

Indonesia 2045: The Political Economy of the Possible

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Background

- Indonesia experienced a complex and difficult reform, and yet arguably Indonesia has made significant progress.
- In the last ten years, as the economy has grown by an average of 5% per year
- Per capita income has increased from approximately \$1,222 in 2004 to \$ 4580 in 2022.
- This growth has pushed Indonesia into the group of middle-income countries.
- Asia's economy, including Indonesian economy is predicted to play a major role in the future (Wilson and Purushotaman (2003); Buiters and Rahbari (2011))
- However, there is a risk of Middle Income Trap (Felipe, 2012)

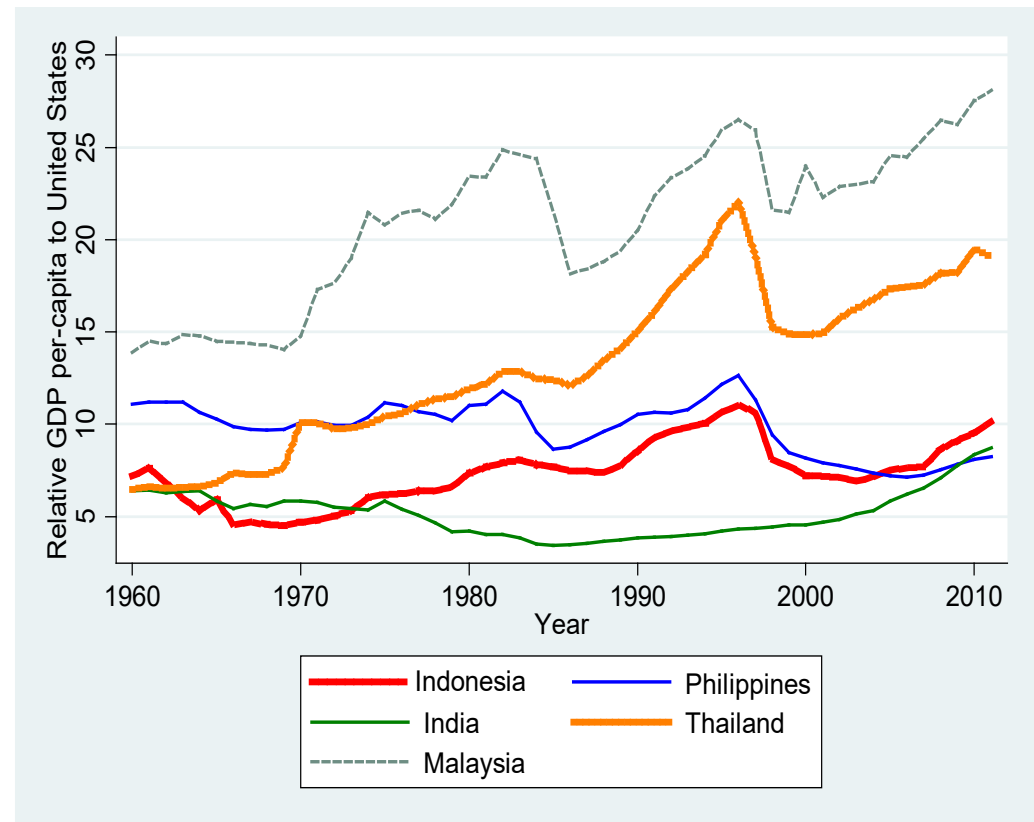
Questions to be addressed

- **Will Indonesia be able to accelerate its transition from middle- to high-income status by 2045**
- **What can be done given the political and institutional constraints? The political economy of the possible**

Indonesia's evolution of relative income: steady but slow

Relative income to the US (in PPP basis) rom 1960-2011

- Indonesia doubled its relative income per-capita compared to 1970. But it took 40 years!
- Similar pattern with middle income countries in Southeast Asia, except Philippines
- 1997 Financial Crisis had a devastating impact



Demographic dividend 2025, but aging population begin in 2050



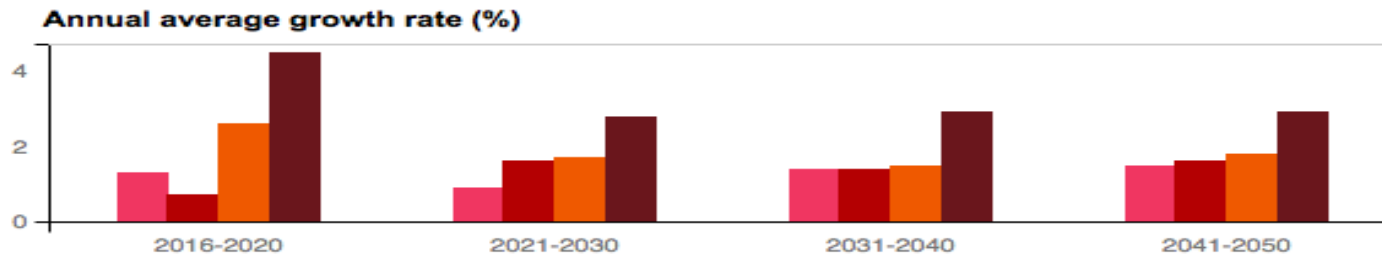
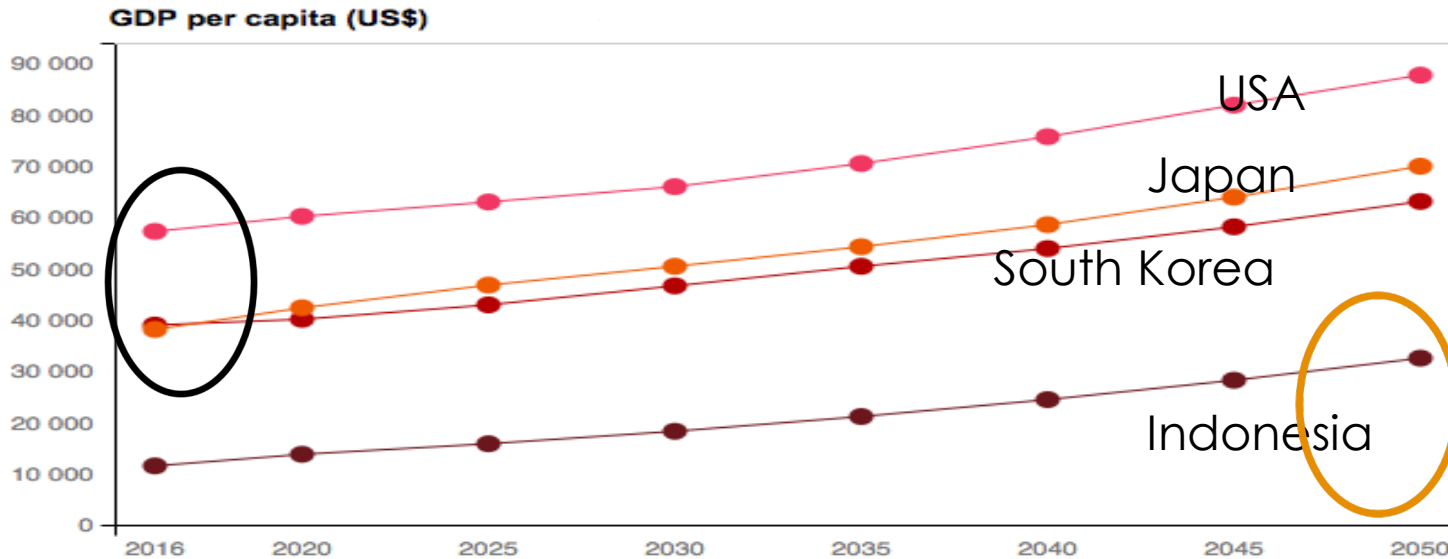
TABLE 1

SUMMARY OF DEPENDENCY AND ECONOMIC SUPPORT RATIOS,
ASIA AND NEAR EAST COUNTRIES, 2000, 2025, AND 2050

	Total dependency ratio			Child dependency ratio			Old age dependency ratio			Economic support ratio		
	2000	2025	2050	2000	2025	2050	2000	2025	2050	2000	2025	2050
East Asia	0.462	0.474	0.649	0.349	0.265	0.266	0.113	0.210	0.383	0.761	0.675	0.575
South East Asia	0.568	0.460	0.570	0.494	0.336	0.308	0.074	0.124	0.262	0.709	0.705	0.661
South Asia	0.649	0.472	0.522	0.573	0.360	0.306	0.076	0.112	0.216	0.658	0.660	0.623
Japan	0.468	0.673	0.838	0.217	0.226	0.254	0.250	0.447	0.583	0.637	0.582	0.545
South Korea	0.393	0.477	0.678	0.299	0.252	0.270	0.094	0.226	0.417	0.647	0.622	0.564
Philippines	0.676	0.458	0.521	0.615	0.353	0.305	0.061	0.105	0.216	0.677	0.672	0.649
Thailand	0.450	0.453	0.660	0.366	0.274	0.278	0.084	0.178	0.382	0.787	0.728	0.653
Indonesia	0.546	0.456	0.573	0.473	0.333	0.313	0.073	0.123	0.260	0.683	0.695	0.652
Bangladesh	0.622	0.428	0.523	0.569	0.344	0.309	0.052	0.084	0.213	0.753	0.761	0.728
India	0.620	0.459	0.531	0.540	0.336	0.300	0.081	0.123	0.232	0.641	0.638	0.601

Source: Mason, Lee, Russo (2000)

Growing old before becoming rich?



Average annual growth rate, 2016-2050

We must accelerate our
GDP growth.

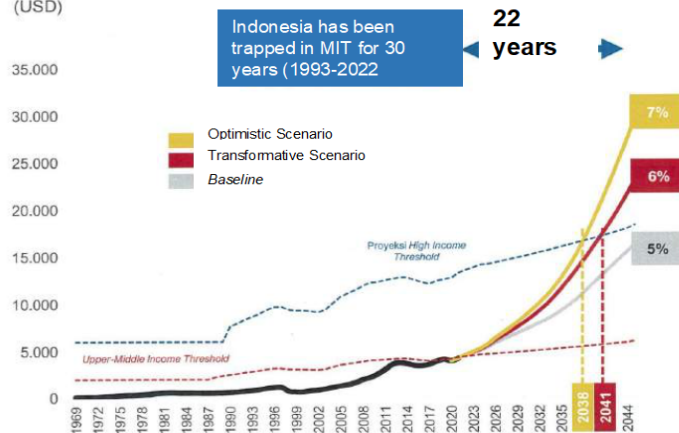
TO ACHIEVE THE OBJECTIVE OF THE GOLDEN INDONESIA 2045 : BIG AND PERSISTENT EFFORT

TARGETS OF ECONOMIC TRANSFORMATION FOR INDONESIA GOLD 2045



Economic transformation aims to lift Indonesia out of the middle-income trap and into a high-income country. For this reason, the Indonesian economy must achieve an average growth of 6-7% in the next 20 years, high economic growth that is inclusive and sustainable

Proyeksi GNI per Capita Indonesia (USD)



Scenario	Average Growth	Years Escape form MIT
Transformative	6%	2041
Optimistic	7%	2038

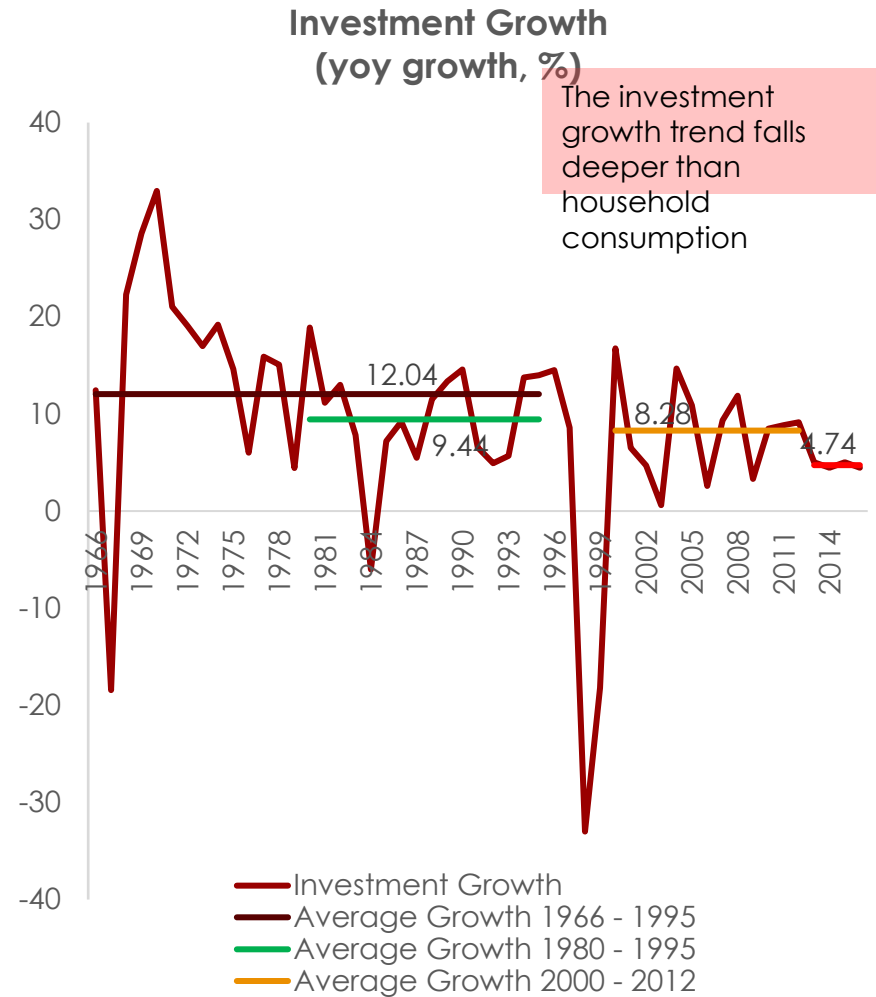
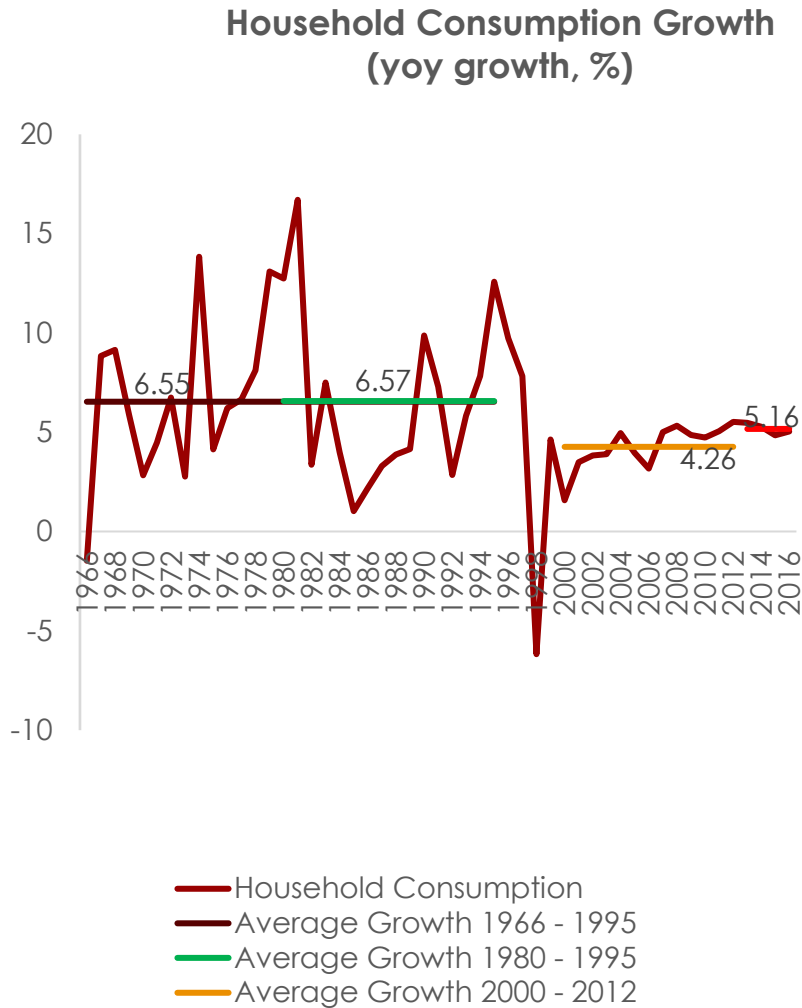
Economic Transformation

1. Science and Technology, Innovation and Economic Productivity
2. Green Economy Implementation
3. Digital Transformation
4. Domestic and Global Economic Integration
5. Cities as Centers of Economic Growth



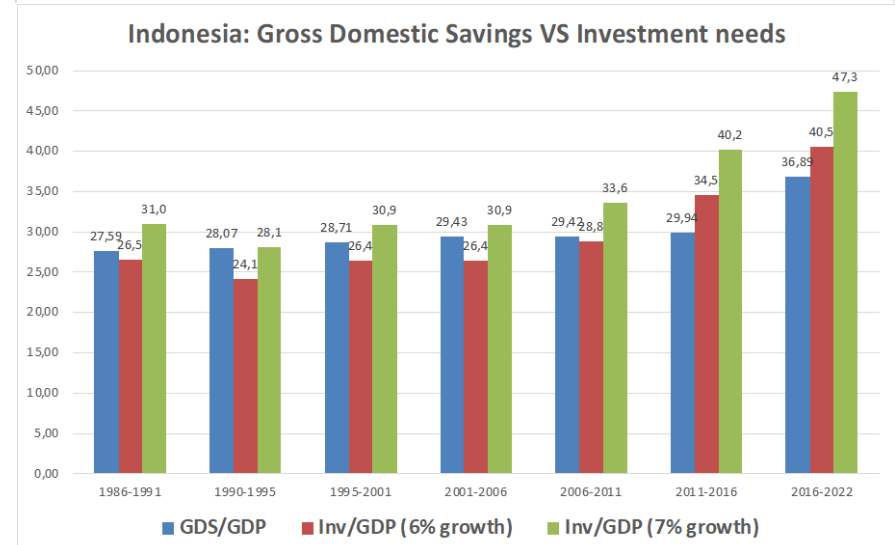
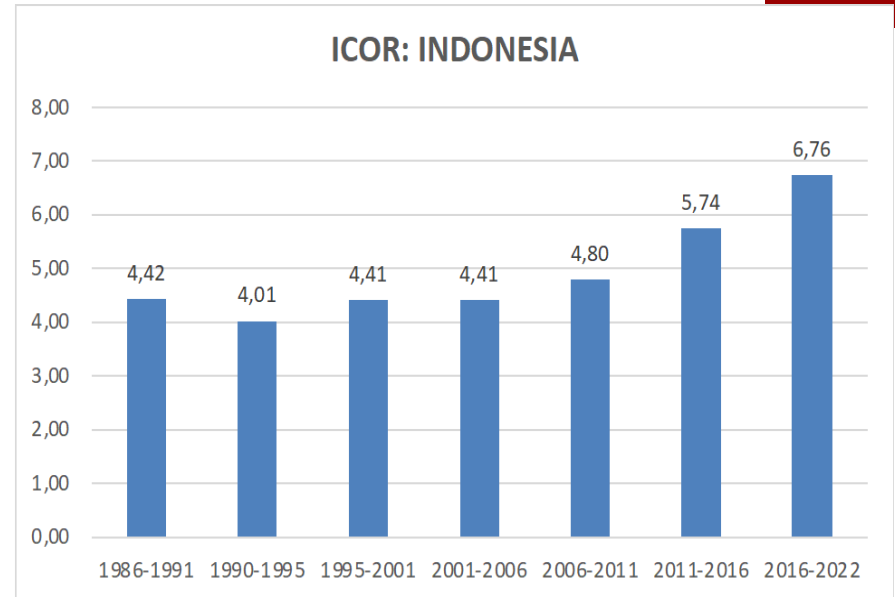
Source: Preliminary Draft RPJPN 2025-2045, May 19 2023

Consumption-driven growth is outpacing investment-driven growth.



Can we grow faster than 6%??

- **ICOR=6.8 (investment/GDP ratio) (2016-22)**
- **Every additional 1% GDP growth will necessitate a 6.8% of I/GDP**
- **6-7% GDP growth will require I/GDP : 40.8%-47.6%**
- **S=Indonesia's Gross Domestic Savings/GDP: is 37% (2016-22)**
- **Thus Current Account Deficit (CA) > 3%.**
- **Countries having CA Deficits > 3% that are financed by portfolio are more vulnerable to capital flow volatility (historical experiences in EM including Indonesia**
- **Policy options: improve productivity (lower ICOR): human capital, infrastructure, governance; FDI in export oriented sector —> business climate; increase S= Tax/GDP**



Average. Data 1998-99 and 2020 are not included (outlier due to crisis)

Policy continuity or change?

- Shifting towards high growth cannot happen instantly without jeopardizing macro-stability. It has to go through the supply side (Improve productivity) to reduce ICOR;
- Supply side: investing in human capital: education, health; short-term and long term
- Improvement in governance (institutional reform)
- Infrastructure development (logistics, ICT)
- Financing: increase tax ratio/GDP; FDI; External Financing
- Environment for knowledge exchange: labor market, creativity, openness to FDI
- Managing political process

The importance of export sector

Comovements between Innovations in Private Consumption with Innovations of GDP Components ^a

Lags	Components of GDP		
	Government consumption	Gross fixed capital formation	Exports
0	0.12	0.06	0.24
-1	-0.16	-0.04	-0.27
-2	-0.22	-0.01	-0.41
-3	0.26	-0.07	0.29
-4	0.20	-0.13	0.49

Source: Estimated from BPS National Account

^a Comovements between innovations of each component derived from original data that spans from 2000-I to 2008-IV. Here growth is expressed as annual (year-to-year) growth

Export volatility and concentration

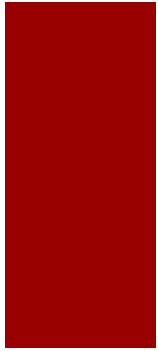
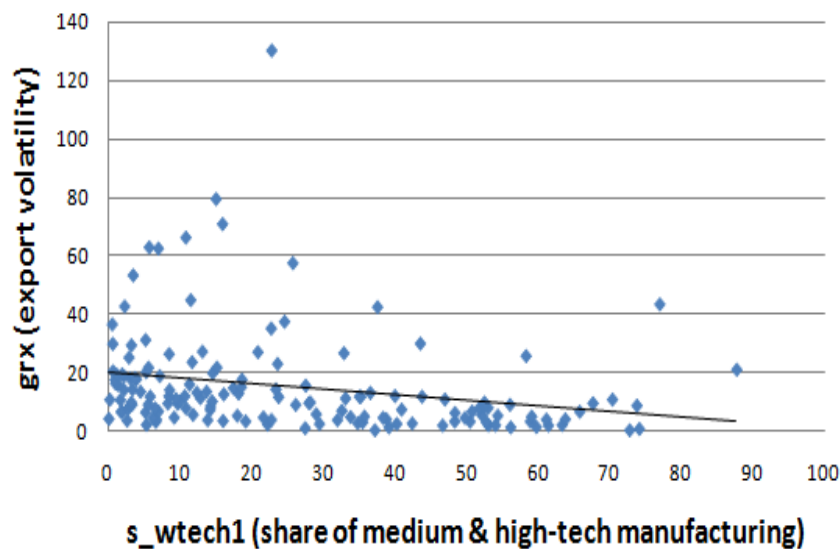


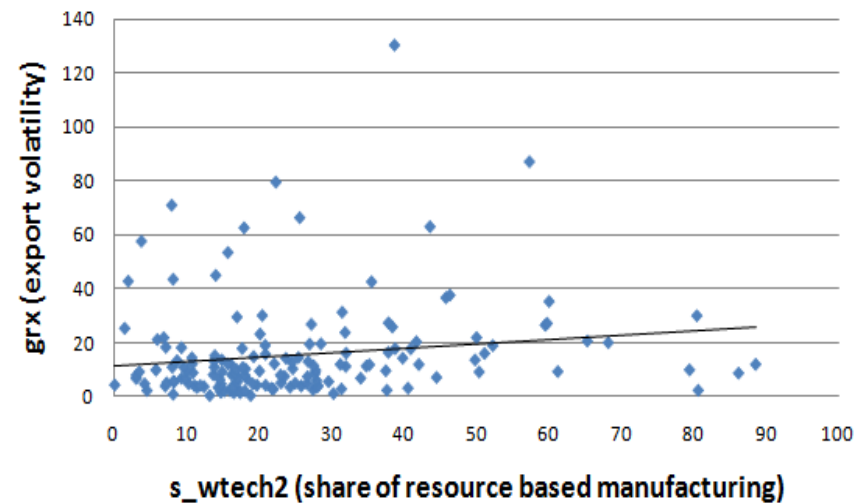
Figure 8: Export volatility and concentration in medium & high tech manufacturing

Figure 9: Export Volatility and concentration in resource based manufacturing

World Technology 1



World Technology 2



Indonesia made slow progress in export diversification; especially during the commodity boom; Dutch Disease?

Figure 11 Relatively Slow Progress in Diversifying Export Products

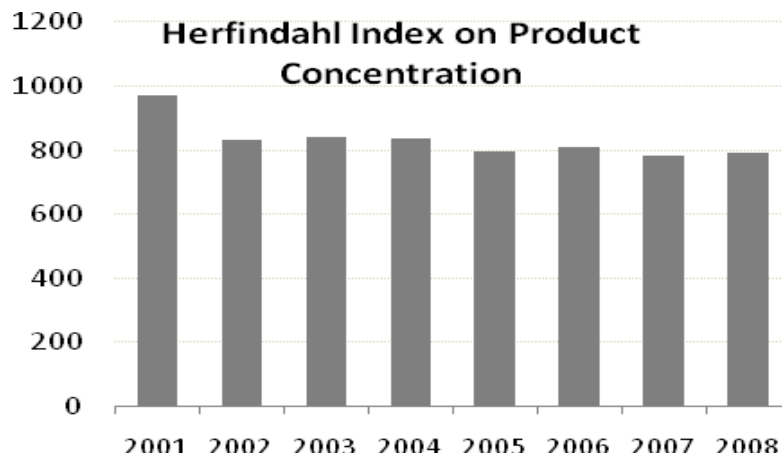
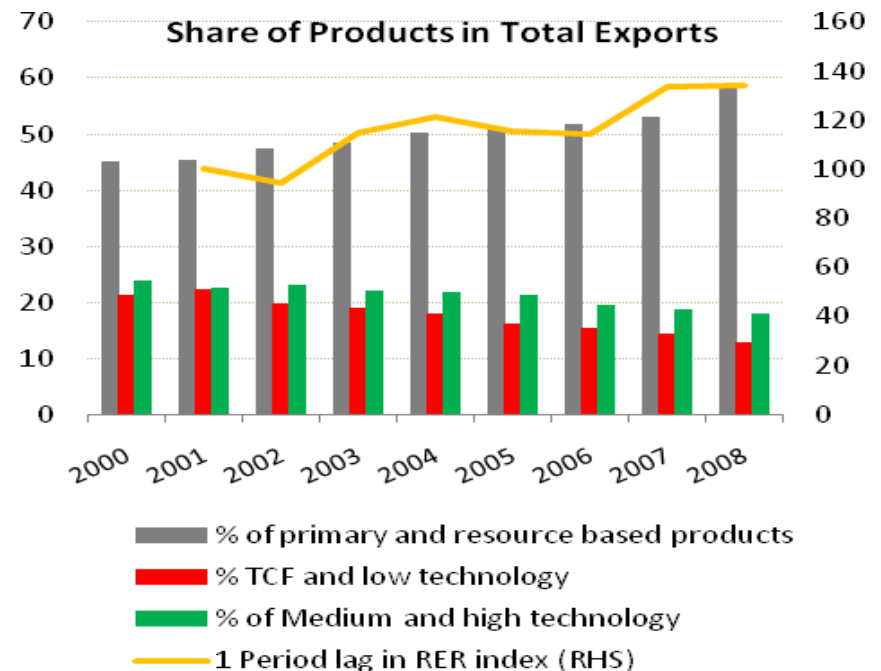


Figure 12 Increasing Share of Primary and Resource Based Products

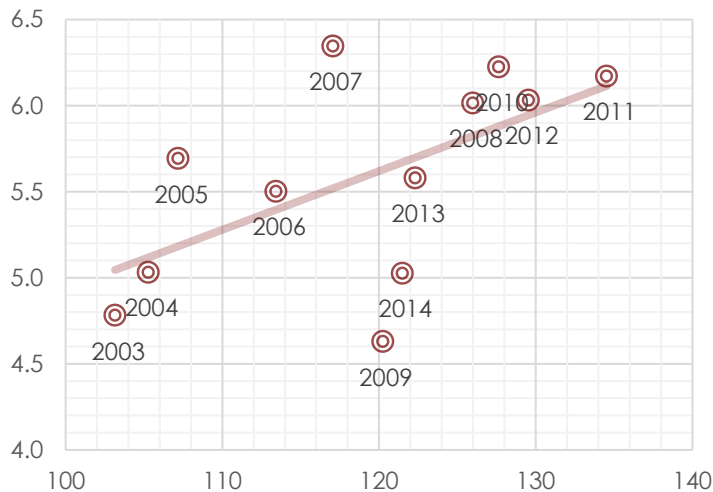


Source: Bank Indonesia and authors' calculation using UN-Comtrade data. Classification is based on Lall (2000)

Terms of Trade effect

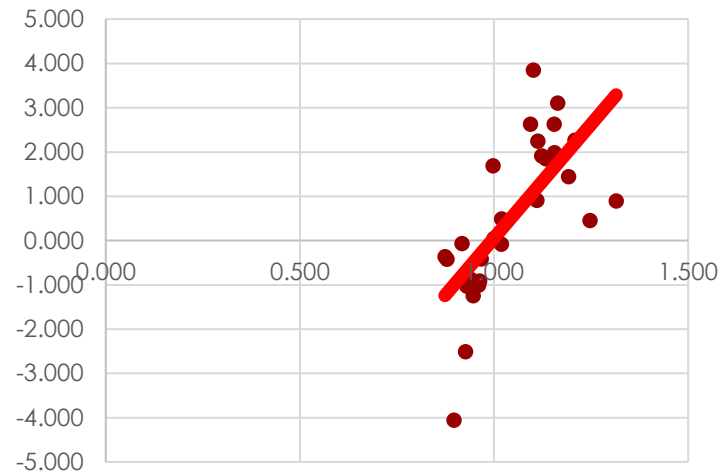
Indonesia : GDP growth and Terms of Trade

GDP Growth (% Y) and Terms of Trade (Index 2000=100, X): Indonesia

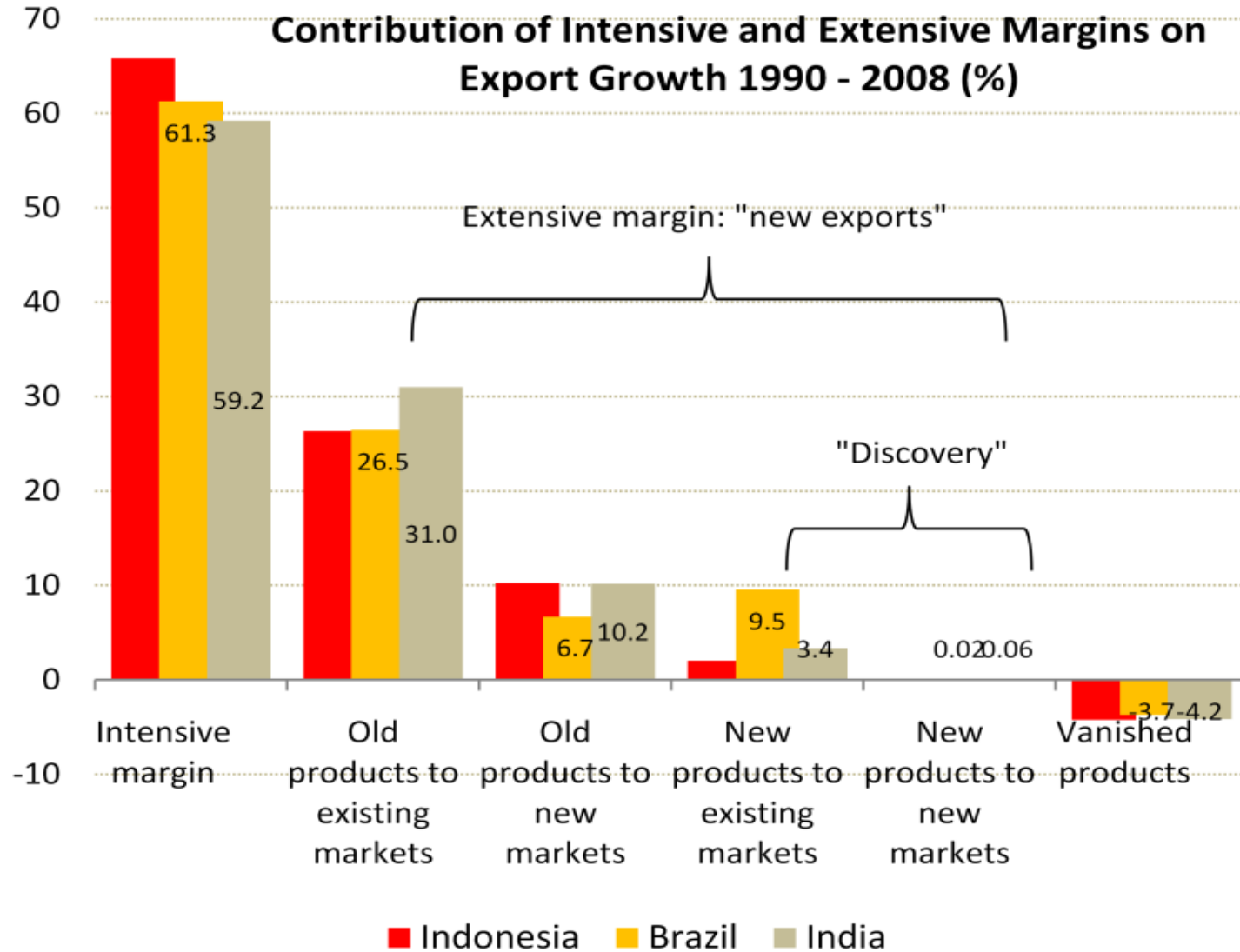


Indonesia: Terms of Trade and Primary Fiscal Balance to GDP

Indonesia: Terms of Trade and Primary Fiscal Balance to GDP



Indonesia could do more in promoting new export



Development challenges are beyond macro-stability

	Brazil	China	India	Indonesia	Malaysia	Philippines	Thailand	Vietnam
Characteristics (2013)								
Population (person mn)	200.4	1,357.4	1,252.1	249.9	29.7	98.4	67.0	89.7
GDP Per Capita (in PPP, USD)	5,823	3,583	1,165	1,810	6,998	1,581	3,438	1,029
Density (person/sq km)	24.0	144.6	421.1	137.9	90.4	330.0	131.2	289.3
Real Exchange Rate Movement (%)								
2003-2013 (average)	68.3	31.4	-0.3	6.4	2.5	39.2	25.0	50.9
PISA Test Score (2012)								
Math	391	613	351*	375	421		427	511
Science	406	580	348*	382	420		438	528
Broadband Penetration								
Fixed (wired)-broadband subscriptions per 100 inhabitants (2013)	10.08	13.36	1.16	1.3	8.22	9.12	7.36	5.62
Logistics Performance Index (2014)								
Percentage of shipment met quality	82	76	67	70	97	71	83	76
Government effectiveness score	-0.08	-0.03	-0.19	-0.24	1.10	0.06	0.21	-0.30

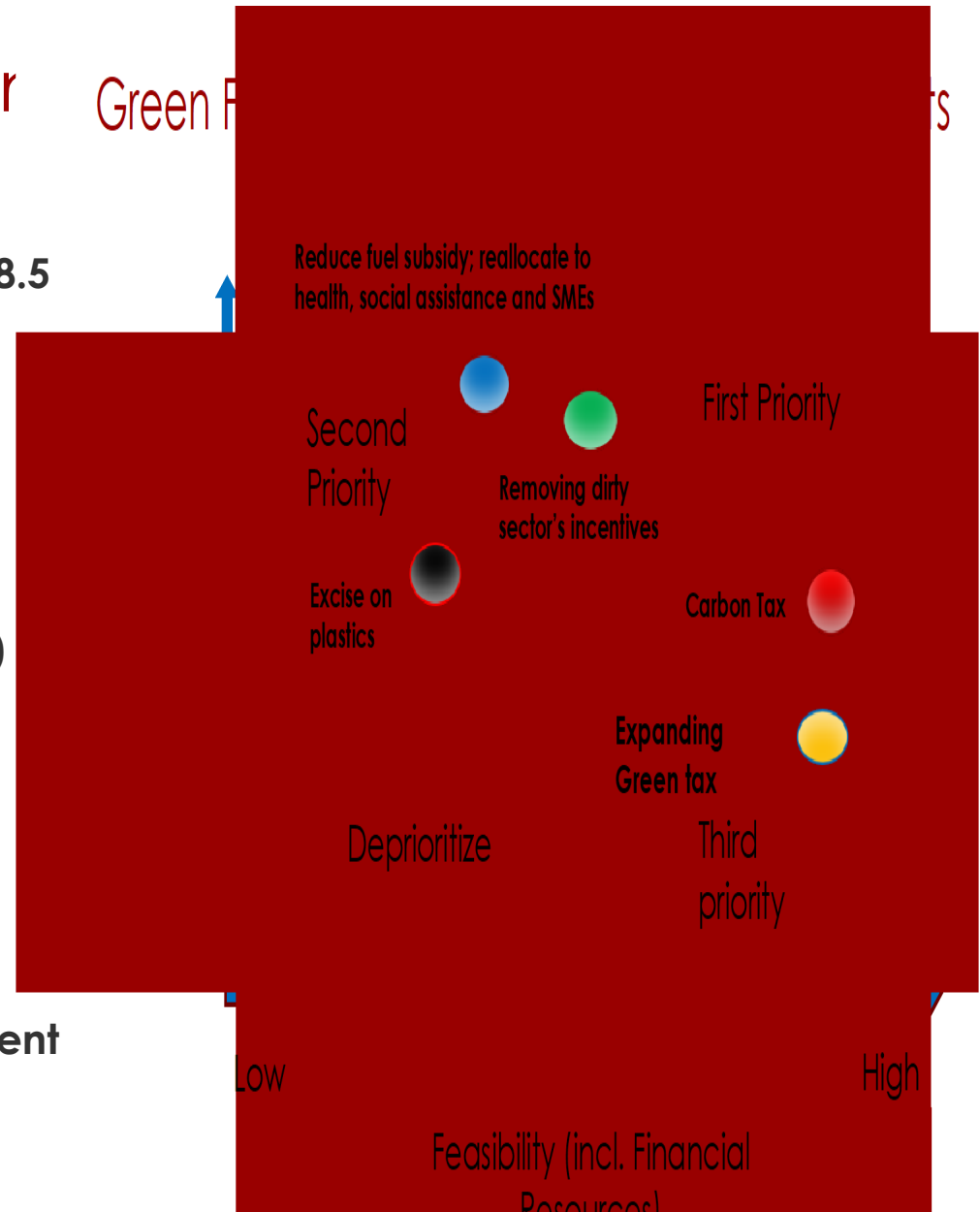
* Tamil Nadu dan Himachal Pradesh

Sources: World Bank, ITU, BUIS and others

Just Energy Transition

- ❖ Weathering the transitional risks
- ❖ Financing the green economy \$28.5 bn to achieve NDC
- ❖ Limited fiscal capability
- ❖ Getting the price right
- ❖ Climate finance:
 - Domestic Resources Mobilization (Green Fiscal Policy)
 - External Financing:
 - MDB,s, Concession loans, SDR,
 - Private Sector and philanthropy
 - Basel reform (Triggs)
- ❖ Impact on Macroeconomic (Current Account, exchange rate etc)

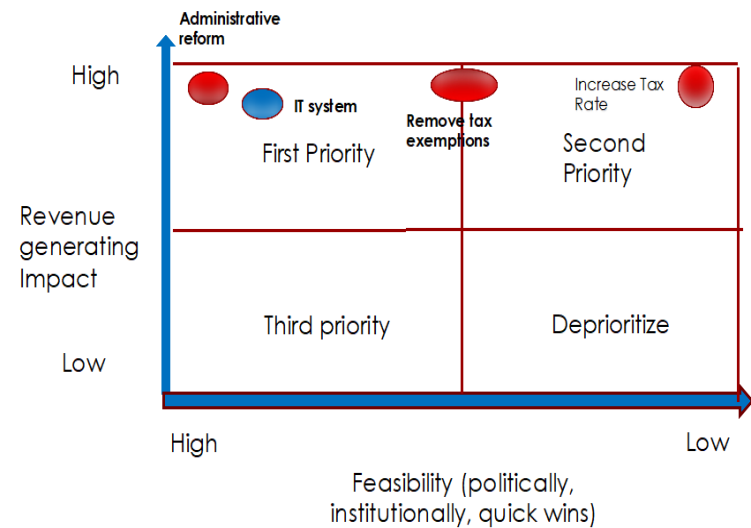
Green F



Budget Strategies: mobilize revenue and improve quality spending

- Increase Tax Rates?
- Administrative reform
- Reduce Tax exemption
- Review Tax Expenditure: post audit
- Case study Indonesia: Basri, Felix, Hanna and Olken (2021) shows that developing country governments can increase tax revenue through both enhanced administration and increases in tax rates. But they also imply, at least in the case of medium-sized firms, that **improving administration** can have a particularly dramatic effect in increasing revenues.

Revenue Strategies



Note: feasibility includes administrative capability, time frame, political economy

Allocate: Align Investment Choices with Country Needs

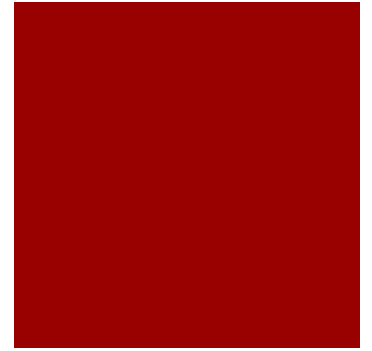
Current Expenditure

- Focus on quality of spending
- Review effectiveness of subsidies: case of fossil fuel subsidy; the richest 20% of households receive six times more benefits in fuel subsidies than the poorest 20%. Reduce fuel subsidies and use the savings to fund social assistance programs (Basri, Hanna, Olken, 2020)

Capital Expenditure: Cost effectiveness

- Investment on health; Education (short term vs long term); political cycle
- Investment Infrastructure (impact; political economy perspective)
- Digital technology to boost job (youth unemployment); Re-skilling and up-skilling
- Ear marking: use of natural resource revenues for longer-term benefits, such as human development. The results are mixed (OECD, 2017); concerns including :
 - limits budgetary flexibility

Managing Political Economy



“We all know what to do, we just don't know how to get re-elected after we've done it. “

Jean Claude-Juncker, President of EU

Middle class: Rising expectation

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

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

Class	P	V	A M C	M C	U C
	Poor	Vulnerable	Aspiring Middle Class	Middle Class	Upper Class
Household status	Below national poverty line (PL)	>10 percent chance of being poor next year (1,0-1,5xPL)	<10 percent chance of being poor but >10 percent chance of being vulnerable (1,5-3,5xPL)	<10 percent chance of being poor or vulnerable (3,5-17xPL)	>17xPL
Per capita consumption —Rp is Monthly US\$* is daily	<Rp 354k <US\$2.20	Rp 354-532k US\$2.20-3.30	Rp 532k-1.2m US\$3.30-7.75	Rp 1.2-6.0m US\$7.75-38 sub-groups: MC 1 (Rp 1.2-3.2m; US\$7.75-20); MC 2 (Rp 3.2-6.0m; US\$20-38)	>Rp 6m >US\$38

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

Source: Susenas and World Bank calculations.

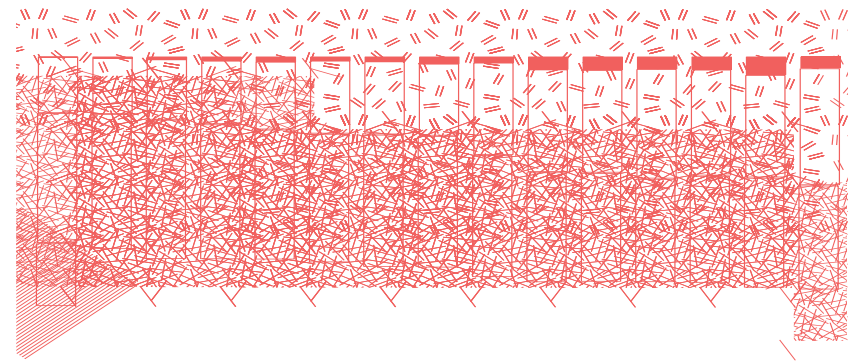
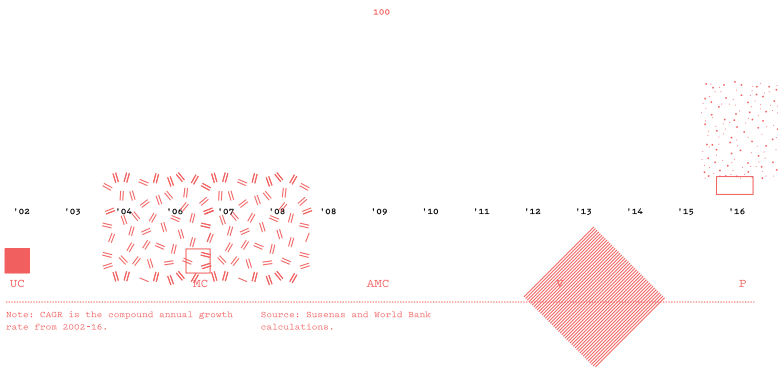


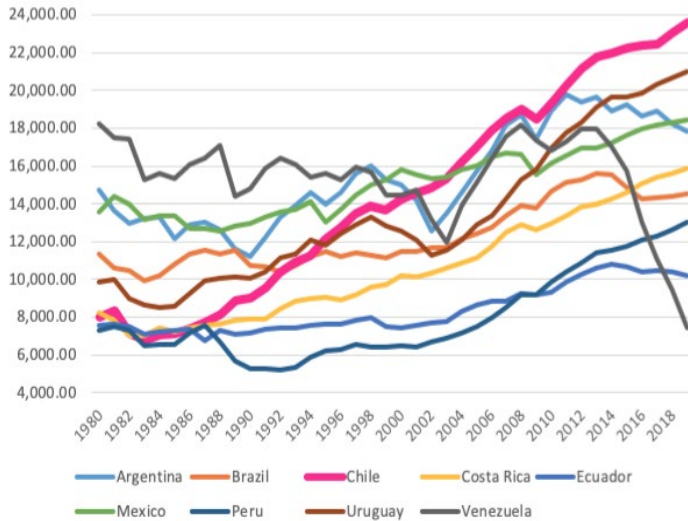
FIGURE E.3 Consumption distribution by class, 2002-16 (percent of population)

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



Will the Chilean paradox play out in Indonesia?

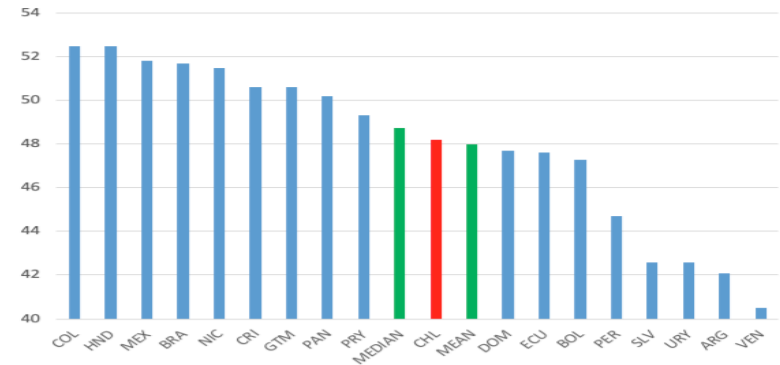
Figure 1 GDP per capita, selected Latin American countries, 1980-2019



Source: IMF

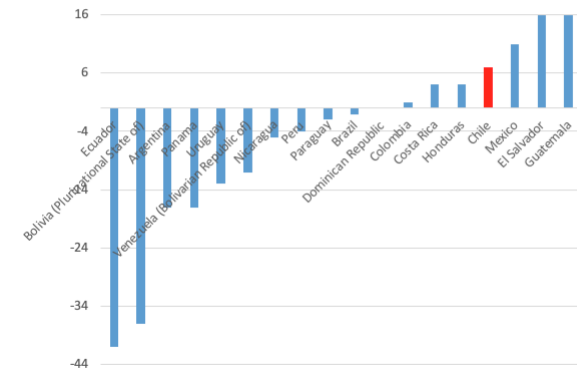
- Chile experienced rapid economic growth
- The fastest reduction of poverty and inequality in the region.
- Many Chilean citizens feel that inequality has greatly increased.
- 'Malestar' triggered the violent social unrest of October 2019.

Figure 2 Gini coefficient, Latin America, 2016



Source IDB

Figure 4 Change in perception of inequality



Source: ECLAC

Chilean Paradox

- Vertical vs horizontal inequality
- Narrative and perception
- Expectation vs reality (speed)

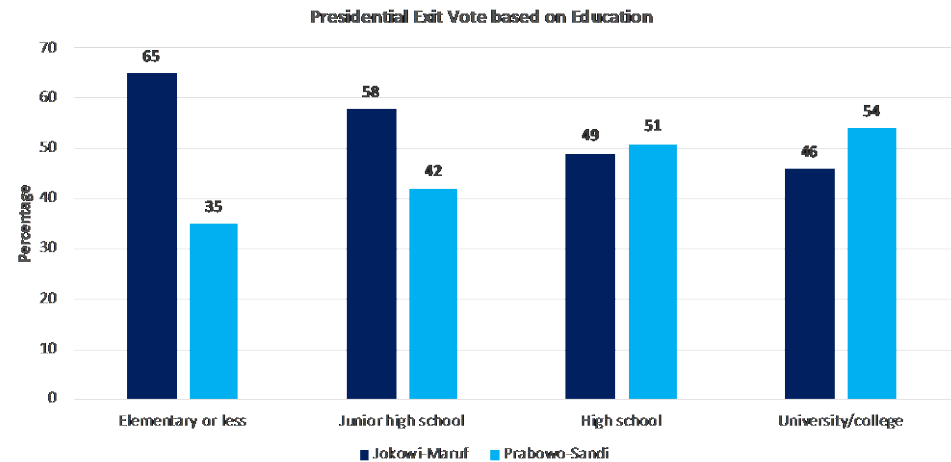
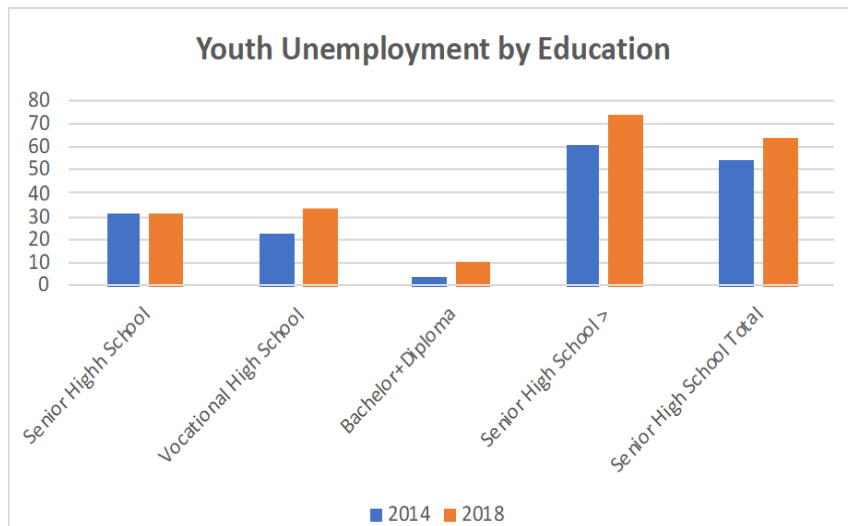
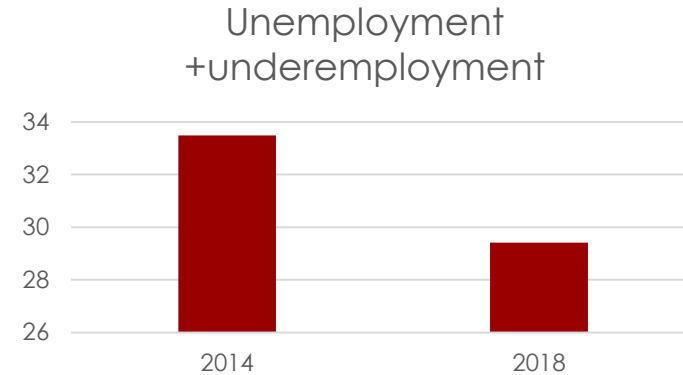
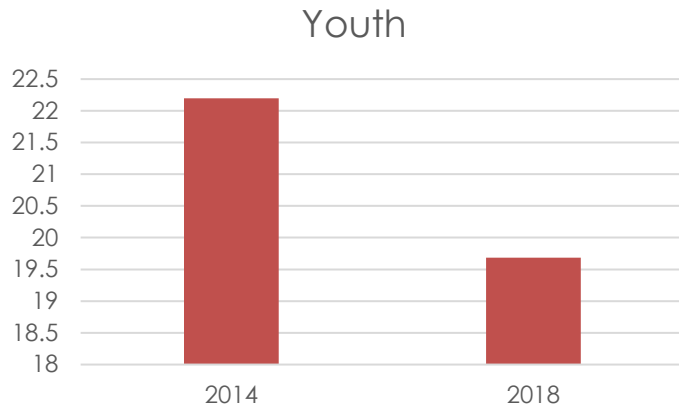
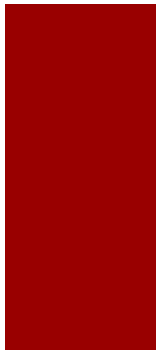
Source: Edwards, 2023

Table 1 Chile and the OECD's Better Life Index

Sub Index	Chile's ranking in sample of 40 nations	Highest-ranked Latin American country in category
Housing	25	Chile
Income	35	Chile
Jobs	31	Mexico
Community	37	Brazil
Education	35	Chile
Environment	32	Brazil
Civic engagement	40	Brazil
Health	29	Brazil
Life satisfaction	21	Mexico
Safety	35	Chile
Work-life balance	34	Brazil

Source: OECD Better Life Index

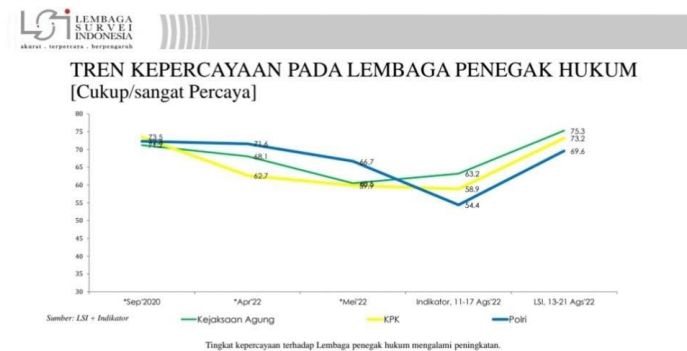
Indonesia: Youth Unemployment and the 2019 Election



Young and educated unemployed have continued to increase 2014-2018, they feel dissatisfied with government

No Viral no Justice?

- Can Middle class play a role for reform or social change?
- Case Sambo; Saiful Mahdi (Amnesty); corruption in tax and custom office etc.



22
Survei Nasional, 13-21 Agustus 2022

KASUS & KEPERCAYAAN TERHADAP DJP

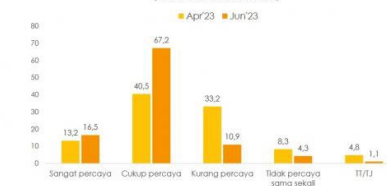
Apakah Ibu/Bapak tahu/pemah dengar berita tentang mantan pegawai pajak, Rafael Alun (Sambodo/Al) yang memiliki harta kekayaan sangat besar di luar harta yang dilaporkan kepada negara? ... (%)



Sekitar 36.6% tahu kasus Rafael Alun, cenderung menurun ketimbang dua bulan sebelumnya.

Ada yang berpendapat bahwa kasus oknum mantan pegawai pajak tersebut akan membuat masyarakat tidak percaya lagi kepada lembaga perpajakan (Direktorat Jenderal Pajak/DJP). Bagaimana dengan Ibu/Bapak sendiri, apakah Ibu/Bapak sangat percaya, cukup percaya, kurang percaya atau tidak percaya sama sekali dengan lembaga perpajakan (DJP) dalam mengelola hasil pajak? ... (%)

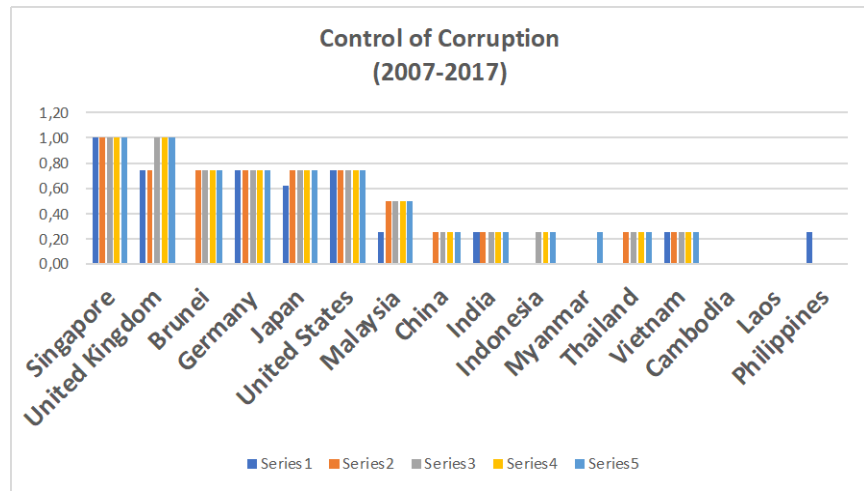
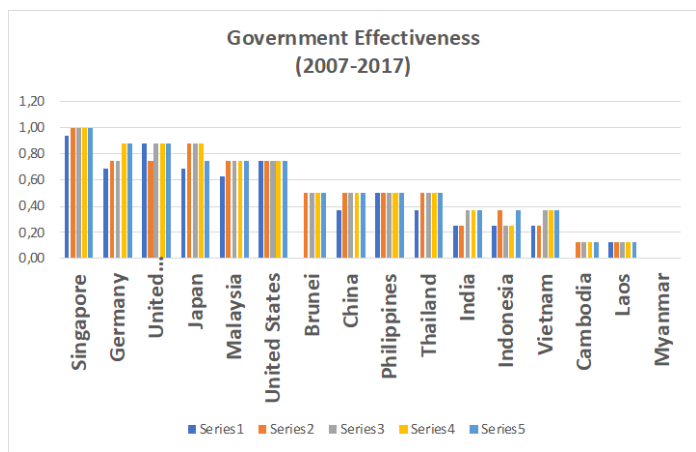
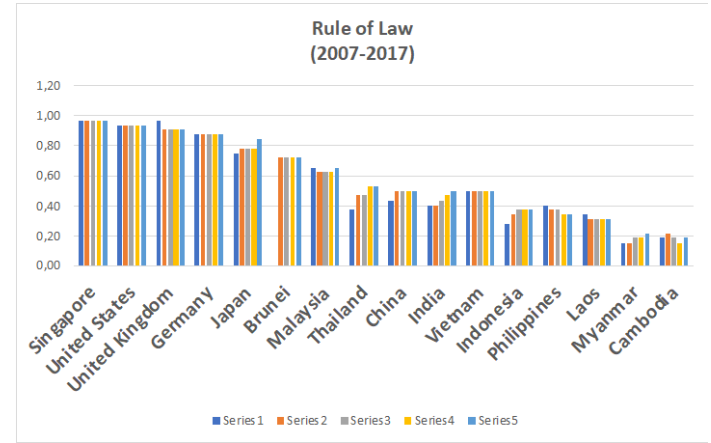
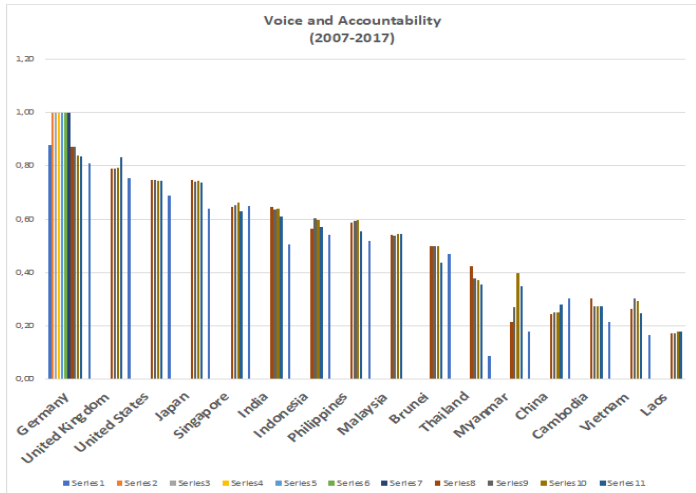
[Basis: tahu kasus Rafael Alun]



Di antara yang tahu kasus, kepercayaan terhadap DJP dalam mengelola hasil pajak meningkat signifikan dibanding dua bulan lalu.

INDIKATOR

Indonesia: Governance Indicators



The Political Economy of the possible



- Economists are usually blame 'politics' or 'institutional failure' vs how to incentivize politicians to support reform (economically sound and politically sound):
- Domestic politics, geo political tension, global trend, climate change issues → inward looking vs outward looking; tug of war will continue
- The political economy of the possible: how to work within constraints
- Reform is often been associated with significant impacts, but resources, time horizon and political support are often limited. Thus Pick your own battle, work within constraints. Create success story, building political credibility, move to more difficult target. While simultaneously try to achieve best practices
- Best fit in the short-run, best practice in the long-run
- Focus on problems, being flexible on solutions, not the other way around
- Ownership of the reform is the key
- Managing the expectation, the importance of media and communications with stakeholders
- Institutionalizing reform

Thank you