INCLUSIVE AND SUSTAINABLE GROWTH ASSESSMENT

1. Indonesia made continued developmental progress over the period covered by the country partnership strategy (CPS), 2016–2019. It maintained a robust economic expansion with average annual growth rates of 5%, contributing to a reduction in the poverty rate from 11.1% in 2015 to 9.2% in 2019. Taken in a broader context, Indonesia’s developmental successes and its status as a thriving democracy are tremendous achievements for a country that just two decades ago was emerging from a severe economic crisis while undergoing rapid political change. A Group of Twenty (G20) member, Indonesia was the seventh-largest economy in the world in purchasing power terms in 2018 and was declared an upper-middle income country in 2020.¹

2. Despite this progress, serious developmental challenges remain. Economic growth slowed after the end of the commodities boom in 2012. Substantial inequality of outcomes and opportunities exists. Poverty remains high in many regions. Indonesia struggles to develop human capital, and its labor force lacks the technical and entrepreneurial skills needed in a changing global economy and for overcoming a possible middle-income trap. The risks to the country posed by external economic uncertainty, climate change, and environmental degradation are severe.

3. The coronavirus disease (COVID-19) pandemic is already having severe human and economic impacts in Indonesia. As of 24 August 2020, the country counted 153,535 COVID-19 cases and 6,680 resulting deaths, with many more cases and deaths likely uncounted.² The lack of protection for informal workers, who make up the majority of the labor force, means that the economic impacts of lockdowns will be severe and are likely to be felt disproportionately by the most vulnerable. Increased government expenditures to provide fiscal support to Indonesia’s response as revenues fall will widen the budget deficit. Economic growth is expected to sharply decline, while the risk of successive waves of outbreaks as well as globally subdued demand could delay the recovery. The course of the crisis is still uncertain, and its impacts on Indonesia, as well as its broader implications for the world economy, remain difficult to predict.

4. Tackling the underlying constraints to inclusive and sustainable growth will be critical for a robust recovery in the medium term. This includes developing sufficient human capital; establishing the institutional and physical infrastructure necessary for a rapid economic recovery; and making Indonesia more resilient to crises, climate change risks, and environmental degradation. The Asian Development Bank (ADB) can continue to be an effective partner for Indonesia and support inclusive and sustainable development over the term of the CPS for 2020–2024 by working to overcome potential barriers to future growth and assisting the government’s response to COVID-19.³

A. Recent Growth, Poverty, Inequality, and Environmental Dynamics

5. Growth. Indonesia’s economy grew at an annual rate of 5% from 2015 to 2019 (Table 1), continuing a steady economic expansion since the end of the Asian financial crisis (AFC). Indonesia’s estimated potential growth rate averaged almost 5% in 2000–2007 and increased to

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³ The assessment benefited from helpful comments and guidance by Vikram Nehru, distinguished practitioner-in-residence at John Hopkins University, and Yougesh Khatri, associate professor at Nanyang Business School, as well as economic analysis from Patrick Farrell, a consultant with the ADB. Climate change and environmental research support provided by Bradley Hiller, a consultant with the ADB.
5.8% in 2008–2014. This period of elevated growth coincided with the global commodities boom. The economic disruption caused by the COVID-19 pandemic has led to a revision of Indonesia’s expected growth forecast for 2020 down to −1%, the slowest rate of growth in 21 years, and further revisions may be required. The International Monetary Fund (IMF) anticipates global economic growth to be −4.9% in 2020, and output in 2021 to be 6.5% below pre-pandemic projections. The speed at which the global economy and external demand bounce back from this crisis could influence the rate of Indonesia’s own recovery.

6. **Fiscal and monetary policy.** The Government of Indonesia has maintained a prudent fiscal stance, with deficits below the statutory limit of 3% of gross domestic product (GDP) from 2015 to 2019 (Table 1). Central government debt increased from 27.4% of GDP in 2014 to an estimated 29.8% in 2019. Total expenditures averaged 15.0% of GDP and revenue averaged 12.7% of GDP over this period. Inflation moderated from 6.4% in 2015 to 3.0% in 2019 and is expected to remain subdued. The deficit is expected to reach 6.3% of GDP in 2020 because of the increased financing needs and the pressure on government revenue from COVID-19.

7. **Domestic resource mobilization.** Indonesia’s ratio of revenue to GDP is in decline, from 13.1% in 2015 to just 12.4% in 2019. The downward trend is attributable mainly to declining tax revenues, which have fallen from 10.8% of GDP in 2015 to 9.8% in 2019, as well as falling revenues from oil and gas because of lower commodities prices. The decline in tax revenues partly results from a narrow tax base and limited tax administration capacity. Revenues from commodities accounted for 10.8% of total government revenue in 2019, down from 19.7% in 2014. The Ministry of Finance anticipates revenues in 2020 to be more than 20% below projections because the COVID-19 pandemic has limited economic activity and further depressed commodities prices. On a positive note, the Ministry of Finance recorded a 34% increase in the number of taxpayers, from 4.4 million in March 2019 to 6.3 million in March 2020, which should give a fillip to future tax revenues. Debt financing is constrained by the relatively small size of the domestic capital market. The government’s current tax reform agenda includes a gradual reduction in the corporate tax rate while broadening the tax base, simplifying tax administration, and streamlining and consolidating regional taxes.

<table>
<thead>
<tr>
<th>Table 1: Selected Macroeconomic Indicators</th>
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</thead>
<tbody>
<tr>
<td><strong>2015</strong></td>
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<tr>
<td>Total GDP (current $, billion)</td>
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<tr>
<td>GDP growth (%)</td>
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<tr>
<td>Inflation (%)</td>
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<tr>
<td>GDP per capita (current $)</td>
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<tr>
<td>GNI per capita (Atlas method, current $)</td>
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<td>Current account balance (% GDP)</td>
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<td>Fiscal balance (% GDP)</td>
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<tr>
<td>Total revenue (% GDP)</td>
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<td>Total expenditure (% GDP)</td>
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<tr>
<td>Gross domestic savings (% of GDP)</td>
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<tr>
<td>Gross fixed capital formation (% of GDP)</td>
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</table>

( ) = negative, $ = United States dollar, GDP = gross domestic product, GNI = gross national income. Sources: Asian Development Bank and World Bank data.

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7 ADB staff calculations based on Haver Analytics data.
8. **Sector composition.** The economy has been shifting toward services. Industry has declined from a high of 48.1% of GDP in 2008 and stood at 39.0% of GDP in 2019, while services have grown and now account for 44.2% of GDP.\(^8\) Agriculture has remained steady at roughly 13.0% of GDP since 2010 and stood at 12.7% of GDP in 2019.\(^9\) Notably, manufacturing value added as a share of GDP has declined from 32.0% of GDP in 2002 to 19.7% of GDP in 2019.\(^10\) The decline in manufacturing is partly attributable to a deteriorating business environment after the AFC and rising commodity prices, which together encouraged a shift in Indonesia’s exports to commodities and away from more complex manufacturing.\(^11\) These are worrying trends for an economy that will increasingly need to compete with high-income countries in manufacturing to maintain growth and avoid the middle-income trap.

9. **Balance of payments.** The current account has remained in deficit since the end of the commodities boom in 2012, averaging –2.2% of GDP between 2015 and 2019.\(^12\) Indonesia ran more than a decade of current account surpluses from 1998 to 2011, which averaged 2.4% of GDP. Indonesia has generally had a positive overall balance of payments since 2015, with the current account deficit offset by a surplus in the financial account, although the value of foreign direct investment (FDI) into the economy alone is not always sufficient to cover the current account deficit. Indonesia therefore often relies on more volatile portfolio inflows to finance its current account deficit, which increases the risk of macroeconomic instability. Bank Indonesia’s reserve assets were $129.2 billion at the end of 2019, sufficient to cover 7.3 months of imports and the government’s external debt service costs (footnote 12). While the IMF assessed Indonesia’s external position as sustainable, vulnerabilities arise from the country’s reliance on portfolio capital flows to finance its current account deficit, given the risk of global macroeconomic uncertainty.\(^13\) At the start of the COVID-19 pandemic, the withdrawal of portfolio capital led to a sudden depreciation of the Indonesian rupiah, which Bank Indonesia stabilized by releasing more than $9.6 billion of reserve assets in April 2020.\(^14\)

10. **Policy environment.** Beginning in 2015, the government introduced several economic policy packages covering various reforms aimed at simplifying business and trade regulations, addressing fragmentation of responsibilities and poor coordination across government agencies, improving trade logistics, and reducing barriers to investment. These reforms contributed to Indonesia’s sovereign credit being elevated to an investment-grade rating by all three major credit rating agencies in 2019.\(^15\) Compared with the 2015 edition, Indonesia jumped 41 places to be ranked 73rd out of 190 countries in the World Bank’s Doing Business 2020 report.\(^16\) However, Indonesia also introduced new barriers to international trade, both by raising tariffs and implementing new non-tariff barriers such as local content requirements.\(^17\) Several bottlenecks continue to discourage private sector investments and FDI inflows, such as local partner

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\(^{13}\) IMF. 2019. *Article IV Consultation*. Washington, DC.

\(^{14}\) A. W. Akhlas. 2020. *Indonesia’s forex reserves drop $9.4b in March as BI steps up efforts to stabilize rupiah*. The Jakarta Post. 7 April 2020.

\(^{15}\) Standard & Poor’s increased Indonesia’s rating to BBB stable outlook in May 2019, revised to BBB negative in April 2020. Fitch affirmed its BBB stable outlook (April 2020). Moody’s affirmed its Baa2 stable ranking (February 2020).


\(^{17}\) T. Diela. 2018. *Indonesia raises import taxes on 1,000-plus goods to support rupiah*. Reuters. 5 September 2018.
requirements and an extensive negative investment list. Parliament is expected to approve major new reform measures in 2020, in the form of two omnibus bills regarding issues related to job creation and taxation, although negotiations are still ongoing as of the time of publication.

11. **Competitiveness and complexity.** The importance of generating more value addition through more complex production activities will continue to increase as incomes rise, but there are signs of stagnation or decline in Indonesia's competitiveness. Viewed from a longer-term perspective, the incremental capital output ratio (ICOR) has risen since the global financial crisis (Figure). The rising ICOR is indicative of declining efficiency, with the economy requiring more investment input per unit of growth. In terms of economic complexity, Indonesia ranked just 71st out of 125 economies in the 2017 Economic Complexity Index. Most of the Indonesian workforce is not engaged in complex or high-technology activities, and only 20% of the employed population reported using the internet on the job for productive purposes. Only 6% of Indonesian firms assessed themselves as using advanced technologies. A ranking of technological readiness compiled by the Economist Intelligence Unit places Indonesia among the least technologically prepared countries in Asia. In a similar vein, the World Economic Forum ranks Indonesia behind many other countries in the region in its preparedness to adapt to the demands of more technologically driven and complex production.

![Elevated Incremental Capital Output Ratio (3-year moving average)](chart)

Sources: World Bank, Asian Development Bank calculations.

12. **Labor market.** Unemployment has been steadily decreasing, and the unemployment rate stood at 5.3% in August 2019. Still, compliance with labor regulations on wages, social security, outsourcing, and dismissals is limited. Even though 40.8% of the workforce (52 million people) consider themselves to be employees, only a small share (11 million, or 9% of the total working population) has a permanent employee contract with mandated benefits. Although a shift toward the formal sector has taken place overall—the ratio of workers engaged in informal work fell from 69.4% in 2009 to 56.8% in 2020—informality is higher for women and the rate of informality declined less rapidly for women than men. In addition to being more likely to work informally, women's labor force participation is 54.6%, compared with 83.8% for males, and a substantial gender wage gap exists—women are earning a monthly average of Rp2.5 million ($167)

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18 ICOR is calculated as gross fixed capital formation (% of GDP)/annual GDP growth rate.
23 ADB calculations based on Badan Pusat Statistik data
compared with men’s Rp3.2 million ($217) (footnote 24). The COVID-19 pandemic is expected to cause a deterioration of the labor market. Estimated job losses in Indonesia as a result of the lockdowns could be in the range of 1 million to 7 million under ADB’s current best-case and worst-case scenarios. The self-employed, casual employees, and unpaid workers, who make up the majority of the labor force, have a limited safety net and are likely to be hardest hit by job losses.

13. **Finance sector.** The finance sector is growing but remains narrow and heavily reliant on bank financing. Bank assets account for 74% of the sector’s loan assets, while securities make up just 10%. The mutual fund industry, insurance companies, and pension funds all remain small. Stock-market capitalization (46% of GDP) and the bond market are smaller as a share of GDP than those of other comparable Southeast Asian economies, and the bond market is dominated by government issues. The government bonds that are issued represent just 15.3% of GDP, compared with a regional average of 58% of GDP. Promisingly, a greater share of the population is participating in the finance sector: the Financial Services Authority’s Financial Inclusion Index rose from 67.8% in 2016 to 76.2% in 2019.

14. **Infrastructure development.** According to the 2018 Global Competitiveness Report, Indonesia ranked 71st of 140 economies on infrastructure, down from 56th of 144 in 2014. In the 2018 edition of the Logistics Performance Index, Indonesia ranked 46th of 160 economies, up from 63rd in 2016, but below Malaysia (44), Viet Nam (42), Thailand (35), and the People’s Republic of China (PRC, 29). Shipping facilities in the archipelago are inadequate, constraining trade. Transportation is a serious problem in urban areas as well—an estimated $5 billion is lost every year because of traffic congestion in Jakarta alone. Power outages are frequent: firms in four provinces reported experiencing more than 48 hours of outages per year. Isolated rural communities still often lack basic access to electricity. Internet access lags that of peer countries, with Indonesia (57th of 100) ranking behind Viet Nam (50th), Thailand (39th), PRC (36th), and Malaysia (35th) in the 2020 Inclusive Internet Index. Indonesia invested 4.6% of GDP in infrastructure in 2017, part of a $350 billion infrastructure drive during President Joko Widodo’s first term, but this fell short of the climate-risk adjusted infrastructure investment needs of 6% of GDP.

15. **Population trends.** With 268 million inhabitants in 2019, Indonesia is the world’s fourth most populous country after the PRC, India, and the United States. Population growth moderated slightly from 1.3% in 2010 to 1.2% in 2019. Indonesia currently has the potential to enjoy a demographic dividend since more than two-thirds of its people are of working age, a favorable demographic balance expected to last until at least 2030. However, capturing the benefits of this demographic dividend requires engaging and including young people in the economy. At the same time, Indonesia needs to prepare for the aging of its population because the number of people older than 60 years is expected to double by 2040, from 27.5 million to 57.4 million. Differences in fertility rates, life expectancy, and intra-regional migration have

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resulted in wide regional variations, and both Central and East Java are predicted to have more than one-in-five residents older than 60 years by 2035.

16. **Poverty status and trend.** The rate of decline in poverty has slowed since 2011, a trend partly attributable to both the difficulty of eliminating remaining poverty and heightened inequality compared with previous decades. Indonesia’s poverty incidence fell from 11.1% of the total population in 2015 to 9.2% in 2019. However, about 20.6% or 56 million people are clustered marginally above the national poverty line and are highly vulnerable to economic shocks. As a result of the COVID-19 pandemic, the poverty rate is expected to increase to 11.9%–12.8% in 2020. The difference in poverty rates between urban (6.6%) and rural (12.6%) areas is growing since urban poverty declined more rapidly during 2015–2019. Poverty varies by region, and poverty rates are higher in eastern Indonesia—26.5% of residents of Papua are below the poverty line, followed by 21.5% in West Papua and 20.6% in East Nusa Tenggara. Agriculture provides income for a significant share of Indonesian households and remains crucial for poverty reduction.

17. **Gender disparity.** Women are more likely to work informally than men, are less likely to be in the labor force, and a persistent gender wage gap exists (para. 12). While women make up the majority of students in tertiary education, 26.2% of young women were not in employment, education, or training in 2019, compared with 20.5% of Indonesia’s youth overall. Also, 34.4% of women of productive age have full-time responsibility for the care of family members, compared with 3.5% of men (footnote 24). Indonesian women have a Human Development Index score of 0.681 (men: 0.727). Surveys report that 33% of women have experienced sexual or physical violence.

18. **Health care and outcomes.** Per 1,000 people, Indonesia has only 0.43 physicians, 2.42 nurses, and just 1.20 hospital beds, all among the lowest ratios in Southeast Asia. Regional disparities in access to health care are large, with 53.3% of the hospitals in the country located in Java and Bali and only 9% in eastern Indonesia, a region accounting for 29% of Indonesia’s land area. Health outcomes are improving, but poor children are often vulnerable to stunting, which limits their chances to grow to their fullest potential. Life expectancy at birth has been increasing, reaching 69.4 years in 2018, but is lower than in regional peers such as Malaysia, Thailand, and Viet Nam. The COVID-19 pandemic will place even more pressure on Indonesia’s underfunded health system, and as the focus is diverted to COVID-19 patients, people will have less access to routine health services and medical care for acute and chronic conditions.

19. **Education.** Indonesia frequently ranks among the worst performers in Programme for International Student Assessment (PISA) educational assessments. Of the 70 countries in the

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2015 assessment, Indonesia ranked 63rd in mathematics, 64th in reading, and 62nd in science. In the 2018 edition of the assessment (79 countries), Indonesia’s scores declined in all three areas and its rankings fell to 73rd in mathematics, 74th in reading, and 71st in science. Girls outperformed boys in both science and mathematics, but girls tend to attend fewer years of schooling. As Indonesia seeks to transition up the value-added chain and avoid a middle-income trap, these human capital limitations could become more salient.

20. Inequality status and trend. Indonesia has a higher Gini coefficient than many regional peers such as Viet Nam or Thailand. From 2009 onward, incomes tended to grow faster for the top deciles of the income distribution than for the lowest deciles. From 2009 to 2018, the share of income going to the bottom 60% of the population fell from 27.6% to 23.5%, while the richest decile increased its share from 32.2% to 32.5% (Table 2). Since 2015, signs of a modest reversal of this trend emerged. From 2015 to 2019, inequality as measured by the Gini coefficient fell from 0.40 to 0.38. This recent decline in the Gini may be attributable to a decline in the wages accruing to the top 10% of the wage distribution since 2015.

<table>
<thead>
<tr>
<th>Quintile 1 (lowest income quintile)</th>
<th>2009</th>
<th>2011</th>
<th>2013</th>
<th>2015</th>
<th>2017</th>
<th>2018</th>
</tr>
</thead>
<tbody>
<tr>
<td>Quintile 2</td>
<td>8.0</td>
<td>9.4</td>
<td>9.5</td>
<td>7.9</td>
<td>8.6</td>
<td>8.4</td>
</tr>
<tr>
<td>Quintile 3</td>
<td>15.0</td>
<td>16.8</td>
<td>15.7</td>
<td>11.9</td>
<td>11.7</td>
<td>11.5</td>
</tr>
<tr>
<td>Quintile 4</td>
<td>24.6</td>
<td>23.3</td>
<td>24.4</td>
<td>26.1</td>
<td>19.2</td>
<td>25.8</td>
</tr>
<tr>
<td>Quintile 5 (top income quintile)</td>
<td>47.8</td>
<td>46.2</td>
<td>47.4</td>
<td>50.4</td>
<td>55.5</td>
<td>50.7</td>
</tr>
<tr>
<td>Top 10% alone (decile 10)</td>
<td>32.2</td>
<td>31.3</td>
<td>30.8</td>
<td>35.4</td>
<td>32.8</td>
<td>32.5</td>
</tr>
</tbody>
</table>


21. Urbanization. Indonesia is urbanizing rapidly: based on population projections from Statistics Indonesia (BPS), urban residents are expected to account for 63.4% of the total population by 2030, up from 55.3% in 2018 and 49.9% in 2010. Informal settlements accounted for 21.8% of Indonesia’s total urban population in 2018, down from 27.3% in 1993. However, the number of people living in informal settlements nearly doubled in absolute terms from about 17.5 million in 1993 to 32.1 million in 2017. Stresses from unplanned urbanization in Jakarta, as well as Jakarta’s exposure to natural hazards and flooding, have motivated the government’s decision to pursue the construction of a new capital city in Kalimantan.

22. Impacts of climate change. As an archipelago with many low-lying islands that are home to large coastal cities, more than 80,000 kilometers of coastline, and 42 million people living less than 10 meters above sea level, Indonesia is highly exposed to climate change risks. Rising seas are projected to submerge 2,000 of the country’s 17,000 islands by 2050. Indonesia is forecast to be one of the first countries to experience “climate departure,” threatening recent development gains and future growth prospects. Climate-related extreme events such as rain-triggered landslides, floods, and wildfires have been increasing in frequency and magnitude. A

52 “Climate departure” refers to the point at which the average temperature for future years is expected to exceed the hottest year in the historical record (from 1860 to 2005). Climate departure is a tipping point, after which the climate of a place no longer resembles its historical record. See Mora et al. 2013. The projected timing of climate departure from recent variability.
continuation of these changes could threaten Indonesia’s food security and directly impact the habitability of many existing settlements and cities. Indonesia is highly exposed to natural hazards such as severe storms, the severity of which are likely to increase with climate change.

23. **Contribution to climate change.** Indonesia also has a critical part in global efforts to limit climate change—its rainforests play an important role as a carbon sink and reducing its emissions could be instrumental in limiting the effects of climate change. Increasing fossil fuel use and large-scale forest fires have contributed to a 54% increase in greenhouse gas (GHG) emissions since 2000, making Indonesia the world’s fourth-largest GHG-emitting country. Indonesia emits about five times more GHGs per unit of economic output than the world average, although pollution per capita is still lower than in other major polluter countries. Much of this pollution is a result of land use and forest conversion, mostly from fires set to clear land and the burning of peatlands. However, nearly 40% of the GHG emissions result from economic activities such as energy, waste, industrial processing, and production use.

24. **Health impacts of pollution.** Indonesians suffer from increasing pollution with serious impacts on their health and well-being. In 2015, daily emissions from Indonesian forest fires exceeded total daily emissions by the United States on some occasions, causing a haze across Southeast Asia estimated to be associated with 100,000 premature deaths. A reliance on private transportation in urban areas (less than 10% of urban commuters use public transport) contributes to congestion and vehicular particulate pollution. Jakarta’s air quality is 4.5 times worse than the World Health Organization (WHO) limit. Water pollution is another major environmental stressor. Only one in three urban households has access to decent water and only one in 100 is connected to a sewerage system, posing high risks to public health. Plastic pollution clogs many of Indonesia’s waterways and spreads into surrounding seas, threatening marine life and the development of tourism.

25. **Progress toward the Sustainable Development Goals.** Indonesia’s 2019 voluntary national review of its progress in achieving the Sustainable Development Goals (SDGs) names three primary hurdles: (i) poor access to public services and inequality of economic opportunity because of poverty and the remoteness of locations; (ii) weak capacity of subnational governments to comply with national standards, which limits the effectiveness of public services; and (iii) limited availability of adequate, up-to-date, and disaggregated data for development planning. Indonesia’s estimated annual SDG financing gap is projected to widen from $10 billion–$21 billion in 2020 to $175 billion–$355 billion in 2030. Strengthening institutional capacity and mobilizing domestic resources could help close this gap.

54 The New Climate Economy, World Resources Institute. 2019. *Commentary: Why Indonesia is right to seek a low-carbon future for the sake of its economy, and people.* Washington, DC.
26. **National Medium-Term Development Plan for 2020–2024.** The National Medium-Term Development Plan (RPJMN), 2020–2024 completes the National Long-Term Development Plan (RPJPN), 2005–2024. As this RPJMN coincides with the end of the RPJPN, the pressure increases to meet the remaining targets, which include developing the infrastructure and achieving the development indicators expected of an upper middle-income country. One focus of President Widodo’s policy priorities is on improving infrastructure and connectivity, accelerating the development of human capital, promoting investment, and pursuing structural and regulatory reforms. The President’s policy direction and the focus of the RPJMN present an appropriate framework for incorporating the COVID-19 recovery efforts.

B. **Key Impediments to Inclusive and Sustainable Growth**

27. Key impediments facing Indonesia were identified by examining the critical needs of the country in the coming years as transition as a newly upper-middle-income country, its developmental shortcomings in recent years, as well as the impact of the COVID-19 pandemic. As outlined in Section A, Indonesia maintained an economic expansion for nearly 2 decades and has made developmental progress across several dimensions. However, progress is at risk of reversal from the adverse impact of the COVID-19 pandemic, and new challenges are emerging as Indonesia seeks to transition to higher value-added production while confronting global trends such as climate change and an increasingly uncertain economic landscape.

28. Indonesia faces three major impediments to its future development and to ensuring a robust recovery from the impact of COVID-19. First, the country’s difficulty in developing its human capital and ensuring the well-being of its people limits productivity, holds back growth, leads to poor health outcomes, and risks leaving Indonesia stuck in a middle-income trap. Second, Indonesia must establish the institutional and physical infrastructure that can aid a rapid economic recovery from COVID-19, tackling its persistent struggles with maintaining a supportive policy environment for private enterprise, marshalling resources to develop infrastructure and make other critical investments, and increasing domestic and international investment. Third, Indonesia is highly exposed to crises that threaten developmental progress—such as the COVID-19 pandemic, climate change and environmental degradation, and disasters triggered by natural hazards—and must increase its resiliency and disaster risk management capacity.

1. **Human capital constraints and limits to ensuring well-being**

29. Human capital consists of the knowledge and skills that people accumulate through education and training as well as the health and well-being necessary to enable people to realize their potential. Even as Indonesia produced steady economic growth, it made only modest advances in educational quality, health, provision of decent work, and social protection relative to the progress of comparable countries. Indonesia ranked 87th out of 157 countries in the inaugural Human Capital Index, placing it among the bottom half of countries in the world. Its educational system lags that of comparable countries, and on-the-job training is rare. Women have fewer opportunities than men in the labor force.

30. Indonesia also struggles to ensure the well-being of its people, and the shortcomings of its health system are particularly apparent in the context of a global pandemic. Access to health

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62 In 2000, Indonesia had a UNDP Human Development Index score of 0.606, behind Thailand’s (0.64) and ahead of Viet Nam’s (0.579). In the 2018 rankings, Indonesia (0.694) fell further behind Thailand (0.755) while Viet Nam caught up with Indonesia. UNDP. 2019. **Human Development Index.** New York.

care is not universal, and the capacity of the health care system is limited. Poor children are often vulnerable to stunting, which curtails their chances to grow to their fullest potential. Persistent poverty, poor health outcomes, health stressors from unplanned urbanization, and the weakness of the social protection system also undermine well-being in Indonesia. The COVID-19 pandemic is likely to further worsen health outcomes and push more vulnerable Indonesians into poverty.

31. **Struggling education system.** The availability of basic education is almost universal in Indonesia, but the quality of education offered is often poor. Indonesia ranks among the worst performers in international educational assessments (footnote 47). The weaknesses of the educational system contribute to a shortage of high school graduates with the capacity to be trained as skilled workers. Universities in Indonesia perform poorly in international rankings, and public universities only have the capacity to absorb 18% of high school graduates, while higher education institutions outside Java have limited financial resources and less qualified staff. Enrollment in polytechnic programs is low, particularly among women, and the quality of these programs is often poor. While some scholarship programs do send talented students abroad, these programs cannot make up for Indonesia’s overall educational shortcomings.

32. **Lack of skills and skill development in the labor market.** Close to half of employed Indonesians are underqualified for their positions. Only 8.9% of employees report that they have participated in certified job training to improve their skills—the providers of informal jobs, which make up the bulk of opportunities, tend not to invest in their workers. It is estimated that demand for semiskilled and skilled workers may rise to 113 million by 2030, which is likely to exacerbate the skill shortages and skill mismatches throughout the economy. The International Labour Organization (ILO) estimates more than 60 million jobs are at risk of automation in Indonesia.

33. **Persistent poverty and inequality.** Poverty is a major obstacle to the development of human capital: populations in and near poverty must meet their immediate needs and frequently suffer from poor health and well-being. Indonesia’s high levels of inequality restrict the resources available for those at the bottom of the income distribution to improve their situation and meaningfully pursue upward mobility. Populations in and near poverty are particularly vulnerable to shocks, such as disasters triggered by natural hazards and fluctuations in food and commodity prices. An additional concern is the economic consequence of the COVID-19 pandemic, as the poverty rate is expected to increase in 2020.

34. **Poor health outcomes.** Indonesia struggles to ensure good health outcomes. Life expectancy at birth has increased but still lags behind regional peers (footnote 46). Indonesia is among the five countries with the greatest number of stunting cases in the world. The estimated cost that stunting among its workforce imposed on the Indonesian economy was 10.5% of GDP in 2018. Additionally, changing climate conditions are also creating the conditions for evolving disease patterns (dengue) and the emergence of zoonotic diseases.

35. **Weak health care system.** Improvements to health outcomes have been limited in part by Indonesia’s health care systems. Universal health coverage through the national health

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insurance scheme (JKN), covered 221 million people (just over 82% of the population) as of June 2020, but those living in Indonesia’s most impoverished regions often have limited access to quality health care. Further, Indonesia has fewer doctors and hospital beds per capita than its peer countries. The limited capacity of the health care system makes a prudent public health response to the COVID-19 pandemic essential to prevent hospitals from becoming overburdened.

36. **Limited social protection programs.** Social protection systems are essential for maintaining well-being. Indonesia’s current social protection expenditure as a share of GDP per capita is only 0.7%, significantly lower than that of comparable middle-income countries, such as 4.0% of GDP in Viet Nam. The structure and scale of Indonesia’s pension system is not adequate to meet the needs of the elderly population: nearly 86% lack access to a pension and poverty rates are higher among older individuals. According to the 2014/2015 Indonesia Family Life Survey, 65% of the elderly rely on financial help from their children. Further, pension contributions are mandatory only for workers in the formal sector, and many jobs do not comply with social security programs, excluding the most vulnerable workers from these systems. Issues regarding the quality and accessibility of services persist despite efforts to increase access. Attempts to extend health care coverage did not always result in more enrollments.

2. **The need to establish a firm foundation for economic recovery**

37. The COVID-19 pandemic and associated economic downturn have also exposed weaknesses that could constrain Indonesia’s economic recovery. Economic growth since the AFC has been in large part dependent on low value-added goods such as commodities and simple manufactures. Indonesia has not yet laid the foundations for a transition to high value-added manufacturing and the more complex industries better able to drive future growth. To accelerate its economic recovery, Indonesia will need to address various political, institutional, and regulatory issues that continue to curb private sector activity while establishing the infrastructure necessary to support economic growth and the development of new industries.

38. **Barriers to private investments.** The perception of weak rule of law and high corruption contribute to low investor confidence in Indonesia despite the country’s strong growth performance. Land acquisition is difficult, and the permitting process is long and drawn out. Stringent labor laws, which include the largest termination payments in the region, depress hiring rates. Indonesia has a large state sector, and state-owned enterprise (SOE) assets have been growing as a share of GDP since 2012. SOEs hold monopolies in many sectors, preventing the entry of private players and the benefits of competition.

39. **Regulatory barriers to firm growth.** Structural and administrative hurdles limit firm growth, with major implications for economic development. Micro and small enterprises (MSEs) account for 98.3% of all firms. They generally have low productivity and limited capability to adopt emerging technologies, and often struggle to produce high-quality products. Moreover, MSEs

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often pay wages below the statutory minimum, frequently rely on informal work agreements, rarely invest in skills training for their workers, and do not possess the financial acumen for bookkeeping. MSEs rarely expand in scale because not only do they often lack the capacity and management expertise for growth, they are also hampered by regulations—developing from a small firm into a medium-sized enterprise incurs a substantial cost of compliance with regulatory burdens that all but the most competitive firms are unable to afford.

40. **Limited access to capital.** Many firms in Indonesia have a difficult time accessing capital. While MSEs account for 98.3% of all enterprises, credit lent to large firms amounts to 88% of all loans. Banks often choose not to lend to micro, small, and medium-sized enterprises (MSMEs) as it is difficult to assess the creditworthiness of smaller companies. When firms do obtain credit, they bear high rates—the lending rate averaged an annualized 10.5% over 2018 and remained at that level for the first quarter of 2019. A lack of access to savings, affordable loans, and money transfer services constrains the ability of the poor to improve their economic situation.

41. **Limited domestic resource mobilization capacity.** Limited government revenues constrain the financing of infrastructure and social sector needs, as the budget relies heavily on nontax revenues that fluctuate with international commodity prices. Managing challenges with domestic resource mobilization may require a more efficient and effective tax administration. The government has been taking steps to improve tax administration, but the tax base remains limited. Revenues are expected to contract as the COVID-19 pandemic reduces economic activity and depresses commodity prices, following on several years of steadily falling government revenues.

42. **Inadequate infrastructure.** The costs imposed by poor transportation infrastructure undermine Indonesia’s competitiveness—constraining domestic economic activity and limiting integration into global production chains—while poor energy infrastructure limits business investment and productivity. Infrastructure constraints are very salient in Indonesia’s cities, which often suffer from congestion and insufficient flooding control. Inadequate infrastructure is an important constraint on women’s participation in the workforce, as many women work at home and require reliable household electrification and transportation.

43. **Trade and investment protectionism.** Indonesia had one of the most restrictive regulatory frameworks toward FDI among 68 middle-income countries surveyed by the Organisation for Economic Co-operation and Development (OECD) in 2018. A high level of policy uncertainty, notably with regard to tariffs, makes the costs and potential payoffs of investments uncertain. These barriers limit Indonesia’s integration into global supply chains and hinder the development of some industries by raising the price of inputs, constrain the development of domestic manufacturing, and result in higher prices for households.

3. **Vulnerability to disasters, climate change, and environmental degradation**

44. The need for strengthened disaster risk management has been further highlighted by the COVID-19 pandemic, but Indonesia also must build resilience to the many varied crises that it faces regularly to safeguard its developmental progress. Indonesia is vulnerable to unpredictable natural hazards because its islands stretch across a region exposed to extreme weather, earthquakes, tsunamis, and volcanoes. As an archipelagic nation with many low-lying islands,

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Indonesia is highly exposed to climate change, which could slow development if not managed effectively and risk increasing food insecurity. Pollution and environmental degradation impose major costs that directly threaten the future of key industries such as tourism and fisheries. In recognition of the dangers posed by climate change and environmental degradation, Indonesia has adopted ambitious green development goals to mitigate climate change and drive future growth. Still, Indonesia must take additional proactive steps to prepare for future crises.

45. **Frequent disasters caused by natural hazards.** A wide range of natural hazards, including earthquakes, tsunamis, volcanic eruptions, floods, droughts, and forest fires, impact Indonesia. Since 1990, Indonesia has experienced an average of 289 significant natural disasters per year. The direct economic cost of disasters is estimated to average $1.4 billion annually. Despite the frequency of these crises, disaster risk management only received funding equivalent to 0.04% of GDP in 2019. The severity of extreme weather events will likely increase with rising sea levels and more unpredictable weather patterns. Much existing infrastructure is inadequate to cope with the effects of climate change. Informal settlements are often in hazard-prone areas and are particularly vulnerable because of substandard materials and a lack of planning.

46. **The COVID-19 pandemic and potential future pandemics.** The impacts of COVID-19 have exposed challenges with disaster risk management. Despite government actions to control the pandemic beginning in February, cases continue to increase and daily new cases surpassed 1,000 for the first time on 10 June 2020. Stronger action is needed to prevent greater proliferation. Further, incursions into as-yet untouched forests also raise the risks for encounters with new zoonotic diseases that could spark future pandemics.

47. **Exposure to climate change.** Indonesia is uniquely exposed to climate change risks. Sea level rise threatens to submerge hundreds of its islands and directly impact its many large coastal cities. As a result of climate change, Indonesia is forecast to experience symptoms such as higher temperatures, increased duration and frequency of heat waves, more rainfall during the wet season, longer dry spells and a delayed monsoon, sea level rise, and higher storm surges.

48. **Agriculture and food security.** Despite an overall increase in food crop production, food security is still a concern. More and more unpredictable weather patterns and shorter growing seasons because of climate change have the potential to erode food security in Indonesia. 38% of the population could not afford a nutritious diet in 2017, contributing to a high incidence of stunting. Indonesia has one of the highest rates of stunting in Asia—30.8% of the population in 2018 exhibited signs of it, which is well above the regional average of 25.7%.

49. **Environmental degradation and pollution.** More than 80% of Indonesia’s population lives in areas where the average annual particulate pollution level exceeds WHO guidelines. The largest contributor to pollution is forest conversion, largely because of fires set to clear land and the burning of peatlands, leading to a substantial loss of forest cover. Poor waste

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84 Global Facility for Disaster Reduction and Recovery. 2019. *Indonesia.* Washington, DC.
88 ADB. Forthcoming. *Climate Change and Disaster Risk Management Assessment: Indonesia.* Manila.
90 Latest estimates from Indonesia’s Ministry of Health.
management is a major contributor to pollution in Indonesia’s rivers and surrounding seas. Degradation imposes human costs to health and well-being and undermines the development of key industries such as tourism and fisheries.

4. Crosscutting challenges

50. Several crosscutting issues must be considered while seeking solutions to the impediments above. While elements of these issues are embedded in the preceding analysis, these challenges have broad impacts and merit special attention. Indonesia must also focus on making progress toward achieving the SDGs in order to reach remaining targets by 2030.

51. **COVID-19.** The COVID-19 pandemic has already caused substantial loss of life and significant economic disruption in Indonesia. As in many countries, steps to manage the health impacts of the virus have led to sudden stops in economic activity that leave the most vulnerable at risk of falling into poverty. The dire human costs and unprecedented global economic slowdown resulting from the pandemic may continue for the next several years, making the path to economic recovery uncertain. A concerted government policy response that combines necessary and critical public health measures with creative economic policies, while being sensitive to the needs of different vulnerable groups, is needed to support recovery in a radically changed global economy.

52. **Private investments and innovations.** Increased private sector investment, innovation, and dynamism offer the potential to help Indonesia achieve higher growth rates and make progress on the many developmental hurdles that it faces. Catalyzing private sector investments has been a priority of both the government (which launched private sector initiatives on pressing developmental issues, such as the National Plastic Action Partnership) and ADB, which has proactively pursued private investments and partnerships in critical sectors.

53. **Gender equality.** Women participate in the workforce at a lower rate than men, which is partly explained by social norms, greater female participation in the informal economy, and the demands placed on women to perform household work. Persistent gender gaps hold back overall human development in Indonesia. Limited labor market opportunities for women constrain the competitiveness of the economy, and discriminatory policies against women pose an additional threat to gender equality.

54. **Digitization and innovation.** Indonesian firms and all levels of government have been slow to adopt the latest technologies, and investments in research and development in Indonesia are minimal. Better preparing Indonesian firms to harness emerging technologies can help them increase their efficiency, boost their competitiveness, and enable them to establish new industries able to drive Indonesia’s future growth. Support should also be given to e-governance initiatives and other innovative tech-based solutions aimed at improving the provision of public services.

55. **Local and regional economic development.** Indonesia’s high level of inequality stems in part from the unequal distribution of development across the country. In 2018, East Nusa Tenggara had a nominal per capita gross regional product (GRP) of Rp18 million ($1,288) while Jakarta had a per capita GRP of Rp248 million ($17,388), more than 13 times higher. Poverty rates are higher in remote regions, which are often poorly connected to the rest of the country.

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56. **Governance.** Tackling the development challenges faced by Indonesia will require effective, responsive, and accountable governance. The Government of Indonesia names weak governance and institutional capacity, including issues of corruption and bureaucratic inefficiencies, as constraints to inclusive growth. Indonesia has made progress in the international Corruption Perception Index, but corruption concerns remain widespread. Supporting subnational governments, which are responsible for the provision of many public goods and vary widely in their capacity, will be important for promoting convergence across Indonesia.

57. **Regional cooperation and integration.** Indonesia is a founding member of the Association of Southeast Asian Nations (ASEAN) and participates in many subregional cooperation initiatives. Starting in 2001, Indonesia’s trade with the rest of ASEAN grew rapidly to reach 24.5% of its exports and 25.3% of its imports in 2019. However, since 2010, growth in its trade with ASEAN as a percentage of total trade has stalled and has declined in dollar value. Indonesia’s integration with its neighbors is threatened by its absence from the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) and slow progress toward the ASEAN Economic Community and the Regional Comprehensive Economic Partnership (RCEP).

C. **Implications for ADB Country Engagement**

58. ADB is well positioned to help Indonesia tackle the impediments to future growth posed by (i) its low levels of human capital and struggles ensuring the population’s well-being, (ii) the hurdles to establishing a firm foundation for economic recovery, and (iii) the threats posed by the country’s vulnerability to crises. Managing these policy priorities will help ensure that growth is inclusive, competitive, and resilient; and that Indonesia emerges stronger after the COVID-19 pandemic. ADB efforts to develop human capital and ensure well-being can include deepening and expanding programs to improve education and skills training, supporting the development of social protection systems, and building health care system capacity. Indonesia’s recovery from the economic consequences of the COVID-19 pandemic can be accelerated through support for infrastructure and connectivity investments across the country, encouraging efforts to boost economic diversification and upgrading, support for financial market deepening, and assistance in establishing an enabling environment for private investment. Building increased resilience to crises can be supported by boosting disaster risk management capacity, improving water and food security, and ensuring that climate issues and environmental sustainability are mainstreamed in all ADB projects to support a green recovery. ADB will also need to be responsive to Indonesia’s evolving needs as the COVID-19 pandemic impacts the country and the world.

59. Pursuing projects in these areas would be well aligned with the operational priorities of ADB’s Strategy 2030 and would also be well aligned with the policy priorities laid out by President Widodo and outlined in RPJMN, 2020–2024. Ensuring country ownership of operations and seeking partnerships with the international community will be key to success in these efforts. Further, high-quality research and empirical backing will be critical for informing project design and feeding into ADB knowledge products. ADB can maximize its development impact by instituting the One ADB approach to better bring together knowledge and expertise from across the organization to design projects that incorporate multiple perspectives and are responsive to Indonesia’s complex needs. ADB should further strengthen offerings of innovative financing solutions to boost the impact of government investments, unlock private finance, and make the most of its own investments. Leveraging partnerships will be critical to achieving positive developmental outcomes in Indonesia. ADB should also seek to catalyze knowledge generation and sharing, and support the adoption of cutting-edge technologies in Indonesia.