of tax payments per year to just 10.

As noted in the *Survey*, a significant part of the problem resides at the sub-national level, and indeed, in July 2016 3 000 sub-national government regulations that were inconsistent with national legislation were scrapped. If Indonesia is to make more progress in improving its business climate, sub-national governments need to streamline and harmonise their bureaucracy. There is enormous regional variation in these regulations, with some matching international best practice. The lagging regions should be encouraged to emulate the leaders.

The Survey makes recommendations to make further gains:

- Reduce transaction taxes (including stamp duties, licensing fees and business registration) and the tax on the acquisition of land and buildings by imposing ceilings or replacing them with fixed fees;
- Improve coordination and information sharing among government agencies, so that businesses are not obliged to notify each agency of having completed administrative tasks in another;
- Step up monitoring of the implementation of national regulations across the country;
- Speed up procedures at the land registry office; and
- Make the business registry electronic.

Figure 1. Indonesia's global competitiveness rankings, aggregate and subcomponents, 2016



1. Recalculated ranking for Indonesia excluding the "market size" subcomponent.
Source: World Economic Forum, Global Competitiveness Report 2016-2017

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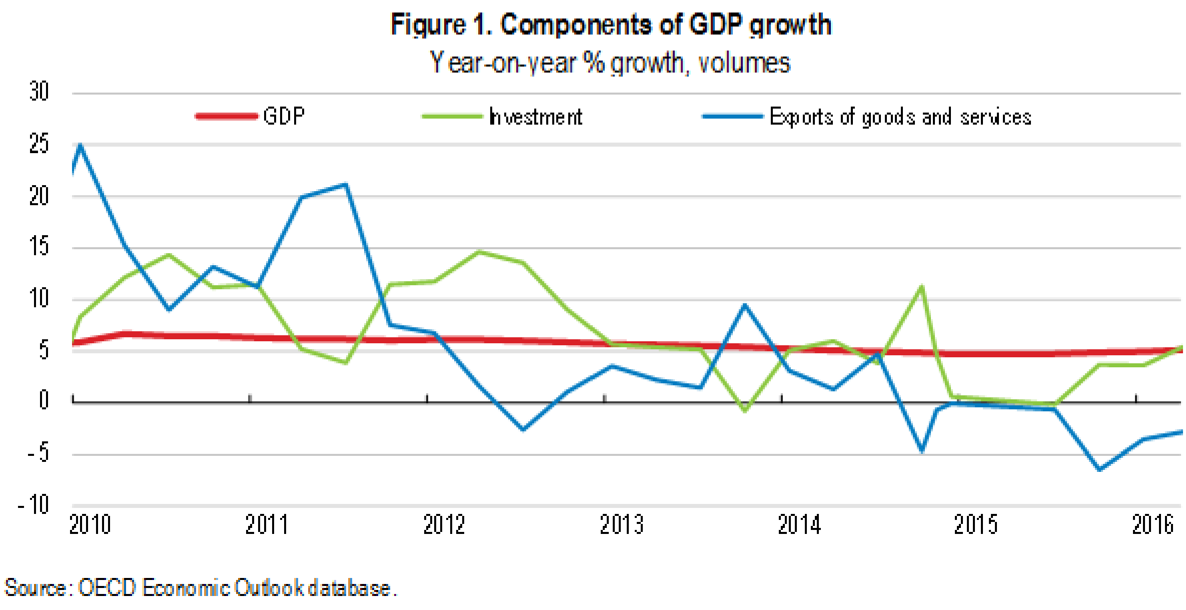
Funding priority spending

will become increasingly challenging in Indonesia

By Patrice Ollivaud and Petar Vujanovic, Indonesia Desk, OECD Economics Department

As described in the *2016 OECD Economic Survey of Indonesia*, economic growth is expected to pick up over the course of 2016 and into 2017. Despite persistently weak external conditions, confidence is returning, with inflation moderating, a stable rupiah and government investment in infrastructure gathering pace. Thanks to the stabilisation of the economy, BI has cut interest rates six times since January 2016, each time by 25 basis points. As recommended in the *Survey*, if growth disappoints, the authorities should continue to employ a prudent monetary policy to stabilise output without endangering financial stability.

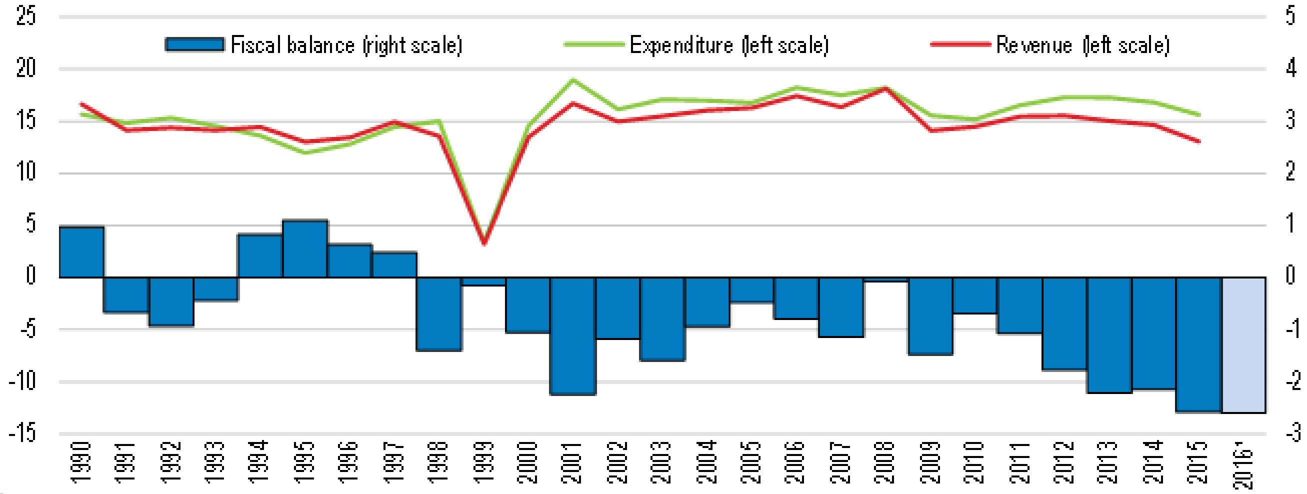


Seizing the opportunity resulting from lower oil prices, the government substantially reduced fuel subsidies from about 19% of public expenditure in 2014 to 7% in 2015. The funds were mostly reallocated towards ambitious programmes to alleviate infrastructure gaps and poverty. However, the poverty rate is still relatively high compared to peer countries at a similar level of development. Moreover, a lack of infrastructure, especially in transportation (including maritime), logistics, water treatment and energy supply, is hampering Indonesia's economic, business and social development.

The recent boost to confidence could be undermined if the government fails to deliver on its promises, notably in terms of infrastructure investment. With lacklustre revenues notably due to low tax compliance, the government's programme is at risk. For several years, the fiscal deficit has been close to the 3% legal cap (Figure 2). In June and then in August, expenditure cuts (first by 1% and then 6.5% of government expenditure) were announced in the wake of lower revenues and a larger projected deficit. A tax amnesty was launched in July to boost tax collection. With the OECD's Automatic Exchange of Information regime due to come into force over the next two years, the timing of the amnesty is good, as it provides taxpayers with an early opportunity to regularise past non-compliance. As of 30 September, over 400 000 Indonesians had declared about 3 500 trillion rupiah (USD 280 billion) in assets, generating about 90 trillion rupiah (USD 7 billion) in additional government revenues.

Figure 2. Central government revenue, expenditure and balance

% of GDP



1.OECD staff estimates

Source: CEIC database.

In addition, improving the efficiency of public spending would allow getting the most out of existing resources. To that end, the *Survey* highlights in particular the need to boost the capacity and skills of civil servants, particularly in some sub-national governments. The “big-bang” decentralisation has proven to be popular and successfully brought government closer to the people. In order to complete it, more tax autonomy at the regional level would help to improve both tax collection and accountability.

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