OPEN FORUM
USINDO Brief
A PUBLICATION OF THE UNITED STATES–INDONESIA SOCIETY

"Indonesia: Middle Income Country in Transition"

A Special Open Forum and Lunch with

Sri Mulyani Indrawati
Managing Director, World Bank
Former Minister of Finance, Republic of Indonesia

February 29, 2012

On February 29, 2012, USINDO hosted a Special Open Forum with the World Bank Managing Director, Sri Mulyani Indrawati.

Indonesia is gaining prominence as an emerging market economy, a rising democracy, and an emerging power with global influence. Despite its not yet being a member of the BRICS group, it is considered one of the largest Middle-Income Countries (MICs) in the world.

Indonesia's economic performance is commendable. Global financial crisis notwithstanding, Indonesia maintained a 5.2% of growth in the last decade. As with other MICs, however, Indonesia is not free from the risk of falling into the "middle-income trap".

Ms. Sri Mulyani Indrawati discussed the challenges currently facing Indonesia as a middle-income country (MIC), and measures that need to take place to overcome these challenges. Four transformations are currently taking place in Indonesia:

1. Economic transformation

The major challenge in Indonesia's economic transformation is how to accelerate growth and adopt a new growth model at the same time. While the old model promotes growth, it does not address issues pertaining to the other transformation dimensions.

Indonesia needs to maximize its potential, capitalizing more on the commodity prices of the export-oriented mining and agricultural industries. Despite a comparative advantage in natural resources, Indonesia is among the lowest receivers of Foreign Direct Investment (FDI) in the mining sector. The right formulation of policy as well as institutional framework is needed to unleash this potential. There is also a need to design a downstream industry in the agriculture sector. This is not a totally new concept; the New Order's 25-year development plan was based on agricultural comparative advantage. A downstream industry in this scenario is possible with a more highly educated labor force.

Indonesia also needs to capitalize on its high "demographic dividend," with its asset of a large relatively youthful population. The labor-intensive model worked in the past when there was less political freedom and labor unions were relatively suppressed. Now there is more freedom of association, which creates a relatively more complicated environment to work. There is a potential flow of capital because of this composition of labor, but low skills and education pose a significant impediment to growth. It is crucial to have a good labor policy that addresses both the supply side (labor quality) and the inequality caused by high growth.

2. Geographic transformation

Indonesia is experiencing a dramatic spatial change due to its growing economy. The urban population grew more than 55% during 1995-2005. By 2015, more people will live in the urban areas, and the whole of Java will be urbanized by 2025. This constitutes both an opportunity and a challenge.

In the long run, Indonesia will no longer depend on Jakarta as a center of growth. Connectivity, however, is a problem. Traveling and transportation within Indonesia is more costly than traveling abroad. There is significant potential revenue in fishing and agriculture, but these are also the lowest taxed sectors. Good connectivity requires more infrastructure (roads, seaports, airports) development.

3. Social transformation

The social transformation is the result of a growing middle class. On the positive side, it creates potential youth demand. According to an FDI survey, for example, Japan now chooses Indonesia not only as a transition hub for their exports, but also as an investment opportunity due to the growing size of Indonesia's domestic market. A big and strong middle class provides a solid backdrop for governance, democracy and coordination efforts.

On the negative side, this social transformation leads to a middle-class trap. When the economy grows fast, inequality becomes a major problem. There is a higher demand for more and better public services, and when this is not fulfilled, the middle class will opt out and instead seek private services or even services abroad. If they do not care for the public services, they do not want to pay tax for them.

4. National identity transformation

Indonesia is not free from diversity issues (ethnicities, religions, regions), but its founding fathers were commendable for providing the nation with a sense of national identity.

MICs are now contributing equally with the upper income countries at the global level. However, MICs still need to articulate their voice in order to constructively play and shape global policies. Some countries may be capable of voicing their concern, but they lack qualified human resources and the required institutional capacity to play prominent regional and global roles.

To overcome these challenges, two changes need to take place.

First, **the change in human capital**. Indonesia has made significant progress in education spending; at least 20% of the national budget is now allocated to education sector. Access to education is improving; approximately half of the labor force consists of graduates from secondary or higher education institutions. However, naturally only a small percentage of those attain the highest quality rankings.

The World Bank is engaged in the education sector, but focusing more on the quality of education (teacher training, curriculum, pedagogy). Thinking and behavioral skills are still relatively low. Asians are generally good in math and natural sciences, but generally not as much in subjects such as language, writing, and social sciences.

Improvement in the education sector requires not only financial resources, but also the right design and content. It is more complicated in Indonesia's case as much of responsibility for education is delegated to lower level governments. Primary and secondary (junior high) education is managed at the district (*kabupaten*) level. High schools are administered at the provincial level. Only higher/tertiary education is managed at the national level. This requires coordination and arrangement between local and central governments.

Second, **the institutional change**. The first institutional change applies to the public finance institutions. In this case, Indonesia is moving in the right direction, by providing good checks and balances measures through the following reforms: the state finance law, the treasury law, and the state audit law. The second institutional change that needs to take place involves a broad and comprehensive reform in the civil service sector, including the judicial and law enforcement sectors.

The third institutional change relates to the national and local government institutions. With the decentralization approach, more power has now been delegated to the local governments. The capacity of the local governments to make the most of the delegated power, however, is still relatively low. Regardless, this remains a positive opportunity: the closer the power to the people, the easiest for them to check it.

While many MICs still have to face similar internal challenges, despite the emerging global and regional opportunities, now remains an exciting time for MICs.

A Q and A session followed Ms. Indrawati's presentation.

Q: How does Indonesia deal with a declining oil production?

We certainly have the opportunities through new investments for exploration and so forth. This has to do with a policy framework. More transparency (in contracts, i.e. how revenue is received and distributed) will promote ownership. The more people know, the more they are going to see that investors, both foreign and domestic, are bringing something for the good of Indonesia. Good practices in mining do exist. Transparency can and should be demanded.

Q: Can you give a comparative perspective on the relative capabilities of China and Indonesia to avoid the middle-income trap? Does Indonesia have to carry out measures to increase its ability to avoid the trap, as in the case of China?

There are a lot of similarities, not only with China but also with many other MICs. China is moving further into a market economy. Government plays a role through state enterprises and public finance, and the local governments play a role as investors. In the long run, however, the declining global market environment cannot sustain their growth model. So they also need to change their growth model.

In terms of inequality, China is a very specific case. The public services can only serve regular residents and not the rural migrants who move to urban areas. This is a big dimension to public finance. The local government cannot provide the public service without increasing their deficit, which is financed by borrowing from the banking system.

This is not the case for Indonesia. Our local governments cannot borrow from the banking system without approval from the ministry of finance. On the other hand, they cannot generate their own revenue. The tax basis is still very much centralized. We need to relax the regulation, and put in place prudent indicators.

On the issue of urbanization, China's situation is more dramatic. The equivalent of a new city is created every month. This poses a challenge in designing public services and greening the urban areas. Their current design consumes more energy. In Indonesia urban areas grow organically, never designed. During Suharto's administration, Bappenas strongly supported education investment in urban planners. Unfortunately, many of them now became politicians.

Q: On the connectivity, many MICs are moving ahead to tackle the digital economic challenge of modernizing while prioritizing the economy as an engine of growth. Does Indonesia need to move the institutional power of the ministry that handles decisions on connectivity?

This has always been a debate in Indonesia. Politically it is one country and one nation, but economically it is not yet united. The Indonesian government has developed a master plan with six economic corridors to connect Indonesia geographically through infrastructure development. But for the next few years, local governments will still depend on the central government. The central government should use its power and utilize the budget design to provide the right incentive to the regions, whether it is to be delivered based on performance, coordination, or the national plan.

Q: Is there a general consensus among major political parties on economic policies or do they have different views?

I am not a political analyst. But based on my experience dealing with the political parties, they do not have very different economic platforms. Indonesia is not about different ideology or extreme views; the difference is in the priorities, whether it is more budget allocation for social protection, or for outer Indonesia, for example.

Q: Regarding political connectivity, Indonesia has many people and many islands, yet the representatives of the core political system do not seem to have grassroots. How do you mobilize consensus if they are not really representatives of their districts?

I am not sure if that is entirely true. The People's Representative Council (DPR) is certainly dominated by politicians who are mostly based in Jakarta. It is, however, not clear whether those who claim to reside in their respective regions are indeed residents of those regions. We do, however, have a Regional Representative Council (DPD) comprised of real regional representatives. But their power is secondary to DPR by law.

Given our geography, it is indeed difficult to represent the people, both in terms of the quality and the quantity of the representation. This is still a struggle; this is why we should not take for granted our national identity. It needs to be maintained and constantly redefined. But information system has made it easier and cheaper to connect.

Q: What are the roles of World Bank and Asian Development Bank in MICs?

The mandate of the World Bank and other development banks is dealing with poverty reduction. In the past, poverty existed only in the poor and low-income countries (LICs). However, in the last three to four decades, many LICs have transformed into emerging MICs. We should not forget that hundreds of millions poor still live in these MICs. Indeed, these MICs may have more resources than what the banks offer. But their relationship with development banks is no longer about lender and borrower; it is about knowledge exchange. It is not about construction of roads or school buildings, but rather about designing school system or making sure that high quality roads are delivered. It is not borrowing for the money, but for the system or learning the procedures.

Q: Of the three countries (Indonesia, India, Mexico) I observed in over three decades, Indonesia is the only country that I am aware of that does not have world-class higher education institutions. English, for example, is

not widely used in universities. Is this being solved?

It is surely recognized as a challenge. However, many universities now offer bilingual or international programs, including sandwich programs. I am more optimistic about this. Knowledge and information can now travel in a low cost manner. Access to Internet is increasing. Indonesia is now among the biggest Internet users in the world. Language mastery should not become a barrier, because technology can facilitate that. There are many young and smart Indonesians. Singapore has penetrated down to junior high schools looking for bright Indonesians and offering them scholarships. Indonesia is providing and creating the right environment. It all depends on the behavior of the middle class to consistently demand better public service and governance.

###