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BETTER POLICIES FOR BETTER LIVES

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This book has...

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BASIC STATISTICS OF INDONESIA
(2011 unless noted)

Area (thousands sq. km)	1 911
POPULATION	
Total (2010, millions)	237.6
Inhabitants per sq. km	124.4
Net average annual increase during 2000-10 (per cent)	1.5
Urbanisation rate (2010, per cent)	49.8
Age distribution (per cent of total population)	
0-14	26.4
15-64	67.9
65+	5.7
EMPLOYMENT	
Working-age population (millions)	171.2
Total employment (millions)	110.5
Labour force participation rate (per cent)	69.2
Open unemployment rate (BPS definition, per cent)	6.7
Informality rate (BPS, per cent)	64.0
Headline CPI inflation (per cent, end-of-year)	3.8
GROSS DOMESTIC PRODUCT	
GDP at current prices and current exchange rate (USD billion)	846.1
Per capita GDP at current prices and market exchange rate (USD)	3 511
Average annual real growth over previous 5 years (per cent)	5.9
PUBLIC FINANCES (per cent of GDP)	
Revenue	16.3
Expenditure	17.4
Nominal balance	-1.1
Gross debt	24.3
INDICATORS OF LIVING STANDARDS	
Upper-secondary educational attainment (2010, per cent of 15+ population)	29.7
Literacy rate (per cent of 15+ population)	92.8
Doctors per 1 000 inhabitants (2007)	0.288
Infant mortality per 1 000 live births (2010)	27.2
Life expectancy at birth (2010)	70.7
Human Development Index (2010)	72.3
Income inequality (Gini coefficient)	0.41
Poverty incidence (March 2012, national poverty line)	12.0
Internet users per 1 000 inhabitants (2010)	99
Improved sanitation facilities (2010, per cent of population with access)	54
EXTERNAL SECTOR	
Current account (USD billion)	1.7
In per cent of GDP	0.2
Exports of goods (USD billion)	201.5
In per cent of GDP	23.8
Average annual growth over previous 5 years (per cent)	14.2
Imports of goods (USD billion)	166.1
In per cent of GDP	19.6
Average annual growth over previous 5 years (per cent)	17.6
Outstanding external debt	
In per cent of GDP	26.6

Executive summary

Improved macroeconomic and structural policy settings since the Asian crisis have yielded strong and remarkably stable economic growth, as well as a marked reduction in poverty. Further institutional and policy reform would boost productivity growth and help the government reach its objective of becoming one of the 10 largest economies in the world by 2025, while promoting a socially inclusive and green development path.

The country is in a favourable situation to undertake necessary reforms

Real GDP is projected to grow at around 6% this year and next, led by robust domestic demand. Monetary policy should, as planned, ensure that inflation will remain on a downward trend, using interest rates, liquidity management and macro-prudential measures. Indonesia's infrastructure and social spending needs are substantial and will need to be efficiently financed. A substantial reduction in energy subsidies, which fail to achieve their social goals and have significant fiscal costs, would free up resources for pressing social and economic needs. At the same time, well targeted cash-transfer schemes will be necessary to keep poverty from worsening and thereby help to overcome resistance to energy price increases. Wide communication on the gains and distributional benefits of this reform, together with a rule linking subsidised fuel prices to international oil prices that does not have to be renegotiated every year would ease implementation.

There is significant scope to raise revenues by improving the tax system and tax administration. Broadening tax bases and improving compliance, particularly by high-income individuals, would make the system fairer. This should be achieved by allocating more audits where risks of underpayment are higher, making more intensive use of existing information, setting up more large-taxpayer offices and enhancing administrative capacity. Removing exemptions and raising the tax rate on economic rents in the resource sector would generate higher revenues efficiently. Efforts to bring the self-employed into the tax net should be reinforced.

Faster productivity growth will boost living standards

Formalisation of workers and firms will be a key source of productivity growth and could be encouraged by preventing excessive increases in the minimum wage, introducing a sub-minimum wage for youth and implementing reforms to make the formal labour market more attractive to workers and firms. One option to effectively protect workers against job-loss risks in the future would be to introduce limited unemployment benefits coupled with individual unemployment-insurance accounts while removing rigidities in the formal labour market. A simplification of the cumbersome licensing process would reduce the administrative burden facing companies.

Notwithstanding a vibrant financial sector, firms' access to finance could be eased by making the information collected by the credit bureau available to all financial institutions.

Underdeveloped financing sources such as venture capital and micro-finance could be deepened by removing current restrictions to entry. The Master Plan for the Acceleration and Expansion of Indonesia's Economic Growth, which is meant to speed up infrastructure development, can be supported by additional public outlays without endangering fiscal sustainability. A lack of qualified workers also hampers productivity gains, and public resources should focus on the most cost-efficient programmes that manage to develop the skills of school dropouts and workers. Support to small firms could be made more effective by clarifying responsibilities within the central government and between it and local authorities, and by consolidating existing schemes. Relaxing those restrictions on inward direct investment that cannot be justified by public-interest concerns and removing the non-tariff barriers that are detrimental to trade and growth would also be useful.

Key policy recommendations

Monetary policy and the financial regulatory framework

- Achieve the inflation target and, as planned, reduce it over time. This would be achieved by relying on interest rate, liquidity management and macro-prudential measures.
- Step up efforts to pass a micro-finance law, and expand the sectoral coverage of the regulatory framework.

Policies to finance key development programmes

- Significantly diminish fossil-fuel and electricity subsidies, and implement enhanced compensatory cash-transfer programmes to prevent a rise in poverty. Communicate widely on the efficiency and distributional benefits of reform. As an interim measure, re-establish a rule linking fuel prices to developments in international oil markets, to remain valid until subsidies are markedly reduced.
- Move the resource-sector tax regime closer to a system of taxing rents. Review export taxes, considering their implications for the whole economy, including international trade. Phase out exemptions from VAT. Revisit corporate tax holidays granted to firms in "pioneer industries".
- Enhance efforts to bring the self-employed into the tax net, including by reducing temporarily penalties for previous non-compliance for first-time taxpayers only. Increase resources devoted to auditing high-risk and affluent taxpayers, and make more use of third-party information to assess tax liabilities.

Policies to spur microeconomic efficiency

- In provinces where minimum wages are already high in relation to average wages, resist increases that exceed trend productivity gains. Introduce a sub-minimum wage for youth directly linked to the general minimum wage. Reduce onerous severance payments and ease dismissal procedures in the formal labour market. In return introduce unemployment benefits possibly coupled with individual unemployment saving accounts.
- Systematically review all significant existing business licenses at the national and local levels, with a view to simplification, and ensure licensing remains cost-effective.
- Make information collected by the credit bureau available to all non-bank financial institutions.
- Public finances permitting, increase public outlays on cost-effective infrastructure projects beyond what is already planned.

- Ease access to education and training for students from disadvantaged backgrounds. Rigorously assess the cost-efficiency of all existing programmes aimed at upgrading dropouts' and workers' skills, and phase out those found to be inefficient.
- Clarify government responsibility in the delivery of support to small firms. Regularly assess the efficiency of existing programmes and redirect resources to the most cost-effective schemes.
- Re-examine the effectiveness of policies to encourage the formation of clusters, to reserve certain industries for small firms alone, and to require foreign direct investors to partner with local SMEs.
- Assess the impact of non-tariff measures on trade and the domestic economy, and remove those that are found detrimental to growth. Remove the new regulations that restrict the range of products a general importer can import. Relax remaining barriers to foreign direct investment, unless they address valid public-interest concerns.

Assessment and recommendations

The key challenges

Indonesia is Asia's fifth largest economy, the fourth most populous nation in the world and endowed with abundant natural resources (Table 1). Thanks to a series of strong policy reforms and improved governance, significant progress has been achieved in social and educational dimensions since the 1997-98 Asian crisis, and the quality of human capital has been markedly enhanced. Strong macroeconomic performance can be attributed to successful policy management and to the substantial reforms undertaken since the Asian crisis that strengthened the macroeconomic framework and liberalised the international trade regime. Considerable investments in network industries have boosted potential output, and further improvements are expected with the gradual implementation of the Master Plan for the Acceleration and Expansion of Indonesia's Economic Growth. The economy has also been supported by the dynamism of its small firms, which have accounted for most of the job creation and half of the production growth since 2008 (Figure 1). Gains in total factor productivity have been increasing over time, a pattern that is observed in many other countries in the region (Table 2; Park, 2010).

The economy is still far from growing sustainably at the 7-9 % per year rate that would be needed to achieve the government's objective, laid out in May 2011, of becoming one of the 10 largest economies in the world by 2025. To a large extent, institution building is a precondition for Indonesia to reach this ambitious growth objective. Looking forward, the demographic dividend will fade over the next decade. At this stage of economic development, a key challenge for the country is to enhance its productivity, which will in turn raise prosperity, even though data limitations frequently do not allow strong policy recommendations to be made. It will be critical for sustainability that the fruits of high growth are enjoyed by all. Although the poverty rate has continued to decline in recent years, inequality has turned up.

Environmental sustainability features prominently in the government's development strategy. GHG emission reduction targets have been set at the national level (26% by 2020, compared to a business-as-usual scenario, 41% with international support) and have been supplemented by targets at the sectoral level. Despite some progress, there is still significant scope to boost carbon productivity (Figure 2). As underlined in the 2010 *Economic Survey*, there is also evidence that Indonesia's forestry resources are being unsustainably depleted. It will thus be crucial to slow the pace of deforestation by tackling, in particular, illegal logging.

Table 1. **Selected indicators for Indonesia**

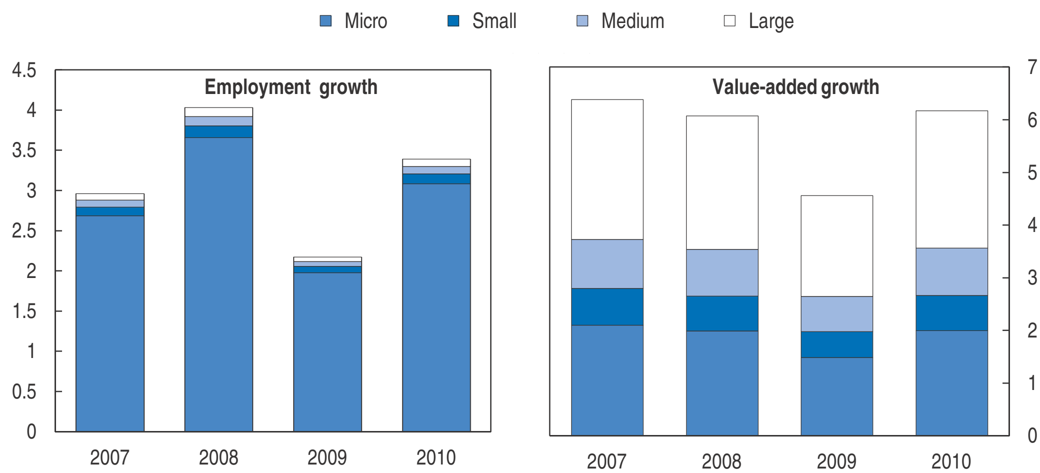
	1995	2000	2005	2007	2008	2009	2010	2011
Population								
Total, million	194.8	206.3	220.9	224.2	227.6	234.4	237.6	241.0
Age distribution (per cent)								
0-14	33.1	30.2	28.5	27.7	27.4	27.0	26.7	26.4
15-64	62.7	65.0	66.3	66.9	67.2	67.4	67.7	67.9
65+	4.2	4.7	5.2	5.4	5.5	5.6	5.6	5.7
Absolute poverty rate[1] (per cent)	-	19.1	16.0	16.6	15.4	14.2	13.3	12.5
Gini coefficient	0.36	-	0.36	0.36	0.35	0.37	0.38	0.41
Net enrolment ratio (secondary education, per cent)	-	46.7	56.0	65.7	64.5	65.1	67.3	-
Employment and inflation								
Employment (million)	80.1	89.8	93.4	99.9	102.6	104.9	108.2	109.7
Informal employment (per cent of employment)	-	-	69.5	69.5	69.6	69.3	66.9	62.2
Unemployment rate (per cent)	-	6.1	11.2	9.1	8.4	7.9	7.1	6.6
CPI inflation (per cent, end-of-year)	9.0	9.3	17.1	6.6	10.2	2.8	7.0	3.8
Supply and demand								
GDP (current trillion *rupiah*)	454.5	1 389.8	2 774.3	3 950.9	4 948.7	5 606.2	6 436.3	7 427.1
GDP (current USD billion)	202.4	166.1	285.6	432.2	512.7	543.3	708.8	846.1
GDP growth (real, per cent)	8.2	4.9	5.7	6.3	6.0	4.6	6.2	6.5
GDP per capita growth rate (real, per cent)	6.1	4.5	4.4	5.3	4.9	3.6	2.3	5.4
Demand (growth, per cent)								
Private consumption	12.6	1.6	4.0	5.0	5.3	4.9	4.7	4.7
Public consumption	1.3	6.5	6.6	3.9	10.4	15.7	0.3	3.2
Gross fixed investment	14.0	16.7	10.9	9.3	11.9	3.3	8.5	8.8
Exports	7.7	26.5	16.6	8.5	9.5	-9.7	15.3	13.6
Imports	20.9	25.9	17.8	9.1	10.0	-15.0	17.3	13.3
Supply (per cent of nominal GDP)								
Agriculture	-	15.6	13.1	13.7	14.5	15.3	15.3	14.7
Mining	-	12.1	11.1	11.2	10.9	10.6	11.2	11.9
Manufacturing	-	27.7	27.4	27.0	27.8	26.4	24.8	24.3
Services[2]	-	44.6	48.3	48.1	46.8	47.8	48.7	49.1
Public finances (state government, per cent of GDP)								
Revenue	15.7	14.8	17.9	17.9	19.8	15.1	15.5	16.3
Expenditure	14.4	15.9	18.4	19.2	19.9	16.7	16.2	17.4
Nominal balance	1.3	-1.2	-0.5	-1.3	-0.1	-1.6	-0.7	-1.1
Gross debt	-	88.8	47.3	35.2	33.1	28.4	26.1	24.3
External sector (per cent of GDP)								
Trade balance	3.2	15.1	6.1	7.6	4.5	5.7	4.3	4.1
Current account balance	-3.2	4.9	0.1	2.4	0.0	1.9	0.7	0.2
In USD billion	-6.4	8.0	0.3	10.5	0.1	10.6	5.1	1.7
International reserves (gross, USD billion)	-	-	34.7	56.9	51.6	66.1	96.2	110.1
Outstanding external debt (end-of-year)	-	85.3	45.8	31.6	30.2	31.8	28.6	26.5

1. Per cent of people below the national poverty line, where the latter is the value of per capita expenditure per month needed for a person to stay in decent living conditions.
2. Includes electricity, gas, water and construction.

Source: Statistics Indonesia, Government financial statement (audited), World Bank, and OECD calculations.

Figure 1. **Contributions to employment and value-added growth by type of firm**

Percentage points



Source: Ministry of SMEs and Co-operatives.

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Table 2. **Potential output growth and contributions**

	GDP growth	Potential GDP growth	Contribution to potential output growth		
			TFP	Capital	Labour
1980-89	6.4	6.5	1.0	3.7	1.8
1990-97	7.6	6.0	0.9	3.9	1.3
1998-99	–6.2	1.9	–0.2	1.1	0.9
2000-09	5.1	4.1	1.5	1.7	1.0
2007	6.3	5.2	2.1	2.0	1.2
2008	6.0	5.6	2.1	2.3	1.3
2009	4.6	5.6	2.2	2.1	1.3
2010	6.2	5.8	2.2	2.3	1.3
2011	6.5	5.9	2.2	2.4	1.3

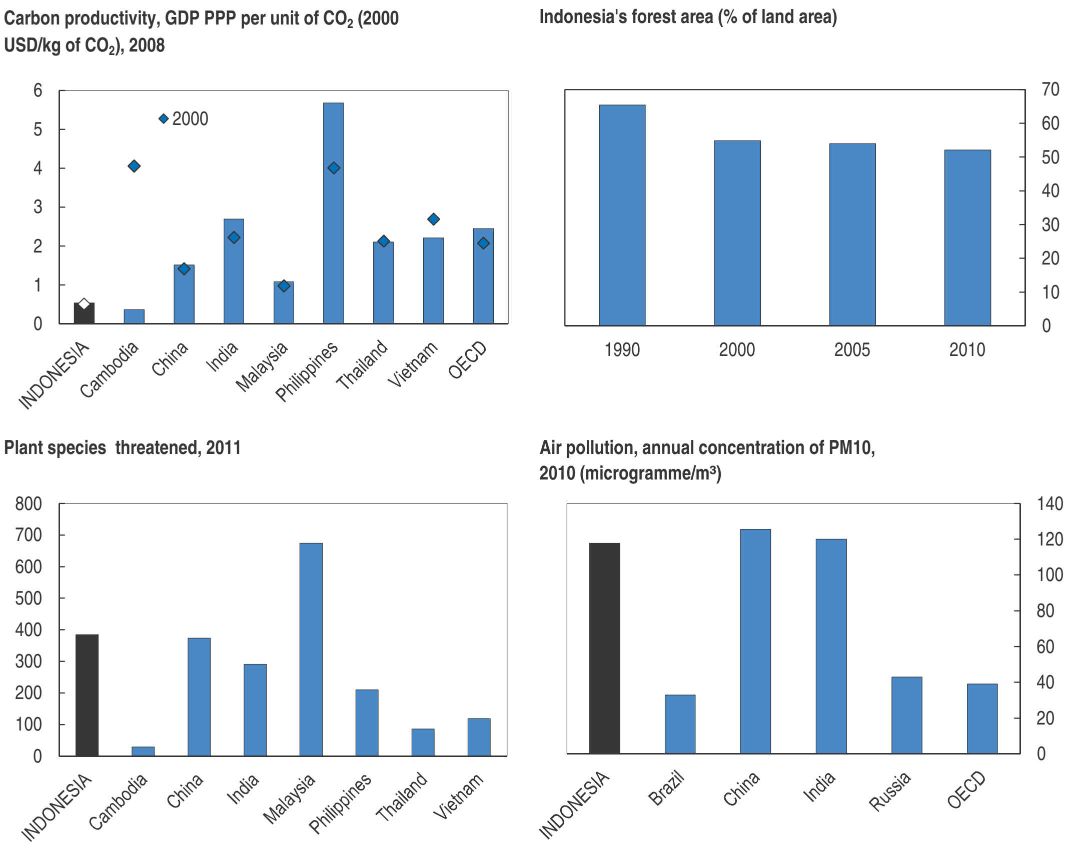
Source: OECD calculations using a production function approach detailed in OECD (2010).

Recent macroeconomic developments and short-term prospects

The macroeconomic framework is sound, and the country's sovereign credit rating has recently been raised to investment grade by two of the three largest international rating agencies. A deep national market with strong domestic demand growth has shielded the economy from downturns in other parts of the world. Indeed, the amplitude of the cycle has diminished markedly over the years, including in the 2008-09 global crisis, in contrast with the experience of other Asian economies and to some extent in OECD countries (Box 1). To a large extent, the adoption of an inflation target and rules-based prudent fiscal frameworks in the mid 1990s contributed to economic stability. In addition, although international tariffs have declined markedly since the Asian crisis, the economy still relies on international trade much less than regional peers, and was thus insulated from the 2009 global trade collapse.

The economy is expected to grow at around 6% this year and next (Table 3). This is lower than the official projections, mostly reflecting differences in the assumed global environment (Table 4). Private consumption and investment are likely to be the main drivers of growth. Limited fiscal stimulus would also sustain domestic demand. The

Figure 2. **Selected green-growth indicators**



Source: International Energy Agency, World Bank, World Health Organisation.

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Box 1. **Business cycles in Indonesia**

This box compares the business cycle in Indonesia, selected Asian economies and the OECD. Given the paucity of long time series for many of these countries, the approach is restricted to the 1990-2011 period and relies on the methodology used in Dalsgaard *et al.* (2002). Cycles are computed on a quarterly basis using the gap between actual GDP and its trend, where the latter is derived from a Hodrick-Prescott filter. The amplitude of the cycle is then proxied by either the standard deviation of the gap within a six-year overlapping period or the average absolute size of the gap.

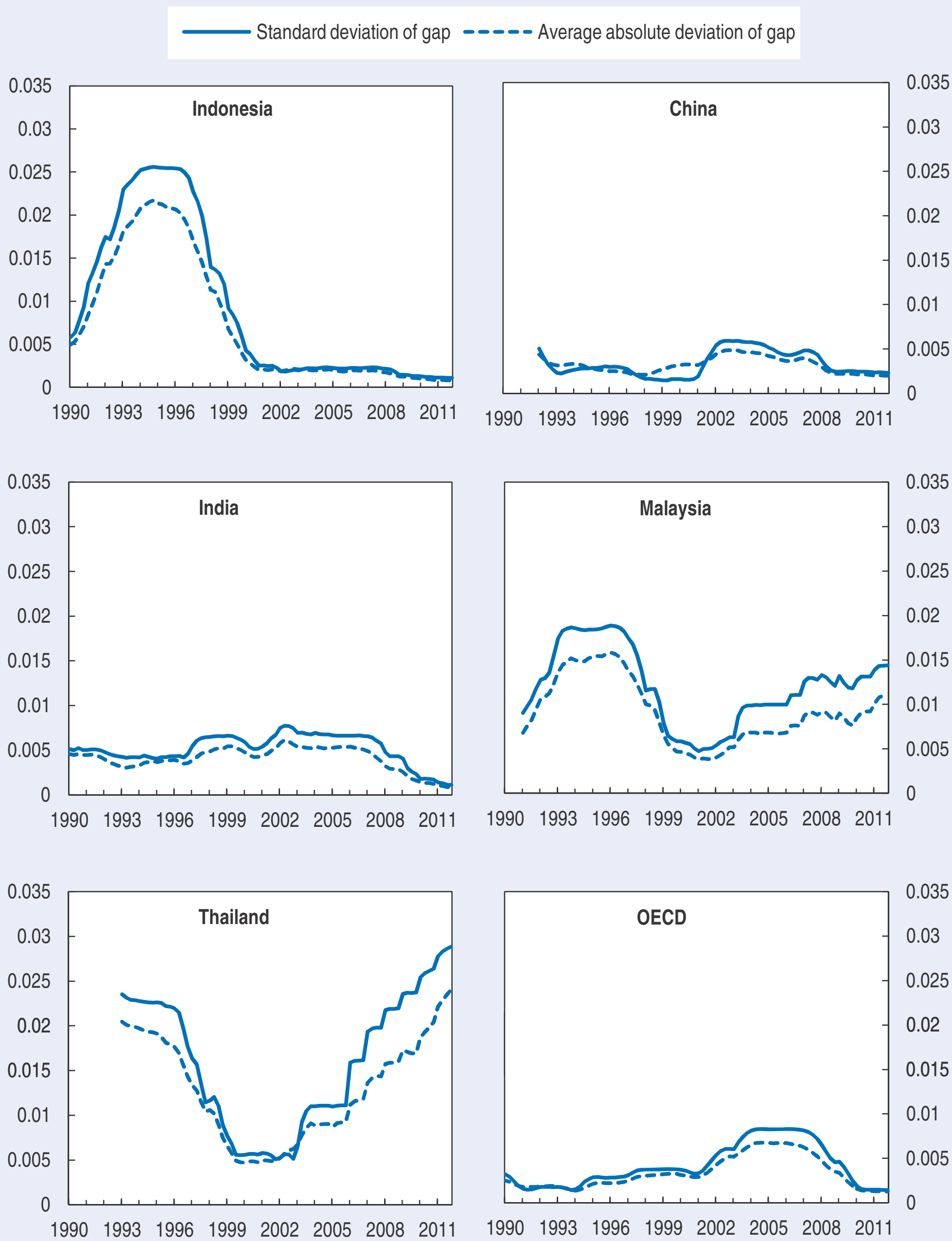
The amplitude of business cycles in Indonesia fell sharply after the Asian crisis and has stayed relatively low since then (Figure 3). By contrast, Malaysia and Thailand have experienced a rise since 2002. Volatility also increased in OECD countries in the second half of the 2000s but has remained low.

The decreasing amplitude of output gaps in Indonesia is mainly related to increased stability of domestic demand. This reflects an improved economic policy framework and governance that have led to macroeconomic and political stability. But another explanation could be that official statistics fail to capture the large size of the informal sector and its potentially greater volatility.

Box 1. **Business cycles in Indonesia** *(cont.)*

Although measured cycles have become smaller, concordance statistics, which measure the extent of business cycle synchronisation, show that Indonesia's cycles have continued to move in line with those of Thailand and Malaysia, even in the aftermath of the 2008-09 global crisis. Despite recent free-trade agreements with China and India, no change in synchronisation with these economies is discernible thus far.

Figure 3. **Amplitude of business cycles**



Source: OECD calculations.

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Table 3. **OECD Economic projections**

	2010	2011	2012	2013
Real GDP (per cent)	6.2	6.5	6.0	6.2
Inflation (end-year, per cent)	7.0	3.8	4.2	4.7
Current account (per cent of GDP)	0.7	0.2	–0.8	–1.4
Public deficit (per cent of GDP)	–0.7	–1.6	–2.1	–1.9

Source: OECD, September 2012.

Table 4. **Indonesian government projections**

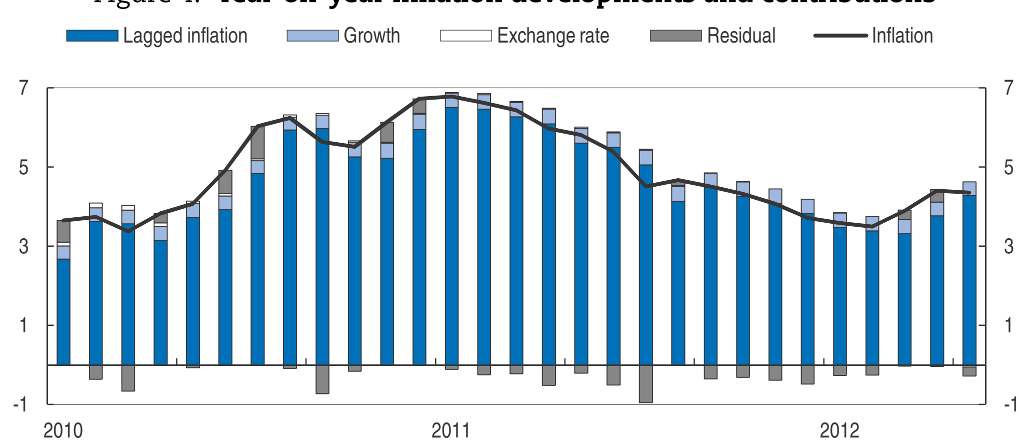
	2010	2011	2012	2013
Real GDP (per cent)	6.2	6.5	6.5	6.8
Inflation (end-year, per cent)	7.0	3.8	6.8	4.5
Current account (per cent of GDP)	0.7	0.2	0.4	0.6
Public deficit (per cent of GDP)	–0.7	–1.6	–2.2	–1.6

Source: Government financial statement (audited), August 2012.

current account is set to deteriorate somewhat, as the balance of investment income worsens, and to move into a deficit for the first time since the last quarter of 2008. Import growth is likely to exceed export gains. These trends are of little concern in a developing economy like Indonesia, merely reflecting the fact that investment needs exceed domestic savings, with the difference financed by external borrowing and import growth continues to be led by productivity-enhancing capital goods.

Headline inflation has markedly decelerated up until very recently, following food price developments. It remains unclear nonetheless whether this slowdown will be permanent, as a significant part of the deceleration remains unexplained (Figure 4). Good inflation management and lower transport costs may have played a role, but their effects are hard to quantify. While average inflation declined after the global financial crisis compared to the 2002-07 period, pressures have not fully dissipated. Strong domestic demand is likely to push up inflation in 2013. In addition, labour markets are tight, and expected rises in the minimum wage could encourage significant wage demands. Credit

Figure 4. **Year-on-year inflation developments and contributions**



Note: Contributions have been derived using a standard Phillips curve equation.
Source: OECD calculations.

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growth has been rising but is still much lower than in 2008 and is dominated by borrowing for working capital and investment rather than consumer loans. Recent developments in global markets suggest that the Indonesian crude oil price is unlikely to exceed the trigger set out in the revised 2012 Budget, which would have allowed the central government to raise the price of subsidised fuel. In the absence of such a hike, inflation would most likely edge up gradually but would remain below the ceiling of its target range.

The main risks to the short-term outlook are external. Increased global risk aversion, in large part related to the euro area crisis, could reverse the capital inflows of the past few years, endangering the financing conditions for government and banks alike and cutting growth. On the other hand, recent sovereign rating upgrades allow Indonesia to tap into many investment funds that are restricted to holding investment-grade assets. In addition, it is likely to remain relatively sheltered from a slowdown in world trade, unless other Asian economies and commodity prices are significantly affected. At the time of writing there are increasing signs of slowdown in Indonesia's main trading partners.

Macroeconomic policy considerations

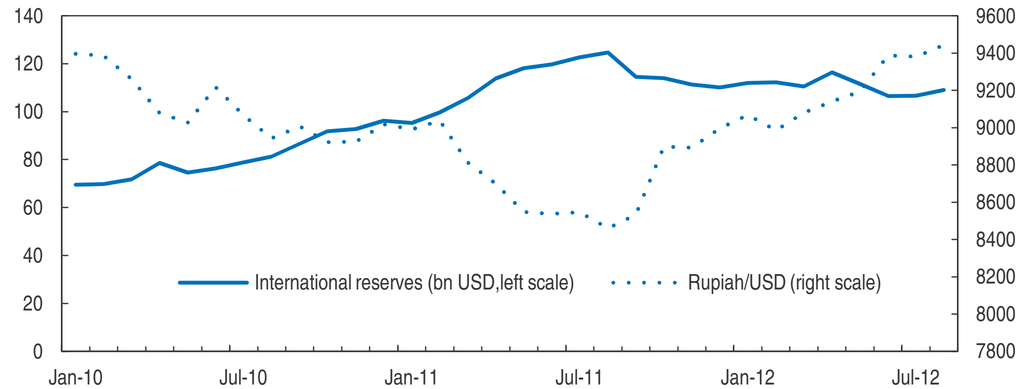
Indonesia's general macroeconomic and financial frameworks have improved significantly over the last few decades. Inflation has been brought down from more than 58% in 1998 to 4.6% in 2011. As underlined in the 2010 *Economic Survey*, financial markets have proven more resilient than in the past. Thanks to prudent management and strong economic growth, fiscal outcomes have been enviable by any standard. Still, refinements to the framework and the conduct of policies could foster the country's adaptability to new challenges. Stepped-up efforts in fighting corruption will also be necessary.

Monetary policy

The monetary policy framework combines inflation targeting with a flexible, though not fully floating, exchange rate. The main instrument to achieve price stability is the policy rate (BI rate). However, other instruments supplement Bank Indonesia (BI)'s tool box. Since 2008, BI has managed capital inflows through foreign-exchange intervention. A one-month minimum holding period for BI's short-term paper that applies to both residents and non residents was introduced in July 2010, and programmes such as the government's bond stabilisation framework, which defines the conditions under which the authorities can buy such securities, have been put in place to cope with potential reversals in capital flows. These actions proved successful, in particular during the autumn of 2011 when global financial turbulence increased the volatility of capital inflows and the exchange rate (Figure 5). Evidence suggests that the exchange rate remained broadly consistent with fundamentals during that period (Box 2). Since then, the *rupiah* has depreciated.

In the context of an increasingly uncertain international environment, BI's communication strategy has focused on achieving the inflation target and reducing exchange-rate volatility. The central bank has indicated that it will henceforth manage the quantity rather than the price of money. BI has maintained its policy rate constant since February 2012 and has lowered the floor of the band for interbank interest rates to remove excess liquidity. One main consequence is that interbank rates have drifted away from the policy rate (Figure 6). This may have weakened the strength of traditional interest-rate transmission channels, as changes in the policy rate have not been systematically followed by similar moves in the interbank rate.

Figure 5. **Exchange rate and international reserves**



Source: Datastream.

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Box 2. **Equilibrium exchange rate for the *rupiah***

This box examines the degree of misalignment of the *rupiah* using the Fundamental Equilibrium Exchange Rate (FEER) method, developed by Williamson (1994).

The FEER is defined in real effective terms as the exchange rate consistent with the economy being in both internal and external balance. As in Wren-Lewis and Driver (1998), the FEER is estimated by modelling only the current account and using conventional aggregate trade equations. This has the advantage of simplicity, and as a consequence it is relatively easy to examine the sensitivity of FEER estimates to key assumptions. One of the disadvantages is that it does not ensure the consistency between the assessments of trend output and structural capital flows. More importantly, any feedback from the FEER to the inputs for trend output and structural capital flows is ruled out. Last, this method gives no indication of the main factors influencing the value of the currency.

Deviation of the real effective exchange rate from its equilibrium level is calculated using quarterly data from the OECD *Economic Outlook* and IMF's *International Financial Statistics*. Trade elasticities were derived from the estimation of standard trade equations for Indonesia, whereby trade volumes are expressed as a function of demand and competitiveness. Pain *et al.* (2005) provide a justification for these specifications.

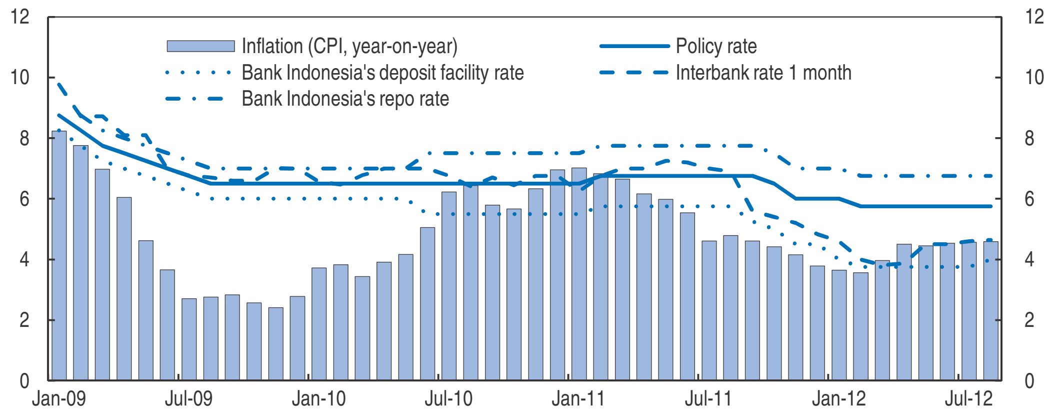
FEER estimates of misalignment rely heavily on how the current account target is calibrated. To compute this target, long-term projections for the current account are derived using United Nations population projections and an equation for the current account reported in Cheung *et al.* (2010) for emerging and developing countries. This equation incorporates demographic and convergence effects. Depending on the specification used and the period considered the long-term average of the current account balance for Indonesia is found to lie around a surplus of 0.3 to 1% of GDP.

Overall, the *rupiah* appears to have been broadly at equilibrium in 2011. The real effective exchange rate was slightly overvalued by 0.2-1.5% on average, depending on the current account target chosen. This is consistent with IMF estimates for that year (IMF, 2011a).

Source: OECD calculations.

Figure 6. **Interest rates and inflation**

Per cent



Note: The deposit facility (FASBI) rate is the rate of Bank Indonesia's overnight deposit facility for commercial banks. It applies to idle money that private banks leave with the central bank when they have excess liquidity. The rate does not apply to banks' statutory reserves at the central bank.

Source: Bank Indonesia.

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BI has also sought to deepen foreign exchange markets by supplying US dollar term deposits. In addition to managing liquidity, it intends to have recourse to macro-prudential measures to ensure financial stability. A maximum loan-to-value ratio for property loans and minimum down payments on vehicle loans have been announced. The monetary authorities have also signalled that they could hike reserve requirements for some categories of banks.

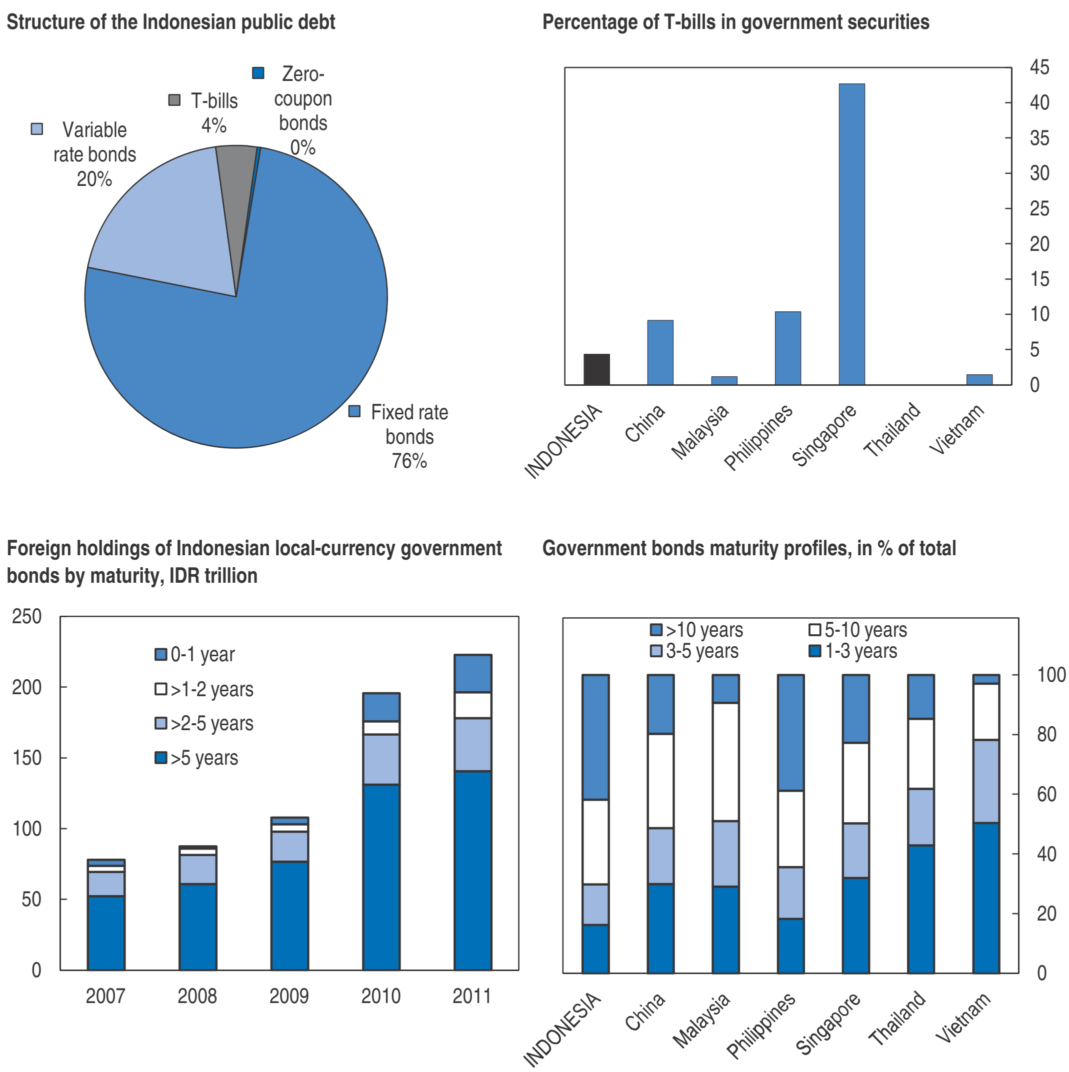
While changes in reserve requirements may help to manage credit growth, very little is known about their impact on inflation, as their effectiveness can be eroded by financial innovation or regulatory arbitrage. Moreover, this type of measure may be less effective in shaping expectations about the policy stance because market players can more easily interpret the signals sent by interest-rate moves. In particular, raising interest rates to tighten the monetary stance sends a clear signal that reining in inflation is the primary objective of monetary policy. In this context, it would be preferable to rely on both interest-rate increases and liquidity or macro-prudential measures to achieve the inflation target.

Efforts to manage large-scale capital inflows have led to a major shift in the size of the central bank's balance sheet. BI's capital declined significantly through to the third quarter of 2011 when it was close to its required floor of IDR 2 trillion. It has risen since then, as the pace of international reserve accumulation has slowed. Looking forward, if BI's capital were to fall significantly and approach its statutory minimum, monetary policy could be affected. It would thus be preferable to phase out BI's capital requirement, which serves no essential purpose in modern central banking.

A number of policy options could strengthen BI's financial position. Injecting funds to meet the capital requirement needs legislative approval and could be perceived as a threat to its independence. Selling some of BI's assets, such as land and buildings, could provide only limited short-term relief. A more promising option would be to lower the cost of monetary operations by using repurchase agreements selling and repurchasing T-Bills (*Surat Perbendaharan Negaran*, SPN) rather than Bank Indonesia Certificates (*Sertifikats Bank Indonesia*, SBIs) as the main instrument for open-market operations. The Indonesian monetary authorities already use T-Bills for some operations but are constrained by their limited supply (Nasution, 2012). The small share of T-Bills in public debt and the relatively high average maturity of government securities, even those owned by foreign investors, suggest that there is room to increase the issuance of T-Bills, even though this would increase public finance vulnerability (Figure 7). SBI issuance could then be gradually scaled back. Such a switch would also encourage banks to make loans, rather than hold SBIs, and thereby help to strengthen their intermediation function. Any change, if desired, would ideally be made in the context of a broader review of the financial relationship between BI and the central government.

Figure 7. **Public debt structure**

End-year 2011



Source: Asiaonline, Ministry of Finance.

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Financial regulation framework

Smoothing the transition to a single regulator for financial markets

In October 2011, enabling legislation was passed to implement a unified financial supervisory model. A new Financial Services Authority (*Otoritas Jasa Keuangan*, OJK) will oversee all such activities as of end-2013. One of the main issues will be to ensure that the new agency is properly staffed and can draw on the current expertise of BI and the Ministry of Finance. In addition, given the very short transition period, implementing regulations will need to be issued as soon as possible to ensure that the new financial authority, which will be responsible for micro-economic oversight, works in close collaboration with the central bank, which is in charge of macro-prudential supervision.

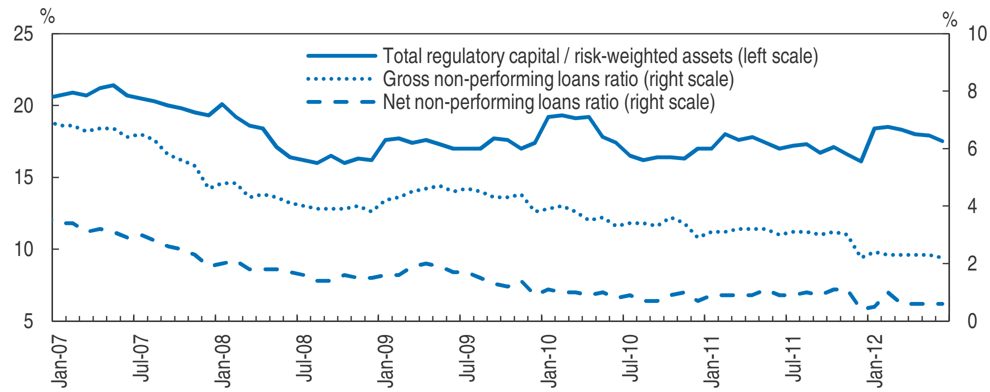
The banking supervisory framework meets international standards and has been improved to deal with problem banks. At the moment, a bank can be placed into surveillance only because of liquidity problems or when its capital ratio falls below 8%. Other troubled banks can be put into intensive surveillance at the discretion of the financial authorities. Nonetheless, the financial system safety-net law needs to be passed to ensure that the authorities can adequately deal with systemic risk. A memorandum of understanding on mutual coordination to safeguard the stability of the financial system was signed in June 2012 by the government, BI, OJK and the Deposit Guarantee Corporation, but it will need to be reviewed once the new regulatory authority is in place. One result was the establishment of a crisis-management protocol, defined under the OJK law, that sets out the actions to be taken by each institution in the event of a financial crisis. In any case, the existing legal protection in the Act governing the functioning of each authority needs to be strengthened to ensure legal protection to officials involved in the management of a potential crisis will effectively be provided, especially given the record of the judicial uncertainty that the former Minister of Finance faced in the aftermath of decisions taken during the 2008 global crisis.

Deepening financial markets

Despite some progress, financial markets are still shallow. Deepening them would help to maintain financial stability over the medium term and ease access to finance, especially for small firms. The soundness of the banking sector has improved over time (Figure 8). In June 2010, BI introduced a policy package to develop money markets. A wider range of instruments has been provided, and banks have been encouraged to conduct more transactions in the wholesale market. Still, some segments of the financial markets, such as venture capital and micro-finance, remain insufficiently developed.

As in other countries in Asia, most venture capital companies do not provide genuine risk capital (Naqi and Hettihewa, 2007). In February 2012, the Minister of Finance issued a decree to encourage venture-capital providers to focus on non-bankable firms (those that do not have access to bank loans) and introduced regulations on entry, licensing and capital requirements. These changes go in the right direction, but it will be important to assess their effect regularly. Efficient monitoring will require a significant improvement in the quality and coverage of statistics, in particular a clear distinction between venture capital and private equity. The government has also granted venture capital companies tax exemptions for certain investments made in particular industries. This support should be reconsidered, as it risks distorting the allocation of scarce capital and increasing rent-

Figure 8. **Banking soundness indicators**



Source: Bank Indonesia.

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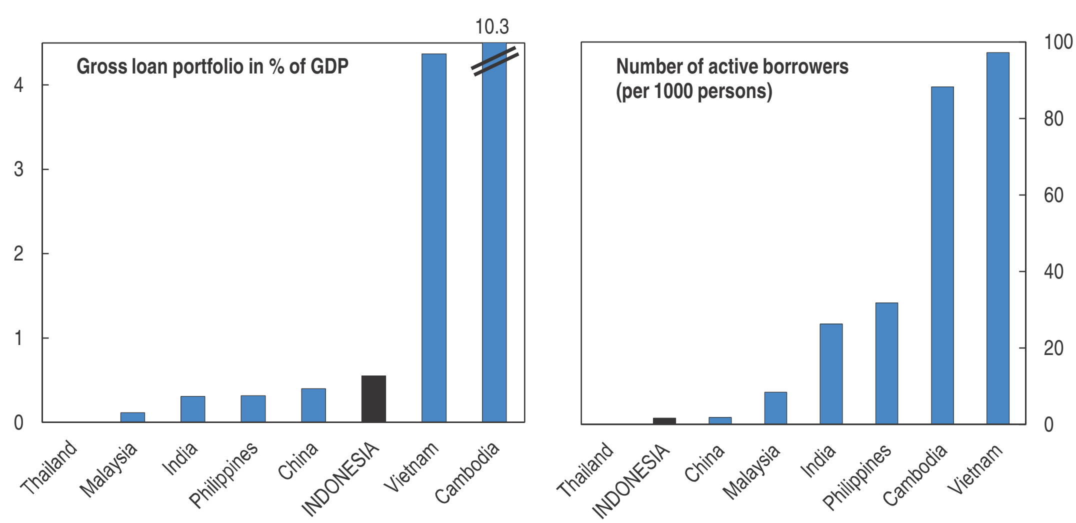
seeking behaviour. Moreover, the existing restriction of 85% on foreign ownership of venture-capital companies could hamper entry and would best be removed.

As in many developing economies, micro-finance has expanded rapidly in recent years, although Indonesia does not appear to be at the forefront in the size of its micro-finance markets (Figure 9). The largest proportion of micro-finance institutions are within the formal sector, and the market is dominated by a few commercial banks. However, many of the micro-finance providers are informal, as they have a strong incentive to operate in the least regulated market segment. As banks incur a financial penalty when they lend to institutions without a legal status, the financing source of these informal micro-loan providers is restricted. In 2009, a decree created a regulatory framework under existing laws to govern non-bank and non-co-operative financial institutions that operate outside the regulatory framework. But the decree has not been fully implemented, and efforts should be stepped up to put it into operation.

Figure 9. **Indicators of micro-finance**

2010



Source: Mixmarket.

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Another way to deepen markets would be to inject stronger competition in banking. At the moment, the market is highly concentrated, with the large banks, such as *Bank Rakyat Indonesia*, holding dominant market positions in rural and micro-finance. Even though the market is *de jure* open to newcomers, the minimum capital requirement is fairly high for commercial banks and rural banks in some regions, and it is not easy to obtain a license (World Bank, 2010a). A move from the current single-licence model for banking operations to a multi-license approach similar to that in other countries in the region is under discussion. Also, caps on bank ownership (foreign or domestic) became effective in July 2012 except for banks that fulfil a range of criteria such as passing a prudential examination that focuses on good corporate governance practices and financial soundness. This measure is not retroactive. However, it may deter large acquisitions, particularly by foreign financial firms, even if the Indonesian banking sector would remain open by regional standards. It would thus be useful to investigate to what extent these recent and mooted regulatory changes could effectively hamper entry and, if required, reconsider them in this light.

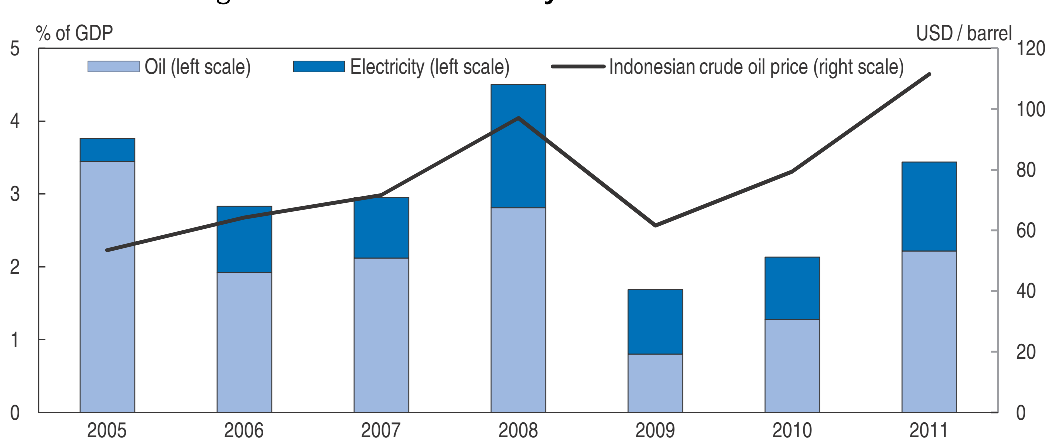
Fiscal policy

Fast growth and sound budget management have put the country on a strong fiscal footing. Since the 2003 Fiscal Law, public deficits have been capped at 3% of GDP and public debt at 60%. The gross public debt burden has been markedly reduced to an estimated 24.3% of GDP in 2011 from a peak of 88% in 2000, and public deficits have consistently remained below the 3% threshold.

Changing the spending mix

The fiscal resources put into energy subsidies would be better used elsewhere. Energy subsidies are expected to amount to almost 19% of central-government spending in 2012 and reach 24.1% in the 2013 draft budget (Figure 10). By contrast, spending on social assistance and infrastructure remains insufficient for the country's needs (Table 5). Rethinking the spending mix is required to achieve the authorities' ambitious development objectives, fund the 2014 establishment of public health insurance and at the same time eliminate the budget deficit by 2015 as envisaged in official medium-term economic

Figure 10. **Oil and electricity subsidies in Indonesia**



Source: Ministry of Finance, Indonesian Directorate General of Oil and Gas.

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Table 5. **State government budget realisation**

Percentage of GDP

	1990	2000	2005	2010	2011
Revenues and grants	21.6	14.8	17.9	15.5	16.3
Tax revenues	11.3	8.3	12.5	11.2	11.8
Income tax	4.2	4.1	6.3	5.5	5.8
Value added tax	4.2	2.5	3.7	3.6	3.7
International trade taxes	1.5	0.5	0.5	0.4	0.7
Non taxes revenues	10.3	6.4	5.3	4.2	4.5
Government expenditures	20.3	15.9	18.4	16.2	17.4
Central government expenditures	16.8	13.6	13.0	10.8	11.9
of which: Personnel	3.6	3.1	2.1	2. 3	2.4
Interest payments	2.5	3.6	2.4	1.4	1.7
Subsidies	1.8	4.5	4.4	3.0	4.0
Inter-government transfers	3.5	2.4	5.4	5.4	5.5
Education spending	–	–	2.8	3.5	3.6
Health spending	–	–	–	0.5	0.6
Social programmes	–	–	0.9	1.1	1.0
Infrastructure	–	0.8	0.9	1.5	1.7
Public deficit	1.2	–1.2	–0.5	–0.7	–1.1
Public debt	–	88.8	47.3	26.1	24.3

Note: State government includes central and regional governments.
Source: Ministry of Finance.

projections. As underlined in the 2010 *Economic Survey*, energy subsidies, which mostly take the form of under-pricing of energy use, distort consumption decisions, encourage carbon emissions and are ineffective as social policy. Indeed, they benefit mostly the richest: in 2009, 40% of the gasoline subsidies to households went to the richest 10% and less than 1% to the bottom 10% (World Bank, 2012a). Fuel subsidies are estimated to be regressive, as their share in income is three times higher for the most affluent households than for the poorest. Even though the Constitution prevents complete liberalisation of domestic fuel prices, it is still possible to significantly reduce energy subsidies.

Government proposals in 2011-2012 to reduce fossil-fuel and electricity subsidies have faced fierce political resistance. In the end, the proposed hike in electricity prices was rescheduled to 2013. Plans to reduce the volume of subsidised fuel have also been postponed, with the exception of all government vehicles used by officials and state-owned enterprises (both central and regional). In addition, the vehicles owned by plantation and mining companies are also prohibited from using subsidised fuels. Measures to improve energy efficiency have also been announced. To contain the cost of energy subsidies, a conditional rule, which is valid only for this year, allows the government to raise the price of subsidised fuel if the average Indonesian crude oil price over six months exceeds USD 121 per barrel (*i.e.* exceeds by 15% the assumption set in the revised 2012 Budget). But developments in the oil price suggest it is likely to stay below this threshold. In the draft 2013 Budget, the government has proposed an increase in electricity tariffs, while exempting poor households.

Postponing the rise in energy prices is likely to raise doubts about the government's commitment in this area and endanger the fiscal situation. A rise in energy subsidies in the event oil prices increase but remain below the threshold would boost overall spending directly and through an increase in education spending, which are required legislatively to amount to 20% of general-government spending. This will be only partially offset by a rise in revenues from the oil and gas sector. Moreover, the risk of hitting the 3% of GDP deficit ceiling may prompt a decrease in spending in growth-enhancing programmes. This would be particularly detrimental to long-term growth.

Reallocating energy subsidies to high-quality spending programmes, although necessary, is likely to continue to face strong opposition. A package of measures combining a gradual removal of subsidies with targeted cash-transfer schemes to compensate poor households from the rise in energy prices, similar to those introduced successfully in 2005 or 2008, together with extensive communication on these compensation programmes would protect the poor and could help to overcome resistance to reform. In the short term a conditional rule allowing the authorities to hike subsidised fuel prices when the world oil price moves up rapidly could prevent an excessive increase in the fiscal burden. In addition, making this rule valid until subsidies are significantly reduced would ease reform implementation. A similar rule was introduced in 2002 but had to be abandoned because it was poorly communicated and resulted in public protests. Widespread communication on the benefits of reforms and their distributional effects and on the compensation package that will prevent poverty from worsening, would reduce the likelihood of this happening again. This could be done by a new independent agency, as was recommended in the 2010 *Economic Survey*.

The spending mix could also be improved at the regional level. At the moment civil service salaries represent more than 40% of regional expenditure. In most regions, they are funded through central government transfers from the general allocation fund (*Dana Alokasi Umum*, DAU), so that regional governments have no incentive to save on salary spending and spend more on infrastructure. A moratorium on the recruitment of administrative employees was enacted in mid-2011 to limit the rise in personnel expenditures. Switching the financing of salaries of regional civil servants from the DAU to revenues from increased local taxation, as currently proposed in the context of the changes to the inter-governmental finance law, would improve incentives and help to keep public accounts on a sustainable path over the medium term. This should be done, however, alongside a comprehensive civil service reform, including a review of pay scales and performance management.

Improving budget execution

Budget execution remains a major challenge, particularly for capital spending. Although the latter increased markedly in 2011, disbursements amounted to only 82% of what was expected in the revised 2011 Budget (World Bank, 2012a). In addition, spending is often disbursed only at the end of the year, which can undermine its effectiveness and quality.

Recent moves to a medium-term expenditure framework and changes to the procurement system are expected to improve planning capacity and budget execution. In addition, the Land Acquisition Law is likely to speed up the implementation of infrastructure projects, especially in the energy and raw materials sectors. A team has been set up of evaluators and monitors (*Tim Evaluasi dan Pengawasan Percepatan Penyerapan Anggaran*, TEPPA) aiming at accelerating budget execution. Incentives, such as financial penalties to individual ministries at the central level, have also been introduced, and the government is preparing a regulation on budget execution.

Efforts should also be pursued to cut spending delays at the regional level. The government plans to introduce multi-year general guidelines on the use of regional transfers for specific purpose (*Dana Alokasi Khusus*, DAK), but this will be challenging, since regional budgets still rely on annual planning and accounting systems. Over the long term, enhancing governance, especially at the local level, is likely to facilitate the speed and quality of spending decisions.

There is scope to make better use of the large amount of idle funds that have been accumulated over the years in regional public accounts because spending has fallen short of that initially planned. Such funds amounted to IDR 60 trillion on average per year from 2007 to 2010. The government plans to restrict the level of idle funds to no more than three months of routine expenditure. But it is vital that these resources be allocated to areas where needs are most pressing. The government has proposed that a minimum of 20% of regional budgets be dedicated to capital expenditure (including maintenance). However, given the extreme regional diversity of infrastructure needs, setting a standard minimum requirement may not be appropriate. It would be more effective to encourage regions to allocate more resources to capital expenditure by adjusting financial incentives.

Box 3. **Recommendations on macroeconomic and financial-market policies**

Monetary policy

- Achieve the inflation target and, as planned, reduce it over time. This would be achieved by relying on interest rate, liquidity management and macro-prudential measures.

Financial markets

- Step up efforts to pass a micro-finance law, and expand the sectoral coverage of the regulatory framework.

Fiscal policy

- Significantly diminish fossil-fuel and electricity subsidies, and implement enhanced compensatory cash-transfer programmes to prevent a rise in poverty. Communicate widely on the efficiency and distributional benefits of reform. As an interim measure, re-establish a rule linking fuel prices to developments in international oil markets, to remain valid until subsidies are markedly reduced.

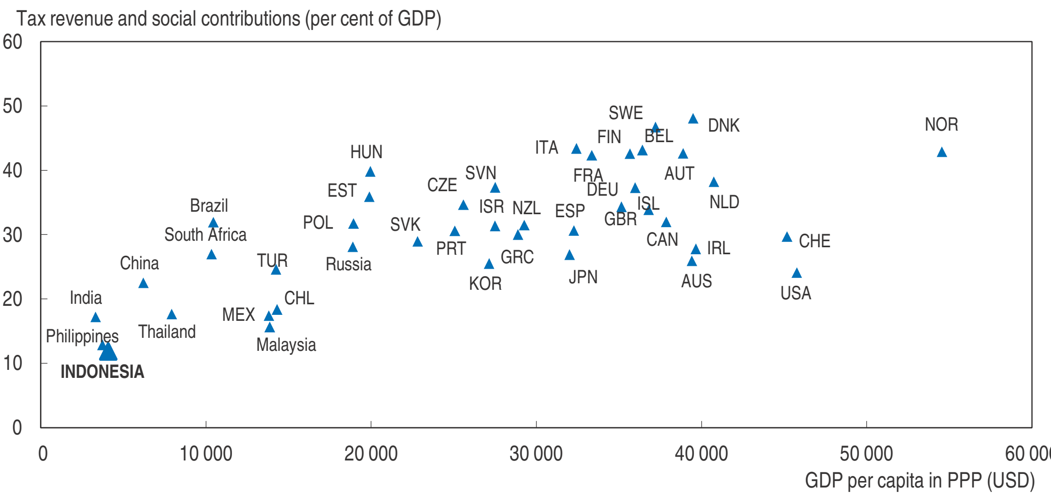
The tax system

Raising revenues to finance needed social and infrastructure spending

The country will face considerable financing needs as it expands the coverage of its social security system and develops its infrastructure. Lowering energy subsidies would free up resources, but programmes in priority areas will also need to be financed through higher tax revenues. Although it has increased over the years, the tax-to-GDP ratio of less than 12% is low by international standards (Figure 11). To a large extent, this reflects widespread informality and tax evasion. But recent examples from other developing countries like Peru or Vietnam show that significant increases in tax revenues are possible despite the existence of large informal sectors. According to the 2013 draft Budget, the tax-to-GDP ratio is expected to remain broadly stable, despite an increase in VAT revenues. Over the medium term, raising tax revenues would proceed by modifying the tax mix and to a greater extent by increasing compliance. The appropriate objectives in the choice of

Figure 11. **Tax-to-GDP ratio and GDP per capita**

2009



Note: Non-tax revenues such as royalties are not included. Data are for 2008 for India and central government only for Malaysia.

Source: OECD Revenue Statistics, IMF Government Finance Statistics, Indonesia Ministry of Finance, Philippines Department of Finance.

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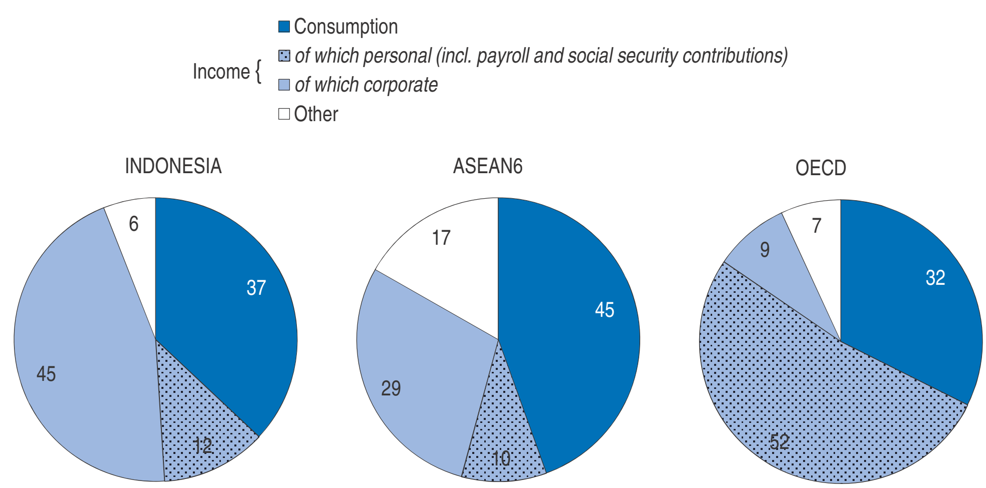
tax instruments would be to raise sufficient revenues while minimising distortions and keeping the tax system easy to administer.

The tax structure appears to be broadly in line with OECD best practice. Corporate income tax rates in Indonesia have declined to 25% and are close to those of many neighbouring countries. Indonesia still relies more heavily on corporate tax revenues, but to some extent, this may reflect strong profits in Indonesia's natural resource sector, which accounts for more than a fourth of corporate tax receipts (Figure 12).

Figure 12. **Tax structure**

Per cent of tax revenues



Note: ASEAN6 includes Cambodia, Laos, Malaysia, Philippines, Thailand and Vietnam. Australia, Japan and Poland are not included in the OECD average due to missing 2010 data.

Source: OECD Revenue Statistics, IMF WEO database, Indonesia Directorate General of Tax.

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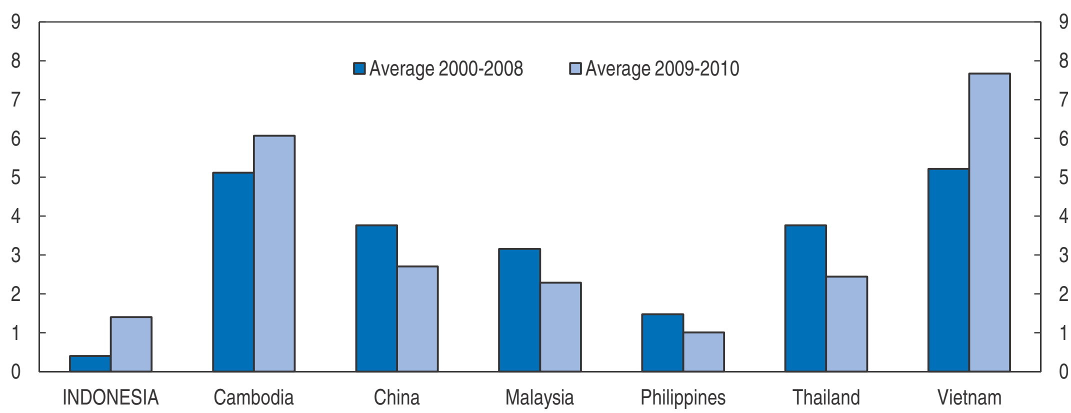
Foreign direct investment (FDI) inflows have been increasing, albeit from a comparatively low level (Figure 13). They grew by 18.5% in 2011. According to the latest A.T. Kearney FDI confidence index, Indonesia moved from the 20th to the 9th most attractive FDI destination from 2010 to 2012 (A.T. Kearney, 2012). While further corporate tax cuts might attract more FDI, a number of other factors may play important roles (Lipsey and Sjöholm, 2011). It may be preferable to focus on the main factors holding back investment, such as poor infrastructure conditions and weak governance in some areas. In any case, alternative revenue sources, including personal income tax revenues, are more difficult to expand in Indonesia than in the average OECD country with a more advanced tax administration and a smaller informal sector, suggesting that it is better not to erode corporate income tax revenues but to make further progress in raising compliance and tax revenues more generally.

Figure 13. **FDI net inflows in selected Asian economies**

Per cent of GDP



Source: World Bank.

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Increasing taxation in the resource sector

The estimated government revenue take in the oil and gas sector is lower in Indonesia than in some other countries (Johnston, 2008; Agalliu, 2011). Fiscal arrangements in the oil sector take the form of production-sharing contracts in which the contractor bears the entire risk of exploration and development. At the same time, the exploitation of new or marginal fields, which involves taking more risk than those already producing, is likely to become increasingly important, given the declining trend of Indonesian oil production. Thus, if the government wishes to raise its take, it may also need to bear more of the risks involved in exploration and development, moving toward a system of taxing resource rents.

The tax burden on the mining sector is not far from the average faced by all other sectors, which seems too low, given that this sector benefits from resource rents (Chapter 1). The optimal way to capture such rents would be to tax profits at a high rate above a certain threshold that guarantees that any given project is sufficiently profitable. This would get the incentives right and account for all costs, including exploration and development. If abandoning the current royalty system is too difficult to implement, another possibility would be to continue to levy royalties while losses are incurred, but shift the tax base onto rents once profits begin to accrue. Such a system already exists in Israel's gas sector (OECD, 2011). A possible first step in the direction of taxing rents more would be to extend the non-deductible 10% net profits tax on mining activities in state reserve areas to the standard mining licenses, while recognising all past exploration and development expenses. If deemed necessary, this rate could be raised at a later date.

Indonesia applies export taxes to crude palm oil and cocoa beans, and the government has recently announced the introduction of a new 20% export tax on selected mineral ores. Export taxes on commodities are part of the country's development strategy to foster the development of processing industries. While export taxes reduce overall economic efficiency in the short term by moving production away from the lowest-cost location, they can spur productivity gains in the downstream activity through network and learning effects over the medium to long term. Export taxes can also help to reduce price volatility or achieve food-security objectives. This was an important motivation behind the palm oil tax. Also, in some cases such as mining, they could be used to curb pollution-generating production activities. Finally, export taxes can be seen as a source of public revenue, although in the case of mining levying a higher tax on resource rents (as suggested above) is likely to be a less distortive way to generate resource revenues.

There is evidence that export taxes have contributed to the development of downstream industries, including through FDI in the case of the cocoa industry in Indonesia, but they also hurt other sectors, notably cocoa growers. International experience points to mixed results of such a strategy, with success stories in some countries and failures in others. In particular, these taxes are likely to divert international trade and have been prohibited in many regional trade agreements (Piermartini, 2004). They can also harm the international competitiveness of Indonesian producers and slow their integration into the world economy. More generally, relying on export taxes appears to be a more risky strategy than directly tackling the underlying factors constraining the development of downstream activities, such as infrastructure bottlenecks and poor governance, which are a prerequisite for a sustainable development path. Progress in these areas is likely to take time to materialise, and the authorities therefore view export taxes as an alternative instrument. However, they are clearly only second best, and their economy-wide effects, including their effects on international trade, will need to be carefully monitored.

Moving to a greener tax system

A carbon tax would be an effective instrument to reduce emission intensity in electricity generation and industry. Currently carbon taxes do not exist in Indonesia, and indeed the large energy subsidies are equivalent to taxes applied at negative rates. Reducing fossil-fuel subsidies would help to reduce the carbon footprint of the economy, but this should not be seen as a precondition for introducing a carbon tax at an initially relatively modest level, as suggested by Ministry of Finance (2009). Such a tax is currently under consideration by the Indonesian authorities, together with a cap and trade system. A low initial rate might help to reduce the political resistance towards such a tax as well as its impact on international competitiveness.

As discussed in the 2010 *Economic Survey*, Indonesia also grants implicit subsidies through a range of tax expenditures, such as support to biofuels. However, full-cycle energy savings associated with biofuels that are produced with palm oil or jatropha, as in Indonesia, are still being debated, particularly as existing regulations that prohibit forest clearing for biofuels are difficult to enforce (OECD, 2012a). Hence, current support to biofuels needs to be carefully reviewed.

Removing tax exemptions

Many tax exemptions give rise to unnecessary distortions. Following public consultations with a number of industries, the government recently announced a set of temporary corporate income tax holidays over five to ten years for large investment projects in so-called "pioneer industries", including base metals, textile machinery, oil refining and equipment for renewable energy and telecommunications. Tax holidays, especially when granted to selected industries, distort corporate taxation, create opportunities for policy capture and may make it difficult for the tax authorities to evaluate the foregone revenues. They should thus be reconsidered. Investment tax credits are usually found to be a better instrument to support investment than exempting profits, provided they are available to all economic activities.

Indonesia's VAT appears to be generally well designed. It is levied at a single rate of 10% on domestic added value and on imports. But a considerable number of products and activities are exempt and in June 2012, further exemptions were granted to public transportation services. The exemptions create revenue losses, although the size of the losses is hard to evaluate. IMF estimates suggest that phasing out exemptions and boosting the efficiency of VAT administration to Thailand's level could increase revenue, which currently represents some 4% of GDP, by 1.8% of GDP without raising the rate (IMF, 2011b). This should be a priority.

Employer-provided fringe benefits and allowances often amount to a non-negligible share of compensation packages for high-income employees, but are not taxed at the personal level. Subjecting these benefits to personal income taxes could help to broaden the tax base and increase the redistributive effect of personal income taxes. This is likely to boost public revenues despite the deductibility of fringe benefits from the corporate tax base, as recipients of such benefits often have a marginal tax rate above the corporate tax rate.

Increasing tax compliance

The greatest potential for increasing the fairness of the tax system and fiscal space lies in improving tax collection. For almost all tax instruments, Indonesia's take is low. Thanks to a substantial overhaul of the tax administration (Directorate General of Taxes or DGT), the number of taxpayers and the compliance ratio for filing annual returns have risen markedly over the last few years. But there is substantial scope to expand the effective personal-income tax base. Less than 60% of taxpayers who are required to file an annual income tax return actually do so, and more than 80% of revenues are paid by 3% of households (Nugraha and Lewis, 2011).

A tax census is underway to detect undeclared economic activity and bring it into the tax net. It is directed in particular at the self-employed, who, unlike formal-sector employees, are not subject to tax-withholding and can thus escape tax more easily. This initiative is useful but is likely to face significant implementation challenges. It should be complemented by measures to make voluntary compliance easier, including removing the necessity to apply for a tax identification number and using an already existing numbering system instead, such as the one used for national identity cards. For employees with one single source of income subject to withholding taxes, the requirement to file annual tax returns could be reconsidered.

In addition, reducing the penalties for past non-compliance of first-time taxpayers for a limited period would encourage more people to register as taxpayers.

Reducing the extent of tax evasion, particularly by high-income individuals, is key to boosting tax revenues and enhancing the legitimacy of the tax system. This could be done through greater use of third-party information and indicators of tax liabilities, such as purchases of costly consumption items, which DGT has now been authorised to use, although the implementation of this authorisation is still pending. The authorities have also successfully used deterrence in the form of public denunciation of tax evaders and legal sanctions like travel bans and prison terms.

A key element in the success of tax administration reform has been the establishment of large taxpayers' offices. But there are only four such offices, and there seems to be scope to roll out more across the country. In addition, the DGT headquarters should continue to provide local offices with assistance to manage property taxes, which will formally be delegated to them as of 2014, given their low staffing levels and limited expertise. A simplification of the assessment of the tax basis for property taxes would also help to ease the burden on these field offices.

In view of the administration's limited capacity, tax audits should apply procedures that focus more on high-risk taxpayers than at present. Although tax audits in Indonesia have become more risk-focused, valuable resources are still committed to automatic audits of taxpayers with a low risk profile. This diverts resources and leads to long delays. It would be preferable to abolish automatic audit requirements and instead to focus on those cases where there is evidence of, and opportunity for, non-compliance.

Box 4. **Recommendations on raising tax revenues**

Broadening the tax base

- Move the resource-sector fiscal regime closer to a system of taxation of rents.
- Review export taxes, considering their implication for the whole economy, including international trade.
- Phase out exemptions from VAT.
- Revisit corporate tax holidays granted to firms in "pioneer industries".

Improving tax compliance

- Enhance efforts to bring the self-employed into the tax net, including by reducing temporarily penalties for previous non-compliance for first-time taxpayers only.
- Increase resources devoted to auditing high-risk and affluent taxpayers, and make more use of third-party information to assess tax liabilities.

Improving microeconomic efficiency

Fostering formalisation

Increasing the share of economic activity in the formal sector is a crucial goal, as it would increase productivity, which has been particularly lacklustre in small firms, and allow any given amount of tax revenue to be raised with lower rates and thus less in the way of efficiency losses.

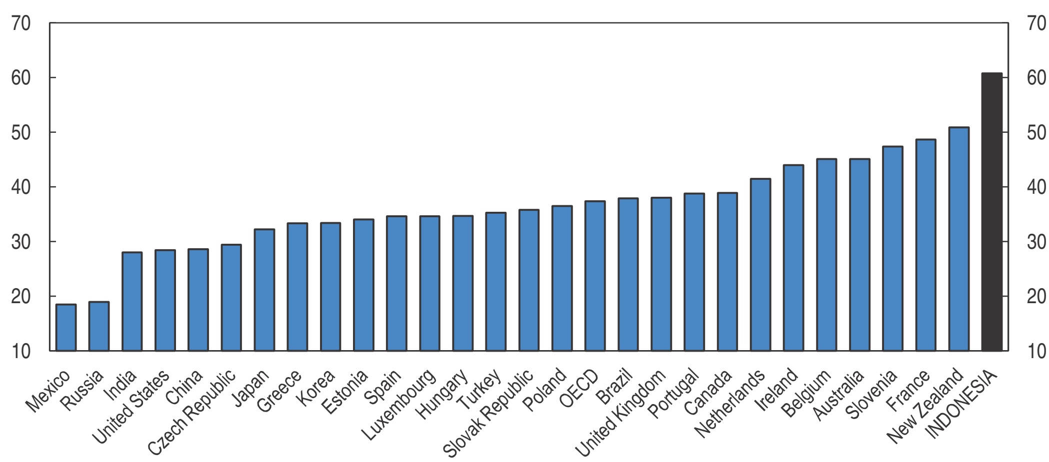
Reforming the labour code

Labour costs are an important factor bearing on efficiency and incentives to formalise. They have been increasing at a faster pace in Indonesia than in other South-East Asian economies. This reflects, in particular, high minimum wages in some provinces combined with generous severance payments and stringent employment protection legislation for some employees.

Relative to average wages, Indonesia has one of the highest minimum wages in the world, equal to 65% of the average wage of salaried workers, although the situation varies somewhat across provinces (Figure 14). This lowers employer incentives to formalise (Suryahadi *et al.*, 2003). Very often large increases are observed in provinces where the minimum wage is already well above the estimated living wage (Chapter 2). In such provinces, increases in the minimum wage should be limited to trend productivity gains. The introduction of a sub-minimum wage for youth directly linked to the general minimum wage could also offset the impact of a high minimum wage on labour-market entrants. Such an instrument already exists in many OECD countries and in India.

Figure 14. **Ratio of minimum wage to average wage by country**

Per cent, 2010



Note: Data are for 2011 for Indonesia.
Source: Employment Outlook database and Going for Growth (OECD, 2012b).

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An effective way to encourage formalisation while enhancing worker protection would be to rely on a two-pronged strategy of introducing unemployment benefits, which do not currently exist, and cutting onerous severance payments and easing dismissal procedures for workers with permanent formal-sector contracts. At the moment much of the labour code is poorly enforced and affords only weak protection to workers. By contrast the provision of unemployment benefits would pool job-loss risks and could benefit more workers. However, such a measure is often found to be costly in countries where job-search requirements are difficult to monitor. One option would be to limit, at least initially, the level of the unemployment benefit and complement it with individual unemployment saving accounts, which would be potentially tax-supported and could be drawn down during the job-search period. This alternative would be less costly than the introduction of a standard unemployment benefit system but is also likely to be more difficult to administer by both workers and the government. Yet, it would strengthen incentives for the employed to avoid job loss and those of the unemployed to return to work quickly.

Improving the business environment

A heavy regulatory burden can also influence firms' decisions to become formal. Considerable progress in reforming regulation has been achieved in recent years, but improvements have concentrated mostly on making it easier to start a business. The system of business licensing is still complicated, lengthy and costly and acts as a barrier to entry. On average, running a business is still more cumbersome in Indonesia than on average in OECD or Asia-Pacific Economic Cooperation countries, and the burden is particularly heavy for small firms (World Bank, 2012b).

Decentralisation in 2001 and the resulting transfer of regulatory oversight to localities are reported to have worsened the business environment (KPPOD, 2008). The number of levies and costs firms have to cope with has increased, creating excessive red tape and regulatory uncertainty. Sub-national licensing is currently being reviewed. The focus is on eliminating illegal taxes and user charges. Some efforts have been made, but more are required to remove licensing requirements that are detrimental to growth or inconsistent with national regulations. More generally, there is a need to methodically evaluate the costs and benefits of new and existing licences and make more systematic use of regulatory impact assessments (RIAs).

Since the mid-1990s, the government's strategy to streamline the business licensing process has been based on one-stop shops. These are local government offices that consolidate the processing of business licenses from separate departments into one location to provide faster, simpler and less costly services. Most Indonesian cities have by now complied, and a one-stop-shop system is being implemented for central-government licenses. The national government has also approved legislation mandating the simplification of local licensing requirements, but progress has been uneven across provinces. Regional governments' failure to implement the law could be sanctioned. This will pave the way for a single-license model that is currently under discussion. Going forward, the authorities could also envisage relying extensively on regulations that would apply to anyone who engages in certain business activities, rather than licenses. This approach enables businesses to enter or expand in markets more easily and would reduce the scope for illegal side payments (OECD, 2012c).

Diminishing tax compliance costs, especially for small firms

There is ample room to lower compliance costs and thereby encourage more firms to become formal, even though taxation does not appear to be the major factor behind informality in Indonesia. The World Bank's 'Paying Taxes' publication ranks Indonesia 130th out of 183 economies with respect to the ease of paying taxes. Costs are particularly high for small firms. A specific turnover-based tax regime for small firms with low rates (micro firms will continue to be exempt) is being discussed within the government. Examples from other emerging-market economies, like Brazil's *Simples Nacional* programme, suggests that a simpler taxation system for micro and small firms can promote the creation of start-ups and the formalisation of unregistered workers. Nevertheless, preferential tax treatment for small firms needs to be carefully designed to avoid discouraging firms' development as the advantages of the special regime will be lost if firms grow beyond the revenue threshold.

The use of electronic interactions between taxpayers and authorities presents significant scope for easing tax procedures, at the stages of registering, filing and paying taxes. Some steps have already been taken in this direction, but electronic filings still account for less than 1% of annual tax returns. Further progress could be achieved by allowing taxpayers without access to computers to pay taxes using automatic teller machines, such as in Singapore, Malaysia, India and Hong Kong.

Boosting investment

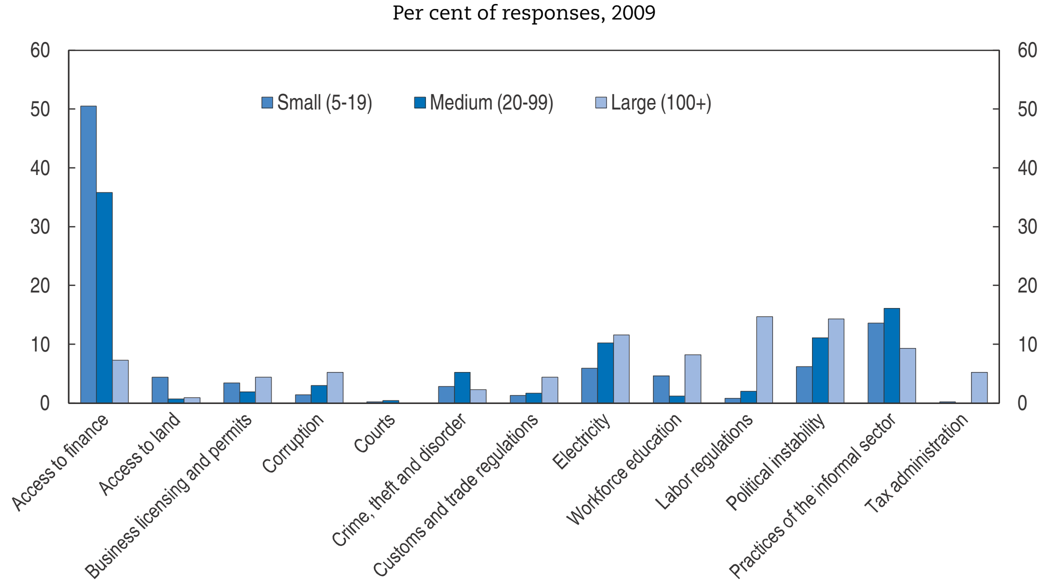
Another option to spur productivity growth is to remove obstacles to investment, especially for small firms.

Easing access to finance

According to the World Bank's Entrepreneurship Survey, access to finance is by far the greatest impediment to investment for small and medium-sized Indonesian firms (Figure 15). While the lack of financial instruments prevents excess liquidity from being channelled into financing tangible investment, small firms face additional difficulties.

Figure 15. **Principal obstacles to investment by size of Indonesian firms**

Per cent of responses, 2009



Source: World Bank, Enterprise Survey for Indonesia.

StatLink http://dx.doi.org/10.1787/888932711296

Poor credit information and difficulties in enforcing contracts are likely causes of high credit costs. One way to reduce the cost of screening clients is through the establishment of credit registries that provide information on firms' payment histories. A public credit bureau (*Biro Informasi Kredit*, BIK) has existed in Indonesia since 2006. It has helped to improve transparency and information. Its information is restricted to credit and, as in many other countries, is more oriented toward consumer credit than commercial lending. A limitation of the BIK is that access to it is limited and subject to the approval of the banking supervisor. Letting non-bank financial institutions access all the information collected by BIK could spur lending to small firms.

Many small businesses cannot get credit because they are unable to provide the types of collateral required and face harsher bank lending terms than larger firms. Some of these issues may be tackled by policies developed by BI in the Indonesian Financial Inclusion framework. But the authorities need to clarify land-rights provisions covering both individual and communal rights to secure firms' property rights to assets they can pledge as collateral. In addition, stronger creditor rights would allow lenders to reduce the risk of future losses. This is particularly important, given the weak judicial system. Simplification of costly loan-recovery procedures would also be helpful.

To ease access to bank lending, in 2007 the government put in place the people's business credit KUR programme (*Kredit Usaha Rakyat*) which provides government credit guarantees to firms which are profitable but could otherwise not get credit from banks. KUR is estimated to have had a positive impact on wages and production (BRI, 2009). A limitation of the programme is that it is concentrated on the trading sector and certain regions. One way to expand coverage of the programme would be to allow more banks to qualify for the scheme, even though this would increase fiscal risk. The government could also improve awareness amongst entrepreneurs of available financing options. Finally, now that the programme has been in place for few years, it would be useful to reduce the number of ministries involved in its design and implementation.

Encouraging infrastructure investment

There is a broad consensus that the unsatisfactory state of infrastructure is holding back economic activity and investment in Indonesia. In particular, high transport costs are weighing on production efficiency. Despite some improvement, the road and railway networks remain in poor condition, and the capacity of seaports appears to be limited. The quality of electricity supply also remains a major concern.

The Land Acquisition Law, passed in December 2011, allows the government to take over land for development while owners are guaranteed compensation. Implementing regulations were issued in August 2012. It is expected to accelerate infrastructure development. In addition, the Master Plan for the Acceleration and Expansion of Indonesia's Economic Growth (*Masterplan Percepatan dan Perluasan Pembangunan Ekonomi Indonesia*, MP3EI) provides a strategic direction for investors on where the government's economic development focus will be in the next 15 years. The MP3EI foresees that about IDR 1924 trillion (around 26% of GDP) will be allocated to infrastructure sectors from 2010-14. But about 72% of these funds are expected to be financed by the private sector or through public-private partnerships or foreign direct investments, which will be challenging in the current business environment. The government could consider raising, even substantially, the amount of infrastructure investment it intends to finance, which was only 1.7% of GDP in 2011. This would not endanger fiscal sustainability if revenues were raised, as discussed above. If carried out properly, increased infrastructure would have large pay-offs at the country's current stage of development. In any case, all new infrastructure should be as resilient as possible to natural disasters, whose impact falls most heavily on the poor.

But, injecting more money in the sector will not be sufficient. New regulators have been established in rail transportation and water and sanitation, as recommended in the 2010 *Economic Survey,* and a set of guidelines clarifies the use of private-public partnerships in network industries. Additional reforms are required to lower regulatory uncertainties, including strengthening the powers of existing regulators and improving co-ordination between national and local authorities. In addition, removing electricity subsidies to consumers would improve the finances of the state-owned electricity producer, which are in wretched shape, and attract private investment. Until subsidies are significantly reduced, adequate compensation to the company, as suggested by the OECD Guidelines on Corporate Governance of State-Owned Enterprises, would improve its balance sheet.

Better enforcing intellectual property rights

Finally, more stringent enforcement of intellectual property rights (IPR) would encourage investment. IPR legislation has been updated to meet international standards, and special measures have been taken to meet the needs of small firms, but intellectual property piracy remains a major concern. It is important to allocate more resources to better enforce IPR regulations. In addition, policies should reduce the time and cost of enforcement procedures and improve firms' confidence in the process. Streamlined procedures would make patent litigation more accessible to small firms, as evidence from the United Kingdom has shown (Cusmano and Dean, 2011).

Improving the availability of qualified labour

Productivity gains can also be achieved by raising the general level of skills in the workforce. At the moment, workers' skills often do not meet employers' expectations, and there remains a critical need to broaden basic skills. The level of education of SME owners is also low.

International evidence points to the importance of teaching quality as a key factor in determining educational outcomes. Despite some budgetary allocations to tackle this issue following the 2005 Teacher Law, efforts to monitor progress in teaching quality through regular assessment of teachers' pedagogical skills need to be maintained.

Easier access to education for students from disadvantaged backgrounds will expand the pool of skilled workers. As indicated in the 2010 *Economic Survey*, enrolment is particularly low in secondary education, suggesting the need to facilitate the transition from primary to higher levels of education. Even if a complete understanding of the factors determining dropping out from school is lacking, early withdrawal could be curbed by extending conditionality in income-support programmes to include secondary-school attendance. Financial support to students from poor families could be provided through a higher per-student transfer under the School Operations Fund programme (*Bantuan Operasional Sekolah,* BOS) – which includes direct block transfers to schools to finance non-payroll recurrent expenditures – for schools located in remote areas and catering to poor students. Alternatively, conditional cash transfers would ease access to education of disadvantaged students.

Programmes have been put in place to provide skills to the large number of youths who drop out without any qualification. But there is no follow-up monitoring to check whether these programmes have proven successful in lifting skills and in favouring integration into the formal labour market. It would be useful to rigorously assess the cost efficiency of all existing programmes aiming at upgrading dropouts' skills and phase out those found to be inefficient.

Employer surveys suggest that a large number of educated workers do not have the expected level of skills given their level of education. Vocational schools offer an alternative path to providing students with the generic skills necessary to find a job. The sector has expanded rapidly in recent years, and the authorities wish to expand it further to reach a 30/70 general/vocational ratio by 2015. Rather than increasing further the number of vocational training providers, it would be preferable to concentrate vocational schools' curricula on on-the-job and practical training that is highly valued by employers. In addition, removing formal education from the negative investment list, as is currently being discussed, would facilitate entry of foreign providers.

Changes to the tertiary-education sector are also required to make it more responsive to firms' needs. In August 2012, the authorities passed a Higher Education Bill to increase the autonomy of higher education institutions. Greater autonomy for tertiary-education institutions will allow them to adapt more quickly to firms' skill needs and give them incentives to ensure high-quality teaching. A range of cost-sharing instruments could be used to alleviate the financial burden borne by poor students. A 2009 law already mandates that scholarships be available for at least 20% of the student population. Better availability of student loans would also ease access, especially in the current context of improved governance and targeting as well as more developed banking activity.

Employer-provided training is scarcer in Indonesia than in other South-East Asian economies. Firm-based training could be encouraged through the creation of a national training fund, similar to those existing in Malaysia or Latin America, which would consolidate resources allocated to training and direct them to their most cost-efficient use. Participation of employer representatives in the management of this fund would ensure that feedback from the labour market is incorporated into training content.

Reviewing support to small firms

Although support to SMEs is generally rated as effective by firms, some changes could improve the efficiency and consistency of public assistance delivery. Since 2008 support has been, by law, a government function. Most central-government ministries are currently involved in the delivery of support, but local governments also provide their own programmes. A lack of effective coordination has resulted in a plethora of sometimes overlapping measures and an inefficient delivery of support. More clearly defined responsibilities among the different levels of government and within the central government would help to improve coordination and ensure resources are used efficiently.

Moreover, the authorities only monitor rather than evaluate programmes, focusing on those that are strategic (Suryahadi *et al.*, 2010). It is essential to regularly assess the cost-effectiveness of existing programmes. To be credible and prevent policy capture, it would be preferable to assign this task to an independent agency. Once such a rigorous evaluation is undertaken, it may be possible to consolidate support by phasing out inefficient measures and directing resources to the most cost-effective schemes.

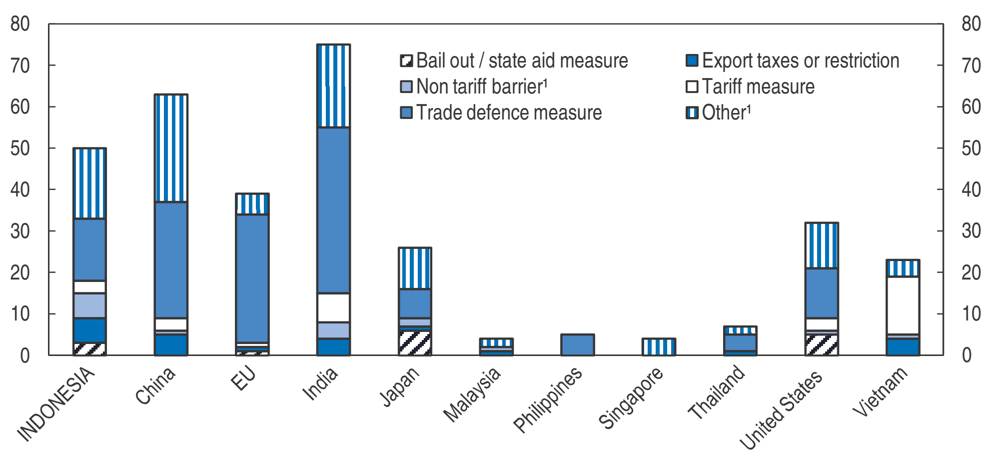
One of the main strands of policy support has been to encourage the formation of SME clusters, and a number of corporate tax incentives have recently been introduced for this purpose. Although clusters can be the source of productivity gains and facilitate the delivery of support, there is also evidence that most Indonesian SME clusters tend to grow spontaneously without government intervention (Marijan, 2006). It may thus be useful to examine the effectiveness of such policies. In addition, Indonesia has been protecting small firms by reserving certain industries for them and requiring partnerships with them in its FDI policies to foster technological spillovers. However, this restriction could also discourage foreign companies from investing in Indonesia, thereby hampering firms' growth, and needs to be reconsidered.

Opening the economy further to foreign trade and investment

Despite Indonesia's longstanding commitment to free trade, several non-tariff measures have been erected since the end of 2008, reflecting concerns that the economic crisis could spread through Asia. The number of new trade-restricting measures is lower than in China and India but notably higher than in regional peers (Figure 16). Most seriously, new regulations to restrict the range of products a general importer can import are expected to come into effect by the end of this year. While the government has remained committed to lowering tariff rates, it has had recourse to non-tariff measures, which can be put in place by one of the many government agencies that have prerogatives in this area, without formal coordination. Only some of these measures can be justified on public health and environmental grounds. It would be useful for an independent agency to carefully examine the impact of these non-tariff measures on trade and the domestic economy and roll back those that are found detrimental to growth. As indicated in the 2012 OECD *Review of Regulatory Reform*, reducing the number of ministries and agencies that have the ability to erect non-tariff barriers could prevent an excessive rise in such barriers in the future (OECD, 2012c).

Figure 16. **Restrictions to trade in Indonesia and selected economies**

Increase from end 2008 to June 2012



1. Other measures include public procurement, competitive devaluation, consumption subsidy, export subsidy, import ban, import subsidy, intellectual property protection, investment measure, local content requirement, migration measure, quota, sanitary and phytosanitary measure, state trading enterprise and state-controlled company, sub-national government measure, technical barrier to trade, and trade finance. Non tariff barriers are those not included in other measures.

Source: Global Trade Alert.

StatLink http://dx.doi.org/10.1787/888932711315

Despite some progress through the publication of a negative investment list in 2007, FDI restrictions have remained relatively stringent in Indonesia. Foreign equity ceilings are lower than on average in Asia in all sectors except banking, mining, oil and gas and electricity (World Bank, 2010b). Moreover, lower-order regulations issued by Ministries or regional governments have sometimes been inconsistent with the Investment Law, creating confusion. Some of these regional regulations have been revised or harmonised with central-government regulations and the negative investment list was also updated in Presidential Decree 2010/36. While many sectors were liberalised for investment, a few others became more restrictive (OECD, 2012c). In March 2012, a government decree tightened FDI restrictions in mining and required foreign mining companies to progressively divest their holdings down to 49% by the tenth year of operation. Moreover, some restrictions have remained in place in key sectors such as pharmaceuticals, distribution, telecommunications, maritime transport and education. In some cases, these could be justified on the grounds of environmental protection, national security, public health and cultural heritage. The authorities have announced that they may revise the negative investment list to spur FDI in some of these sectors. They should consider further relaxing barriers to FDI in sectors where they still exist, unless they are justified by valid public-interest concerns. Indeed, FDI is usually believed to be beneficial to growth and development, as it is a source of technology transfer, allows risk diversification and can deepen financial markets (Kose *et al.*, 2009).

Box 5. **Recommendations to spur microeconomic efficiency**

Labour market and business environment

- In provinces where minimum wages are already high in relation to average wages, resist increases that exceed trend productivity gains. Introduce a sub-minimum wage for youth directly linked to the general minimum wage. Reduce onerous severance payments and ease dismissal procedures in the formal labour market. In return introduce unemployment benefits possibly coupled with individual unemployment saving accounts.
- Systematically review all significant existing business licenses at the national and local levels, with a view to simplification, and ensure licensing remains cost-effective.
- Make the information collected by the credit bureau available to all non-bank financial institutions.
- Public finances permitting, increase public outlays on cost-effective infrastructure projects, beyond what is already planned.

Human capital

- Ease access to education and training for students from disadvantaged backgrounds. Rigorously assess the cost-efficiency of all existing programmes aimed at upgrading dropouts' and workers' skills, and phase out those found to be inefficient.

Support to small firms and foreign trade and investment

- Clarify government responsibility in the delivery of support to small firms. Regularly assess the efficiency of existing programmes and redirect resources to the most cost-effective schemes.
- Re-examine the effectiveness of policies to encourage the formation of clusters, to reserve certain industries for small firms alone, and to require foreign direct investors to partner with local SMEs.
- Assess the impact of non-tariff measures on trade and the domestic economy and remove those that are found detrimental to growth. Remove the new regulations that restrict the range of products a general importer can import. Relax remaining barriers to foreign direct investment, unless they address valid public-interest concerns.

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ANNEX

Progress in structural reform

This Annex reviews progress in the area of structural reform based on the policy recommendations made in the 2010 *Economic Survey*.

***Survey* recommendations**	**Action taken since last Survey**
Fiscal policy framework	
Increase spending on growth-enhancing programmes.	Spending on capital expenditures rose markedly in nominal terms in 2011 but still came in well below budget targets, as did social expenditures. Education spending increased by 5% in nominal terms in 2011, while infrastructure spending went up by 57% in nominal terms relative to 2010 (World Bank, 2012a).
Monetary policy framework	
Stick to the commitment of lowering the inflation target range to 3.5-5.5% by 2014, and move from an end-year to a year-average target.	The inflation target has been reduced to 3.5%-5.5% for 2012.
Financial markets	
Pass and implement the Financial Services Authority (*Otoritas Jasa Keuangan*, OJK) bill as soon as possible in order to specify the roles, functions and degree of autonomy of the OJK.	The OJK bill has been passed, and implementation is planned for 2013-14.
Labour markets	
Introduce unemployment insurance while capping minimum wage increases and reducing severance payments.	No action taken. Minimum wage increases have remained high in some provinces.
Simplify dismissal procedures for permanent contracts, and ease the use of temporary and fixed-term contracts.	The government is planning to improve the rules and regulations on severance pay and fixed-term contract workers.
Environment, deforestation and climate change	
Follow up on the Ministry of Finance green paper, and swiftly review the most cost efficient measures to slow deforestation rates. Make sure the timber legality standard is enforced.	A presidential decree for a National Action Plan For Reducing Greenhouse Gas Emissions ("RAN-GRK") was signed in September 2011. The plan spells out the 2020 emission-reduction targets in five main sectors.
Ensure energy policies are consistent with the objective of emissions reduction.	Energy policies continue to favour the burning of coal and diesel in power generation. In January 2012, the government established a guaranteed feed-in tariff for small renewable-energy producers, to be paid by the state energy company. In May 2012 the government decided to spend IDR 3.4 trillion on new geothermal energy plants.
Stick to the commitment and the planned timetable to phase out fossil fuel subsidies by 2014, and extend the commitment to a medium-term removal of electricity subsidies.	An attempt by the government to lower fuel subsidies and electricity subsidies failed to get parliamentary approval in May 2012. However, the government was authorised to raise the price of subsidised fuel if the world oil price exceeds a certain threshold. In the 2013 draft Budget the government has proposed to raise electricity tariffs by 15%. Poor households would be exempted from the hike.

Survey recommendations	Action taken since last Survey
Introduce a carbon tax.	A carbon tax, together with a cap and trade system, are under consideration.
Review support to biodiesel and ethanol.	No progress made.
Infrastructure	
Use the Medium Term Expenditure Framework more effectively to improve multi-year budget appropriations for infrastructure projects, and improve coordination among ministries responsible for infrastructure development.	Recent moves to a medium-term expenditure framework at the central level are expected to improve planning capacity and budget execution, although regional budgets still rely on annual planning.
Undertake systematic value-for-money tests to assess the relative and absolute cost effectiveness of PPPs.	The National Development Planning Agency BAPPENAS has developed regulatory impact assessment tools.
Provide incentives to local governments to allocate budget resources for roads, water and sanitation by making transfers conditional on appropriate upkeep.	No progress made.
Establish independent regulatory bodies in the sectors currently lacking them, and legally entrench the power and responsibilities of all regulatory bodies.	New regulators have been established in rail transportation and water and sanitation.
Grant independence to existing regulatory entities by eliminating the need for ministerial approval of their decisions and by funding their budgets through license fees and levies on firms.	No progress made.
Lower FDI restrictions on equity and on foreign key personnel in telecoms, transport and electricity.	No progress made. The negative investment list is currently under review.
Realign average water tariffs to cost-recovery levels, and use existing cash-transfer programmes to compensate low-income households.	No progress made.
Reform eminent domain legislation to expedite the process of land acquisition.	A land reform act has been passed that is expected to expedite the process of land acquisition.
Reduce restrictions on cabotage by foreign vessels so as to raise competition in the shipping industry. Allow shipping companies to determine freely their freight and passenger tariffs, and, if necessary, auction subsidies to ensure the provision of services on unprofitable routes.	No progress made.
Social policies	
Raise government spending on education at the secondary level.	Spending on the secondary education has been increased in recent years. Plans to expand spending on secondary education in 2013 have been announced.
Carry out regular assessments of teachers' pedagogical skills and regular monitoring of teacher attendance to tackle the problem of their absenteeism.	Additional funds have been allocated to scholarships for teachers to pursue undergraduate and graduate degrees. A joint ministerial decree was issued in 2011 to impose a minimum teaching load of 24 hours per week for teachers.
Raise government spending on health care, and carry out a comprehensive costing of Jamkesmas. Public finances permitting, include coverage for patient transport and related costs under Jamkesmas.	Overall social expenditures rose by only 3.3% in nominal terms in 2011 and Jamkesmas itself increases as much as IDR 1 trillion per year. A costing review of Jamkesmas has been carried out.
Carry out a comprehensive actuarial costing of existing social protection programmes to allow the appropriate associated financing instruments to be identified.	A study on comprehensive actuarial costing was carried out in early 2012. Discussions within the government on the basis of this study are now ongoing.
Better integrate the different social-protection mechanisms.	In November 2011, the Social Security Administrative Bodies Law (BPJS Law) established two new social security administrators (for health and employment, respectively). Once implemented in January 2014 it will consolidate existing health-insurance schemes (including Jamkesmas) and expand coverage substantially. In July 2015 accident and life insurance as well as a pension scheme are to be provided.
Governance	
Pursue efforts to fight corruption and strengthen governance. Step up reforms to the court system.	In December 2011 the President issued a new regulation, which outlines strategies for corruption prevention in law enforcement and other agencies as well as enforcement and asset recovery from corrupt practices. Progress in lowering corruption perceptions has been slow.

Chapter 1

Improving the tax system

Indonesia has come a long way in improving its tax system over the last decade, both in terms of revenues raised and administrative efficiency. Nonetheless, the tax take is still low, given the need for more spending on infrastructure and social protection. With the exception of the natural resources sector, increasing tax revenues would be best achieved through broadening tax bases and improving tax administration, rather than changes in the tax schedule that seems broadly in line with international practice. Possible measures to broaden the tax base include bringing more of the self-employed into the tax system, subjecting employer-provided fringe benefits and allowances to personal income taxation and reducing the exemptions from value-added taxes. Similarly, broad-based investment credits would be a less distortive way to enhance investment incentives than selective tax holidays. Introducing a targeted, simplified tax regime for small and medium-sized enterprises, as currently planned by the government, could foster their integration into the tax system in the longer run, even if its short-run revenue potential is limited.

Upgrading tax administration has made substantial progress in Indonesia since 2002, although there is still scope to improve the training of tax officers and the administration's audit and litigation capacities, while strengthening internal control systems and enhancing the transparency of administrative decisions. The audit system could be further improved by allocating more tax audits on the basis of compliance risks.

In the natural resources sector, particularly in mining, there is a case for increasing the government's share of resource rents through higher tax rates imposed on these rents, as opposed to taxing revenues. This would imply a willingness of the government to bear a larger share of the exploration and development risk than heretofore, which Indonesia, with its improved access to international financial markets and a diversified resource portfolio, is now well placed to do. In the mining sector, a powerful rent tax regime with a large government take would serve the country better than export taxes and ownership restrictions that have been decided recently.

Tax systems vary substantially across countries, and there is no clear guidance from the literature as to what constitutes an ideal set of taxes. The challenge is to design a tax system that keeps welfare- and growth-reducing distortions to a minimum, while achieving the desired revenue and social objectives. In this context a number of general lessons have emerged from the experience of countries in the OECD and beyond. Besides assessing the performance of Indonesia's tax system, one of the objectives of this chapter is to draw on these lessons to point to ways in which it can be improved. The following sections will review the achievements of Indonesia's tax system and view the country's tax mix in international comparison, before discussing in turn taxes on personal and corporate income, resource sectors, consumption, property and international trade. A final section reviews ways to improve the efficiency of tax administration.

Achievements and challenges for Indonesia's tax system

Indonesia has come a long way in improving its tax system over the last decade, both in terms of revenues raised and administrative efficiency. This has improved the economy's performance by increasing the funds available for urgently needed public expenditure items and by easing the compliance burden on taxpayers. Going forward, the Indonesian authorities have formulated ambitious development targets, especially for enhancing the nation's infrastructure and expanding the social safety net, which imply significant financing needs. At the same time, the rapidly growing middle class will surely create a political demand for improvements in both social security programmes and public goods provision. Moving towards a greener economy will also add to expenditure needs. Financing the measures that will meet these objectives will require more public revenues, and this will be one of the principal challenges for the tax system in the years to come.

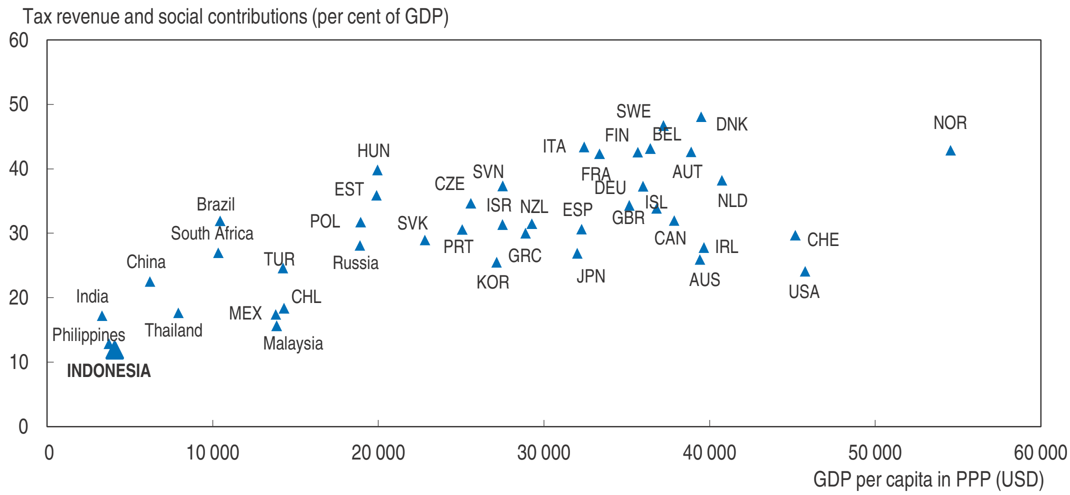
Indonesia's tax take is low compared to both regional and OECD peers: the ratio of general government tax revenues to GDP was 12.6% in 2011, slightly lower than in 2008, and one of the lowest in the G20. According to the 2013 draft Budget, the tax to GDP ratio is expected to remain broadly stable, despite an increase in VAT revenues. For comparison, several of the more developed ASEAN countries collected more than 15% of GDP in tax revenues in 2009, and the OECD average was at 33.8% of GDP excluding non-tax revenues (Figure 1.1). The IMF estimate of the maximum tax revenue that Indonesia could achieve by broadening the tax base and enhancing compliance at current rates is 21.5% of GDP (IMF, 2011a).

Raising the tax take will involve substantial effort, especially in the context of widespread informality. But the experience of a number of countries has shown that substantial revenue increases are feasible with strong political will and an appropriate policy design. For example, in Peru the ratio of tax revenues to GDP rose from 13 to 17% over the last decade, while in Vietnam it rose from 19 to 24% over a similar period.

The challenge of mobilising additional tax revenues is not the same as raising tax rates. Simply increasing the burden on the current set of taxpayers may exacerbate

Figure 1.1. **Indonesia's tax revenues and GDP per capita**

2009



Note: Non-tax revenues are not included. Data are for 2008 for India and central government only for Malaysia.
Source: OECD Revenue Statistics, IMF Government Finance Statistics, Indonesia Ministry of Finance, Philippines Department of Finance.

StatLink http://dx.doi.org/10.1787/888932711334

existing distortions and perceived inequalities. As the tax take rises, further improvements in the efficiency of taxation become more pressing. There are three dimensions to this, which will be dealt with in the subsequent sections of this chapter. First, the authorities should ensure that the tax mix, *i.e.* the distribution of tax revenues over different tax instruments, strikes a reasonable balance. Second, the design of each of the major tax instruments provides scope for efficiency-enhancing reforms, such as broadening the base and simplifying schedules. And last, but not least, it is important to look at the performance of the tax administration as a crucial determinant of the gap between tax policy and implementation.

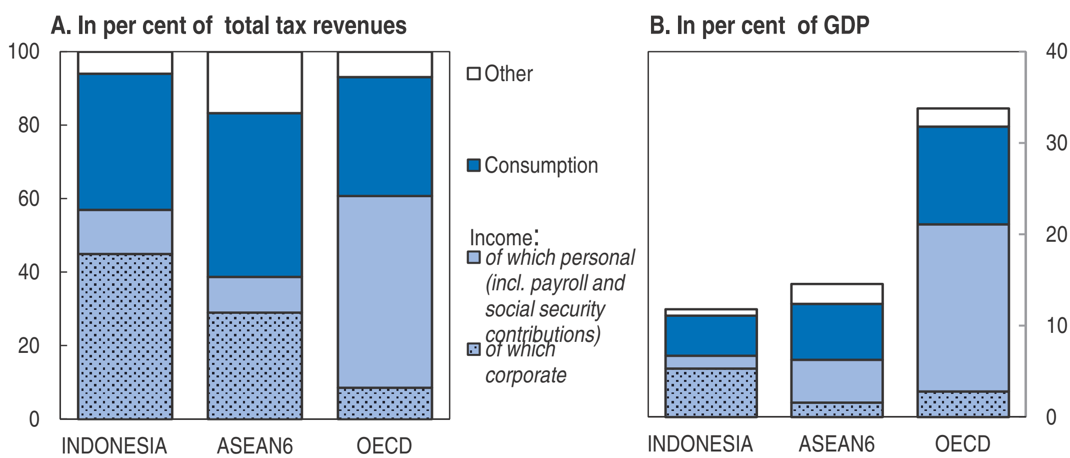
Fiscal decentralisation has been an important issue in Indonesia since the return to democracy in 1998. However, with the exception of property taxes, whose collection will move to the local level in 2014, fiscal decentralisation has been mostly accomplished through the expenditure side and a system of intergovernmental transfers, and will therefore not be dealt with in this chapter. Local taxes currently account for only 0.8% of GDP, with the remaining tax revenue being collected by the central government.

Getting the tax mix right

Governments have a wide variety of taxes at their disposal, with varying impacts on income distribution and the extent of growth-reducing distortions, through different effects on the drivers of growth. For example, labour taxes can influence labour force participation decisions, in particular for second earners, while investment decisions are affected by taxes to the extent that these change their after-tax returns, and even productivity can be affected (Arnold *et al.*, 2011). Different tax instruments are also more or less sensitive to increasing mobility of some kinds of capital and labour. Given the present trends of trade liberalisation, tax competition and regional integration, relatively immobile bases present greater potential for generating additional revenues, most prominently consumption, real estate and labour, although the top skill segment of labour may in fact also be highly mobile.

Key differences between Indonesia's tax structure and those of OECD countries – and to a lesser degree also those of ASEAN countries – include a strong reliance on corporate tax revenues and low personal income tax revenues (Figure 1.2). The preponderance of corporate income taxes is particularly visible when considered as a share of total income taxes; but even relative to GDP, Indonesia manages to raise almost twice as much corporate tax revenues as OECD countries. One possible explanation for this could be its natural resource wealth, for which the resulting rents generate higher corporate profits than elsewhere. Indeed, the oil and gas sector alone accounts for almost 20% of corporate tax revenues. No recent figures are available for other resource sectors, but assuming that the mining sector accounts for roughly another 5% of corporate tax revenues, as survey evidence from 2007 suggests, the adjusted revenue share from corporate income taxes would be close to the level prevalent in the other six ASEAN countries in Figure 1.2 (PWC, 2008).

Figure 1.2. **Indonesia's tax structure compared to OECD and ASEAN countries in 2010**



Note: ASEAN6 includes Cambodia, Laos, Malaysia, Philippines, Thailand and Vietnam. Australia, Japan and Poland are not included in the OECD average due to missing 2010 data.
Source: OECD Revenue Statistics, IMF WEO database, Indonesia Directorate General of Tax.

StatLink http://dx.doi.org/10.1787/888932711353

As regards taxes and levies on personal income, other countries in the region manage to raise a share of GDP three times higher than Indonesia. One reason for Indonesia's particularly large discrepancy with respect to OECD countries is the tiny role of social security contributions, a large item that has been steadily increasing in OECD countries, where they finance a strong degree of social protection including old-age pensions, publicly organised health-care systems, unemployment compensation and other social benefits. Another marked difference is with respect to trade taxes, which have constituted a fairly stable 4% of tax revenues (now 0.5% of GDP) in Indonesia in recent years. This is over four times the OECD average in GDP terms, although lower than for the six other ASEAN countries for which data are available.

The experience of OECD countries over the last three decades provides lessons regarding the link between taxes and growth. Empirical evidence suggests that some tax instruments are more harmful to economic growth than others, allowing the establishment of a ranking according to their "growth-friendliness" (Johansson *et al.*, 2008; Arnold *et al.*, 2011). This evidence is based on panel growth regressions at the aggregate level of OECD economies but is also confirmed by more micro-based analysis at the level of both industries and firms (Arnold *et al.,* 2011). The findings point to the comparatively benign effects of property and consumption taxes on economic growth, while, at the other end of the spectrum, corporate income taxes are typically less growth-friendly than personal income taxes. Potential explanations for these heterogeneous growth effects could be differences in mobility of the respective tax bases, although this conjecture cannot be tested with the available data.

Improving the performance of individual tax instruments

While choosing the right tax mix is important, it is also crucial to optimise each individual tax instrument given policy objectives. In fact, the relative merit of different taxes will in practice depend to a large degree on how well these are designed and implemented, and the OECD evidence on the growth ranking of different taxes should be interpreted as conditional on the average situation in OECD countries. Country characteristics such as institutional development matters for how well a given tax instrument will work in practice, and tax policy design should take such characteristics into account. A focus on taxes that are easy to administer, for example, is likely to be more relevant for Indonesia than for many OECD countries. Aiming for a tax system with few rates and few exemptions, and exploiting tax bases that are easy to observe may help in this regard.

Personal income taxes

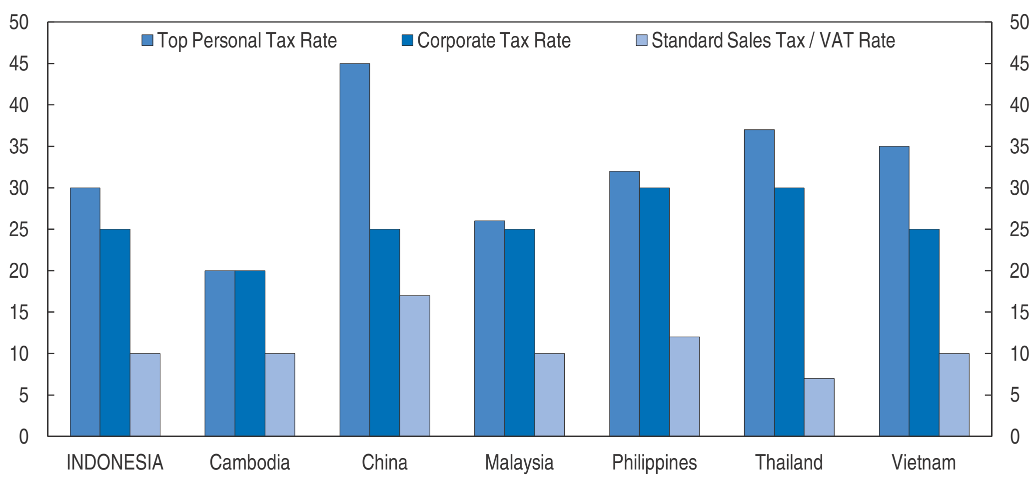
Indonesia generates low levels of revenues from personal income tax (PIT), which is to some degree a common feature among emerging-market economies. At 1.4% of GDP, however, Indonesia raises less than a third of the revenues that other ASEAN countries do and also less than the 1.9% average of lower-middle income countries. Given these low levels, personal income taxes, though in principle less growth-friendly than consumption taxes, provide scope to enhance tax revenues. To the extent that this can be achieved by broadening the tax base, the distortive effects of additional PIT revenues could be limited.

Indonesia operates a PIT system with a threshold income level and progressive rates. For a family with two working adults and two children, no taxes are due below an annual income of around IDR 40 million (currently around USD 4 300); for families with only one earner the threshold is IDR 26 million (currently around USD 2 800). Since annual market incomes of the top income quintile begin at around USD 3 500, personal income taxes concern less than 20% of all Indonesians (Nugraha and Lewis, 2011). For example, a married couple with two children and earnings of 100 and 67% of the average wage, which is a typical example used in the OECD's *Taxing Wages* publication (Gandullia *et al.*, 2012; OECD, 2012), the income tax rate is zero, although they are subject to social security contributions of 2% of wages for the workers' old-age compensation fund, JAMSOSTEK. PIT rates begin at only 5% for the first IDR 50 million of taxable income and move up progressively to a top rate of 30% for taxable income above IDR 500 million (about USD 44 000).

The rate schedule seems broadly appropriate. The fairly high threshold is reasonable as it avoids spending valuable administrative resources on enforcement activities concerning low-income individuals with low taxpaying potential and reduces the tax burden on households with unsatisfied basic needs. At the same time, after having been reduced to 5%, the entry tax rate is low, which avoids creating strong disincentives to formalise and keeps the tax system progressive. At the other end of the spectrum, the 30% top marginal income tax is broadly in line with current practice in the region (Figure 1.3). There are good reasons to avoid high top marginal rates. Incentives to report income would be weakened. Empirical estimates based on Indonesian household surveys suggest that the declared income of higher-income groups is more responsive to changes in tax policy than is the case for low-income taxpayers, and that lower top marginal rates may lead to more income being reported to tax authorities (Yuwono, 2009). In addition, high top marginal rates are widely found to reduce risk taking and entrepreneurship.

Figure 1.3. **Indonesia's tax rates in a regional comparison**

Per cent



Source: www.taxrates.cc.

StatLink http://dx.doi.org/10.1787/888932711372

Recent tax policy changes have increased progressivity for lower taxable incomes and reduced it at the top. Despite significant progressivity in the rate schedule, however, the only available empirical evidence suggests that the contribution of the tax system to reducing income inequality in Indonesia is only marginal (Nugraha and Lewis, 2011). This contrasts with the tax systems of 10 OECD countries for which relevant data are available, where taxes reduce income inequality considerably. In addition, OECD countries have more developed transfer systems, which further improve the distribution of disposable income. Why personal income taxes in Indonesia do so little to reduce income inequality despite a progressive rate schedule is hard to ascertain. One explanation may be tax exemptions that benefit the better-off, such as the fact that fringe benefits and allowances provided by employers are not treated as income and thus not subject to personal income taxation. These can amount to a non-negligible share of compensation packages, and their tax exemption creates incentives to over-exploit their use. Given that fringe benefits are typically more common for employees with higher incomes, taxing these allowances would help to increase the redistributive effect of personal income taxes and broaden the tax base. At the same time, given that the recipients of such benefits often have a marginal tax rate above the corporate tax rate of 25%, overall tax revenues would rise by taxing allowances at the personal level, even if this would imply the deductibility of fringe benefits from the corporate tax base. With regard to tax administration, there might also be differences in the effectiveness of tax enforcement across different income groups, but there is no consistent empirical evidence available to confirm this conjecture.

Indonesia operates a system of withholding taxes at various sources, notably for salaries, interest and dividend incomes, and some inter-company payments for royalties, rentals and services. Taxes withheld at source constitute prepaid tax for the income recipients that are credited against taxes due in the annual tax return. The exception is taxes withheld on interest income, including from listed bonds, where the 15% withholding tax for residents is deemed the final tax. Effectively, this means that Indonesia operates a sort of dual income tax system where interest income is taxed at a fixed rate regardless of the individual's marginal tax rate. Such explicitly schedular tax systems make progressivity harder to implement, but they have in practice proven more effective in securing tax revenues and making use of third-party information, such as information provided by financial institutions (IMF, 2011).

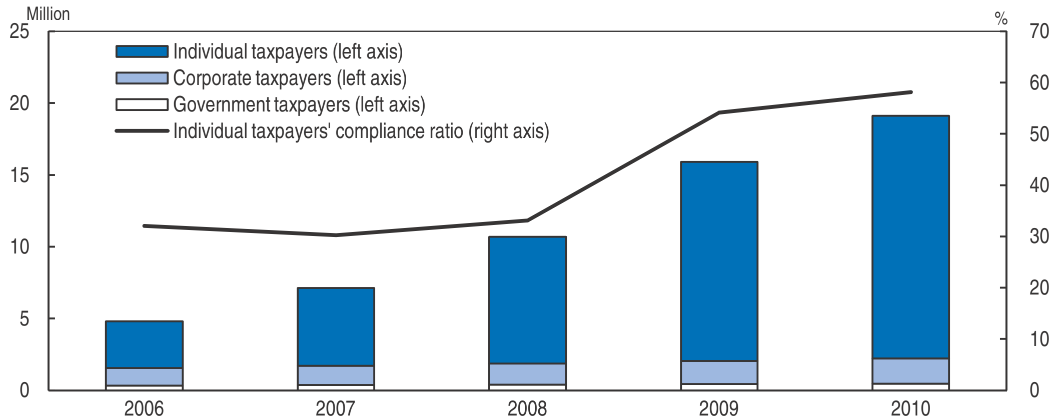
In light of the need to focus on administrative ease, Indonesia's system of withholding taxes seems useful in principle. However, the differential treatment of interest and dividend income for individuals whose marginal tax rate exceeds 15% distorts the asset-allocation choice between fixed income instruments and stocks, without any obvious corresponding benefit. Considering the withholding tax final for dividends, just as for interest income, would reduce this difference, although it would not fully eliminate it due to the double taxation of equity returns at the corporate and shareholder levels. In addition, it would make both administration and compliance easier. The alternative way to reduce the distortions in portfolio choice would be to require full accounting for both interest and dividend incomes in annual tax returns and taxing them at regular PIT rates. This would make it possible to tax the capital income of high-income individuals at higher rates and would even allow the elimination of the differential tax treatment of interest and dividend income through a full imputation system of corporate taxes paid at the shareholder level. However, the cost would be significantly increasing the complexity of the PIT system. An additional drawback of this approach would be that higher taxes on interest income for high-income individuals would increase the incentives for residents to move fixed-income investments abroad, where they may prove difficult to tax at all, even though they would in principle be subject to income taxation in Indonesia.

Broadening the tax base of personal income taxes

More than rethinking tax *policy*, Indonesia's efforts to increase PIT revenues should focus on tax *administration*. The principal challenge here is to expand the effective tax base, which is a declared objective of the Indonesian government. Survey data suggest that PIT revenues amounted to only 43% of the potential revenues that would be collected from a full enforcement of current tax rules (Yuwono, 2009). Fewer than 60% of taxpayers who are required to file an annual income tax return actually do so, and more than 80% of revenues are paid by 3% of households (Nugraha and Lewis, 2011). Yet, the tax authority (Directorate General of Tax, DGT) has made progress over the last few years in increasing the number of individual taxpayers and their compliance ratio for filing annual returns. These have increased from 3.25 million as recently as 2006 to almost 17 million in 2010 (Figure 1.4).

For dependent employees, the withholding system seems to perform well in collecting revenues, although less so in providing information to the tax administration, which often

Figure 1.4. **Number of taxpayers over time**



Source: Indonesia Directorate General of Tax, Annual Report 2010.

StatLink http://dx.doi.org/10.1787/888932711391

receives lump-sum payments from employers without a detailed breakdown of the taxpayers from whom these taxes were withheld. Tax administration could be simplified by lifting the requirement to file an annual tax return for employees with a single source of income and relying solely on the withholding system to assess their tax liabilities. This would reduce both the compliance burden for such employees and the workload of the tax administration. At the same time, employers should be encouraged to provide tax authorities with detailed accounts.

Self-employed individuals, in contrast, are not captured by the withholding system, and no systematic approach exists for assessing their tax liabilities. As a result, a self-employed person may generate income for years without ever drawing the attention of tax officials, and this seems to be an area where there is substantial scope for broadening the base. Efforts are currently underway to bring such activities into the tax net through a census to be completed by November 2012, which effectively involves tax officials going from door to door to detect currently undeclared economic activities. These efforts seem useful, although it remains to be seen how well they perform in practice. They should, however, be supported by measures to make voluntary compliance easier, including the introduction of a single personal taxpayer number, possibly linked to an already existing number that individuals use on a regular basis. One such number is the single identity number (*Nomor Induk Kependudukan*) used on national identity cards issued to all Indonesian residents. At present, potential taxpayers need to take pro-active steps to apply for a tax identification number, and entrepreneurs that never do so are likely to remain outside the system.

An additional useful measure could be to make it easier for the self-employed to become taxpayers by reducing the penalties for past non-compliance of first-time taxpayers for a limited period. Currently, a flat penalty interest rate of 2% per month is charged on all unpaid taxes. This high rate may create strong incentives to remain undeclared for fear of being subject to large penalties on past due taxes if the first filing of a tax return may reveal a previously undeclared activity. For first-time tax filers only, explicit limitations on the penalties for past undeclared activities could be set. At the same time, increasing the incentives for voluntary compliance should not result in regular large-scale amnesty schemes that may cause moral hazard and keenly felt injustice to the compliant.

Another group of income earners that are hard to capture for the tax system are informal-sector employees. Since their income is often not declared to tax authorities by their employers, none of their salaries can be withheld at source. The size of the revenue losses from such workers is hard to estimate, but the high threshold for income taxation in Indonesia means that only informal workers earning substantially more than the average wage would be taxpayers if their employment status were formalised. Tackling informality is a long-standing issue in Indonesia, but the largest obstacles to formalising do not seem to come from the tax system. As discussed in the 2010 *Economic Survey*, generous severance payments, cumbersome business and dismissal procedures and high minimum wages are the principal deterrents to hiring workers on formal contracts. Tax wedges play a comparatively minor role in this context. Averaging 8.2% for a family of four at average wages in 2009, they consist only of social security contributions and compare favourably to the average of almost 30% in OECD economies (Gandullia *et al.*, 2012).

Expanding the PIT tax base involves not only an expansion in the number of taxpayers but also in revenues collected from current taxpayers. Evidence suggests substantial underreporting of taxable income, and the most significant revenue losses are likely to come from higher- and middle-income households. Reducing the scope of tax evasion and avoidance by affluent individuals should therefore be a high priority in improving PIT administration. A failure of elites to pay taxes may not only result in large revenue losses but also undermines the legitimacy of the tax system. In this context, the tax administration should consider making greater use of third-party information and employing indirect ways of assessing tax liabilities. The use of third-party information may include utilising data on assets from stock exchanges, customs administrators, the central bank or anti-money-laundering institutions. At a minimum, information on large assets or consumption items could be used as signals that can trigger tax audits even for individuals who are not registered taxpayers. The tax authorities have recently been authorised to use such information, although implementation is still pending. Deterrence also has a role to play, and a few high-profile cases with heavy sentences could send a clear signal. Indonesian tax authorities recently chose to denounce tax evaders publicly by communicating their names to the media, in addition to imposing legal sanctions including travel bans and prison sentences. The particular relevance of high-income individuals for both tax revenues and the perceived justice of the tax system also warrants setting up dedicated units within the tax administration, which Indonesia has successfully implemented through the establishment of a High Wealth Individuals unit, with technical assistance from the Australian Taxation Office. Establishing additional offices focused on affluent individuals beyond Jakarta should be considered.

Corporate income taxes

Indonesia currently generates around 45% of its tax revenues from corporate income tax (CIT). Assuming that a generalisation of empirical results on the "growth-friendliness" of different tax instruments to an economy like Indonesia's is valid, there may be reasons to be concerned about its comparatively large share of CIT. Indeed, CIT can curb firms' investment and productivity by reducing the after-tax profitability of investment projects and entrepreneurial risk-taking (Schwellnus and Arnold, 2010). As a result, they have been called "success taxes" (Gentry and Hubbard, 2006).

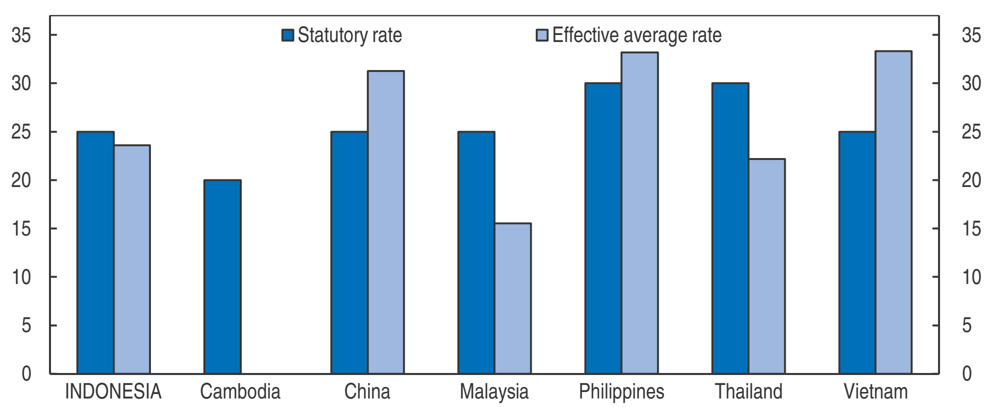
At the same time, two considerations are important to put the high share of corporate tax revenues in Indonesia into perspective. One is that the definition of CIT revenues in Indonesia includes a significant share of revenues from natural resources sectors, whose growth effects are quite different from taxes on other corporate profits, as will be discussed in the next section. Second, expanding alternative revenue sources, including from PIT, is likely to be more difficult in Indonesia than in the average OECD country with a more advanced tax administration. Indeed, the relative administrative ease of corporate taxation is a strong argument for not eroding CIT revenues until further progress has been made with other tax instruments. Even then it may turn out that, following the two recent statutory rate reductions from 30% in 2008 to a current level of 25%,[1] there may be no need to go lower.

Attracting foreign direct investment

An argument to avoid a higher corporate tax burden than other countries in the region is potential competition for inbound foreign direct investment (FDI), which may have positive effects on productivity and wages in the domestic economy (Arnold and Javorcik, 2009; Sjöholm and Lipsey, 2006). There is little evidence, however, that Indonesia's corporate tax burden is much different from other countries' in the region. Its 25% statutory rate is well in line with that of neighbouring countries, although Thailand and Malaysia have lower effective average tax rates (Figure 1.5). Effective tax rate calculations take into account differences in rates, bases (including depreciation allowances) and special regimes.[2]

Figure 1.5. **Corporate tax rates in regional comparison**

Statutory rates and effective average rates, 2012



Note: Data on the effective average tax rate in Cambodia are not available.

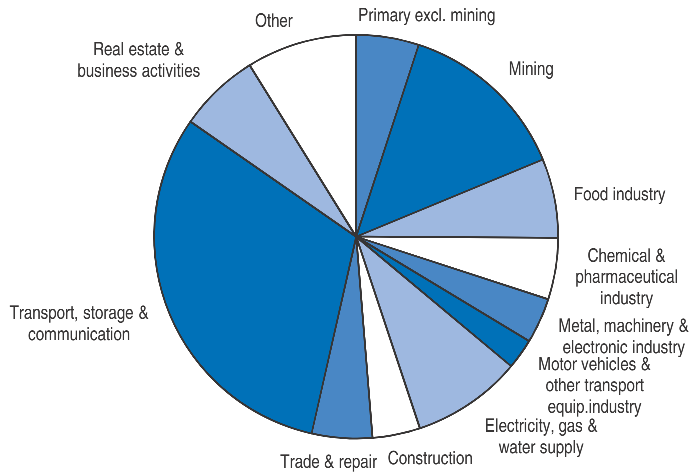
Source: Abbas, S., A. Klemm, J. Park and S. Bedi (2012), "A Partial Race to the Bottom: Corporate Tax Developments in Emerging and Developing Economies", *IMF Working Papers*, No. WP/12/28, International Monetary Fund, Washington, D.C. and www.taxrates.cc.

StatLink http://dx.doi.org/10.1787/888932711410

Indonesia's FDI inflows of almost 2% of GDP are only about half the level in the other six ASEAN economies in Figure 1.5. However, their increase between 2006 and 2011 compares well to this group, second only to Vietnam. This suggests that Indonesia is catching up with respect to its attractiveness for FDI. In 2011, Indonesia attracted nearly USD 19 billion in FDI inflows, which are spread across a number of sectors (Figure 1.6).

Figure 1.6. **FDI net inflows by sector**

2010



Source: Bank Indonesia.

StatLink http://dx.doi.org/10.1787/888932711429

Tax rates are only one element in foreign investors' location decisions. Lipsey and Sjöholm (2011) mention difficulties in the business environment, government institutions, skills and infrastructure as the principal impediments to stronger FDI inflows to Indonesia, and empirical evidence suggests a generally lower elasticity of investment to taxes in developing countries than in developed economies (Klemm and van Parys, 2009). Most importantly, lowering taxes should not be misunderstood as a possible way to compensate mobile foreign investors for shortcomings in other areas because this may risk removing one source of political pressure from necessary policy reforms in those areas while at the same time reducing tax revenues.

Tax incentives to foster investment

Following consultations with a number of industries, the Indonesian government has recently approved a number of corporate tax incentives aimed at supporting "cluster" industries deemed to have a strategic role for the national economy and fostering local development. These incentives are available in principle to 16 sectors, but individual projects become eligible only after receiving the approval of the chairman of the investment board BKPM (PWC, 2011). In addition, the government has announced a new set of temporary corporate income tax holidays over three years for new corporate taxpayers investing at least IDR 1 trillion (USD 105 million) in so-called "pioneer industries", including base metals, oil refining, textile machinery, alternative energy and telecommunications equipment.

Such measures erode corporate tax revenues, distort corporate taxation and create opportunities for policy capture. To ensure the transparency of tax policy, a public reporting of tax expenditure estimates should be introduced as a routine exercise, supplemented by periodic evaluations of particular measures. In addition, allowing discretionary decisions by government officials for specific projects on a case-by-case basis should best be avoided, as it creates incentives for policy capture and hence a particular challenge for institutional capacities. If investment promotion through tax incentives is considered necessary, this is typically better achieved by offering investment tax credits rather than exempting profits, and by doing so on a broad basis to tie tax expenditures tightly to the policy objective of raising investment. Investment tax credits are currently available for any business activity in any of 25 designated economic development zones (*Kawasan Pengembangan Ekonomi Terpadu*, KAPET). By contrast, outright tax holidays are generally viewed as the worst form of incentive, as they run the risk of entrenching corruption in the tax administration and may make it difficult for the tax authorities to evaluate the foregone revenues (IMF, 2011). Therefore, the Indonesian government should reconsider the recent set of incentives and tax holidays for selected sectors and investment projects.

A specific tax regime for small and medium-sized enterprises

The Indonesian authorities are planning to offer simplified tax treatment for small and medium-sized enterprises (SMEs). Currently, most SMEs are informal and do not pay any corporate taxes. Many keep no formal accounts. Enforcing SME tax payments runs the risk of placing a significant burden on local tax authorities without much revenue potential. At the same time, small enterprises often become bigger over the years, and from a longer-term perspective there may be a case for integrating them into a simplified targeted tax system early on. Given the need to allocate scarce enforcement capacities wisely, voluntary compliance will have to be the main pillar of such attempts, whence the need to reduce the high compliance burden faced by SMEs through simplified procedures and tax schedules. Many countries have designed simplified tax regimes for SMEs. One example of such a scheme is Brazil's *Simples Nacional* regime (Box 1.1). It should be kept in

Box 1.1. **Brazil's *Simples Nacional* tax regime**

In 2006, the Brazilian government introduced a simplified tax and regulation system for micro and small companies, called *Simples Nacional*. The legislation was revised in 2008 to further simplify the process. The rationale was to lower tax compliance costs for small firms and encourage them to move into the formal sector.

The *Simples Nacional* combines a range of taxes in a single monthly collection. Taxes that are included are the most important federal taxes and contributions. Micro businesses are defined as individuals or corporations with gross revenue less than or equal to BRL 240 000 (USD 120 000) in each calendar year. Between BRL 240 000 and BRL 2.4 million, the firm is considered small. Firms also have to comply with certain features regarding their ownership of other companies and the activities they are engaged in. Participation in the system is optional, and firms have to apply through a website. All states and municipalities must offer *Simples Nacional*. However, small states can adopt a different enrolment threshold for local tax collection. Municipalities must adopt the same threshold as their state.

In addition to *Simples Nacional*, a special programme encourages individual entrepreneurs (IEs) to become formal. IEs must first register with *Simples Nacional*. They cannot earn more than BRL 36 000 (USD 18 000) per year, must work alone or have only one employee, and cannot own or be a partner or manager of another company. They can work in most sectors, including trade, industry and a range of services. The programme grants a number of advantages. IEs are recorded in the National Register of Legal Entities, which facilitates the opening of a bank account, loan applications and issuance of invoices. IEs benefit from a simplified tax system. They are exempt from federal taxes and pay only a fixed monthly amount. These revenues are revised annually in line with changes in the minimum wage. In return, IEs have access to benefits such as a retirement pension, sickness and maternity leave and insurance for workplace accidents.

Box 1.1. **Brazil's *Simples Nacional* tax regime** *(cont.)*

Since its inception, participation in *Simples Nacional* has been steadily increasing. Because the threshold for enrolment is fairly high, around 70% of all firms pay tax under this regime. Tax collection through the simplified tax system has displayed a similar upward trend, except during the global financial crisis.

Simples Nacional is reported to have contributed to the observed decline in informality. According to official data, the size of informal labour markets declined steadily to 49% of total employment in 2010, compared with 52% in 2006. However, it remains hard to disentangle the effect of *Simples Nacional* from that of buoyant economic performance. There is also evidence that the IE programme has encouraged unregistered workers to become entrepreneurs.

Source: Simples Nacional's website: http://www8.receita.fazenda.gov.br/SimplesNacional.

mind, however, that simplified SME tax regimes have a tendency to create additional distortions as they are often based on revenues or presumptive income, causing disincentives for using intermediate inputs, and they discourage firms from growing above the threshold for graduating into the regular tax system.

The government's current plans include imposing a 2% annual turnover tax for businesses with revenues of between IDR 300 million and IDR 4.8 billion, in addition to establishing a 0.5% tax on enterprises that have monthly revenues below IDR 300 million. As regards enforcement, these plans are going to be supported by the currently ongoing tax census. The combination of a low tax rate, simplified procedures and decisive action to enforce compliance seems a reasonable way forward, even if it is clear that the implementation challenges ahead are still substantial.

Resource taxes and royalties

One of Indonesia's particular characteristics is its rich endowment of natural resources, and the rents associated with the extraction of exhaustible resources are an obvious tax base. Taxes on natural resource extraction stand apart from all other tax instruments for a variety of reasons (Box 1.2). In Indonesia, the aggregate oil, gas and minerals sector generates approximately 30% of government revenues, summing both tax and non-tax revenues, which is very significant from a revenue perspective, although far from the maximum in international comparison (Figure 1.7).

Box 1.2. **Taxation of natural resource extraction**

Extraction of natural resources typically generates economic rents in the form of returns that far exceed the remuneration of capital and risk-taking in other sectors. These excess returns represent a unique case of a tax base that can be taxed without generating distortions. The extensive literature on the topic is mostly centred on issues of how to implement such taxes in the face of a number of specific sector characteristics, including significant uncertainty, high sunk costs, long payback periods and high output price volatility (Daniel *et al.*, 2009).

Box 1.2. **Taxation of natural resource extraction** *(cont.)*

Two of the most commonly used approaches to natural resource taxation include output-based tax instruments such as royalties, and resource rent taxes on profits. The principal difference is that rent taxes take the costs of the extracting companies into account, while royalties do not. Since a significant part of the risk in resource extraction is related to costs, a rent tax means that the government accepts a larger share of the risk, in return for a potentially larger government take. The base for levying royalties is typically either production revenues (in the case of Indonesian schemes) or quantities. Royalties generally do not take into account the cost of exploration and may thus discourage investment in exploration and development of new mineral deposits. As compared to rent taxes, royalties are more likely to influence the decision to produce or not, because they are insensitive (or less sensitive) to costs. As a result, royalties have a tendency to deter investment in marginal projects and to encourage early abandonment of those at the end of their productive lives. Royalties have also been criticised for their regressive character: they tend to overtax projects with high costs and accordingly low profitability.

In contrast, a rent tax attempts to set the tax base as closely as possible to the resource rent. In one theoretically clean form, called a Brown tax, this would effectively make the state a silent partner in the project (Brown, 1948). The state would pay out cash to the private company in years of negative profits and get a positive profit share in years of positive profits. The idea of the government paying out cash in the early years when expected profits are naturally negative has been unpopular in most countries (with the exception of Norway). Therefore, a modified version of a rent tax typically eliminates the cash payout from the government in the early years in return for tax revenues kicking in only once a cumulated threshold rate of return has been met. Israel's recent offshore gas regime is such a scheme (OECD, 2011b). The threshold rate in Australia's petroleum resource rent tax is calculated as a risk-free rate of return plus a risk premium. This approach tends to make a warranted separation between the profits that result from capital and "normal" entrepreneurial risk, which should be taxed at rates close to the standard corporate tax rate, and the economic rent that should be taxed at higher rates.

There is a growing consensus in favour of rent taxes rather than royalties, which are typically treated as non-tax revenues in national accounts. Alaska, China and Algeria have introduced profit-based taxes in recent years (van Meurs, 2009; Johnston, 2008). Australia's new mineral resource rent tax (MRRT) on coal and iron ore operations, along with the extension of the petroleum resource rent tax, are further examples.

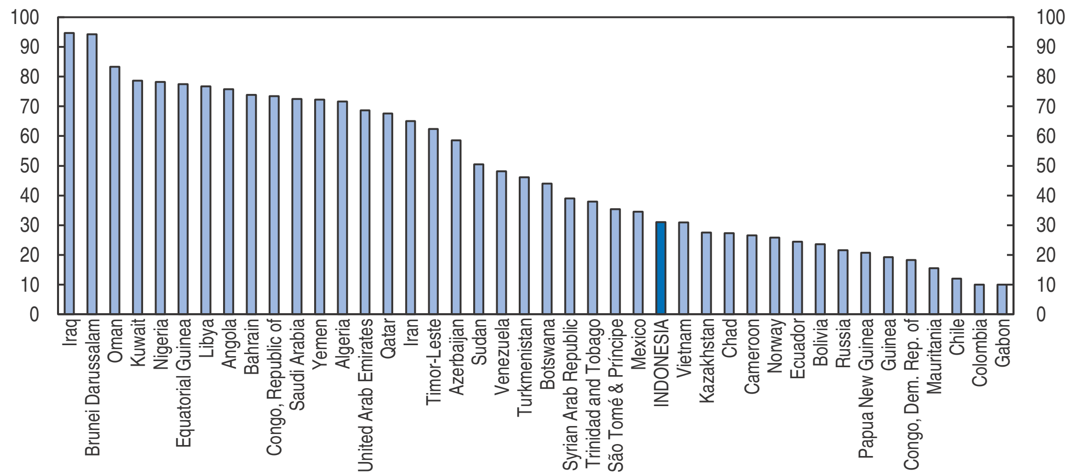
Indonesia is one of few countries where both oil and gas and also mining contribute significantly to GDP. Currently their relative importance for the national economy is about equal at slightly above 5% of GDP each. The trend over the last decade points to oil and gas losing and to the mining sector gaining weight (Figure 1.8). The two broad sectors have separate and quite distinct fiscal regimes. In addition, there are considerable differences in the tax treatment of different projects even within these sectors.

Oil and gas sector

In the oil and gas sector, Indonesia's fiscal regime is largely based on production-sharing contracts (PSCs). These split the extracted oil between the government and the contractor according to an after-tax share, typically around 85/15 or 65/35 for marginal oil fields. Gas PSCs usually involve a 70/30 split but are otherwise similar to oil PSCs. Under

Figure 1.7. **Receipts from petroleum and minerals**

Per cent of government revenues (average 2000-07)



Source: International Monetary Fund (2011), "Revenue Mobilization in Developing Countries", *Policy Paper*, Fiscal Affairs Department, International Monetary Fund, Washington, D.C.

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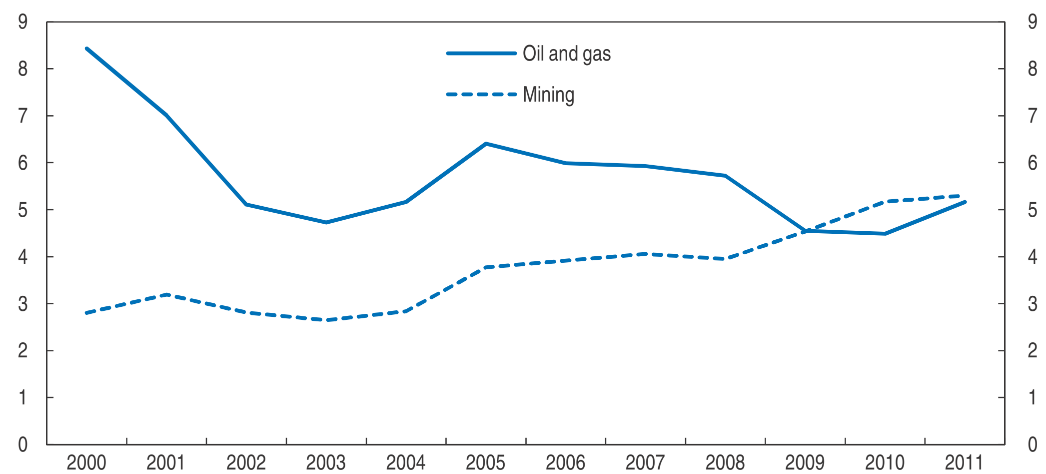
Figure 1.8. **Oil and gas *versus* mining value added**

Per cent of GDP



Source: Statistics Indonesia.

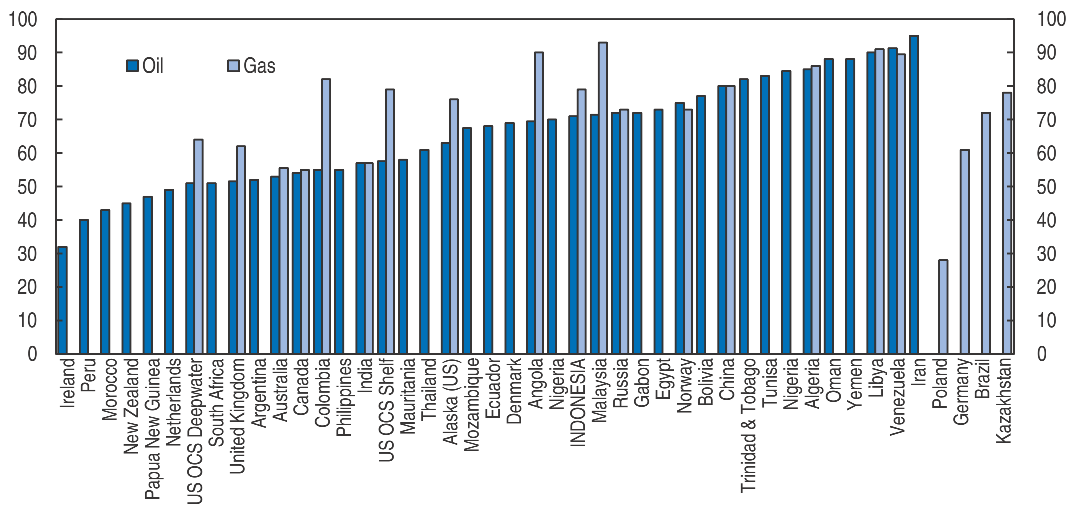
StatLink http://dx.doi.org/10.1787/888932711467

this kind of arrangement, the contractor bears the entire risk of discovery and development, and no costs are recoverable if a project turns out unsuccessful. In the production years, the contractor has the right to claim reimbursement for certain current-year operating costs, depreciation of capital equipment and losses carried forward, although some contract elements put an effective limit on cost recovery (so-called first-tranche oil). In 2008 and 2009, the government set an additional global ceiling to cost recovery across all projects in the national budget, which was widely blamed for poor results in the 2008 and 2009 bid rounds and was later abandoned. However, a number of items were explicitly labelled non-recoverable in a 2010 regulation, and costs for exploration and development incurred before the beginning of production continue to be entirely non-recoverable. Specific investment credits are available as incentives for marginal fields with a rate of return below 15%.

Assessing the exact split in profits that the different and complex oil and gas tax regimes generate is not a straightforward task. Available estimates of the average government take (GT) of Indonesian PSCs vary, and not all are in the public domain. Johnston (2008) estimates Indonesia's average GT at 72% for the petroleum sector, noting that it has declined by more than 10 percentage points over 1998-2007. This places Indonesia 26th of the 45 petroleum tax regimes examined in his study, ordered by increasing GT (Figure 1.9). The average GT in the Indonesian gas sector is estimated at around 82% (Agalliu, 2011). Given that some countries have higher government takes than Indonesia, there may be some scope for increasing it, although there is much uncertainty surrounding these comparisons.

Figure 1.9. **Average government take in oil and gas fiscal regimes**

Share of profits captured by the state



Source: Agalliu, I. (2011), "Comparative Assessment of the Federal Oil and Gas Fiscal Systems", U.S. Department of the Interior, Bureau of Ocean Energy Management, Herndon, VA, for oil, and Johnston, D. (2008), "Changing Fiscal Landscape", *Journal of World Energy Law & Business*, Vol. 1, Iss. 1, pp. 31-54, (by permission of Oxford University Press) for gas.

StatLink http://dx.doi.org/10.1787/888932711486

It is questionable whether the Indonesian government would be able to raise its take without greater recognition of the costs involved in exploration and development. Two countries that persistently rank higher than Indonesia with respect to the GT in both oil and gas, Libya and Algeria, have made steps towards reducing the risks to the private sector by moving towards a rent tax (Box 1.2). Given the declining trend of oil production in Indonesia, the exploitation of marginal fields is likely to become more important in the future, and these fields involve more risk than those already exploited.

At the time when the current PSC scheme was developed, reasons for the state's reluctance to take into account exploration and development costs may have included a desire to smooth revenue streams in the light of financing constraints. Today, however, Indonesia's solid and diversified economy, and constantly improving access to international financial markets may be sufficient reason to rethink some of these choices. Indonesia is better placed to bear fiscal risk than in the past, and its ample portfolio of natural resource projects presents scope to diversify such risks. Financial markets present an alternative way to smooth revenue streams. The cost is most likely lower than the tax revenue that the country currently loses for its reluctance to recognise costs and risks of exploration and development. The Indonesian government should consider allowing for recovery of exploration and development costs in future PSCs and investigate partial cost recovery even in the case of unsuccessful drillings. While remaining within the current PSC framework, this would move the fiscal regime closer to a taxation of rents and strengthen incentives for exploration and development at the same time, consistent with the government's declared goal to raise the lifting targets for petroleum and natural gas. The amount of risk that has to be assumed by contractors could also be reduced if the government commissioned and published basic geological and seismic data on new acreage before offering it for development (Collier, 2009).

Current PSCs also have provisions for one-off bonuses to be paid upon signature, the start of production or above certain threshold levels of accumulated production. Such contract elements effectively amount to borrowing against future resources and usually offer fairly unfavourable terms of borrowing (Collier, 2009), which creates a strong case for not including such clauses in future PSCs.

Libya – which also uses PSCs – has had positive experiences with "Dutch auction" bidding processes in which companies presented sealed-envelope bids of how small a share of production they would accept. This has resulted in government takes of around 95% (Johnston, 2008). Auctions are particularly helpful to mitigate the acute asymmetry of information and can help to limit the scope for corruption that exists in negotiated deals (Collier, 2009). Indonesia should consider using "Dutch auctions" as an allocation mechanism for future PSCs to raise the government take.

Mining sector

The fiscal regime facing the mining sector is governed mostly by provisions in individual mining contracts and licenses that override current law, although a new mining law was implemented in 2009 with the intention of improving the transparency of rules governing the sector. Under current practice, holders of mining licenses (IUPs) are typically required to pay *ad valorem* royalties, with rates varying between 2 and 7% of revenue, according to the mineral produced. In addition, there are land taxes based on the surface area mined. Royalties and land taxes are deductible from taxable income, which is subject to the standard 25% corporate income tax. For licenses in state reserve areas (IUPK), an additional 10% tax is levied on net profit, which is not deductible from taxable income. Operating expenses can be deducted from taxable income with a five-year loss carry-forward provision, while exploration and mine development expenses can be capitalised and are subject to depreciation.

Given that royalties and land taxes are credited against taxes due, the effective income tax burden is determined by either the corporate tax rate of 25% or by the royalties based on turnover, whichever is higher. Some additional levies, local taxes and indirect taxes have to be paid by mining companies. In 2010, the effective tax rate on profits of 25 large mining companies for which annual accounts are publicly available was only 40%.[3] The mining sector contributed around 6% to total tax revenues in 2010, which is only slightly above its share in GDP. Adding non-tax revenues to this calculation, the ratio rises to 6.3%. In other words, the fiscal burden on the mining sector is not far from the average burden paid by all other sectors, which seems too low given that this is a sector where resource rents accrue. Yet, due to a lack of internationally comparable data for the government take in mining activities, it is difficult to put the tax burden on Indonesian mining activities into international perspective.

In the early years of a project when profits are negative or the five-year loss carry-forward rules apply, royalties are due despite the absence of a positive rent. As in the case of oil and gas bonuses, these early royalties amount to government borrowing against future profit shares, and the implicit interest charged on such deals is likely to be higher than the terms available on financial markets. In order to shift towards taxation of rents, turnover-based royalties should be reduced or abandoned. Once the corporate tax base turns positive and resource rents accrue, such rents should be taxed at a higher rate than the standard corporate tax rate (Box 1.2). One fairly easy step in this direction would be to extend the non-deductible 10% net profits tax on mining activities in state reserve areas (*IUPK*) to the standard mining licenses (*IUP*), with loss carry-forward extended to recognise all exploration and development expenses. If deemed necessary, this rate could be raised later.

Moving towards a mining tax regime based on taxing resource rents could be achieved in several ways. The cleanest and most complete overhaul would include doing away with the current royalty system altogether, and moving instead towards taxing profits at a high rate, possibly once a threshold level of accumulated profitability is reached. This would get the incentives right by ensuring full consideration of costs, including those for exploration and development. Implementing such a shift may involve challenges, as the recent experience of Australia has demonstrated, but these challenges are more severe for smaller companies than for the large mining companies that account for the bulk of public revenues from the sector. Alternatively, if abandoning the current royalty system is deemed difficult to implement, there may still be scope to improve both the current system and in particular to raise the government take in the mining sector. Israel, for example, has opted to maintain an existing royalty system and complemented it with a threshold-based rent tax for which all project costs are taken into account. Such a system would maintain the borrowing feature of royalties being due while rents are negative, which may be sub-optimal, but it would shift the tax base onto rents once these accrue. Royalty payments should be taken into account for calculating the accumulated profitability threshold, so that *ex post* taxes paid will depend fully on the size of the resource rent.

Political pressure for bringing more of the benefits of Indonesia's resource wealth to the population at large is visibly on the rise. Talk of benefit-sharing intensified last year in parliament during a three-month strike at a large foreign-owned gold and copper mine, which ended with a 37% pay hike for workers. The existence of such political pressure is understandable and justified, given the evidence of low effective tax burdens on Indonesian mining operations, but the instrument to improve the benefit-sharing should be carefully chosen. Taxing the economic rent at higher rates than at present would be the most efficient way to achieve this, while turnover-based royalties and export taxes distort efficient resource allocation and hamper long-term productivity growth (see section on international trade taxes below). The export ban of selected raw minerals which became effective in May 2012, with an exception for miners that plan to build local processing facilities, is economically akin to an infinitely high export tax rate and is undesirable. The recent debate about export taxes and bans also highlights a significant degree of regulatory uncertainty, which is not conducive to extracting higher tax revenues from mine operators while continuing to attract foreign investors and expertise. The public at large would probably be best served by an efficient tax regime for resource sectors to ensure that the largest part of resource proceeds accrues to the state, while otherwise creating as little distortion as possible in resource-based activities. A shift towards rent-based taxes would bring sufficient flexibility to the system that there would be no need to revisit the tax regime in the case of unexpected profit increases.

Taxes on international trade

In comparison with OECD economies, Indonesia's revenues from taxes on international trade transactions, which amount to 0.5% of GDP, stand out as very high, although lower than in many countries in the region. Traditionally, developing economies have relied to a greater degree on taxing international trade than developed economies, not least because cross border flows are comparatively easy to tax. The global trend towards trade liberalisation has therefore presented challenges for public finances in many developing countries, as tariff revenues have had to be replaced by alternative sources. In this respect, Indonesia and other ASEAN countries have come further than developing economies in other regions of the world. For the average developing economy, trade taxes still constituted around 16% of tax revenues between 2005 and 2009, as compared to 4% for Indonesia. The rates of import duties have fallen in Indonesia, conferring benefits on consumers as well as on firms relying on imported intermediate inputs. Amiti and Konings (2007) estimate that a 10 percentage points reduction in input tariffs has raised the productivity of Indonesian firms that use imported inputs by as much as 12%.

At the same time, almost half of Indonesia’s trade taxes are levied on exports. The government plans to make further use of export taxes, as evidenced by the recent decision to levy a 20% tax on selected mineral ore exports, and the introduction of export taxes on crude palm oil and cocoa. Indonesia’s export taxes on commodities have been designed with several objectives in mind, including price stabilisation, food security and fostering the development of downstream processing industries. In the case of mining, they may also serve to slow the pace of depleting non-renewable resources and polluting extractive activities. Although compliant with multilateral trade agreements, export taxes typically divert trade and have therefore been prohibited in many regional trade agreements (Piermartini, 2004). On the other hand, from the perspective of an individual country that has market power in a given export good, as in the case of Indonesian palm oil exports, export taxes may generate terms-of-trade gains and thus higher real incomes at the expense of foreign buyers.

Export taxes confer a competitive advantage to domestic processing activities by keeping the domestic price of the taxed good below the world price. This comes at the expense of the upstream commodity producers, who receive the lower price. As a result, downstream processing industries can develop even when their costs are otherwise higher than in other countries. By moving production away from the lowest-cost location, export taxes reduce overall economic efficiency at a given point in time. From a dynamic perspective, this picture may change if there are learning effects, meaning that the downstream activity reaches competitive levels of productivity after some time. Under the assumption that such dynamic effects exist, export taxes can enhance economic efficiency when used as a temporary measure.

A number of countries have pursued development strategies whose underlying economic rationale included infant-industry arguments. These strategies have failed in some countries and succeeded in others. Where they have worked, the basic framework conditions for the industries concerned were typically favourable – including the quality of infrastructure, access to other inputs such as reliable energy supplies, skilled labour or the quality of public governance. Some of these features, however, may well explain why processing industries are currently not located in Indonesia, and addressing these issues will be a precondition for the development of a successful and efficient processing industry – with or without an export tax. While the payoff from policies aiming to improve these structural conditions is high and qualitatively certain, a strategy based on granting a temporary cost advantage is risky – and may well fail unless the deeper structural weaknesses are resolved. Levying export taxes runs the risk of creating an inefficient processing industry whose survival is contingent on making the export taxes permanent, resulting in rent-seeking and obvious costs for economic efficiency.

Since export taxes are levied on export revenues, they also distort production decisions in the affected commodity sectors, just as revenue-based royalties do in the case of natural resource sectors. For the mining sector, an alternative strategy to the use of export taxes would be to minimise the policy-induced distortions and levy a high tax on the resource rents instead. The benefits of such a strategy are likely to exceed the uncertain dynamic benefits of an export tax. For other commodity sectors like cocoa and crude palm oil, the possible downstream benefits of an export tax should be weighed against the expected revenue losses inflicted on the two commodity sectors themselves. Whether the net benefit of such a shift is positive should not be taken for granted. Merely observing increased output in processing industries is not sufficient evidence for judging the success of the overall strategy. At the same time, progress on the urgently needed structural policy changes is likely to take time to materialise, and the authorities therefore view export taxes as an alternative instrument. However, they are clearly only second best, and their economy-wide effects, including their effects on international trade will need to be carefully monitored.

Consumption taxes

Consumption taxes, and in particular a well implemented value added tax (VAT), usually create far less distortions than taxes on factors of production like the PIT and CIT. Consumption is typically a less mobile tax base than labour and capital, and consumption taxes are neutral to saving as long as tax rates are expected to remain constant over time. Many developing countries that have in the past relied strongly on import taxes have replaced them by consumption taxes over recent decades. While consumption taxes have often been criticised for their regressive effects on income distribution, the debate on this issue has not reached a clear conclusion. Zolt and Bird (2005) note that in developing countries "the evidence is…that the VAT is likely on the whole to be less regressive than the trade and excise taxes it has replaced", a finding that is also supported by Gemmell and Morrissey (2003). At the same time, much of the regressive effect of a VAT disappears if one takes a life-cycle view rather than looking at a snapshot of the income distribution (Caspersen and Metcalf, 1994). Given the substantial revenue potential of a VAT, its distributional impact should be assessed jointly with the expenditure side, because, if coupled with higher social expenditures, the redistributive effects of VAT-financed spending increases may be progressive.

Indonesia has two kinds of consumption tax: a general VAT that accounts for about 80% of consumption tax revenues; and a number of specific excise taxes on consumption items considered luxury goods. VAT revenues relative to GDP have been fairly stable over the last decade and stood at about 3.6% of GDP in 2010. This is more than in Malaysia and the Philippines and similar to the situation in Thailand; Vietnam and China raise substantially more revenues from VAT (5.8 and 7.1% of GDP in 2010, respectively).

Value-added taxes

Indonesia's VAT seems well designed in general, combining a number of desirable features. It is levied at a single rate of 10% on domestically added value and on imports. Taxing value added is – unlike a sales tax – in principle neutral with respect to the organisation of the value chain, because it taxes only the additional value created at each step. A single rate facilitates administration and avoids distorting individual consumption decisions. Many OECD countries apply lower tax rates to consumption items that are considered basic and therefore more likely to be consumed by low-income households, but such differentiated VAT rates have generally proven to be rather poor redistribution tools because low-rated goods are often consumed heavily by high-income households as well, thereby creating extensive leakage.

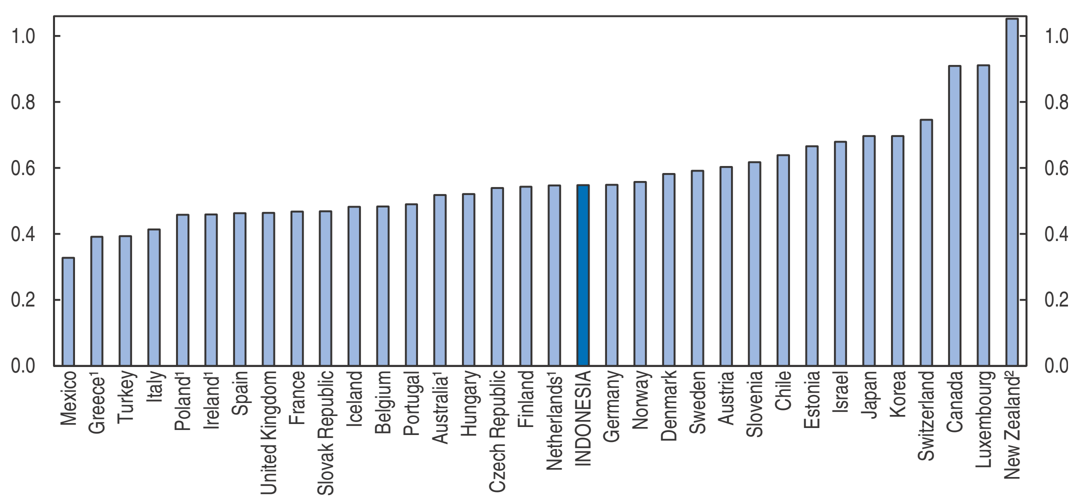
Indonesia applies fairly high exemption thresholds for SMEs (IDR 600 million annually, equivalent to USD 65 000), which may be justified on the grounds of the high compliance costs they face and because it allows the tax administration to concentrate its efforts on taxpayers with higher revenue potential. High thresholds are also an effective way to increase the progressivity of VAT because they confer a competitive advantage on small retailers and their customers, who are likely to be less well off. High thresholds also reduce the incentives for SMEs to remain informal. At the same time voluntary registering should always be easy for SMEs with a high intermediate input content that wish to opt into the VAT system. In fact, trade in intermediate goods may create virtuous circles if a trader's customers are registered for VAT, thus making it advantageous for the trader to register as well (de Paula and Scheinkman, 2006).

How efficient a VAT is in reality depends crucially on whether the tax base is broad, including all consumption, and whether the administration is efficient. VAT bases are often narrowed by exemptions, which create a break in the credit chain because the producers of VAT-exempt goods and services – and hence also all downstream activities – are unable to claim refunds on VAT paid at earlier production stages. Exemptions go against the spirit of a VAT by taxing intermediate transactions rather than just value added and create distortions that may go well beyond the exempt sectors themselves. They also take away the mutual interest of transacting parties for the other party to comply with VAT, which further reduces compliance incentives. Indonesia has exempted a considerable number of activities from VAT, including many food items and farm products, animal feed, coal and other minerals and electricity consumption at quantities usually demanded by residential consumers. Hotels, restaurants and entertainment services are also VAT exempt but subject to specific local sales taxes, which are often higher than VAT rates. In addition, Indonesia excludes a number of sectors entirely from VAT, like many other countries, on the grounds that taxing them would be difficult to administer (financial services) or that they are meritorious (education, health and cultural services). Postal services, broadcast advertising, public transportation, employment and training services are also exempt, and in June 2012, the government further exempted public transportation services from VAT. In the oil sector, contractors are typically exempt from VAT on approved capital items and cannot claim VAT reimbursements on inputs (PWC, 2011). This favours the use of imported intermediate inputs on which no VAT is levied in the exporting country and hampers the integration of the oil sector into the domestic economy. The same holds for mining activities (whose output is VAT exempt), with the exception of capital equipment in those cases where firm-specific contracts provide VAT exemptions that override general tax law. Finally, all economic activity on the island of Batam is VAT exempt. This island with 1 million inhabitants acts as an offshore manufacturing centre for Singapore, which is only 20 kilometres away. There have been repeated reports that this exemption is difficult to administer and creates leakage, although the extent of this is hard to evaluate (Brondolo *et al.*, 2008).

As in most other countries that apply a VAT, exports are subject to a zero rating, but exporters can claim refunds for VAT paid at earlier stages of production. This is what makes a zero rating fundamentally different from an exemption. The zero rating of exports is in line with the destination principle according to which VAT is applied to goods and services according to the tax schedule of the destination country.

One way of gauging VAT efficiency is a measure called the VAT revenue ratio or C-efficiency, which compares actual VAT revenues to those that would be obtained by applying the standard rate on all domestic consumption. While this measure is not perfectly correlated with the quality of implementation of a VAT – it would rise if refunds to exporters are incomplete, for example – it is nonetheless a useful simple way of comparing VAT systems internationally. This comparison reveals that Indonesia is situated in the upper-middle range of OECD countries (Figure 1.10). This is in line with the observation by IMF (2010) that VAT revenue ratios are not systematically much better in developed economies, although the reasons for low efficiency tend to be different between these groups. Low VAT revenue ratios tend to reflect low compliance in emerging-market economies, as opposed to a greater degree of imperfection in policy design, including different rates, in developed countries (IMF, 2010).

Figure 1.10. **VAT revenue ratios, 2010**



1. Data for 2009.
2. New Zealand raised its VAT rate from 12.5% to 15% on 1 October 2010, which raises its ratio above 1.
Source: OECD calculations.

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In Indonesia, the principal ways through which VAT revenue ratio could be raised would be by reducing the number of exemptions and enhancing compliance, both of which should be priorities in order to exploit the VAT's full revenue-raising potential. IMF estimates suggest that improving Indonesia's VAT revenue ratio to the level of Thailand's could increase VAT revenue by 1.8% of GDP without raising the rate (IMF, 2011a). Part of Vietnam's successful efforts to raise the tax take over the last decade involved a reduction in the number of VAT exemptions.

Improving VAT compliance requires measures to strengthen the incentives for voluntary compliance, in addition to stricter controls in case of suspected non-compliance. Voluntary compliance could be enhanced by simplifying a number of procedures, including not requiring an original invoice for every single transaction, faster processing of refund claims and a reduction in the number of VAT audits. At present, every small VAT refund claim automatically triggers a tax audit, which makes participation in the VAT system onerous and puts a heavy burden on the limited resources of the tax administration.

Specific excise taxes and carbon taxes

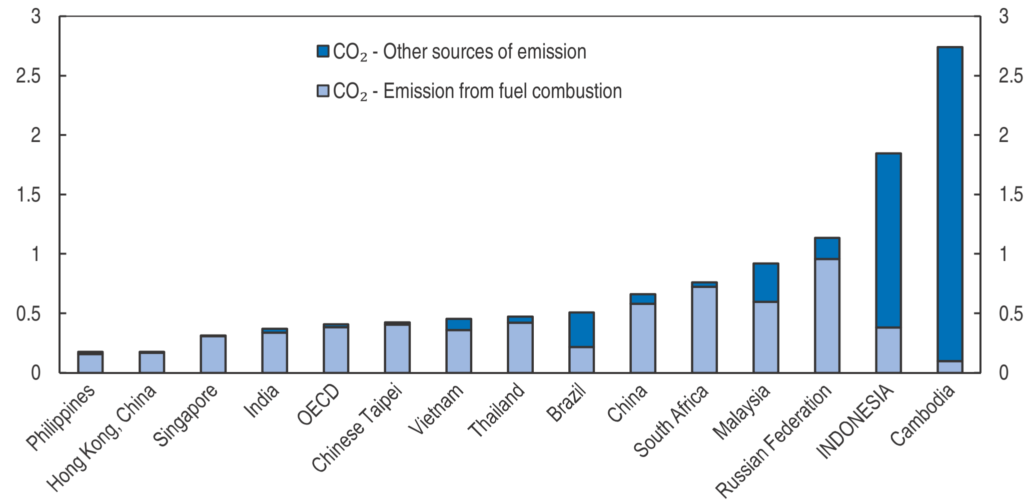
The system of specific excise taxes applied in Indonesia is less neutral than the VAT in the sense that it distorts consumption decisions away from items subject to these taxes. Of course, there may be a number of valid reasons for accepting or even seeking such shifts. Many countries levy specific excise taxes on goods with negative externalities, including alcohol, cigarettes and automotive fuel. At the same time, even where there are no externalities at work, specific taxes on luxury items may be useful because they are fairly easy to administer and for their distributional impact. In the context of Indonesia's skewed income distribution, identifying goods that are mainly consumed by affluent individuals may be considerably easier than in more egalitarian societies. The authorities raised the tobacco excise tax in January 2012 from 12.6% to 15% and have plans to raise it further. In May 2012, the government decided to reduce the luxury goods sales tax for small environmentally friendly cars, although some of the details are yet to be decided. This may be a useful way to lower the emission intensity of car transportation in Indonesia, although not necessarily of overall emissions. However, making the incentive dependent on the amount of locally sourced inputs, as has been discussed, adds a protectionist element to the scheme and should be avoided.

One case of a tax that can be justified on externality grounds is a carbon tax. Energy demand in Indonesia is growing by around 7% annually, and the externalities caused by the resulting carbon emissions are not reflected in current market prices, which embody fuel and electricity subsidies, resulting in energy use above optimal levels. In fact, Indonesia is one of the most CO_2-emission-intensive economies in the world, although most of its emissions result from deforestation, rather than from energy combustion (Figure 1.11). Electricity generation is based to an increasing extent on coal in order to reduce the reliance on oil imports, although a proper accounting of the economic externalities of coal firing would make the choice of coal look less beneficial than portrayed by current price signals.

Carbon taxes are under consideration but do not yet exist in Indonesia, while at the same time the subsidies on fuel and electricity are akin to taxes applied at negative rates. Raising the price of carbon emissions would raise the price of activities that are heavy carbon emitters relative to low-emission alternatives, and a carbon tax would be an effective instrument of environmental cost internalisation that would help rebalance

Figure 1.11. **CO_2 emissions intensity by country, 2008**

Million tonne CO_2 equivalent per GDP in PPP (billion 2000 US dollars)



Source: International Energy Agency (2011), *CO2 Emissions from Fuel Combustion*, Paris.

StatLink http://dx.doi.org/10.1787/888932711524

growth towards lower carbon intensity. A Green Paper by the Ministry of Finance has suggested to "work towards the implementation of a carbon tax on fossil fuel combustion, in parallel with a removal over time of energy subsidies" (Ministry of Finance, 2009). This strategy is a promising way forward and should be put into practice. While lowering fossil fuel subsidies would be a strong contribution towards reducing the carbon footprint of the economy, their reduction should not be seen as a precondition for introducing a carbon tax. Fossil fuel subsidies are currently affecting consumption choices of final fuel consumers, but the introduction of a carbon tax would provide an immediate price signal to reduce the emission-intensity in power supply and industry, in particular with respect to future investment decisions. Introducing a carbon tax at an initially relatively modest level might help to reduce the political resistance towards such taxes.

Property taxes

Property taxes, in particular recurrent taxes on immovable property, are generally considered to have more favourable growth effects than other tax instruments (Arnold *et al.*, 2011). Even though their incidence is not fully understood (Sennoga *et al.*, 2008), the positive correlation between real estate values and the wealth or incomes of their owners suggests that this tax will be heavily borne by the well-off, in particular when levied at progressive rates, as is the case in Indonesia. Since the value of real estate is often enhanced by public expenditure on infrastructure in the surrounding area, property taxes may also serve as a way to recoup some of the costs thereby incurred (Trinh and McCluskey, 2012). Even from an administrative point of view, property taxes compare fairly well, because real estate is easy to observe. These features can make property taxes an attractive tax instrument that should be part of any strategy to increase tax revenues, although the revenue potential of even a well designed and administered property tax has its limits. In Indonesia, property taxes amounted to less than half a percent of GDP in 2011. Among ASEAN countries, property taxes usually also account for a very small fraction of revenues. The average OECD country raises around 1.8% of GDP from property taxes, although in several OECD countries property taxes account for over 3% of

GDP. In some countries, these figures include taxes on financial wealth, which Indonesia does not have. Such taxes can escalate to high rates on capital returns, and the case that financial wealth is easier to observe than the income derived from it is rather weak.

Land and buildings are currently taxed at a rate of 0.5% of the taxable sale value, where the latter is set at either 20% of the estimated resale value for properties below IDR 1 billion or 40% otherwise. Hence, the effective property tax rate is progressive, at 0.1% or 0.2% of the assumed resale values. The main challenge in designing property taxes lies in evaluating the assumed resale values, especially for properties that have not been on the market for many years. As a result, many countries apply property taxes on the basis of outdated property values that are below market values, a problem that is also severe in Indonesia. Some estimates suggest that only 40% of potential revenues are collected due to the undervaluation of properties. In order to increase property tax revenues, assumed resale values should be brought up to date and re-evaluated regularly. If such regular updates turn out difficult in the current setup, the tax authorities should consider moving towards simpler forms of assessing the tax base for property taxes.

Real estate values depend on the size and location of the land and the buildings on it. In light of administrative constraints, Vietnam, for example, has successfully implemented a simple property tax by focusing only on the former element in assessing property values. Location within an urban area is assessed through an adjustment coefficient that reflects the type of urban area and the overall quality of the street that the land fronts. Such area-based property taxes are commonly used to assess property in the absence of a well developed real estate market in developing economies (Rao, 2008). In addition, some countries also factor in an assessment of the value of a property based on the constructed surface area of the buildings on the property. In this simple form, the administration of property taxes requires mostly surface-area measurement and avoids the need for costly collection and analysis of detailed market data (Bing *et al.*, 2009). Several countries in Central and Eastern Europe (Czech Republic, Hungary, Poland, Slovak Republic) have implemented new area-based property tax systems, and there is evidence that these work well in these transition economies (McCluskey and Plimmer, 2011). Maintaining Indonesia's progressive effective tax rate would be compatible with assessing property values on such a simplified basis. Given that Indonesia has decided to delegate the administration of property taxes to the municipal level, where administrative capacities are likely to be more limited, a simplified way of assessing property values that can be easily updated may be a useful step towards increasing property tax revenues.

Property taxes also include transaction-based taxes such as stamp duties or transfer fees. The distortions resulting from such non-recurrent property taxes are far greater than those of recurrent taxes on real estate because they reduce the liquidity of real estate markets. This may result in reduced geographic mobility for households, thereby hampering labour-market adjustment to local shocks, and adds to the burden of registering business property for enterprises. In Indonesia, stamp duties are set by provincial governments. According to World Bank (2012), the average cost to register property is about 11% of the property value. This is almost triple the average cost in its neighbours in the region. Reducing the tax burden on property transactions and shifting it towards recurrent property taxes would cut the cost of doing business and reduce distortions on real estate markets without any harm to the budget.

Improving the efficiency of tax administration

Indonesia embarked on a complete overhaul of its DGT in 2002 with support from international donors including the World Bank. The principal challenges that the reform aimed to deal with included weak organisational structures, poorly trained tax officials, significant integrity issues and extensive non-compliance. The reform package was designed around four main pillars. First, through a re-organisation of tax offices DGT has moved away from duplicative and narrowly focused tax-by-tax approaches towards function-based structures and taxpayer segmentation based on size. This has resulted in the creation of special large taxpayers' offices. Headquarters organisations have been established to guide these function-based structures. Second, human resource management has been modernised, including by reviewing remuneration policy. Third, a more intensive use of information technology has led to an updating of administrative processes, including the introduction of electronic filing and registration, and risk analysis. Fourth, a focus on better governance and integrity through codes of conduct, internal control units and whistleblower protection has improved the tax authorities' reputation. DGT has also started to provide a wide range of informative tax publications and conducted various active tax education programmes. These substantial efforts have borne fruit in the form of an estimated 1.2% of GDP in additional revenues due to improved tax collection, which should provide encouragement for further progress in this area (IMF, 2011b). Indeed, a number of challenges remain for tax administration, as evidenced first and foremost by Indonesia's low tax take despite a tax policy design that is broadly reasonable and not as far from international best practice as the low level of revenues might suggest.

A key element of the success of Indonesia's tax administration reform so far has been the establishment of large taxpayers' offices, which have allowed the administration to devote more attention and resources to those taxpayers with the largest potential for increasing public revenues. With only four such tax offices for the entire country, however, there seems to be scope to take this strategy further by rolling out more of them across the country, while ensuring that they implement a robust overall strategy in a consistent manner. Besides dealing with the 700 largest companies on matters related to CIT and VAT, these offices should devote more resources to high-wealth and high-income individuals, especially after a number of cases of tax avoidance by members of the country's elite have attracted much public attention and eroded the public trust in the legitimacy of the tax system. A natural next step is to devote more attention to medium-sized taxpayers, as Indonesia has started to do by creating 28 medium-sized taxpayers' offices. The focus of the approximately 300 small taxpayer offices – resulting from merging former Tax District Offices, Tax Audit Offices and Property Tax Offices – should be a thorough implementation of the tax census that the government has initiated in order to expand the number of taxpayers at the local level. In the course of the delegation of property tax collection to the municipal level, these local tax offices will be formally responsible for administering property taxes as of 2014. Given that their capacities are typically lower than in other parts of the tax administration, the DGT headquarters has recognised the need to provide them with continued assistance in administering these taxes. A simplification of the assessment of the tax basis for property taxes, as recommended in the previous section, may also help to ease the burden on these field offices.

Improving the tax administration's institutional capacity will also require better training of tax officials. Taxpayers frequently report significant variance in their capabilities both across regions and within the same tax office. Currently more than half of

DGT staff have not completed more than secondary education, while 16% have not even completed secondary education (DGT, 2011). Improving remuneration policies and internal training programmes that would allow an increased share of highly qualified officials is likely to pay off in terms of raising tax revenues. Enhancing the flexibility of employment contracts would also make it easier for DGT to dispose of officials with poor performance while hiring more educated new people. The pool of human resources with which DGT operates has been very stable over the last few years, which seems atypical for an institution undergoing such fundamental changes. This is one area where DGT is constrained by government regulations that apply to all public institutions and which can stand in the way of applying modern human-resource-management practices that would provide incentives for high performance and non-corrupt behaviour by tax officials as well as develop their skills and professionalism.

One particular area where the tax authorities may wish to consider improving their capacities is the appeal system. Once a tax dispute is taken to court, private parties are often able to outspend the authorities on procuring legal advice, resulting in an uneven playing field. In 2010, over 70% of appeal cases were partially or fully granted. Allowing the tax authorities to have recourse to external legal advice in appeal cases where substantial public revenues are at stake may be a useful way to compensate for limited internal capacities. Negotiated settlements can also be a way to reduce the costs of litigation, and tax authorities should be given the authority to use this tool. Currently all tax appeals must be handled by a single tax court in the capital. In order to speed up the appeal system, the announced plan to establish five additional tax courts outside Jakarta is welcome. In addition, further increasing the authorities' capacity to avoid profit-shifting and transfer pricing in the case of multinational enterprises would be useful.

Integrity is also an essential element of good institutional performance. Despite an increased focus on integrity issues, there still seems to be room for improvement, not least because of events in 2010 and 2012 when several tax-related cases involving DGT personnel undermined the level of public trust. These events have led some to question the implementation of a tax administration reform that had been widely accepted previously. Stronger internal control systems and disciplinary actions may be helpful to reach this objective. The transparency of administrative decisions is one factor of integrity as perceived by taxpayers. This could be enhanced by making it easier for the public to access their tax-related information and by establishing precedent-setting rulings that are publicly accessible and binding for future decisions in comparable cases. In the same vein, all decrees and implementing regulations on tax matters should be made easily available to the public. This has been achieved in Vietnam, where all administrative procedures were collected into one single law in 2006.

Easing tax procedures – where Indonesia compares poorly with most other countries in international comparison – would strengthen the incentives for compliance and correct self-assessment. The World Bank's Paying Taxes survey ranks Indonesia at position 131 out of 183 jurisdictions with respect to the ease of paying taxes, although it has moved up 3 spots over the last year (World Bank, 2012).

The use of electronic interactions between taxpayers and the authorities presents significant scope for improving tax procedures at the stages of registering, filing and paying taxes. DGT has begun to allow electronic filing, and this has cut the time required to pay taxes by more than half – from 560 hours in 2006 to 266 hours in 2011 (World Bank, 2012).

However, despite a five-fold increase in the number of electronically filed returns, they still account for less than 1% of the total. In a pilot programme, DGT has begun to make electronic filing easier for Jakarta and Bandung residents, with full deployment across the country planned by the end of 2012. DGT objectives also include offering several payment channels, including through internet banking and ATM machines. These are steps in the right direction and should be pursued further. Better use of information technology should also include ensuring a linkage between computer software used by the tax and customs administrations, as well as linking to databases used by other public agencies.

Although they are not the only tool to improve tax compliance, tax audits constitute an integral part of any tax system based on self-assessment. Given that the tax administration has limited resources to conduct tax audits, these should be allocated in a way to maximise expected revenue collection. This implies a risk-based audit procedure, sparing taxpayers with a good compliance record, while focusing on those where there is evidence of non-compliance, possibly on the basis of earlier non-compliance or external data sources. Although tax audits in Indonesia have become more risk-focused, DGT still has to commit valuable resources to automatically triggered tax audits of taxpayers with a low risk profile. Any tax return showing an overpayment of tax and including a refund claim is subject to a compulsory tax audit, for example. Since this happens most often in the application of VAT, excessive staff resources are devoted to auditing VAT returns, while the prospects for enhancing revenue collection would be larger in the area of income taxes. In the future, automatic audit requirements should be abolished, while strengthening the risk focus of tax audits. The fact that the 65 000 audits conducted in 2010 resulted on average in additional revenue collection that was 16 times larger than audit costs suggests that DGT may be well advised to continue increasing the number of tax auditors. This would also reduce the currently long delays to obtain a tax audit where it is required to receive a refund and speed up the reimbursement of tax refunds.

Finally, tax administration reform should be accompanied by reforms in other areas, particularly law enforcement. In March 2012, DGT signed an agreement with the National Police to guarantee closer surveillance to prevent tax fraud. This includes providing security and oversight of tax officials as they go about their work and assistance in locating missing persons and assets, following a number of high-profile graft cases involving tax officials. Such co-operation among different public agencies seems promising.

Box 1.3. **Summary of recommendations: tax reform**

In order to raise the tax take and the efficiency of the tax system, the government should consider undertaking the following measures:

Personal income taxes

- Continue efforts to expand the number of taxpayers, in particular among the self-employed. Adopt a single taxpayer number for individuals, and eliminate the need to apply for one, *e.g.* by using the national identity card number. Consider removing the need to file a tax return for employees with a single source of income. Temporarily reduce penalties for previous non-compliance for first-time taxpayers only.
- Subject employer-provided fringe benefits and allowances to personal income taxation, and move towards equal tax treatment of interest and dividend incomes, for example by considering the withholding tax on dividends as final, as is the case for interest.

Box 1.3. **Summary of recommendations: tax reform** *(cont.)*

Corporate income taxes

- Reconsider tax incentives and in particular tax holidays for specific sectors or investment projects. If investment incentives are granted, make them broadly available to all companies, and give preference to investment tax credits over tax holidays.
- Publish estimates of tax expenditures, including investment incentives, on a routine basis to enhance their transparency, and conduct periodic evaluations of all of them.
- Reduce the compliance burden for small firms by introducing a specific tax system, combining simplified procedures with a low tax rate and decisive action to enforce compliance, as planned by the government.

Oil and gas and mining royalties and taxes

- Take exploration and development risks into account by allowing full recovery of the associated costs from production revenues.
- Move away from revenue-based royalties and give greater weight to taxing economic rents, at higher rates than at present.
- Reconsider local processing requirements and local ownership requirements in the mining sector, and focus on raising the government's tax take instead.

Taxes on international trade

- Review export taxes, considering their implication for the whole economy, including international trade.

Consumption taxes and carbon tax

- Reduce the number of activities that are exempt from VAT to a minimum.
- Introduce a carbon tax at an initially low rate.

Recurring taxes on immobile property

- Update the property value registry to increase the tax take from recurrent taxes on immovable property. Consider moving towards a simplified area-based assessment of tax liabilities.

Tax administration

- Allocate more tax audits on the basis of risk assessments, and eliminate automatic audit requirements. Increase the number of government auditors.
- Make greater use of third-party information and indirect ways of assessing tax liabilities, *e.g.* by using information on assets or consumption items to trigger tax audits even for those not registered as taxpayers.
- Move forward with the planned tax census to expand the tax base beyond current taxpayers, and establish additional tax offices specialised in affluent individuals beyond Jakarta.
- Continue efforts to improve the human resource management of the tax authorities by reducing disparities in training across tax offices and officials. Enhance the administration's litigation capacity, and consider the use of external legal services in important appeal cases, while moving forward with plans to establish tax courts outside of Jakarta.
- Strengthen internal control systems and disciplinary action within the tax administration. Improve the transparency of administrative decisions by allowing taxpayers access to their tax-related information, publishing all decrees and implementing regulations and using publicly accessible precedent rulings.

Notes

1. An additional 5 percentage points reduction is available under certain conditions through a provision that aims at fostering local capital market development. These conditions include at least 40% local listing and dispersed ownership for a number of years, but few firms seem to take advantage of this provision.
2. The effective tax rates in Abbas *et al.* (2012) are calculated as the average effective corporate income tax rates paid by a hypothetical equity-financed investment in plant and machinery, assuming a pre-tax rate of return of 20%.
3. This information was extracted from the ORBIS database published by Bureau van Dijk.

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Chapter 2

Promoting SME development

Micro, small and medium-sized firms (MSMEs) are a key source of employment and economic growth in Indonesia. They contributed to the country's economic resilience during the 2008-09 financial crisis. But many suffer from low productivity, curbing their role in boosting living standards. There are several ways to spur MSME productivity growth over the medium term.

The first route would be to encourage the formalisation of small firms. Lessening red tape through simplification of the licensing process and lowering tax compliance costs would help. Avoiding excessive rises in the minimum wage in provinces where it is already at a reasonable level would also be important. Looking forward, it would be useful to remove rigidities in the formal labour markets, while moving to some form of unemployment benefit system to insure workers against job-loss risks.

The second route would be to boost investment. Clarifying property rights for real estate, and making the information collected by the credit bureau available to all financial institutions would ease access to finance. At the same time, the development of financing alternatives such as venture capital, leasing or micro-finance would enhance credit supply. The poor state of infrastructure, in particular in the transportation and electricity sectors, is also perceived as an important impediment to investment and could be remedied by increasing public infrastructure spending on cost-effective projects.

The third route would be to enhance the quality of human resources. The country suffers from a lack of skilled workers, and policies should aim both at increasing the pool of workers and making education and training institutions more responsive to evolving labour-market demand.

Indonesia has a long tradition of supporting MSMEs. But responsibilities between the different levels of government and within the central government need to be clarified to minimise overlap and inefficiencies. A rigorous assessment of existing programmes would allow schemes to be consolidated and scarce public funds to be directed to their most cost-effective uses.

Small firms are especially numerous in Indonesia, and the number of small firms per capita is much higher than in most other countries (Kushnir *et al.*, 2010). They have historically been the main players in domestic activity, especially as providers of employment opportunities. Small enterprises have also been an important engine in the development of local economies and communities.

This chapter seeks to identify ways to ensure that small firms make their fullest contribution to job creation and productivity to underpin sustainable growth over the long term. It starts by describing the main characteristics of small firms in Indonesia, as well as their role in supporting the economy during the 2008-09 global crisis. The chapter then examines ways to boost their productivity over the medium term by encouraging them to formalise and invest. It then looks at policy changes that could help to enhance the skills of the workforce, before reviewing policy support. A last section makes policy recommendations.

Small firms helped the economy weather the 2008-09 financial crisis

There is no commonly agreed definition across institutions and countries of what is a small firm (Box 2.1). This chapter relies on a wide range of databases, which adopt different

Box 2.1. **What is a small firm?**

An important constraint in analysing SME development is the great diversity in the definition and classification of small firms across institutions and countries. The most common practice is to rank firms by number of employees. But other variables like net assets, sales and investment levels are also sometimes used. There is also variation in defining the upper and lower size limits of an SME. Finally, the coverage varies depending on whether the informal sector and micro firms are included or not.

Below are the definitions from the main sources used in this chapter:

- *Data from the Ministry of SMEs and Co-operatives and Bank Indonesia*. The data follow the definition set out in the 2008 Law. Micro firms are defined as enterprises with net assets less than IDR 50 million (land and buildings excluded) or enterprises which have less than IDR 300 million total annual sales. Small firms are enterprises with net assets from IDR 50 million to IDR 500 million (land and buildings excluded) or with total annual sales from IDR 300 million to IDR 2.5 billion. Medium-sized firms are those with net assets from IDR 500 million to IDR 10 billion (land and buildings excluded) or with total annual sales from IDR 2.5 to 50 billion.
- *World Bank Enterprise Survey.* Size is defined by the number of employees: from 5-19 the firm is small, and from 20-99 it is a medium-sized firm. The survey covers only the formal sector and firms with more than 5 employees.

Box 2.1. **What is a small firm?** *(cont.)*

- *International Finance Corporation – MSME country information*. The definition varies across countries. For Indonesia, data are for the formal sector and taken from the Ministry of SMEs and Co-operatives and follow the definition in the 2008 Law.
- *Tax registration*. For tax purposes, small firms are those that have assets valued between IDR 50 million and IDR 500 million with an annual turnover of between IDR 300 million and IDR 2.5 billion, while medium-sized enterprises are those that have assets valued between IDR 500 million and IDR 10 billion and have a yearly turnover between IDR 2.5 billion and IDR 50 billion.

Source: Ministry of SMEs and Co-operatives, World Bank Enterprise Survey, Bank Indonesia.

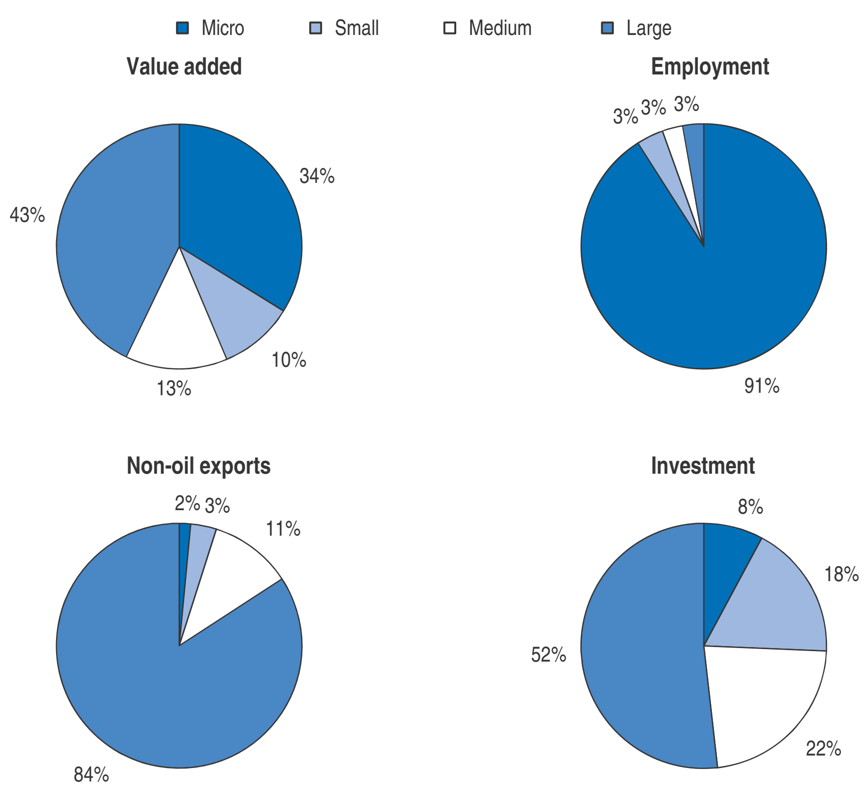
definitions. To the extent possible, the focus is on the broader concept of micro, small and medium-sized firms (MSMEs). But when not possible the analysis covers just small and medium-sized firms (SMEs).

A snapshot of the MSME sector

MSMEs constitute the dominant form of business organisation and represent more than 99% of the total number of firms in Indonesia, 97% of employment but only 57% of value-added (Figure 2.1). Most are scattered widely through the rural parts of the country.

Figure 2.1. **Firms' demographics in Indonesia**

2010



Source: Ministry of SMEs and Co-operatives.

StatLink http://dx.doi.org/10.1787/888932711543

They generally serve small and localised markets and are responsible for half or less of investment. While micro enterprises are mostly in the agriculture sector, small firms dominate in the trade and hotel sectors. Medium-sized firms account for a tiny part of MSMEs. This "missing middle" in the production structure is common in South-East Asia.

As in regional peers, most SMEs in Indonesia are privately and domestically owned and have the status of sole proprietorships (Table 2.1). The majority of these firms are gathered in co-operatives whose number almost doubled from 2005 to 2011.

Table 2.1. **Small firms' characteristics in Indonesia and selected Asian economies**

	Cambodia 2007	Malaysia 2007	Philippines 2009	Thailand 2006	Vietnam 2009	Indonesia 2009			
						Small	Medium	Large	All
Age (years)	7.8	18.3	14.6	–	6.5	14.7	16.6	20.2	15.0
Proportion of private domestic ownership in a firm (%)	89.4	92.2	95.8	96.7	94.5	89.9	87.5	77.6	89.4
Per cent of firms with legal status of:									
Publicly listed company	0.5	60.3	10.1	0.0	0.0	0.8	2.0	5.3	1.0
Privately held Limited Liability Company	15.8	0.0	35.6	83.8	11.4	4.0	13.5	59.8	6.2
Sole Proprietorship	60.6	20.1	32.6	0.0	35.6	87.6	68.1	26	84.3
Limited Partnership	6.5	0.0	4.3	0.0	40.2	6.8	14.3	8.6	7.5
Proportion of permanent full-time workers that are female (%)	–	27.4	40.6	44.3	36.0	32.9	41.2	40.7	33.9
Per cent of firms with a female top manager	–	13.5	37.9	–	31.1	32.9	20.1	13.1	31.2
Per cent of firms competing against unregistered or informal firms	–	–	33.5	–	64.4	65.8	65.0	37.2	65.1
Per cent of firms formally registered when they started operations in the country	84.6	18.0	98.3	–	89.1	24.7	55.0	91.3	29.1
Number of years firm operated without formal registration	0.9	–	0.1	–	0.7	2.4	2.8	1.2	2.4
Per cent of firms identifying practices of competitors in the informal sector as a major constraint	33.4	14.6	25.7	–	16.7	14.7	16.0	8.1	14.7

Note: Size is defined by the number of employees: from 5-19 the firm is small, and from 20-99 it is medium-sized.
Source: World Bank Enterprise Survey.

As in other countries, SMEs in Indonesia have a lower propensity to export than larger firms (Table 2.2). The share of SMEs in non-oil exports has been declining since 2008; they now represent less than a fifth of non-oil exports, though part of SME output may be exported indirectly through subcontracting arrangements.

One specificity of SMEs in Indonesia is that most operate in the informal sector. The percentage of firms that are run with formal registration is, as expected, lower for Indonesian SMEs than for large firms, but also lower than for such firms in Cambodia and Vietnam. Moreover, the number of years spent in the informal sector is higher, suggesting that incentives to become formal are lower in Indonesia than in regional peers.

SMEs are more likely to pay a bribe than large firms, and a greater share of survey respondents seem to expect to have to bribe officials to obtain a license (though not a government contract) than in Vietnam or the Philippines (Figure 2.2). The former outcome could reflect SMEs' lower bargaining power but also sometimes their non-compliance with regulations, which makes them a more likely target for corrupt officials. There is also

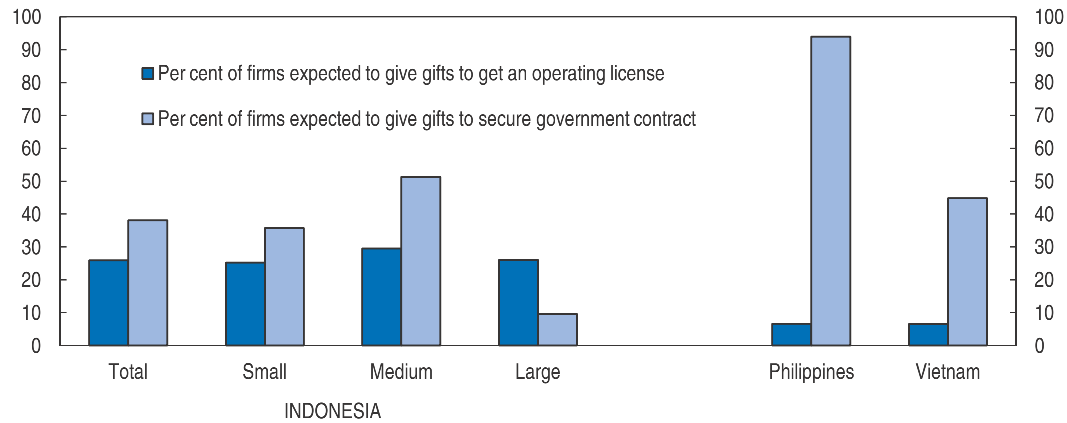
Table 2.2. **Small firms' foreign trade in Indonesia and selected Asian economies**

	Cambodia 2007	Malaysia 2007	Philippines 2009	Thailand 2006	Vietnam 2009	Indonesia 2009			
						Small	Medium	Large	All
Per cent of firms exporting directly or indirectly (at least 1% of sales)	9.1	30.0	5.0	40.7	5.1	1.6	14.2	55.3	4.1
Per cent of firms using material inputs and/or supplies of foreign origin	–	30.3	23.6	14.3	42.5	2.5	12.4	55.9	4.9
Per cent of firms identifying customs and trade regulations as a major constraint	9.8	11.5	9.8	18.5	1.1	3.7	11.8	12.5	4.8

Note: Size is defined by the number of employees: from 5-19 the firm is small, and from 20-99 it is medium-sized.
Source: World Bank Enterprise Survey.

Figure 2.2. **Indicators of corruption in selected economies**

2009 or latest available year



Source: World Bank Enterprise Survey.

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evidence that corruption at the local level (where licenses are usually delivered) reduces entrepreneurship in Indonesia (Vial, 2011).

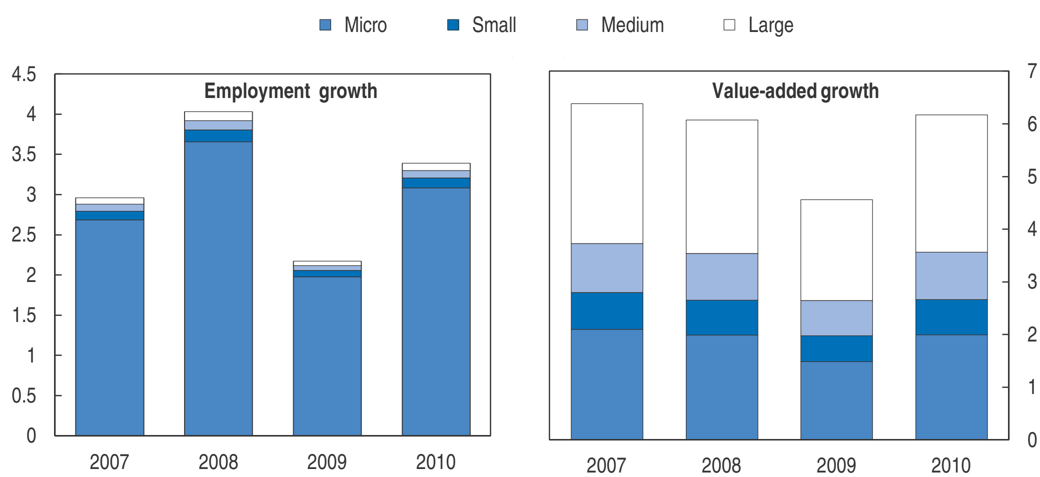
The role of small firms during the crisis

MSMEs have been the main contributors to employment growth in Indonesia in recent years (Figure 2.3). This helped to sustain household income during the crisis and is one of the factors explaining the steady decline in the poverty rate. MSMEs have contributed more to the growth of value-added than large firms, with micro firms representing the bulk of MSME contributions. One reason for this good performance may be the low reliance of micro and small firms on formal markets and credit, which allows them to respond more quickly than large firms to sudden shocks (Berry *et al.*, 2001).

Some of these developments could also reflect Indonesia's current stage of economic development. Indeed, according to Ayyagari *et al.* (2011), SMEs contribute more to employment in low- than in high-income countries. It seems, however, that SMEs account for a larger share of employment in Indonesia than in the average lower-middle income country. Another factor could, in principle, be business age: mature firms usually make up a large fraction of employment in developing economies (Ayyagari *et al.*, 2011). Although Indonesian SMEs are relatively mature, firms' age does not seem to be a significant factor in explaining employment shares (Figure 2.4).

Figure 2.3. **Contributions to employment and value-added growth**

Percentage points



Source: Ministry of SMEs and Co-operatives.

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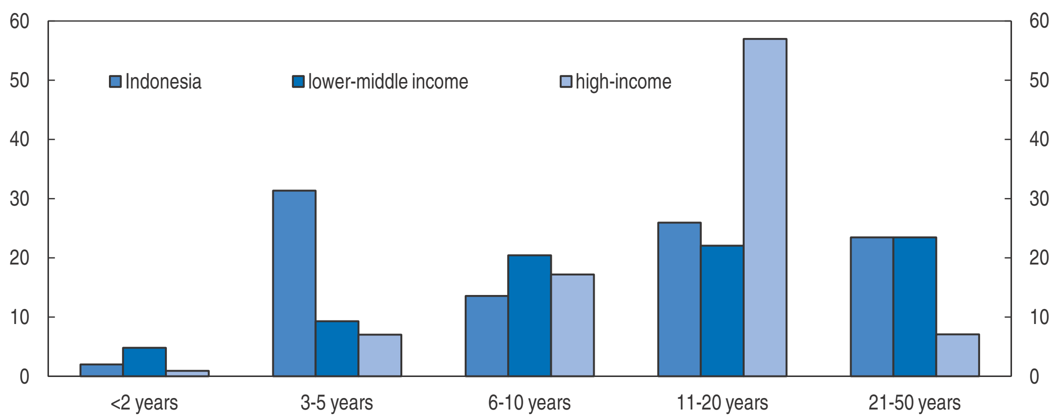
Figure 2.4. **Employment share by firms' age**

Per cent, 2008 or latest available year



Note: Micro firms are not included. Large firms are included.
Source: Ayyagari et al. (2011) "Small *vs* Young Firms across the World", *Policy Research Working Paper*, No. 5631, The World Bank, Washington, D.C.

StatLink http://dx.doi.org/10.1787/888932711600

Good employment performance has not been accompanied by significant gains in productivity by small firms. Labour productivity appears to have increased faster for larger firms than for their small counterparts since 2008, and the gap between the two groups has widened (Table 2.3). Overall, small firms are found to be 80% less productive on average than large firms. This is consistent with what is observed in other developing economies and can be explained by the fact that small firms usually use manual modes of production (Ayyagari *et al.*, 2011; Banerjee and Duflo, 2005). They also lack inputs such as skilled workers, new machines and IT processes and the know-how to improve methods of production.

The issue of small firms' poor productivity performance is likely to gain in importance in the years to come. With the gradual economic integration of ASEAN economies and the

Table 2.3. **Labour productivity by type of firms**

GDP per employee in IDR million

	2006-08	2009-10
Micro, Small and Medium Enterprises	1.2	1.3
of which: Micro	0.7	0.8
Small	6.1	6.5
Medium	10.1	11.6
Large	30.4	32.9
Comparison Large/MSMEs	25.1	25.8

Source: OECD calculations using data from the Ministry of SMEs and Co-operatives.

implementation of regional free-trade agreements with China and India, Indonesian small firms are going to face stronger competition in the domestic market. In addition, production costs are expected to rise as the social safety net expands and the country moves to a greener economic footing.

International evidence suggests that a large SME sector is often associated with strong growth in GDP per capita, though there is little evidence on the direction in which the causality runs (Beck *et al.*, 2005). But a necessary condition for job creation by SMEs to translate into stronger long-term growth is that they not exhibit too low productivity. There are three ways to prevent this and to spur SME productivity growth. The first would be to encourage formalisation, as there is evidence that productivity is higher in the formal sector as firms enjoy easier access to finance. The second would be to remove obstacles to investment and facilitate SME growth. The third would be to increase the pool of qualified workers. These are reviewed in turn in the following sections.

Encouraging the formalisation of small firms

According to the 2009 World Bank Enterprise Survey, only 25% of small firms are legally registered when they start operating in Indonesia. Indeed, red tape, high tax compliance costs and rigidity in the formal labour market can hamper formalisation. Reforms in these areas are nonetheless unlikely to be sufficient to foster formalisation, if firms expect no benefit from registration. It is thus necessary to make more visible its advantages.

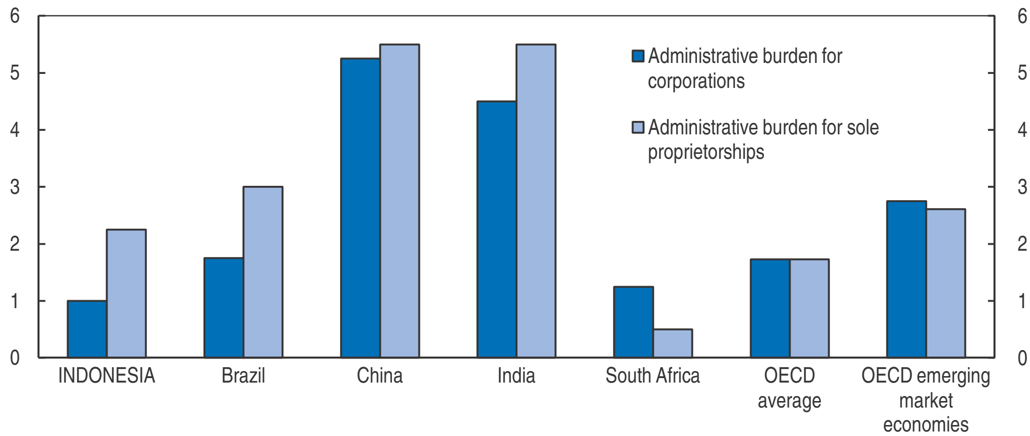
Reducing red tape

A heavy regulatory burden can influence firms' decisions to become formal. Evidence from Mexico, Colombia and Malaysia suggests that the simplification of business registration procedures can lead to an increase in the number that register. Administrative costs to register a firm, as measured by a *de jure* indicator, are lower in Indonesia than in other emerging-market economies and than in OECD countries (Figure 2.5). Important progress in this area has been achieved in Indonesia in recent years. The time needed to start a business in Jakarta has, for instance, been reduced by 70% since 2006. These improvements can be attributed to the nationwide introduction of a computerised system for company registration – *Surat Administrasi Badan Hukum* (SABH) – and the creation of standard incorporation forms for limited liability companies.

However, despite this improvement, starting a business is still more cumbersome in Indonesia than on average in members of the Asia-Pacific Economic Cooperation (World Bank, 2012). While micro firms are exempt from licensing requirements, the burden is

Figure 2.5. **Administrative burden to register a business in Indonesia and selected economies**

2008



Note: The indicator ranks from 0 (less restrictive) to 6 (most restrictive). OECD emerging market economies include Czech Republic, Hungary, Korea, Mexico, Poland, Slovak Republic and Turkey.
Source: OECD.

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heavy for small firms, which pay more per employee or as a percentage of sales than larger firms. In practice, small firms in Indonesia need twice as many days to get an operating licence than their larger counterparts. Small Indonesian firms also face a disadvantage compared to counterparts in some regional peers. According to the World Bank Enterprise Survey, it takes fewer than 10 days for a small firm to obtain an operating licence in Vietnam as compared to more than 20 in Indonesia. In addition, Indonesia imposes a minimum capital requirement of IDR 50 million (around USD 5300) when starting a limited liability company, 25% of which needs to be deposited in the founder's bank account. Most other APEC economies have abolished such requirements, and the Indonesian authorities should consider phasing it out as well.

Regional government licenses that impose a large burden on businesses are the main issue to be tackled. Decentralisation and the resulting transfer of the regulatory oversight to 440 cities and districts in the early 2000s are reported to have worsened the business environment. It has increased the number of levies and costs with which firms have to cope with and has created generalised over-regulation and regulatory uncertainties (KPPOD, 2008). A large majority of regulations are now imposed at the regional level (Box 2.2), leading to highly variable situations across the country. According to World Bank (2012), it is easiest to start a business in Yogyakarta and most difficult in Manado.

Consistent with the objective stated in the 2010-14 National Development Plan, 12 500 sub-national regulations are in the process of being reviewed. But the focus has been on eliminating illegal taxes and user charges. Some attention has been devoted to licenses that would be detrimental to growth or would be inconsistent with national regulations, but efforts need to be pursued. Excessive licensing creates a barrier to entry to markets and may also impede innovation and flexibility. As suggested by the 2012 OECD Review of Regulatory Reform, effort should be made to systematically review the stock of significant sub-national licensing requirements and assess their costs and benefits to ensure that they remain cost-effective and deliver the intended outcome (OECD, 2012a). Since 2011, academic studies on sub-national regulations are required by law but a

Box 2.2. **The licensing process in Indonesia**

This box reviews the various licenses required for a firm to operate in Indonesia and current processes to obtain them.

Indonesia has put in place a simplified licensing system for SMEs. SMEs whose asset is below IDR 5 billion usually choose this option, while large and foreign companies seek BKPM licenses that offer some investment facilities (OECD, 2012a).

The business license for location (SITU) is the most difficult to obtain. The government must assess whether the proposed business location complies with its spatial plan. It is a pre-requisite for other licenses and is issued by the economic section of the regional government (*kabupaten*). Rules to obtain SITU vary across the country. The process is particularly cumbersome and costly in the region of Kupang, where any of 270 different tariffs could be applied, depending on the specific business, and firms need to renew their license every year.

In addition to SITU, there are also construction (IMB) and nuisance permits (HO). The construction permit combines building function, land use, road access and safety requirements. It requires not only blueprints of the building, but also approval by local authorities (village and sub-district heads) and neighbours. The nuisance permit assesses the disturbance caused by business activities such as traffic or noise. It requires approval by neighbours.

The trading license (SIUP) is required for firms engaging in trade activities. It is valid for the whole country. This license is usually needed to obtain bank loans and to be able to participate in government tenders. In the same vein, the industrial registration (TDI) is the major technical license required for SME industrial activities.

Firms are also often required to apply for various product-specific and activity-specific licenses. Examples include permits to produce or transport commodities. These licenses may be issued by the central, regional or local governments. Some of them need approval from local business associations.

Finally, firms have to pay a *retribusi*, a government tax or payment that is collected as payment in return for a service for the issuance of permits from various government agencies.

Source: SMERU (2009), the Asian Foundation (2007), OECD (2012a).

quantitative assessment is not explicitly asked for and the studies are not well integrated in policymaking and in public consultations. In this regard, the OECD's Competition Assessment Toolkit can provide useful information on ways to achieve the objectives that typically underpin business licensing without unnecessarily harming competition. Specific attention should be given to examine the impact of licences on MSMEs. Licenses that are found to be unnecessary should be phased out. A pre-requisite would be to take stock of all existing sub-national regulations. This would also allow benchmarking and encourage the dissemination of best practises.

The national government has approved legislation mandating the simplification of local licensing requirements. It also set statutory limits for the time needed to issue two licenses that are governed at the national level but are issued by local governments. Fees for local licences were also eliminated for SMEs by decree in 2007. Still, the implementation of these regulations varies across localities in the absence of clear implementing guidelines. Only some local governments have simplified their licensing requirements by merging procedures, introducing statutory time limits and eliminating or reducing licensing fees. Local governments should be encouraged to rationalise and consolidate licensing processes. One way forward would be to sanction regional governments that fail to make significant progress in this area.

Since the mid 1990s, the government's strategy to streamline the business licensing process and reduce compliance costs has been based on the establishment of one-stop shops. These are local government offices that consolidate the processing of business licenses from separate departments into one location and thus help to provide faster, simpler and less costly services. General guidelines for the establishment of one-stop shops were issued in 1997. In 2006, the Ministry of Home Affairs issued regulations instructing local governments to set up one-stop shops within a year. Most Indonesian cities have by now complied. The rest need to follow suit. Regarding central-government licenses, a 2009 Presidential decree introduced the concept of a one-stop-shop system (PTSP). The law required the consent of some 16 ministries to delegate their authority to BKPM, the government investment agency, in licensing and non-licensing services. All relevant ministries have now signed off on the various decrees, and implementation of PTSP is underway.

Further simplification and automation of the process could speed up registration. Experience from Singapore shows that establishing a virtual one-stop shop that collects all required information through a single online interface and shares it within the government can reduce registration time. The Indonesian authorities have already taken steps in this direction. In January 2010, they launched the National Single Window for Investment (NSWI), an electronic platform for investments that enables investors to apply for license and non-license services online in the Free Trade Zone and Free Port of Batam. In addition, a central government initiative aims to implement an integrated information system for transferring data from the local one-stop shops to the BKPM and to the relevant ministries. These initiatives are welcome and should be pursued.

Additional improvement could be achieved by gradually moving to a single licence for registering and operating a business. This question is currently being discussed within the central government for the licences for which it is responsible. However, discussions are still at a very early stage. Going forward, the authorities could envisage moving from the current model, which relies extensively on licensing, to regulations that would apply to anyone who engages in certain business activities. This approach enables businesses to enter or expand in markets more easily and would reduce the scope for illegal side payments (OECD, 2012a). Existing licensing schemes should be evaluated to determine whether their removal or a shift to regulations instead of licenses might lower barriers to entry.

Simplifying tax procedures

Excessive tax compliance costs – *i.e.* the amount of time and resources required by firms to comply with the tax system – can distort the choice of business form, including the decision to move from dependent employment to establishing a business and/or the decision to structure an SME in incorporated or unincorporated form. Nonetheless, the tax system does not appear to be the major factor explaining informality in Indonesia. At the moment micro firms are effectively exempt from tax, and there are some specific provisions for small firms. As SME tax collection represents only a small part of total public revenues, adjustments to policies to further reduce the tax compliance costs for SMEs are currently being discussed by the Indonesian government through the establishment of a simplified tax system for small firms (Chapter 1).

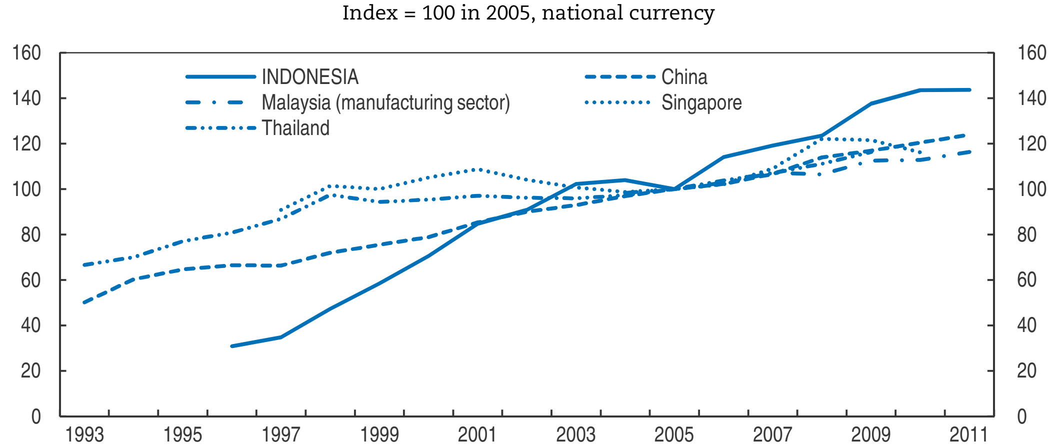
International evidence suggests that the establishment of a simpler taxation system for micro and/or small firms can encourage more start-ups and the formalisation of unregistered workers. For very low-turnover businesses for which a simplified procedure may still be excessive and discourage participation in the formal economy, there may be a need to introduce a simple tax (for instance, a turnover-based tax) to replace regular income tax and/or VAT. A pre-condition for this measure to work in the case of Indonesia would be to prevent potential tax evasion that could occur by keeping a part of turnover out of registers. Another measure to lower compliance costs would be to allow small firms to adopt cash accounting (based on daily cash entries of payments/revenues) and other simplified accounting procedures and to be subject to less frequent filing requirements. From the point of view of maximising the efficiency of the whole tax system, a preferential tax treatment for small firms needs to be carefully designed to prevent such a system from becoming an obstacle to firms' development as the advantages of the special regime will be lost if firms grow beyond the revenue threshold.

Limiting the rise in labour costs

MSMEs employ most of the Indonesian workforce. As such, labour costs are an important factor bearing on their incentives to formalise. Unit labour costs have been steadily increasing since the mid-1990s and appear to have grown faster than in regional peers (Figure 2.6). This reflects developments in wages (as social contributions barely exist) and productivity.

Figure 2.6. **Unit labour costs in selected Asian economies**

Index = 100 in 2005, national currency



Source: OECD calculations using national sources.

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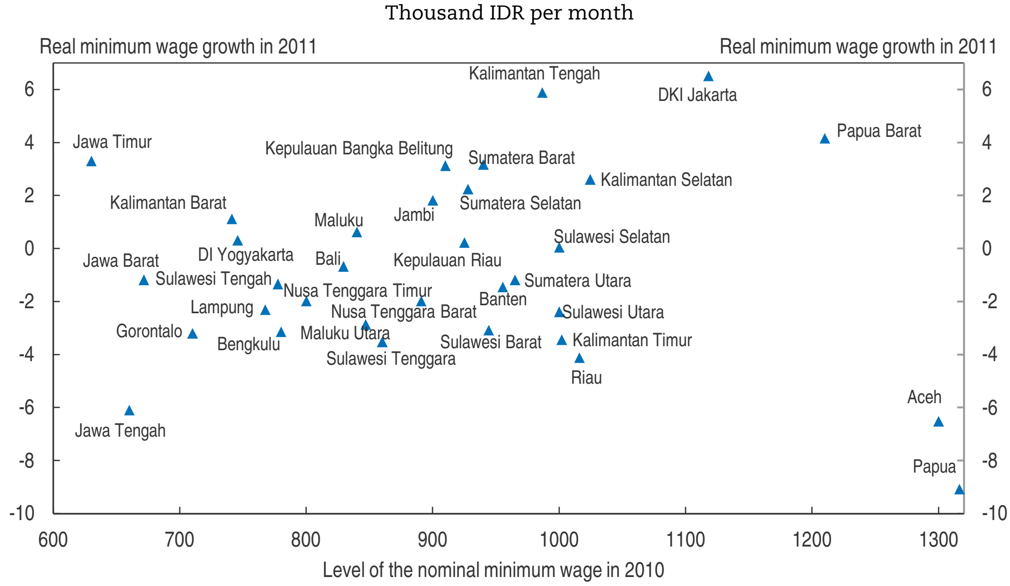
Resisting excessive increases in the minimum wage

A factor bearing on SME labour costs is the minimum wage. Minimum-wage provisions have become increasingly onerous, especially since decentralisation in 2001, when they became the prerogative of local governments. Indonesia has one of the highest relative minimum wages in the world, equal to 65% of the average wage of salaried workers, although the situation varies somewhat across provinces. Minimum wages are used as the main reference for salary negotiations, rather than just as a social safety net for the poor workers. However, firms can easily opt out of minimum-wage requirements if they prove they cannot afford them (Saget, 2008).

Minimum wages rose by 8.8% on average across all provinces in 2011, with increases of more than 15% registered in some. According to the Ministry of Manpower and Transmigration, minimum wages are projected to rise by 9.2% on average in 2012. Jakarta is expected to experience an even higher rate (18.5%), with the monthly level rising to IDR 1.5 million (USD 170). Although a jump in excess of productivity gains may be justified in areas where the minimum wage is low and below an estimated decent wage, there does not seem to be a clear negative relationship between the 2010 level of the minimum wage and its 2011 increase across provinces (Figure 2.7). If anything, the relationship appears to be slightly positive. In any case, increases cannot be justified in terms of catch-up effects. In provinces where the minimum wage is above an estimated decent wage, increases in the inflation-adjusted minimum wage should be kept in line with trend productivity gains. In addition, it would be useful to introduce a youth sub-minimum wage, which could offset some of the effect of high minimum wage on employment opportunities for new entrants. Such an instrument is common in OECD countries, such as the United States, and also exists in India.

Figure 2.7. **Real minimum wage increases by province**

Thousand IDR per month



Source: OECD calculations using Statistics Indonesia data.

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Reforming the labour code

Severance payments are high by international standards and hiring and dismissal procedures for formal-sector permanent workers are amongst the most restrictive in East Asia. At the same time, the complexity of the rules makes labour costs difficult to predict. Legislation pertaining to fixed-term contracts is also rigid, which limits their use by small firms. These factors contribute to widespread labour-market informality and the extensive use of employees without contracts (OECD, 2010a). According to some estimates from the Ministry of National Development Planning, 62% of employment was informal in 2011.

While formalisation will certainly augment workers' income, it should also boost their productivity, as there is evidence that formal workers have easier access to training than their informal counterparts.

The labour code has proven extremely difficult to reform, even though in effect it has provided only weak protection to workers. For example, only a third of eligible employees who lost their jobs in 2008-10 actually received severance pay (World Bank, 2010d). A way to counter resistance to reform would be to compensate the reduction in severance payments and employment protection by the introduction of unemployment benefits, which are currently non-existent. Supplying unemployment benefits would have the advantage of pooling risks and providing coverage to the workers who need it most. However, the cost of providing unemployment benefits is found to be particularly high in emerging-market economies with large informal sectors (OECD, 2011). Requiring benefit recipients to search for work would be a way to counter moral hazard, but this may prove difficult, given the limited institutional capacity Indonesia has at the moment and would require significant investment in activation policies. A more promising approach would be to limit the amount of such benefits and to complement them with individual unemployment saving accounts as in Austria. Such accounts would be potentially tax-supported and provide assistance to liquidity-constrained unemployed individuals during their job search. By allowing workers to run down their accounts when they are unemployed, workers internalise the cost of unemployment benefits. This strengthens the incentives facing the employed to avoid job loss and those of the unemployed to return to work quickly. This option would be less costly than the introduction of a standard unemployment benefit system but is also likely to be more difficult to administer.

Boosting small firms' investment

Gains in SME productivity could be achieved through investment. Obstacles to investment vary widely with the size of firms. According to the World Bank Enterprise Survey, access to finance is by far the most important impediment to investment for small firms in Indonesia. A large informal sector is also reported to discourage investment, as do high electricity costs and political instability.

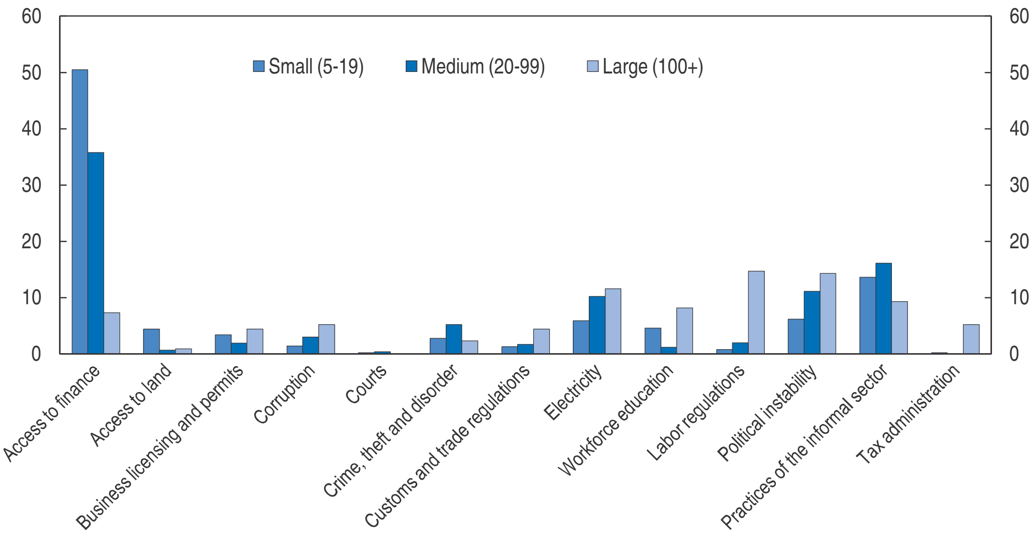
Access to finance

Small firms' financing is the most binding obstacle to investment by far (Figure 2.8). This is consistent with the 2005 Bank Indonesia survey on MSMEs, which suggests that access to finance becomes increasingly problematic as the scale of the business decreases. It is also similar to what is observed in developed and other developing countries (Beck *et al.*, 2006). Access to credit is particularly stringent for Indonesian small firms operating in the informal sector. One consequence is that a large amount of capital is provided by self-financing or informal sources such as loans from individuals and family (Table 2.4). In 2009, 90% of informal enterprises in Yogyakarta or Banten had no bank loans but rather used a social network of family, friends and neighbours as their main source of financing (ADB, 2010).

Given the severity of these financing constraints, the authorities have focused on measures to facilitate access to the banking sector. In 2001, banks were asked to establish self-determined targets for SME lending and report them. This replaced a 1992 regulation that required at least 20% of their loans to be directed to SMEs. Over the years, banks have channelled an increasing share of their liquidity to the MSME sector. Non-performing-loan

Figure 2.8. **Principal obstacles to investment by size of Indonesian firms**

2009, per cent



Source: World Bank Enterprise Survey.

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Table 2.4. **Small firms' access to finance in Indonesia and selected Asian economies**

	Cambodia 2007	Malaysia 2007	Philippines 2009	Thailand 2006	Vietnam 2009	Indonesia 2009			
						Small	Medium	Large	All
Share of investment financed internally (%)	41.9	34.0	85.6	27.5	85.4	86.2	85	81.9	85.8
Share of investment financed by banks (%)	5.3	35.9	5.2	49.9	6.1	5.7	6.5	8.5	6.0
Share of investment financed by supplier credit (%)	9.5	7.1	2.3	2.3	0.3	1.3	0.1	1.5	1.1
Share of investment financed by equity or stock sales (%)	0.0	3.9	0.6	12.3	0.8	2.4	4.9	6.0	3.0
Share of investment financed by other financing (%)	43.3	19.2	6.3	8.0	7.5	4.5	3.5	2.0	4.2
Share of firms using banks to finance working capital (%)	11.6	44.3	11.8	53.0	30.6	10.8	35.9	39.8	13.8
Share of loans requiring collateral (%)	97.4	61.7	43.1	98.4	99.1	81.1	94.6	91.7	83.6
Share of firms identifying access to finance as a major constraint (%)	16.3	13.4	15.3	34.9	15.2	14.8	12.4	5.7	14.3

Note: Size is defined by the number of employees: from 5-19 the firm is small, and from 20-99 it is medium-sized.
Source: World Bank Enterprise Survey.

ratios suggest that the quality of loans to small firms compares favourably with conventional loans (World Bank, 2010a). But bank loans remain concentrated in the trade and service sectors and in the Java and Bali regions. In addition, most loans are used to finance working capital, while investment financing represents less than one-third of the total (Table 2.5).

Collateral and property rights

The lack of collateral is often reported to be the binding constraint to credit access and results in harsher bank lending terms and conditions for small firms than for large firms.

Table 2.5. **Bank loans to SMEs**

End 2011

	IDR billion	Per cent of total	Per cent of total loans
Total	**479 887**	**100**	**21.6**
Sectors			
Agriculture, livestock, forestry and fishery	32 948	6.9	28.4
Mining and quarrying	3 995	0.8	4.7
Manufacturing industry	52 820	11.0	15.4
Electricity, gas and water supply	1 244	0.3	2.7
Construction	24 943	5.2	33.0
Trade, hotel, and restaurants	224 874	46.9	54.3
Transport and communication	19 288	4.0	20.2
Financial, ownership and business services	30 690	6.4	17.0
Services	35 429	7.4	19.5
Not identified	89 086	18.6	13.0
Region			
Java and Bali	297 414	39.8	20.6
Outside Java and Bali	450 299	60.2	57.9
Type of credit			
Working Capital	375 296	78.2	34.9
Investment	104 587	21.8	22.6
Business size			
Micro	102 905	21.4	4.6
Small	150 912	31.4	6.8
Medium	226 069	47.1	10.2

Source: Bank Indonesia.

In addition, SME managers sometimes lack the skills needed to apply for a loan and meet bank standards, and hence promoting financial education could be very useful in this context. Efforts have been made in this area through the development of the Indonesian Financial Inclusion framework. In some other cases, the use of SME assets as collateral entails so much effort that in the end small firms would have to provide collateral with a higher value than that of the loan received. Since 2004, commercial banks have been allowed to accept assets other than land or buildings as deductions in determining loan loss reserves when allocating credit to SMEs. This measure, however, failed to significantly enhance small firms' access to credit.

Both creditor and lender rights need to be strengthened. Stronger creditor rights would allow lenders to reduce the risk of future losses. This is particularly important given the weak judicial system. Simplifying current costly loan-recovery procedures would also be helpful. Securing borrowers' property rights to assets they can pledge as collateral can help borrowers both in accessing finance and in obtaining cheaper and longer-term loans. Beck *et al.* (2008) show that, in terms of access to external finance, small firms benefit disproportionally from higher levels of property rights protection. In particular, despite some improvement, property rights regarding land are poorly defined and constrain the ability of small borrowers to use their properties as collateral. Indeed, the 1960 Agrarian Law recognises the rights of local communities over ancestral lands (OECD, 2012b). But subsequent laws governing the use of forest, water, minerals and plantations fail to reflect this entitlement. As a result, complex and opaque regulatory requirements for the issuance of permits and concessions allow corruption and conflict to thrive. The authorities need to clarify land rights provisions covering both individual and communal rights so as to reduce their regional diversity. The capacity of legal provisions to ensure debtors and creditors' rights relies nonetheless on an effective enforcement of the law.

Another way to boost bank loans is to provide government credit guarantees to non-bankable firms, *i.e.* those that have a profitable business but do not have access to bank loans. This is the objective of the people's business credit programme (*Kredit Usaha Rakyat,* KUR), launched in 2007. To supplement the collateral for loans, the government and some co-operative state banks provide a guarantee fee. There is a credit ceiling of IDR 500 million. The interest rate is determined by a Committee chaired by the Coordinating Ministry of Economy. Four state-owned banks, 26 regional banks, 2 sharia banks and one private bank participate in the programme.

KUR is estimated to have had a positive impact on wages and production (BRI, 2009). By end-2011 it had benefited 2.2 million people for a total disbursement of IDR 29.5 billion. Although the programme is judged to be relatively successful, it is reported to suffer from leakages, with some firms benefiting from the guarantees while they had access to credit. It would be useful to estimate the magnitude of these leakages, identify their source and take appropriate action to fix them. Another limitation of the programme is that its support is concentrated on certain regions (Java and Bali 49%, Sumatra 23% and Kalimantan 10%). Credit distributed to the productive sector, in particular agriculture, has been on the rise but remains smaller than that to the trading sector (38.5% of total disbursements). One way to expand the sectoral and regional coverage would be to allow more banks to qualify for the scheme, even though this may bring extra risk on the government balance sheets. In addition, the government could act to improve awareness among entrepreneurs of the range of financing options available to them. Finally, now that the programme has been in place for a few years, it would be useful to reduce the number of ministries involved in design and implementation, which amounts to 10 at the moment.

Credit-guarantee companies can also help viable but non-bankable MSMEs to obtain loans by providing guarantees. International experience suggests that these companies represent a powerful instrument to ease SME access to finance, while limiting the fiscal burden, assuming they are properly designed to ensure that they are financially sustainable and that they target non-bankable firms rather than merely providing more favourable conditions to firms which could access market credit in any case (OECD, 2012c). So far, however, these firms have been perceived as unprofitable businesses and rather play the role of insurance companies in Indonesia (Djamhari, 2010). They also lack expertise. While experience from Asian countries highlights the importance for guarantors to have sufficient capitalisation and prudent risk-management practises (Shim, 2006), initial capital requirements appear to be excessively restrictive (IDR 100 billion at the national level, IDR 25 billion at the provincial level). It would be useful to adjust the regulation of credit-guarantee companies and encourage them to refocus their business model on the provision of credit guarantees, rather than insurance.

Information asymmetries

Contrary to the conventional wisdom, recent evidence suggests that banks want to expand their activity in the MSME segment, especially as margins in other banking markets have narrowed. But obtaining information on the creditworthiness of potential clients is costly. MSME borrowers often have no financial track record and are unable to provide reliable information. As a result lenders are likely to perceive the risk of lending to

MSMEs to be greater than what it is in reality and will charge higher interest rates or be reluctant to lend at all.

One way to overcome the high cost of screening and monitoring clients is through the establishment of credit registries that provide reports on firms' loan repayment histories. Love and Mylenko (2003), in a study of 5 000 firms in 51 countries, find that the presence of private credit registries is associated with lower financing constraints and a higher share of bank financing. According to World Bank (2006), the availability of credit history information is found to reduce processing time, costs and default rates. A credit registry is likely to be more effective to the extent that it obtains both positive and negative information, builds credit histories for a large number of potential borrowers and processes comprehensive credit reports in a timely fashion. This requires sufficient capacity in banks to be able to process such information. To address this issue and in response to the ASEAN's SME development roadmap, Bank Indonesia and the Ministry of SMEs and Co-operatives will start to develop an SME-specific credit scoring system in 2013.

A public credit bureau already exists in Indonesia, but its scope needs to be broadened. Established in 2006, the *Credit Bureau (Biro Informasi Kredit, BIK)* collects and records credit/loan data in the Debtor Information System. The data are then processed to generate Individual Debtor Information (IDI) Histories. BIK has helped to improve transparency and information. Its information is restricted to credit and is more oriented toward consumer credit than commercial lending, as in many other countries (Wattanapruttipaisan, 2003). As a result, it does not improve access to finance by new firms that undertake risky investments that can potentially lead to high economic returns. A limitation of the BIK is that its access is still restricted. Data collected by BIK can be used by financial institutions, who are members (commercial banks, large rural banks and non-bank credit card suppliers). Other financial institutions can become members subject to the banking supervisor's approval. Letting non-bank financial institutions become members could spur SME lending.

Improving accounting and auditing standards can also facilitate SME access to finance by reducing informational opacities and encouraging lending based on financial statements. One possibility would be to have recourse to simpler standards, which would take into account the costs and the capability of SMEs to prepare financial statements and focuses on the need for information on cash flows, liquidity and solvency. One such example is the International Financial Reporting Standards (IFRS) for SMEs, which are about to be adopted by many OECD countries, though not all (International Finance Corporation, 2011).

Financial deepening and banking competition

The legal and regulatory framework of the financial sector plays a critical role in improving the SME financing landscape. Banking regulation that allows entry of efficient banks and promotes market competition may reduce margins in traditional business lines and induce banks to develop SME banking. Both firm-level and industry-level studies suggest that having developed financial markets benefits small businesses more than large firms.

The characteristics of Indonesia's banking system may inhibit lending to small firms. Even though it has more banks than other South-East Asian economies and is largely open to foreign banks, the market is concentrated. This stems from the explicit policy of encouraging mergers and industry consolidation since the 1998 Asian crisis. The four (partially) state-owned commercial banks account for one-half of the loans and the ten foreign banks for one third (Table 2.6). Large banks hold dominant market positions in rural and micro-finance. Although licensing is open, the minimum capital requirement is fairly high for commercial banks and rural banks in some regions, and it is not easy to obtain a license (World Bank, 2010a). As a result, new entrants usually take over an existing bank. Looking forward, the authorities envisage adopting a multi-license model to move toward regional standards. In addition, caps on bank ownership became effective in July 2012, except for banks that fulfil a range of criteria such as passing BI's financial tests that focuses on good corporate government practice and getting approval from the banking regulator. These policies could also hamper market entry. It would be useful to investigate the effect of these recent and mooted regulations on entry in the banking sector and reconsider those that are found to be a major obstacle to entry.

Table 2.6. **Loans to SMEs by type of banks**

End-2011

	Loans to SMEs IDR billion	Per cent of loans to SMEs	Per cent of total loans
State-owned banks	222 645	46.4	29.2
Private national banks	194 234	40.5	19.4
Regional development banks	31 314	6.5	17.8
Foreign-owned banks and joint venture banks	9 971	2.1	4.1
Conventional/Islamic rural banks	21 723	4.5	52.9
Total	**479 887**	**100.0**	

Source: Bank Indonesia.

Some specific restrictions in rural banking can prevent market deepening. At the moment, rural banks can be owned only by Indonesian citizens. Easing this restriction would increase opportunities for capital and technology transfer. Finally, rural banks are subject to stringent restrictions for opening new branches. Branches may be opened only in the same province as the main office, and the bank must have been financially sound over the past year, have maintained a capital adequacy ratio of at least 10% and have current information technology. Although Bank Indonesia is applying these restrictions in a very liberal manner, it would be advisable to eliminate these requirements.

While the stock market has performed relatively well since the 2008 global crisis, it remains shallow compared to regional peers, and small companies have been reluctant to go public. Despite the existence of the specific Initial Public Offering (IPO) process for SMEs, the number of small companies being listed is extremely limited. One explanation is the disproportionate costs incurred after an IPO in terms of information disclosure. Less onerous reporting and disclosure requirements for small firms, while preserving the need to ensure good governance and transparency, could also make IPOs an attractive option for financing.

Some segments of the non-bank financial markets are insufficiently developed, with the result that young growing firms are not well served. They need more resources than can be provided by informal investors, family or friends or their own capital. But they are too small to rely on institutional investors, banks or stock markets. Venture capital and alternative financing such as leasing and micro-finance aim to fill that gap.

The venture-capital industry can finance SMEs with a strong potential for growth but which do not manage to obtain financing through traditional channels because they have not yet demonstrated favourable performance. This industry is still underdeveloped in Indonesia and constitutes a small segment of the country's financial sector. In particular, it has not managed to attract new investors in recent years, and most venture-capital companies are owned by the government or large national companies. One reason may be the shallowness of stock markets. In particular, the small number of IPOs, which provide an exit opportunity for venture capitalists, has been found to be a significant explanatory variable explaining firms' engagement in venture capital (Jeng and Wells, 2000). Against this background, the government has granted venture-capital companies tax exemptions for investments made in some industries. But this risks distorting the allocation of scarce capital and increasing rent-seeking behaviour, and should be reconsidered. Moreover, the existing restriction of 85% on foreign ownership of venture-capital companies could hamper entry and would best be removed. This is particularly important as the lack of expertise in the industry is costly.

As in other countries in Asia, most venture-capital companies do not provide genuine risk capital (Naqi and Hettihewa, 2007). Some function like commercial banks, albeit with fewer restrictions, and still rely on collateral. In February 2012, the Minister of Finance issued a decree to encourage them to focus on non-bankable firms. It also introduced regulation on entry requirements, licensing and capital requirements. These changes go in the right direction, but it will be important to regularly assess their effect. However, efficient monitoring of the venture-capital market will require a significant improvement in the quality and coverage of statistics, in particular a clear distinction between venture capital and private equity.

Leasing (*i.e.* renting machinery or equipment whose ownership rests in the hands of a financial institution), can relax financing constraints facing SMEs. This arrangement is particularly suited to the needs of new SMEs that do not have a long credit history nor collateral, especially when financial markets are shallow. Clients benefit from a number of advantages including simple collateral arrangements and flexible contracts. Collateral is easier to repossess, and capital requirements are lower for leasing companies. Leasing is also an accepted mode of financing under Shariah rules.

Despite these advantages, leasing, which is provided by multi-finance companies, has played a limited role in Indonesia in recent years, though it was widely used before the 1998 Asian crisis. Since then, the share of leasing in total revenues of multi-finance companies has declined from 17% to 12% in 2010. As multi-finance companies rely mostly on bank loans for their financing, they are sometimes unable to offer competitive rates (World Bank, 2006). The lack of expertise in credit risk assessment related to leasing has also discouraged multi-finance companies from entering these markets. The Indonesian authorities could foster leasing activity by freeing the industry from existing restrictions. In particular, phasing out the current limits on foreign ownership to a maximum of 85% of equity capital could enlarge the pool of financing for multi-finance firms and bring in technology and expertise. Another option would be to phase out the current investment restriction set out in a 2000 Minister of Finance decree according to which the total investment made by a multi-finance companies cannot exceed 40% of its own equity.

In recent years, micro-finance initiatives have gained prominence in Indonesia, as in other developing economies. According to Mixmarket data, such loans amounted to USD 274.4 million in 2010 and were allocated to almost 410 000 borrowers. Many of the providers are informal as they have a strong incentive to operate in the least regulated segment (Box 2.3). As banks incur a financial penalty when they lend to institutions

Box 2.3. **Micro-finance in Indonesia**

Indonesia has a long history in micro-finance. The first micro-finance institution, *Badan Kredit Desa*, was established 100 years ago.

The largest proportion of micro-finance institutions are well within the formal sector. Commercial banks account for about 80% of the loans. *Bank Rakyat Indonesia* (BRI) dominates the sector. BRI has an operational advantage because of its extremely wide network of branches enabling it to reach rural villages. This makes it difficult for any newcomer to challenge its position. According to BRI corporate policy, loans to MSMEs should make up to at least 80% of the bank's total portfolio (World Bank, 2010a). BRI's premier micro loan product is Kupedes, which provides loans up to IDR 100 million, with an interest of around 1½% per month. Clients are in general small traders located close to a BRI unit. Loans are made on the basis of income or clients' characteristics rather than collateral.

Table 2.7. **Characteristics of selected Indonesian micro-finance institutions**

USD, 2010

	Average deposit balance per depositor	Average loan balance per borrower	Cost per borrower	Gross Loan portfolio (million)	Number of active borrowers	Personnel	Return on assets (per cent)	Women borrowers
BMT Sanama	–	–	–	147.3	–	12	1.8	–
BPR AN	111	512	82	1.7	3 387	25	4.9	865
BPR AK	116	677	61	4.5	6 600	48	4.2	1 772
BPR BMMS	346	1257	215	0.7	569	23	1.3	334
BPR DMG	395	1264	314	0.7	550	29	3.0	58
BPR Hitamajaya	126	715	171	1.7	2 326	31	7.8	–
BPR NBP 11	244	1035	91	7.0	6 765	95	6.5	3 124
BPR NBP 2	124	701	122	4.9	6 970	65	5.6	1 184
BPR NSI	104	314	29	3.9	12 479	60	9.1	7 363
BPR Pinang Artha	320	1372	246	1.5	1 061	30	3.7	271
BPR Surya Yudha Kencana	489	1749	128	66.1	37 783	568	5.1	10 521
Dian Mandiri	1	46	37	2.0	44 214	220	0.0	39 695
KOMIDA	27	88	23	3.2	36 109	252	3.9	36 109
KSP Bakti Huria	14	222	60	2.9	13 257	270	1.3	7 603
KSU MUK	84	93	22	0.5	5 277	26	12.7	4 569
MBK Ventura	15	80	23	16.9	212 316	1218	–5.6	212 316
Mitra Usaha Kecil (MUK)	11	120	33	0.7	5 920	48	6.4	5 200
Average	**158**	**640**	**104**	**16**	**24 724**	**178**	**4.1**	**22 066**
Median	**114**	**595**	**72**	**8**	**6 683**	**48**	**4.2**	**4 569**

Source: Mixmarket.

People's Credit Banks (BPR) are also present in the market. They operate in the formal sector and vary in terms of size, market niche and performance (Table 2.7). Finally, micro-finance is also provided by small-scale institutions, which could be formal or informal. Some operate under condition of uncertainty over their legal status, eligibility to mobilise deposits and by which levels of government they are governed. They can be pawn shops, institutions owned and regulated by local governments (LDKPs), NGOs, and small savings and credit societies (*arisan*). Co-operatives and NGOs usually provide subsidised loans for their membership and target groups. They compete with a number of government lending programmes run by departments or State-Owned Enterprises.

Source: World Bank (2010a), Shrader *et al.* (2006).

without legal status, the financing source of these informal micro-loan providers is restricted. A law on micro-finance to clarify the status of institutions not falling under the Banking Act has been under discussion for more than a decade. Various proposals have been submitted to Parliament, but the law has not yet been approved. In 2009 a decree created a regulatory framework under existing laws to govern non-bank and non-co-operative financial institutions that operate outside the regulatory framework. But the decree has not been fully implemented (World Bank, 2010a). Efforts should be stepped up to pass a new micro-finance law and expand the coverage of the regulatory framework.

Fostering infrastructure development

Poor infrastructure is reported to be one of the major factors influencing investment decisions. Despite some improvement, the road and railway networks are still in poor condition, and the capacity of seaports remains limited. According to data from the Indonesian Institute for Sciences (LIPI), transportation costs in Indonesia amount to around 30% of total production costs due to poor infrastructure, while companies operating in China need to allocate only around 12% of their production costs to transporting goods.

The lack of electricity infrastructure can also hinder MSME operations, since small firms seldom have alternative power sources. According to the Asian Foundation, almost half of the 13 000 companies surveyed in 2010 and 2011 experienced power outages at least three times a week. A World Bank report for 2011 ranks Indonesia 161st among 183 countries in the ease of businesses' getting reliable electricity supply.

Fostering infrastructure development has featured as one of the main priorities of the Indonesian government in recent years. Ending a long period of uncertainty, the Land Acquisition Law was finally passed in December 2011 and implementing regulations issued in August 2012. The law empowers the government to take over land for development while owners are guaranteed compensation.[1] Although the law is widely expected to accelerate infrastructure development, it is unlikely to be sufficient to quickly close the infrastructure gap, given the substantial needs.

In May 2011, the President of Indonesia launched the Master Plan for the Acceleration and Expansion of Indonesia's Economic Growth for the period 2011-25 (*Masterplan Percepatan dan Perluasan Pembangunan Ekonomi Indonesia*, MP3EI). The plan provides a strategic direction for investors on where the government's economic development focus will be in the next 15 years. The MP3EI foresees that about IDR 1924 trillion (some USD 213 billion) will be allocated to infrastructure sectors during the period 2010-14. The authorities expect about 72% of these funds to be financed by the private sector or through public-private partnerships or foreign direct investment (Box 2.4). However, attracting such a high level of private and foreign investment may be challenging in the current business environment. Raising the amount of infrastructure investment the government intends to finance will not have a dramatic effect on the public deficit in the long run (Figure 2.9). It could even improve the government balance for sufficiently large private financing. Given the large pay-offs investment in infrastructure are likely to have at the country's stage of economic development, the authorities should consider faster increases in direct public spending on infrastructure. Reducing energy subsidies or increasing tax collection efforts appear to be the most efficient ways to finance this additional spending (Chapter 1).

Box 2.4. **Main features of the Master Plan**

The *Masterplan Percepatan dan Perluasan Pembangunan Ekonomi Indonesia* (MP3EI) is based on the development of six economic corridors, the strengthening of national connectivity and the acceleration of technological and R&D capacity. Within the different economic corridors, the plan identifies sectors that have high growth prospects and where Indonesia has the potential to increase its competitiveness. For the nation as a whole 22 sectors have been given priority, mostly natural resource sectors. The plan also singles out regional investment in infrastructure and development in human resource and technology that would boost growth in these sectors. In addition, the plan highlights the need to implement some cross-cutting reforms. These include ensuring the consistency of national and regional laws and regulations, developing the regulatory framework and putting in place incentives to promote investments.

The plan is expected to be implemented in three sequential phases:

- From 2011 to 2015, the focus will be on measures than can be easily implemented, on speeding up the process of issuing pending regulations and on preparing the ground for the next phases. Few projects during this phase represent new initiatives. Most appear to be projects that were already in the pipeline over the past several years.
- From 2016 to 2020 the focus will be on the acceleration of long-term infrastructure development and on boosting innovation and promoting higher value-added industries.
- From 2021 to 2025, it is assumed that the foundation will be in place for Indonesian industries to compete globally and use high-level technologies.

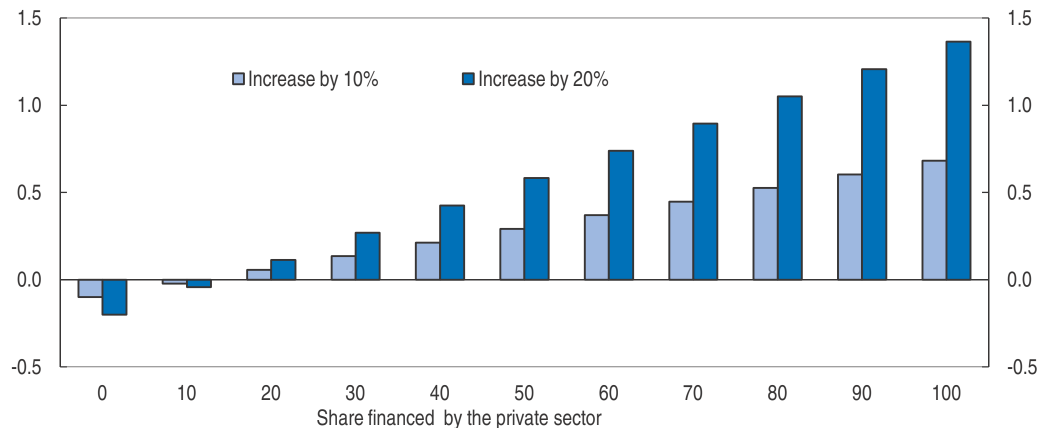
The plan is governed by presidential decrees. Over the next 15 years, the plan targets IDR 4 276 trillion (USD 468 billion) of which 45% will be directed to infrastructure sectors. 51% of total investment is expected to be covered by the private sector, while SOEs would contribute 18%. Central and local governments would finance about 10% of investment mostly in the form of basic infrastructure provision, such as roads, seaports, airports, railways and power generation. The remaining 21% will come from foreign investment and PPPs.

Source: Master Plan (2011), World Bank (2011b).

As underlined in the 2010 *OECD Economic Survey*, an increase in public spending will need to be complemented by additional reforms. Some progress has already been made: new regulators have been established in the rail transportation and water and sanitation sectors, but they are not fully independent. A set of guidelines clarifies the use of private-public partnerships in network industries. In addition, it will be important to strengthen the powers of existing regulators and improving co-ordination between national and local authorities. Regarding the electricity sector, priority should be given to phasing out electricity subsidies. The authorities have envisaged raising electricity tariffs in 2013 by around 3.5% per quarter (15% for the whole year). The authorities should pursue their efforts to lower electricity subsidies, given their long-term deleterious effects on economic growth and the environment. Widespread communication of the benefits and distributional gains of subsidy removal and recourse to existing well-targeted cash-transfer schemes will help to overcome resistance to reform. In any case, until subsidies are significantly reduced, adequate compensation to the state-owned electricity producer, as suggested by the OECD Guidelines on Corporate Governance of State-Owned

Figure 2.9. **Long-term effect of an increase in public infrastructure spending on the public balance**

Percentage of GDP



Source: OECD calculations using elasticities from Sahoo and Dash (2011), "Economic Growth in South Asia: Role of Infrastructure", *The Journal of International Trade & Economic Development*, Vol. 20, Issue 4, pp. 1-36.

StatLink http://dx.doi.org/10.1787/888932711695

Enterprises, would improve its balance sheet and ease financing for such crucial investments.

Promoting innovation by enhancing the enforcement of intellectual property rights

Innovation is likely to be a major source of SME productivity improvement. SMEs can support innovation, not only as knowledge exploiters but also knowledge sources. Small firms in Indonesia appear to innovate less and have less recourse to new technology than regional peers (Table 2.8). This partly explains aggregate developments in R&D spending as a percentage of GDP in Indonesia, which is low and has not risen as fast as elsewhere. Commonly used indicators of R&D outputs such as fees received from royalties, licenses or patents granted are also lower in Indonesia than in Brazil, China and India.

Table 2.8. **Small firms' role in innovation in Indonesia and selected Asian economies**

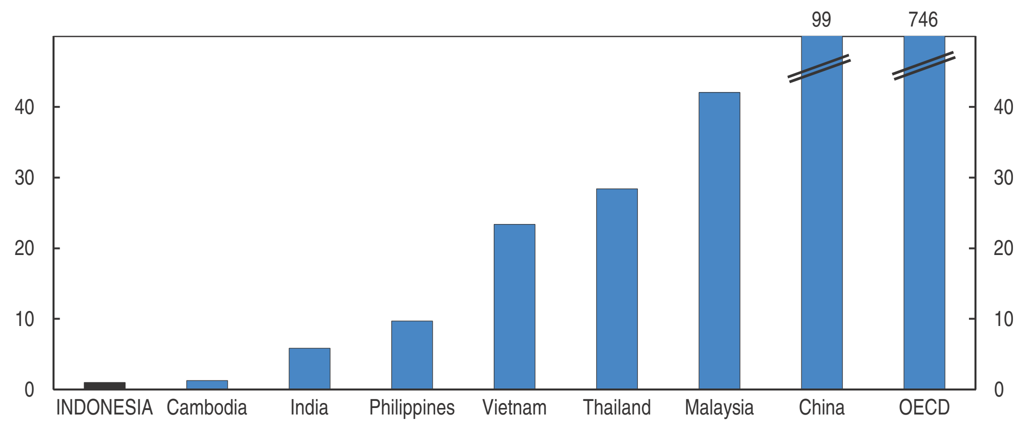
	Cambodia 2007	Malaysia 2007	Philippines 2009	Thailand 2006	Vietnam 2009	Indonesia 2009			
						Small	Medium	Large	All
Per cent of firms with an internationally recognised quality certification	–	12.2	8.6	6.8	6.0	1.6	6.3	40.8	2.9
Per cent of firms using technology licensed from foreign companies	–	–	2.4	–	0.9	2.4	10.3	35.4	4.0
Per cent of firms having their own website	29.0	8.5	36.7	23.6	25.6	4.2	9.2	45.3	5.7
Per cent of firms using e-mail to interact with clients/suppliers	43.7	36.3	49.4	45.4	74.5	9.4	31.1	81.8	13.2

Note: Size is defined by the number of employees: from 5-19 the firm is small, and from 20-99 it is medium-sized.
Source: World Bank Enterprise Survey.

Well designed intellectual property protection will encourage innovation. As many small firms operate in the informal sector, they tend to adopt strategic methods such as trust and secrecy more than formal paths to protecting their intellectual property. When Indonesian small firms adopt formal protections, they have a clear tendency to use trademarks above all other instruments, particularly patents, which are mostly used by foreign companies. This is similar to what is observed in other countries and is likely to reflect the nature of firms' innovation activity (Cusmano and Dean, 2011). However, Indonesia performs poorly *vis-à-vis* regional peers in terms of number of registered trademarks (Figure 2.10).

Figure 2.10. **Trademark registrations**

2010, per 100 000 persons



Source: World Intellectual Property Organisation indicators, 2011.

StatLink http://dx.doi.org/10.1787/888932711714

Intellectual property rights (IPR) legislation was updated to meet international standards in the 2000s. The passage of a new copyright law in July 2002 and accompanying regulations in 2004 strengthened Indonesia's IPR regime. During the same period, the delegation of IPR matters to specialised commercial courts helped to build expertise in the legal system. This has sped up the process, and resulting intellectual property decisions have been judged to be largely sound (Antons, 2007). In addition, special measures have been taken to meet the needs of small firms, raise their IPR awareness, diffuse knowledge about the variety of intellectual property instruments, lower the cost and time for application, and encourage firms to develop their own IPR strategies. The most important measure was the introduction of a special lower fee for small firms filing and administering their intellectual property, with an exemption for micro firms. The authorities also plan to hold courses or implement other capacity-building programmes to provide financial and technical assistance and facilitation for registration of SME trademarks and designs.

Despite the government's significantly expanded efforts to improve enforcement, intellectual property piracy remains a major concern. A lack of company confidence in enforcement mechanisms deters SMEs from accessing the system in the first place. It is costly to monitor potential infringement of IPRs, and the threat of litigation by more resourceful firms can sometimes intimidate SMEs. In March 2006, a presidential decree established a national taskforce for IPR violation prevention. It was intended to formulate policy to prevent IPR violations and determined additional resources needed for prevention, as well as to help educate the public and improve international cooperation to prevent violations. It is important to follow up and allocate more resources to improve enforcement of IPR regulations. In addition, policies should reduce the time and cost of enforcement procedures and improve firms' confidence in the process. Some countries, like the United Kingdom, have streamlined procedures to make patent litigation more accessible to SMEs (Cusmano and Dean, 2011). Adopting a similar approach could be useful for Indonesia.

Increasing the availability of qualified labour

The lack of qualified personnel can be a barrier to productivity growth and is likely to be even more so in the future as the economy moves toward a knowledge-based economy and the size of the non-agricultural part of the economy (which is more education intensive) expands. According to the 2010 World Bank Skill Survey, the skills of senior education graduates do not meet the expectations of Indonesian employers. Only 7% are rated 'very good', with most considered just 'fair'. Although most employers think their workers do not suffer from insufficient basic skills, 40% indicate they lack thinking and behavioural skills as well as vocational skills that are transferable between jobs like computer literacy and language proficiency.

Deepening the pool of skilled workers

Improving access to education is key to raising the general skill level. Enrolment rates have increased at all education levels in Indonesia and have resulted in significantly higher attainment in the younger generation (15 to 29 year-olds), with 35% of the associated labour force having an upper secondary diploma or higher in 2007, as opposed to only 22% for the 30 to 59 year–old cohort. Despite these improvements, the country lags behind regional peers in secondary and higher education, and there are large inequalities in access. As indicated in the 2010 *Economic Survey*, enrolment is particularly low in secondary education, suggesting the need to smooth the transition from primary to higher levels of education. Plans to implement universal secondary education and provide funding to 9.5 million high-school students, including students at general high schools, vocational high school and Islamic schools is expected to enter into force in 2013, although funding still need to be allocated in the 2013 Budget. Early dropping out could also be reduced by allocating additional government spending to extend conditionality in income-support programmes and include secondary school attendance. In addition, a higher per-student transfer under the School Operations Fund programme (*Bantuan Operasional Sekolah*, BOS)– which includes direct block transfers to schools to finance non-payroll recurrent expenditures – for schools located in remote areas and catering for poor students would improve financial support to students from disadvantaged backgrounds. Increased conditional cash transfers to poor households could be an alternative option.

Programmes have been put in place to provide skills to the large number of youths who drop out without any qualification. In the public technical training centres (*Balai Latihan Kerja*, BLKs), trainees receive around 140 hours of basic school training. But the centres suffer from a severe lack of capacity, stemming mostly from budget cuts in the aftermath of the 1997-98 Asian crisis. Their curriculum, which is designed by the central government and is limited to a small number of topics, also does not always reflect local firms' skill needs. Moreover, certifications are issued by the centres themselves and are not valued by employers. In the end, it remains unclear whether such schemes achieve their objectives. Beside formal education, "non-formal" education in the form of equivalency programmes (*pakets*) allows participants who had no access to the formal education system to get qualifications up to upper-secondary level. But, at the moment, there is no follow-up monitoring to check whether these programmes have proven successful in lifting the skills of past participants and in favouring their integration in the formal labour market over the medium term. It would be useful to rigorously assess the cost-efficiency of all existing programmes aiming at upgrading dropouts' skills and phase out those found to be inefficient. Such an evaluation would also help to identify potential ways to improve programmes that are found effective.

Aligning education and training systems with labour-market demands

In addition to raising enrolment rates, there is a need to improve the quality of education services. Employer surveys suggest that a high share of educated workers does not have the expected level of skills from their level of education. Indeed, the skills provided by the education system are not uniform across schools or among students within schools (World Bank, 2010d). Ways to raise teaching quality have been put forward in the 2010 *Economic Survey*. In particular, the 2005 Teacher Law is an important development and creates incentives for teachers to engage in training. However, the law needs to be complemented by efforts to monitor progress in teaching quality through regular assessments of teachers' pedagogical skills. Continued efforts to tackle teacher absenteeism would also yield substantial payoffs. At a minimum, teacher attendance needs to be monitored more effectively.

Vocational schools offer an alternative path to provide students with generic skills necessary to find a job. Their programmes last three to four years and are targeted at 16 to 18 year-olds. Training providers teach mostly technical topics. The curriculum is defined by the Ministry of National Education, with little input from private-sector firms. Moreover, the general coverage of the curriculum is found to be insufficient (World Bank, 2011a). The sector has expanded rapidly in recent years, with a growing number of private-sector providers. The authorities wish to expand it further to reach a 30/70 general/vocational ratio by 2015. Achieving this target is likely to prove extremely costly (World Bank, 2010e). Rather than increasing further the number of vocational training providers, it would be preferable to enhance the importance of generic skills in vocational schools' curricula and focus more on transferable vocational skills (such as computer literacy) and on on-the-job and practical training which are highly valued by employers. This could be done by strengthening the links with the productive sector. Finally, removing education from the negative investment list, as is currently examined in the context of the revision of the 2010 Investment List, would open up the market to competition from foreign vocational-training providers.

Training can also be delivered through apprenticeship programmes aiming at developing workplace learning in the private sector. These initiatives have been regulated since 2005, but companies retain most responsibility on the content and certification, with the government just monitoring whether the regulations are applied. Overall there is little information on the quality and quantity of training provided through this channel (Martinez-Fernandez and Powell, 2010).

Non-formal vocational training provides workers and students with specific and upgraded skills. However, the system does not reach dropouts but is rather used as a complement to formal education. According to the Ministry of National Education, almost 70% of students in the non-formal sector were also enrolled in formal education, while 16% were working. In addition, the quality of services varies across institutions due to the lack of standards in the certification process and weak enforcement of rules once accreditation has been granted. The priority is to ensure good quality for all the training courses and to facilitate access for the poor. Steps have been taken in this direction. The government has started to develop standards for training. This needs to be complemented by a comprehensive quality-control system that will ensure rules are enforced.

Changes to the tertiary-education sector are also required to make it more responsive to firms' needs. Accreditation data show that the average quality of university programmes is improving, albeit slowly, and private institutions are reported to be of poor quality. In addition, some sectors, like manufacturing, experience shortages of higher education graduates, suggesting that curricula may not be connected to sector-specific demands. In its Higher Education Long-Term Strategy 2003-10, the government sought to improve the quality of higher education and enhance its ability to respond to evolving labour-market demand. It is important to grant more autonomy to tertiary-education institutions so that they can adapt more easily to firms' skill requests and ensure high-quality teaching. In August 2012, a Higher Education Bill was passed to increase the autonomy of higher education institutions.

There are a number of ways to address the long-standing issue of unequal access to higher education and cope with increase in tuition fees that could result from the law. First, encouraging participation in secondary education is likely to translate into higher enrolment rates in tertiary-level education, and measures to achieve this have been described above. Second, a range of cost-sharing instruments could be used to alleviate the financial burden borne by poor students. A 2009 law already mandates that scholarships be available to at least 20% of the student population. As public resources are limited, more extensive use of student loans could be made. Indeed, international evidence suggests that a national income-contingent loan scheme that is based on charging moderate fees recouped via the tax system when the graduate enters the workforce and earns above a certain salary level would ease disadvantaged students' access to higher education (Schleicher, 2006). The provision of such loans is currently underdeveloped in Indonesia. One reason is that, like in many other Asian economies, Indonesia's past experience with such schemes has led to mixed results, with high delinquency rates leading to financially unsustainable programmes. But this stemmed essentially from poor administration and weak targeting. A second reason has been the low supply of bank loans. Better governance and targeting as well as more developed banking activity render student loans a more attractive option nowadays.

Strengthening workforce quality

Evidence from East Java suggests that the accumulation of human capital during working time is an important determinant of firms' growth (McPherson and Rous, 2010). Firms can participate in the provision of job-specific skills either through on-the-job training or through co-payments for external training. Employer-provided training is scarcer in Indonesia than in the Philippines or Vietnam (Table 2.9). Less than 3% of small firms are reported to offer formal training. One reason is that in an informal job setting, firms have few incentives to provide training, as trained workers can easily leave and use their upgraded skills elsewhere. This is particularly true as in-firm training is usually targeted at skilled and young workers. Informal in-house training can compensate for the lack of training and should be encouraged. In particular, inter-firm linkages in the value chain provide an opportunity for employees to learn new ways of operating or of marketing a product.

Table 2.9. **Small firms' training opportunities in Indonesia and selected Asian economies**

	Cambodia 2007	Malaysia 2007	Philippines 2009	Thailand 2006	Vietnam 2009	Indonesia 2009			
						Small	Medium	Large	All
Per cent of firms offering formal training	45.8	17.0	14.7	30.9	11.6	2.8	13.2	37.5	4.7
Per cent of workers offered formal training	–	26.8	59.5	33.6	66.0	56.5	55.6	39.7	52.9
Per cent of unskilled workers (out of all production workers)	25.8	63.6	7.8	79.7	10.5	19.6	23.0	36.2	20.4
Per cent of firms identifying an inadequately educated workforce as a major constraint	12.8	13.2	10.0	27.3	5.6	4.5	3.7	6.3	4.5

Note: Size is defined by the number of employees: from 5-19 the firm is small, and from 20-99 it is medium-sized.
Source: World Bank Enterprise Survey.

A last but important reason for the scarcity of training within SMEs is cost. There are currently few financial incentives in place. A number of OECD countries have introduced innovation vouchers to enable SMEs to finance support for new product or process development or invest in training. But an efficient system of controls would need to be developed for such a measure to be efficient in Indonesia. National training funds have also been used in many countries as an instrument for encouraging firm-based training. Examples include the Latin America Fund (National Industrial Apprenticeship Service, SENAI) and the Malaysian Human Resource Development Fund. These funds help to consolidate and administer various sources of financing for training and allocate it according to national priorities. They are usually managed by the central government and directed by a governing board that includes employer representatives. This helps to ensure that feedback from the labour market is incorporated into training content. The authorities could create a national training fund to consolidate resources allocated to training and direct them to their most cost-efficient use.

Developing entrepreneurship

The education level of entrepreneurs in small firms is low in Indonesia. Data from the 2003 Social and Economy Survey (*Susenas*) suggest that more than half of all top managers had no diploma or had completed only primary school. Low levels of entrepreneurial skills can magnify barriers to SME development. In particular, capacity building in terms of improving financial statements and management training is found to have a positive impact on SME development in Europe (European Commission, 2006). There is also evidence that entrepreneurial training for workers in the informal economy facilitates the transition from self-employment in the informal economy to micro enterprise development in the formal economy (Martinez-Fernandez and Powell, 2010). Several programmes already exist to foster entrepreneurship in Indonesia, but it would also be useful to include entrepreneurship activities in school curricula. International experience suggests that most effective courses use interactive teaching methods that incorporate practical experience (OECD, 2010b). However, improving entrepreneurship skills in Indonesia is challenging and will require removing obstacles to accessing formal training.

Policies to support small firms

Given the importance of MSMEs in Indonesia's economic development, support to small firms has been an important facet of policy. As in many other countries, support has taken various forms, ranging from giving privileged access to MSMEs in certain sectors to more traditional credit programmes or subsidies, as well as training and counselling.

Clearly defining responsibilities across the government

Since 2008 support to small firms is by law a public duty, but the responsibilities of the different levels of government still need to be clarified. Most central-government ministries are currently involved in the delivery of support to MSMEs, but local governments also provide their own programmes. SME support is also one of the objective of the Masterplan of Acceleration and Expansion of Poverty Reduction in Indonesia (*Masterplan Percepatan dan Perluasan Pengurangan Kemiskinan di Indonesia*, MP3KI), which aims at reducing poverty by empowering people. A lack of effective coordination has resulted in a plethora of sometimes overlapping measures and an inefficient delivery of support. More clearly defined responsibilities among the different levels of government would help to ensure resources are efficiently used. Local governments should play a crucial role in implementation, given the central government's limited ability to reach out to MSMEs dispersed throughout the archipelago. The role of the central government should be confined to providing financial resources and assistance to local governments and enhancing their implementation capacity. It should also give general direction, assessing progress toward achieving this goal and ensure equity of access to programmes in all regions. There could be economies of scale for the central government to run some specific programmes (such as loan guarantees) when they do not require face-to-face contacts.

Programmes managed by several central-government ministries should be consolidated. One option would be to devolve management responsibility to a single ministry. It would be responsible for developing an overall strategy and monitoring and evaluating progress of different ministries towards the goals of the strategy. It could possibly have control over SME development funding that is currently scattered in nearly all ministries. Other possibilities include the management of policy by a new SME agency, or co-ordination of different ministries by a high-level committee chaired by a senior member of the government such as the Vice-President.

Moving to a neutral financing of support

One particularity of Indonesia's support policy is that it is partly financed by mandatory savings by State-Owned Enterprises (SOEs). Indeed, since 2003 a law mandates SOEs to allocate up to 5% of their net profit to support development of MSMEs and co-operatives. Support includes the provision of soft loans to non-bankable firms through a partner programme as well as the provision of grants to assist capacity-building activities in such areas as production and processing, marketing and technical skills improvement through mentoring programmes, up to a maximum of 40% of the total cost of the investment. A less distortive way to finance support would be to have recourse to general taxation.

Improving the efficiency of support

As stated, there is a multiplicity of programmes providing support. For instance, at least five aim at easing farmers' access to finance (OECD, 2012b). A study of Indonesian

SMEs in regional production networks suggests that assistance is often perceived as effective (Machmud and Siregard, 2009). However, the form of assistance that is most often delivered is not necessarily that which is perceived by firms as the most effective. Counselling, training and financial assistance are those most frequently provided but rank lower in terms of their effectiveness. By contrast business linkage and networking and technology development, which are less frequently offered, are perceived to be more effective than training and financial assistance. Moreover, at the moment, the authorities only monitor rather than evaluate programmes, focusing on those that are strategic (Suryahadi *et al.*, 2010). It is important to regularly assess the cost-effectiveness of existing programmes. To be credible and prevent policy capture, it would be preferable to assign this task to an independent agency. After such a rigorous evaluation is undertaken, it may be possible to consolidate support by phasing out inefficient measures and directing resources to the most cost-effective schemes.

One of the main strands of policy support has been to encourage the formation of SME clusters, the rationale being that, in theory, the latter can be the source of productivity gains through economies of scale in the purchase of raw materials or machinery or spreading of risks associated with demand fluctuations. By locating in geographical dense locations SMEs can also benefit from abundant natural resources and a pool of skilled workers and get easy access to markets (Chamindale and Van, 2008; Bair and Gereffi, 2001). Clusters also allow sharing of R&D expenditures and diffusion/sharing of information on new designs, processes, products and knowledge spillovers (Aylward, 2004). Finally, policy support to SMEs is easier when the latter are concentrated in a cluster. Empirically there is some evidence that small firms that are parts of clusters are in a better position to adopt innovations and to export when compared with dispersed counterparts (Marwadi *et al.*, 2010; Berry *et al.*, 2001). The main drawback is nevertheless that clusters in developing economies tend to be controlled by large dominant enterprises.

SME clusters can already be found in all Indonesian provinces, most of them in rural areas. Some reflect collaboration among a number of extended families that have a long history of cooperation. But there is also evidence that most Indonesian SME clusters tend to grow spontaneously without government intervention (Marijan, 2006). This was the case for instance for two large clusters for leather goods and traditional handicrafts in the Yogyakarta area, which have developed virtually without public intervention (Tambunan, 2005). Against this background, it may be useful to examine the effectiveness of policy measures aimed at encouraging the formation of clusters.

Indonesia has been protecting small firms in its FDI policies by reserving certain sectors for them and requiring partnerships with them in other sectors. These sectors are specified in the negative investment list. This policy was initially intended to foster collaboration between foreign investors and local small firms and can potentially create technological spillovers benefitting the latter. But, this restriction could also discourage foreign companies from investing and needs to be reconsidered. Such policies may also raise obstacles to SME growth, as firms may be keen on staying small to benefit from this privileged access.

Box 2.5. **Summary of recommendations: SME development**

The following recommendations could help to foster SME productivity:

Business environment and labour market

- Systematically review all significant existing business licensing requirements at the national and local levels, with a view to simplification and ensuring they remain cost-effective. Sanction regional governments that fail to make significant progress in simplification and consolidation.
- Public finances permitting, increase public outlays on cost-effective infrastructure projects beyond what is already planned.
- Lower electricity subsidies and have recourse to cash-transfer schemes to compensate poor households for the rise in electricity price.
- In provinces where minimum wages are high in relation to average wages, resist increases that exceed trend productivity gains. Introduce a sub-minimum wage for youth directly linked to the general minimum wage. Reduce onerous severance payments and ease dismissal procedures in the formal labour market. In return introduce unemployment benefits coupled with individual unemployment saving accounts.
- Improve the enforcement of intellectual property rights.

Access to finance

- Clarify property rights for land.
- Make the information collected by the credit bureau available to all non-bank financial institutions.
- Remove the tax exemptions granted to venture-capital companies to support investments in some industries and the existing restriction of 85% on foreign ownership of such companies.
- Step up efforts to pass a new micro-finance law, and expand the coverage of the regulatory framework.

Human capital

- Extend conditionality in income-support programmes to include attendance in secondary education. Increase the per-student transfer under the School Operations Fund (BOS) programme for schools located in remote areas and catering for poor students or alternatively increase conditional cash transfers.
- Rigorously assess the cost-efficiency of all programmes aimed at upgrading dropouts and workers' skills, and phase out those found to be inefficient.
- Remove formal education from the negative investment list.
- Encourage tertiary education financing through student loans.
- Create a national training fund to consolidate resources allocated to training and direct them to their most cost-efficient use.

Policy support

- Clarify government responsibility in the delivery of support to small firms. Regularly assess the efficiency of existing programmes, phase out inefficient measures, and redirect resource to the most cost-effective schemes.
- Re-examine the effectiveness of policies to encourage the formation of clusters, to reserve certain industries for small firms alone, and to require foreign direct investors to partner with local SMEs.

Note

1. The bill covers infrastructure projects such as roads, dams, tunnels, railways, ports and airports, oil, gas and geothermal facilities, power plants and their distribution networks, hospitals and telecommunication networks. It is limited to government projects but allows government to partner with state-owned firms and the private sector. The bill shortens to two years the process of deciding on a project location, with a possible extension of one year. It gives a clear timeframe for land acquisition that includes decisions over a location, an appeals phase and compensation to be decided by a court within 30 days. It will also shorten the time it takes for infrastructure projects to acquire land. Compensation can come in the form of cash, land swaps, share ownership, assisted relocation and/or other forms agreed by both parties. The bill gives local government the power to decide on the location of a project and charges the National Land Agency with overseeing the acquisition process. A separate presidential regulation, which was issued in August 2012, set a maximum time limit of 583 days for the completion of land acquisition and details of steps to be taken for the handover of land for public projects.

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