EXECUTIVE SUMMARY

International Labour Organization

INTERNATIONAL INSTITUTE FOR LABOUR STUDIES

STUDIES ON GROWTH WITH EQUITY

INDONESIA

REINFORCING DOMESTIC DEMAND IN TIMES OF CRISIS

Executive summary and policy recommendations

The global crisis had a relatively limited impact on the Indonesian economy and labour market…

In the two years preceding the onset of the crisis, GDP growth in Indonesia averaged approximately 6 per cent per annum – 6.3 per cent in 2007, the highest growth rate in a decade. This was driven by robust domestic demand, increased private consumption, and high investment rates due to infrastructure and business climate improvements. In addition, unlike the period preceding the Asian financial crisis in 1997, the financial sector was also on a relatively sound footing; prudential control of banks was tight, exposure to international capital flows was limited and the incidence of non-performing loans was declining.

Nevertheless, as the crisis spread and world aggregate demand and trade activity declined, exports from Indonesia also declined, by as much as 18 per cent in the first quarter of 2009. As a result, the rate of growth in Indonesia began to decelerate, falling to just above 5 per cent in the fourth quarter of 2008 and remaining around 4 per cent for the first three quarters of 2009. Growth, however, rebounded quickly and started to recover in late 2009 and by the first quarter of 2010, had reattained pre-crisis rates.

Employment growth also remained robust over the short-lived crisis period with jobs lost only in a few sectors between February 2008 and 2009, most notably construction, transport, storage and communications. However, these sectors combined represent less than 12 per cent of total employment. Moreover, the unemployment rate declined steadily – falling from 8.4 per cent in February 2008, to 8.1 per cent in February 2009 and 7.1 per cent in August 2010. In 2009 – during the height of the crisis – Indonesia was the only G20 or Asian country (with available information) in which economic growth was positive and the unemployment rate had fallen from its 2008 level.

…due to Indonesia's favourable initial conditions…

For many developing countries the transmission mechanisms of the crisis were external channels, notably falling exports. Indeed, in many emerging countries, growth in the pre-crisis era hinged on exports. This was the principal means by which Indonesia too was affected by the crisis. But exports as a percentage of GDP in Indonesia, at approximately 30 per cent in 2008, were lower than many other countries in the region, e.g. more than 75 per cent in Thailand and Viet Nam and more than 35 per cent in China.

In addition, unlike some of its counterparts in the region, Indonesia entered the crisis in a relatively sound fiscal position and could thus carry out counter-cyclical policies without damaging medium-term public finances. In particular, in 2008, the fiscal balance as a percentage of GDP was close to zero (-0.1 per cent) compared to nearly -1.0 per cent in South-East Asia. Moreover, Indonesia benefited from a rather healthy financial sector which had been regulated in the aftermath of the Asian crisis at the end of the 1990s. Notable reforms included stricter financial market supervision and regulation (the so-called Badan Pengawas Pasar Modal) and the introduction of a deposit insurance system (Lembaga Penjamin Simpanan).

…and because of early implementation of counter-cyclical monetary and fiscal measures which reinforced domestic demand...

The Government put in place some immediate measures to stabilize the financial system. When the stock market fell dramatically in October 2008, the Government temporarily suspended operations to avoid further damaging the stability of financial markets. In addition, with a view to boosting aggregate demand and preventing exchange rate depreciations, the Bank of Indonesia (BI) lowered its benchmark interest rate by 375 basis points, from 9.25 per cent in December 2008 to 6.5 per cent in September 2009. Finally, unlike other Asian economies which tried to devalue their currency in order to increase exports, Indonesia's monetary strategy was to keep the rupiah (IDR) proportional to the United States dollar (USD). This was partly to ensure the continuation of foreign investment in Indonesian enterprises, but also due to the fact that most of Indonesia's foreign debt is measured in USD, and thus devaluing the IDR would effectively increase the deficit.

The Government also announced in January 2009 fiscal stimulus measures amounting to 1.4 per cent of GDP (IDR 73.3 trillion or USD 7.1 billion) – the smallest stimulus package in Asia, where the average was just above 7 per cent of GDP. The primary fiscal instrument used was tax cuts, most of which were already planned before the onset of the crisis; these comprised over 75 per cent of the stimulus spending, the vast majority of which consisted of a series of amendments to the personal income tax system (IDR 24.5 trillion or USD 2.4 billion) and lower corporate taxes (IDR 19.3 trillion or USD 1.9 billion). The Government also allocated an additional IDR 12 trillion (USD 1.2 billion) towards infrastructure-related investments which were intended to support an already robust infrastructure programme. The stimulus was quite successful in delivering support quickly: the tax cuts were effective immediately and by the end of 2009, nearly all of the stimulus related to investments in infrastructure had been spent.

The move was a considerable departure from efforts undertaken in other countries. For example, among Indonesia's Asian counterparts the majority of stimulus measures were targeted towards infrastructure investments with less than one-fifth dedicated to tax reductions. Even among advanced economies, less than half of stimulus spending was on tax-related measures. But this departure compared to other countries underscores the uniqueness of the macroeconomic situation in Indonesia. While the country had ample fiscal space to carry out expansionary fiscal policies, it opted for tax measures, which were already in the offing, mainly to continue its efforts to modernize the tax system and improve the tax code to make it more conducive to enhancing business competitiveness and boosting incomes.

…first, through tax exemptions for lower-income households and cuts in income taxes…

There were considerable changes in the personal income tax system with a number of modifications for lower-income earners. In the first instance, the minimum threshold for tax exemption was raised from IDR 13.2 million (USD 1,271) to IDR 15.8 million (USD 1,521) for single individuals, and for married persons it rose from IDR 14.4 million (USD 1,386) to IDR 17.2 million (USD 1,655). Additional tax exemptions were also made available depending on family circumstances, i.e. the number of children. There were also reductions in the effective tax rates at the lower end: those earnings between IDR 25 million (USD 2,400) and IDR 50 million (USD 4,800), the tax rate was cut in half from 10 per cent to 5 per cent and for incomes between IDR 100 million and IDR 200 million (between USD 9,600 and 19,200) the marginal tax rate is now 15 per cent instead of 25 per cent. Changes to the upper income tax brackets and rates were also made.

The motivations underlying the focus on personal tax cuts were multiple. First, the Indonesian Government had already planned on revamping its tax system, and when the crisis hit, there was a renewed urgency to complete the process. Second, the impact of the tax cuts could take effect immediately, thus giving weight to the importance of reacting quickly in time of crisis. And finally, the cuts were critical in boosting incomes of poorer households which – when combined with other policy interventions – could have important multiplier effects.

…and second, by boosting existing social protection programmes developed in response to the Asian crisis…

In many countries, a crisis represents an opportunity to strengthen its social protection schemes. Indeed, this is what happened in Indonesia following the 1997 Asian financial crisis. The country introduced a series of measures, most notably (i) food subsidies programme; (ii) conditional cash transfers; (iii) regional empowerment; and (iv) health services for the poor. This was complemented by new programmes in the years that followed the Asian crisis and efforts to establish a basic framework for the development of universal social security and social assistance (Law No. 40/2004). In this respect, the Government was in a good position to allocate additional support to the existing array of social assistance programmes. In particular, in 2009, although not considered part of stimulus efforts, spending on the existing range of programmes – through the regular budget process – increased by more than 34 per cent or IDR 20 trillion (USD 1.9 billion).

Part of this response included extending the unconditional cash transfer programme (BLT). The programme was reactivated in 2008 to help address challenges associated with the food crisis. In 2009, the programme was extended for an additional 2 months and allocated an extra IDR 2.3 trillion (USD 0.2 billion). The BLT provides short-term income assistance and is targeted to the poorest 30 per cent of households (roughly 18.5 million households). Similarly, the Government expanded on two occasions a conditional cash transfer programme (PKH) which had been in pilot testing at the onset of the crisis. The programme provides financial support to pregnant women or families with children up to the age of 15, on the condition that the children fulfil certain health-care and education requirements. In 2009, nearly one-quarter of a million households were covered, with – at least initially – generally positive results: beneficiaries used the funds for children's school and health needs, food purchases and other basic necessities.

In addition, as part of the stimulus, Indonesia allocated close to 7 per cent (IDR 5.1 trillion or USD 0.5 billion) of the total stimulus (similar to other countries in the region) to provide additional support to low-income households. Most of this funding (IDR 4.5 trillion or USD 0.4 billion) went towards subsidies that led to a reduction in cooking oil prices, a large portion of low-income households' annual expenditure.

…and third, by recognizing the employment effects of mutually-supportive demand- and supply-side policies…

In light of the tax cuts and reinforced social protection measures, incomes of Indonesians received an important boost during the crisis. Preliminary estimates indicate that total household incomes rose as a result of the stimulus package which helped to reinforce domestic demand: domestic consumption grew by 14.5 per cent in the first quarter of 2009 and 9.7 per cent in the second quarter of 2009.

As a complement to these measures, the Government ensured that the business climate remained robust and was in a position to respond to increased demand. In particular, the reduced lending rates established by the BI helped lower the costs of credit but more importantly, the Government established a loan guarantee facility within the People Business Credit (KUR) for firms facing financing difficulties during the crisis. The KUR was established in 2007 to provide increased credit access to small and medium-sized enterprises (SMEs). In addition, as part of the stimulus efforts, corporate tax rates were reduced by 5 percentage points from 30 to 25 per cent. Moreover, small enterprises, i.e. corporate taxpayers with an annual turnover of not more than IDR 50 billion (USD 4.8 million), are entitled to a tax discount of 50 per cent off the standard rate.

In this way, policies supported the interaction of supply and demand — which had important employment effects. In fact, between February 2009 and August 2010, the Indonesian economy generated 3.7 million jobs — of which an estimated 1.2 million were a result of stimulus measures. The impact was particularly strong in the case in sectors related to domestic consumption such as retail trade and agriculture

- Between February 2009 and August 2010, 2.3 million jobs were added in the community, social, and personal services sector, and 255,000 jobs in the financial, insurance, real estate, and business services sector.
- Similarly, the retail trade, restaurant and hotel sector added more than 650,000 jobs.

…which fourth, were complemented by efforts to strengthen the employment-intensity of infrastructure investments, including in rural areas.

The additional investments in infrastructure in the case of Indonesia were comparably low – less than 11 per cent of the stimulus package compared to more than 37 per cent in other developing and emerging economies. However, infrastructure in Indonesia is – as was the case prior to the crisis – a key strategy for improving Indonesia's investment climate. Indeed, leading up to the crisis, investment contributed close to one third of the growth in GDP. Hence, in this respect, the response in 2009 was intended simply to build upon this broader strategy while placing emphasis on employment-oriented activities. Even though there was a time lag in the disbursement of the funds for infrastructure, more than 97 per cent of the allocation was spent by the end of 2009.

Moreover, the labour-intensive public works infrastructure investments – which were well-targeted – had good multiplier effects and provided a much-needed boost to jobs creation (an estimated 450,000 full-time equivalent jobs as a result of stimulus). Moreover, according to a survey conducted by the ILO Country Office for Indonesia and Timor-Leste, disadvantaged groups were the main beneficiaries of the public works spending.

In particular, the National Programme for Community Empowerment (PNPM) – a collection of community development programmes that serve as the primary instrument for poverty reduction in Indonesia – received additional support. In 2009, the budget was increased significantly from IDR 4.2 trillion to 7.6 trillion (from USD 0.4 billion to 0.7 billion). The programme has been shown to be successful in stimulating economic development through improvement in the quality of local physical infrastructure and in generating local employment opportunities.

Moving forward, Indonesia could take advantage of the significant achievements by strengthening social protection...

Despite the recent policies adopted in the wake of the crisis, the coverage of social protection in Indonesia remains more limited than in other Asian countries. Social spending in Indonesia – at 1.9 per cent of GDP in 2008 – is lower than in other emerging Asian economies – roughly one-third compared with Malaysia and Thailand. Moreover, the programmes suffer from a number of weaknesses, including:

- Inefficient allocation: A number of the social assistance programmes, such as the Raskin (Rice for the Poor), while targeted on the poor, have weak distribution channels. They also suffer from large deadweight losses, as some households typically not eligible also benefit from the programme, which reduces scope for supporting the most needy. For example, the aggregate number of the poor in a particular province is defined by the Central Bureau of Statistics, but the details of those eligible for the programme are determined by the district or municipal government, leading in many cases to selection bias. As a result, given the limited supplies, poor households are at times excluded from the rice distribution.
- Limited awareness compounded by lack of coherence and coordination: Many households eligible for social assistance are unaware of the various programmes that exist – exacerbating the challenges of ensuring that the programmes reach the targeted group and have the intended outcome. There are currently some 117 programmes related to poverty reduction, executed by 32 different agencies.
- Poor programme oversight with few evaluation mechanisms in place: In some cases, programmes remain incomplete. For instance, within the infrastructure development projects of the National Programme for Community Empowerment, nearly 30 per cent of projects remain incomplete each year. These delays are mainly the result of the lengthy administrative processes for proposals, the selection of projects, and so on. In addition, except in some instances (usually donor-funded schemes), many of the programmes do not have any evaluation mechanisms in place.

One way to address these systemic issues could be by creating a central coordinating authority, coupled with stronger supervision and monitoring at local levels. This could help improve awareness and delivery and thus improve the overall effectiveness of social protection. For example, in Brazil all the poverty reduction schemes – of which there are only 14 social welfare and poverty reduction programmes – are coordinated by the office of the President. Moreover, any rationalization of schemes in Indonesia should be accompanied by a system of evaluation; the ability of policy-makers to improve the effectiveness of existing (and new) labour market programmes very much depends on a proper evaluation framework.

... addressing high employment informality and promoting the creation of quality jobs…

Approximately two-thirds of the total working population are employed in the informal economy. This is a major social problem but high informality also hinders economic development and, as the report finds, makes the economy more vulnerable to shocks. A number of measures could be introduced in Indonesia that could have the double dividend of improving the overall coverage of social protection and promoting the creation of higher quality jobs, notably:

- Harmonize contribution rates between informal and formal workforces: Currently, within the social security scheme formal workers pay a percentage of their salary whereas informal workers pay a fixed flat rate, making it more attractive, from a tax perspective, to work in the informal economy. However, if all workers were to pay a progressive tax based on income – even though this might lead to under-reporting of income in general – it would at least remove tax as an incentive to gravitate towards the informal economy.
- Promote flexible health-care coverage for informal economy workers: Indonesia has already mandated universal health coverage, but many of the poor do not have access. Such a scheme could benefit from the experience of countries such as Ghana, which switched from a 'cash and carry' system to a compulsory National Health Insurance Scheme in 2005. The scheme, funded by the implementation of a 2.5 percent VAT and individual contributions based on income (with exemptions for the elderly and indigent) offers portable, flexible coverage to informal workers through mutual and private health insurance schemes. The initial results are impressive as registrants increased from 7 per cent of the population in 2005 to 45 per cent in 2008, with the majority of workers coming from the informal economy.
- Simplify the tax regime for SMEs: A sizeable share of employment-rich SMEs are working in the informal economy – often as a result of the tax system. Providing tax (and credit) incentives to firms to "formalize" could help spur formal job creation. Several developing and emerging countries, particularly in Latin America and Eastern Europe have done this quite successfully. For example, Hungary decreased taxes for those employing underprivileged workers, and gave tax concessions to those sectors with informal workers (domestic workers, construction). In Latin America where tax systems are particularly complex, simplifying the tax structure has encouraged businesses to formally register by making compliance less costly and burdensome for SMEs. Countries such as Argentina, Bolivia, Brazil and Peru have introduced simplified tax regimes for SMEs by e.g. replacing the various taxes (such as income and sales tax) with one single tax.
- Support unemployed workers: There is currently no unemployment insurance scheme in place to aid jobseekers, which results in many unemployed workers often resorting to employment in the informal economy. It is important to give consideration to the development of an unemployment benefit scheme which if properly designed could serve both labour market and social objectives. In particular, such a scheme would provide adequate income replacement while keeping workers in contact with the formal

labour market through job-search assistance and skills training. Although launching such a programme would require some initial investments, the case of the Republic of Korea illustrates how this can be achieved in a cost-effective manner. In 1995, the Ministry of Labour in the Republic of Korea used existing facilities and staff to administer and initiate the unemployment insurance scheme in its first year, helping to reduce significantly overall implementation costs.

- Comprehensive skills development policy: A well-functioning labour market requires that labour market information contributes to an over-arching skills development strategy. In the case of Indonesia, however, the current skills development system is rather fragmented. Most skills trainings are not competency-based and certificates are often not recognized. The current proposal to develop a national qualification system is a step in the right direction. Success will depend on a number of key design parameters, notably improved labour market information, establishment of a cost-effective certification system across the country, and a better mapping of skills development delivery channels.

…and promoting employment prospects of youth – who have not shared equally in the benefits of the recovery.

Already before the crisis, in February 2008 unemployment rates for youth aged 15–24, at 21.1 per cent, were much higher than the average in South-East Asia and the Pacific where youth unemployment rates in 2008 were around 15 per cent. During the crisis, youth in Indonesia experienced a modest increase in their unemployment rate – rising to over 23 per cent in August 2008. The situation has since improved somewhat with the unemployment rate falling to just under 20 per cent in February 2010. However, in comparison to their adult counterparts (aged 25–54), youth unemployment rates in Indonesia are more than four times higher – in fact, the gap of more than 15 percentage points is among the highest among countries with available information and remains unchanged since the onset of the crisis. A number of reform options could bolster the employment outcomes of youth:

- Strengthen school-to-work transition: Many of the problems appear to stem from skills mismatches. Efforts are needed to strengthen the ties between educational institutions and the private sector. As a first step, the Government could work to improve the existing apprenticeship programme, for instance by increasing the number of available places and providing greater access to skills training. This could be achieved by developing skills training partnerships with businesses. In the medium term, however, more efforts are needed to ensure improved educational outcomes which are complemented by job growth in productive, high-skilled sectors.

- Encourage the hiring of youth: In the absence of suitable employment opportunities, many youth find themselves seeking jobs in the informal sector. A number of measures could be envisioned to encourage the direct hiring of unemployed youth, such as through targeted subsidies. For example, in China, financial incentives were introduced for private companies to recruit more graduates. Similarly, the Republic of Korea introduced new wage subsidies for SMEs to hire interns on regular contracts at the conclusion of their internship.

Success in addressing these challenges lies in fostering coherence between decent work goals and macroeconomic policies.

Following the 1997 Asian financial crisis, monetary and fiscal policies were focused on inflation and debt reduction. As such, the decade leading up to the crisis was characterized by overall prudence – which was the right strategy, at least initially. However, it has led to reductions in fixed investment, stagnant growth in social protection spending and narrowly focused monetary policy. With growth in 2010 and 2011 set to surpass 6 per cent per annum, the timing could not be more appropriate to reinforce social protection measures and to make macroeconomic policies more job-centred:

1. Leverage existing fiscal space: In Indonesia there remains considerable fiscal space – debt to GDP is less than one-third and household debt to GDP is below 10 per cent – all well below their Asian counterparts. Some of this fiscal space can be allocated to, for instance, improving effectiveness and coverage of social protection schemes, improving skills provision or expanding existing apprenticeship programmes. Spending of this nature should not be seen as a one-off cost – it is an investment in long-term sustainable growth and will bring returns in the future in terms of improvements in the well-being of workers, productivity, incomes and overall economic growth.

2. Make monetary policy conducive to economic growth and job creation: It is important to balance the twin goals of keeping prices stable and spurring economic growth. The experiences of other countries demonstrate that inflation targeting does not need to come at the expense of growth and job creation.

3. Increase access to credit for domestic firms, especially small ones: Evidence shows that firms in Indonesia are performing 30 to 35 per cent below capacity, and one of the primary constraints facing them is exorbitant borrowing costs (lending rates remain two times higher than the average in ASEAN countries). In this respect, the Government has a role to play in creating a conducive environment for private business investment. The Government should consider expanding the People’s Business Credit (KUR) to further strengthen the ability of micro-, small and medium-sized enterprises (MSMEs) to secure financial support. It could also envision giving preferential rates to MSMEs, as was the case recently in Viet Nam.

Indonesia has fared relatively well during the current crisis. And despite the emerging challenges, the country is well-positioned to undertake the necessary reforms. Moving forward, continued recognition of the complementarities among economic, labour and social objectives – especially if achieved through social dialogue – will ensure that the future successes are sustainable and equitable.