Introduction

The Indonesian Economy in Transition —
Policy Challenges in the Jokowi Era and Beyond

Hal Hill and Siwage Dharma Negara

It is now more than twenty years since one of the most decisive and important turning points in Indonesian economic and political history. The year 1998 was one of exceptional turbulence, hardship and uncertainty. The seemingly impregnable Soeharto presidency came to a sudden end on 21 May. The economy and the currency were in free-fall, while an acrimonious relationship had suddenly emerged with international financial institutions. There were nasty episodes of conflict, mostly with serious ethnic undertones. Almost a million of the country’s citizens were internally displaced. There were various “Yugoslav” scenarios of territorial disintegration. Most important of all, there was no institutional roadmap to guide the country through the vacuum that Soeharto’s hasty exit had created.

Viewing the country through the gloomy lens of that era, it is perhaps no exaggeration to state that the economic and political developments over the intervening two decades are little short of miraculous. Indonesia is now regarded as one of the most vibrant democracies in Southeast Asia and in the Muslim world. It has maintained its territorial integrity. There have been four rounds of credible national elections, while democracy has also taken root in the more than 500 subnational jurisdictions. A far-reaching programme of decentralization has been implemented. The economy has returned to at least a moderate growth rate of around 5 per cent per annum. Inflation is well under control, and the macroeconomic framework is secure. The authorities navigated the 2008–09 Global Financial Crisis with little difficulty. The economy is now in much better shape than the resource-exporting members of the much-hyped BRICS group. Indonesia is recognized as a significant regional power through its membership of the G20 and other international fora.

Yet, in important respects, Indonesia is still a country in transition, and one that faces major development challenges. It is still a relatively young democracy, in the process of establishing durable institutions that will be needed to underpin an upper-middle income economy. Its ambitious decentralization programme is still being bedded down into an effectively operating system of government. Tens of millions of its citizens live below — or precariously above — a meagre poverty line. The economy is not growing

Hal Hill is HW Arndt Professor Emeritus of Southeast Asian Economies, Arndt-Corden Department of Economics, Crawford School of Public Policy, Coombs Building, ANU College of Asia and the Pacific, Australian National University, Canberra, ACT 0200, Australia; email: Hal.Hill@anu.edu.au

Siwage Dharma Negara is Senior Fellow in the Regional Economic Studies Programme and Co-coordinator of the Indonesia Studies Programme at the ISEAS – Yusof Ishak Institute, 30 Heng Mui Keng Terrace, Singapore 119614; email: siwage_dharma_negara@iseas.edu.sg
fast enough to quickly eradicate poverty and destitution. Perhaps paradoxically, inequality has risen appreciably during the democratic era. There are daunting environmental challenges, too.

The papers in this and the following issues of the journal address these and other issues at this crucial juncture of Indonesian history, as the country approaches its fifth national elections of the democratic era. The papers are based on a conference organized by the Regional Economic Studies Programme and the Indonesia Studies Programme of the ISEAS – Yusof Ishak Institute in March 2018 with financial support of the Konrad Adenauer Stiftung.

President Joko Widodo — widely known as Jokowi — was narrowly elected to office in 2014 with high expectations. The seventh president of the republic lacked family name, military background and wealth, itself an impressive reminder of the country’s democratic resilience. Jokowi campaigned successfully as an effective local government leader, with a reputation for clean and pragmatic administration. His agenda was to accelerate economic growth, overcome the country’s massive infrastructure deficit, and eradicate poverty. He promised a professional cabinet. His first major economic policy decision was a very significant one, to dramatically reduce the crippling fuel subsidies.

Almost five years later, what can be said about his record? Inevitably, as the papers in this issue document, the outcomes have been mixed. Most of Indonesia’s major development issues are not amenable to quick solutions in a single-term presidency. Moreover, Jokowi had the misfortune to be elected just as the decade-long super commodity boom was fading. For growth to be maintained and the social policy agenda implemented, substantial reform was required. In the event, Jokowi has been a decisive president in some respects, but not the major reformer that some of his supporters had hoped for. He has lived up to his commitment to prioritize infrastructure, and continue with the popular social policies, including health (*kartu sehat*), education (*kartu pintar*) and village grants. His personal integrity has been beyond reproach. He has maintained the stable macroeconomic policy settings of his predecessors.

Yet, in other respects, his policy narratives have struggled to make the transition from local to national government, in part reflecting the “rainbow coalition” of competing interests and diverse views that constitutes his government. He has wavered on international economic policy, between pragmatic openness and economic nationalism. One obvious manifestation has been his three very different trade ministers, and very little progress in rolling back the increasingly protectionist policies that had been introduced during the commodity boom. The continuing very weak tax effort means that the government is not able to fund the public services that the community expects. A one-off tax amnesty is hardly major fiscal reform. Microeconomic reform has also proceeded erratically: simplified business licensing procedures have been introduced, yet the sixteen “reform packages” in totality have not had much impact. The continuing flow of cases before the Corruption Eradication Commission, the KPK, is testimony to the struggle to improve governance standards. The result has been an economy that has continued to progress, but the “new normal” for economic growth appears to be 5 per cent, considerably slower than Jokowi’s campaign pledge of 7 per cent.

Moreover, the international economic environment that Indonesia faces continues to be uncertain and at times volatile, including the normalization of monetary policy in the United States and the threat of an increasingly disorderly trading environment. The rising global energy prices of 2018 should be a positive development for Indonesia. But unless the government is willing to allow domestic prices to follow international trends, paradoxically these higher prices will place even greater stress on the budget as the energy subsidies again blow out.

Six of the papers from the conference are included in this issue. Collectively, they cover a number of dimensions that are key to understanding the economic changes in — and challenges for — the Indonesian economy as it seeks to attain high-income status.

In the first article, Natasha Hamilton-Hart looks at how well do Indonesia’s banking and financial systems serve the needs of savers and businesses. She argues that financial sector performance in recent
years has shown a marked improvement in many areas. Financial stability indicators are mostly robust, suggesting a relatively resilient banking sector. The interventionist policies aimed at promoting financial inclusion and growth introduced by the Jokowi administration have so far not been excessively costly. Moreover, a degree of inefficiency may be the price to pay for financial stability. This article explores some of the policy and structural sources of inefficiency in the banking sector as they have developed over recent years. The author shows that Indonesia’s banking sector is structurally segmented, with limited competition among the largest banks and a competitive but constrained mid-size bank segment.

Next, Gerrit J. Gonschorek and Günther G. Schulze examine Indonesia’s intergovernmental fiscal transfer system. They look at the size, allocation mechanisms, and the economic rationale for the various transfer schemes prevalent in the country. Their article describes some major changes in institutional arrangements and in relative magnitudes of the transfers effected by the Jokowi administration. It assesses the extent to which the government has shifted the policy stance on fiscal decentralization. The study also analyses the effectiveness and efficiency of the existing system, including the recently implemented reforms.

In the third article, Chris Manning and Devanto Pratomo review developments in labour markets and related policies during the Jokowi presidency. It is set in the context of changing employment, wages and productivity since the Asian Financial Crisis and under the previous Yudhoyono government. They argue that Jokowi’s approach has been positive for employment and wages, although less so for labour productivity. Formal sector jobs have continued to grow rapidly and have recovered somewhat in manufacturing, while the downward trend in unemployment has continued. Reform of the minimum wage setting processes has not endeared the President to vocal union groups. But it appears to have moderated the minimum wage increases in the country’s main industrial centres. At the same time, a wider wage gap has emerged between permanent and casual workers and this could have contributed to rising inequality.

In the following article, Sandra Kurniawati, Daniel Suryadarma, Luhur Bima and Asri Yusrina look at the education system in Indonesia. After successfully improving access to education in the early 1990s through virtually universal primary school completion and similar positive trends in senior secondary level, Indonesia began investing heavily in improving learning outcomes since 2005. For almost a decade, the country has been spending about one-fifth of its public funds on education. Teachers have received significant salary increases through the certification programme. Using international test results, this article shows that improvements in learning levels are too small to justify the significant investments that the country has undertaken. The authors argue that, without adding accountability measures that focus on learning outcomes, there is little chance for the investments to provide significant returns in the form of significantly improved learning outcomes.

In the fifth article, Asep Suryahadi and Ridho Al Izzati examine Jokowi’s social assistance programmes. These have given the poor access to education and health services as well as food and cash transfers, and grants for villages as mandated by the Village Law. It assesses the implications of these initiatives on poverty and inequality by correlating economic growth with real per capita household consumption growth by quintile at the district level. This article shows that economic growth has become less pro-poor during the first three years of the Jokowi government, as indicated by the lower growth elasticity of consumption of the poorest 20 per cent of the population. By contrast, those of the middle quintiles have increased significantly and that of the richest 20 per cent remains the highest. This indicates that the poor have been less connected to economic growth compared to the middle class and the rich. The results imply that Jokowi’s poverty and inequality reduction strategy through the expansion of social assistance programmes and grants for villages does not appear to be sufficient to help the poor. Hence, a complementary strategy to connect the poor to economic growth through job creation and income generation is needed.

Finally, John McCarthy and Mulyadi Sumarto look at distributional politics in Indonesia, where social protection policies are rapidly expanding. They discuss the dilemma of “layering”, “nesting” and “social
fit" in Jokowi's poverty policy. This paper focuses on two programmes most relevant to the poor, the rice-for-welfare and the conditional cash transfer programmes. The authors look at the tension between a layered approach to social protection where new institutional arrangements are placed on top of or alongside existing ones, and a nested approach where the principles of a community's own distributional arrangements are located within wider state arrangements. The article concludes that Indonesia is still looking for a welfare regime that fits with the country's political-economic situation and cultural practices. It suggests that improving the social and institutional fit of social protection policies will involve working towards a more polycentric approach where the state supported targeting logic accommodates the social ethic and moral concerns of rural people.

These six papers, collectively, indicate that Indonesia's quest towards becoming a developed and high-income nation is a challenging one. Indonesia clearly needs to accelerate its economic growth in order to reach a high-income economy. With a GDP per capita of US$3,878 in 2017, it will take the country at least two decades of sustained growth acceleration to reach a high-income status. Moreover, the ongoing economic reforms, infrastructure growth and development outside Java must be continued. Current global economic uncertainties and disruptive technological changes require policy responses that not only enhance growth but promote inclusive outcomes as well. It is hoped that these six papers provide insights into some of the deep economic and institutional reforms that are likely to be required in the coming years.