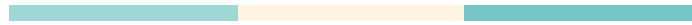


# **Making the New Indonesia Work for the Poor**



## **Overview**





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## Foreword

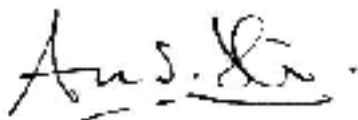
Since 2002, a team of leading Indonesian and international analysts under the umbrella of the Indonesia Poverty Analysis Program (INDOPOV) at the World Bank Office, Jakarta, has been studying the characteristics of poverty in Indonesia. They have sought to identify what works and what does not in the fight against poverty, and to help clarify options available to the government and non-governmental organizations in their efforts to raise living standards and the quality of life for the poor. This report brings together their findings.

This work has been greatly assisted by many Indonesian government institutions, particularly the Coordinating Ministry for the Economy, the Coordinating Ministry for People's Welfare and Bappenas. Many of the leading academic institutions and civil society organizations have also contributed to this report. The Economic Analysis Institute, University of Indonesia (LPEM-UI), the Faculty of Economics, Padjadjaran University (Unpad) and SMERU Research Institute deserve particular mention for their valuable contributions. The work was made possible by funding support from the United Kingdom's Department for International Development (DFID), together with funding from the World Bank.

This report seeks to analyze the various dimensions of poverty in today's Indonesia in a fresh light, based on the important changes that have occurred in the country over the past decade. Earlier Poverty Assessments were undertaken by the World Bank in 1993 and 2001, but generally not in such depth. This Assessment presents a wealth of shared knowledge from the World Bank and Indonesian government that we hope will contribute to a lively policy debate, and ultimately lead to policy and practice changes that will accelerate poverty reduction efforts.

In summarizing its findings, the report presents a concrete policy matrix that suggests how Indonesia might better align policies and programs to achieve its ambitious poverty reduction objectives. Our hope is that these findings will be useful for Indonesia in operationalizing its five-year national development strategy (SNPK), and in planning actions to attain the Millennium Development Goals, and the even more ambitious goals that it has set itself in its SNPK to 2009. These goals include reducing poverty to 8.2 percent, achieving 98.1 percent junior school enrollments and cutting maternal mortality rates from 307 deaths per 100,000 live births currently to 226—all by 2009.

Indonesia today is, of course, a very different place from the Indonesia of a decade ago. It should come as no surprise that the strategies required to reduce poverty have changed just as Indonesia itself has changed. It is our sincere hope that this poverty assessment will be of help in addressing these challenges. In so doing, we hope to contribute towards the continuing remarkable transition that is taking place in this country.



Andrew D. Steer  
Country Director, Indonesia  
East Asia and Pacific Region  
The World Bank

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This report has been prepared by a core team led by Jehan Arulpragasam and Vivi Alatas. The team that drafted the chapters also included Meltem Aran, Kathy Macpherson, Neil McCulloch, Stefan Nachuk, Truman Packard, Janelle Plummer, Menno Pradhan and Peter Timmer. Indermit Gill contributed to the drafting of the Overview section of this report.

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This report was produced under the overall guidance of Indermit Gill, Sector Manager for Poverty Reduction (EASPR) and Bill Wallace, Lead Economist for Indonesia (EASPR) for the World Bank. Strategic guidance and key comments were also provided by Andrew Steer, Country Director, Indonesia.

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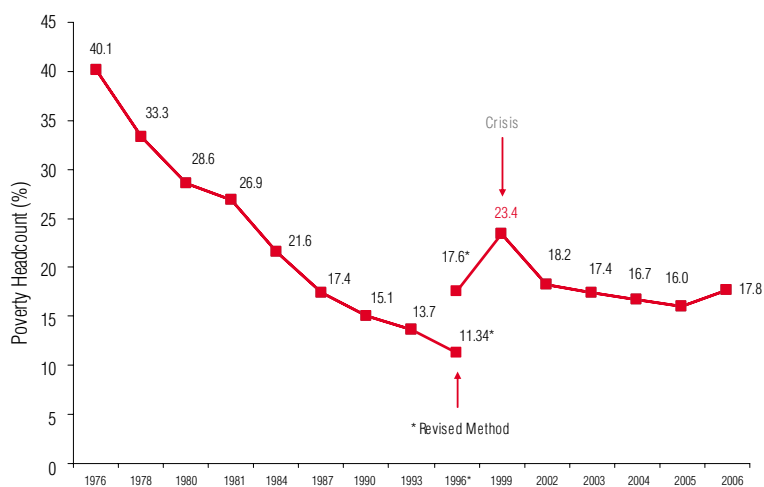


# Overview

## I Making the New Indonesia Work for the Poor

**Indonesia stands at the threshold of a new era.** After the historic economic, political and social upheavals at the end of the 1990s, Indonesia has started to regain its footing. The country has largely recovered from the economic crisis that threw millions of its citizens back into poverty in 1998 and saw Indonesia regress to low-income status. Recently, it has once again become one of the world's emergent middle-income countries. Poverty levels that had increased by over one-third during the crisis are now back to pre-crisis levels (Figure 1). Meanwhile, Indonesia has undergone some major social and political transformations, emerging as a vibrant democracy with decentralized government and far greater social openness and debate.

**Figure 1** Poverty in Indonesia fell rapidly until the 1990s, and has declined again since the crisis



**The challenge of reducing poverty remains one of the country's most pressing issues.** The number of people living below US\$2-a-day in Indonesia comes close to equaling all those living on or below US\$2-a-day in all of the rest of East Asia besides China. The Indonesian government is committed to the objective of reducing poverty in its medium-term plan (RPJM) for 2005-09 which, in turn, draws on a national poverty reduction strategy (SNPK). In addition to signing on to the Millennium Development Goals (MDGs) for 2015, in its medium-term plan the government has laid out its own key poverty reduction objectives for 2009. This includes an ambitious target of reducing the poverty headcount rate from 18.2 percent in 2002 to 8.2 percent by 2009. While national poverty rates may be close to pre-crisis levels, this still means that about 40 million people are living below the national poverty line. Moreover, although Indonesia is now a middle-income country, the share of those living on less than US\$2-a-day is similar to that of the region's low-income countries such as Vietnam.

**Indonesia has a golden opportunity for rapidly reducing poverty.** First, given the nature of poverty in Indonesia, focusing attention on a few priority areas could deliver some quick wins in the fight against poverty and low human development outcomes. Second, as an oil and gas producing country, Indonesia stands to benefit in the next few years from increased fiscal resources—as much as US\$10 billion in 2006—thanks to higher oil prices and reductions in fuel subsidies. Third, Indonesia can harness still further benefits from its ongoing processes of democratization and decentralization.

**The challenge is how to make the new Indonesia ‘work for the poor’.** This is the focus of this report, which aims to contribute to the policy debate and decision-making process in the country by putting forth: (i) new and more comprehensive analysis of empirical poverty diagnostics; and (ii) suggestions on concrete policies and programs for a strategic action-plan to achieve Indonesia’s stated poverty-reduction objectives.

**Indonesia can learn from its own economic growth, government policies and social programs.** Indonesia has had remarkable success in reducing poverty since the 1970s. The period from the late 1970s to the mid-1990s is considered one of the most ‘pro-poor growth’ episodes in the economic history of any country, with poverty declining by half. After the spike during the economic crisis, poverty has generally returned to its pre-crisis levels. The poverty rate fell back to about 16 percent in 2005 following a peak of over 23 percent in 1999 in the immediate wake of the economic crisis. Macroeconomic stabilization from mid-2001 onwards underpinned this recovery, bringing down the price of goods, such as rice, that are important to the consumption of the poor. However, despite this steady progress in reducing poverty, more recently, there has been an unforeseen upturn in the poverty rate. This reversal appears to have been caused primarily by a sharp increase in the price of rice—an estimated 33 percent for rice consumed by the poor—between February 2005 and March 2006, which largely accounted for the increase in the poverty headcount rate to 17.75 percent.

#### Box 1 Why did poverty increase from 2005 to 2006?

In September 2006, BPS announced that the poverty rate in Indonesia had increased during the period February 2005 to March 2006 from 16.0 percent to 17.75 percent—in contrast to steady declines in the poverty rate since the crisis.

The 33 percent increase in rice prices between February 2005 and March 2006—mostly due to the ban on rice imports—is the main reason that poverty rates have increased. Around three-quarters of the additional four million people falling into poverty during this period did so as a result of the rice price increase and, in addition, recent analysis indicates that the fuel price increase was not a major factor in the increased poverty rate. The unconditional cash transfer (UCT) program, which provided cash transfers to 19.2 million poor and near-poor households, more than offset, on average, the negative impact of the fuel price increase for the poor. In other words, the impact of the combined effects of the fuel price increase and the UCT compensation point to a net positive income gain, overall, for the poorest 20 percent of the population.

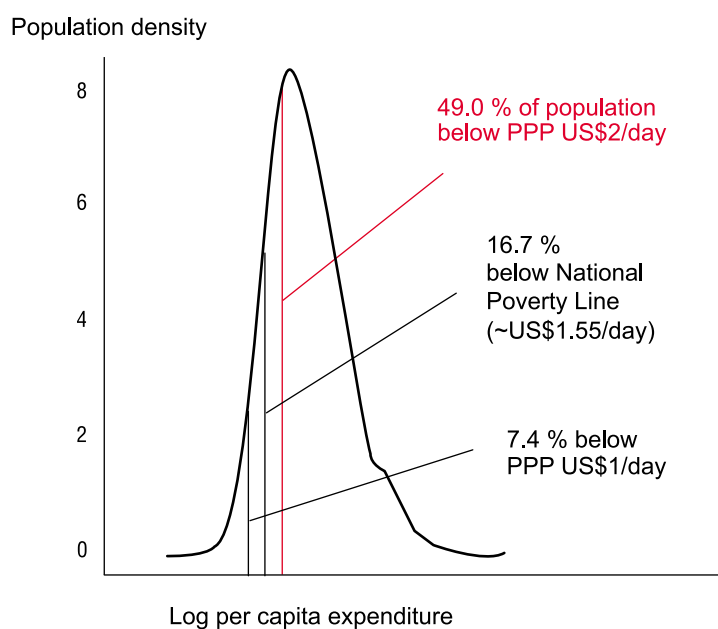
However, with rice prices still going up, and the UCT program drawing to an end, there is a possibility that poverty rates could rise again next year unless economic growth increases significantly.

## Dimensions of Poverty in Indonesia and a Proposed Policy Framework

**Poverty in Indonesia has three salient features.** First, many households are clustered around the national income poverty line of about PPP US\$1.55-a-day, making even many of the non-poor vulnerable to poverty. Second, the income poverty measure does not capture the true extent of poverty in Indonesia; many who may not be ‘income poor’ could be classified as poor on the basis of their lack of access to basic services and poor human development outcomes. Third, given the vast size of and varying conditions in the Indonesian archipelago, regional disparities are a fundamental feature of poverty in the country.

- A large number of Indonesians are vulnerable to poverty.** The national poverty rate masks the large number of people who live just above the national poverty line. Close to 42 percent of all Indonesians live between the US\$1- and US\$2-a-day poverty lines—a remarkable and defining aspect of poverty in Indonesia (see Figure 2). Analysis indicates that there is little that distinguishes the poor from the near-poor, suggesting that poverty reduction strategies should focus on improving the welfare of the lowest two quintile groups. This also means that the vulnerability to falling into poverty is particularly high in Indonesia: while only 16.7 percent of Indonesians surveyed were poor in 2004, more than 59 percent had been poor at some time during the year preceding the survey. Recent data also indicate a high degree of movement in and out of poverty over time: over 38 percent of poor house holds in 2004 were not poor in 2003.

**Figure 2** Forty-two percent of Indonesia's population lives on between US\$1- and US\$2-a-day

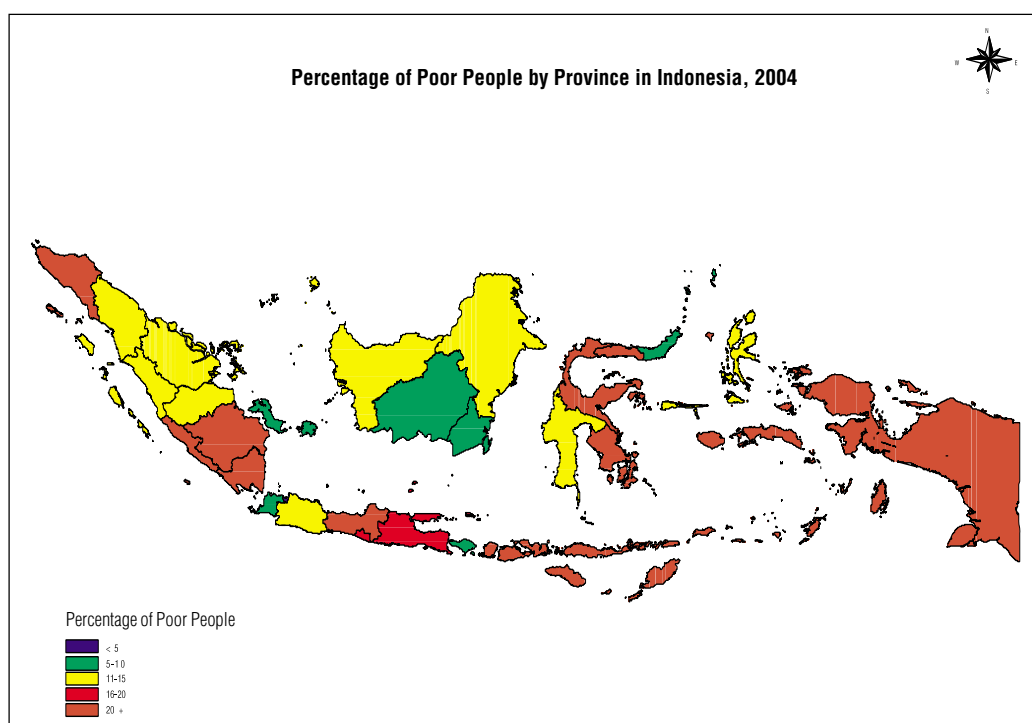


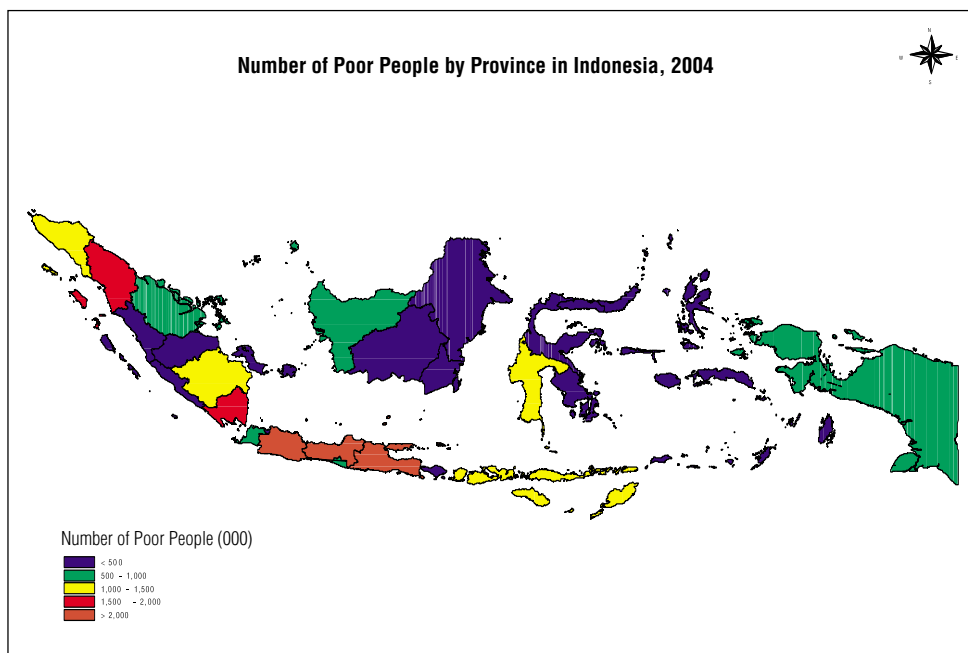
Source: Susenas Panel data, 2006.

- Non-income poverty is a more serious problem than income poverty.** When one acknowledges all dimensions of human well-being—adequate consumption, reduced vulnerability, education, health and access to basic infrastructure—then almost half of all Indonesians would be considered to have experienced at least one type of poverty. Nonetheless, Indonesia has made good progress in past years on some human capital outcomes. There have been notable improvements in educational attainment at the primary school level; basic healthcare coverage (particularly in birth attendance and immunization); and dramatic reductions in child mortality. But in some MDG-related indicators Indonesia has failed to make significant progress and lags behind other countries in the region. Indeed, specific areas that warrant concern are:
  - Malnutrition rates are high and have even risen in recent years: a quarter of children below the age of five are malnourished in Indonesia, with malnutrition rates stagnating in recent years despite reductions in poverty.
  - Maternal health is much worse than comparable countries in the region: Indonesia's maternal mortality rate (307 deaths in 100,000 births) is three times that of Vietnam and six times that of China and Malaysia; only about 72 percent of births are accompanied by skilled birth attendants.

- Education outcomes are weak. Transition rates from primary to secondary school are low, particularly among the poor: among 16- to 18-year-olds from the poorest quintile, only 55 percent completed junior secondary school, compared with 89 percent from the richest quintile from the same cohort.
- Access to safe water is low, especially among the poor. For the lowest quintile access to safe water in rural areas is only 48 percent, against 78 percent in urban areas.
- Access to sanitation is a crucial problem. Eighty percent of the rural poor and 59 percent of the urban poor do not have access to septic tanks, while less than 1 percent of all Indonesians have access to piped sewerage services.
- **Regional disparities in poverty are considerable.** Wide regional differences characterize Indonesia, some of which are reflected in disparities between rural and urban areas. Rural households account for about 57 percent of the poor in Indonesia and also frequently lack access to basic infrastructure services: only about 50 percent of the rural poor have access to an improved source of water, compared with 80 percent for the urban poor. But importantly, across the vast Indonesian archipelago, it is also reflected in broad swathes of regional poverty, in addition to smaller pockets of poverty within regions. For example, the poverty rate is 15.7 percent in Java/Bali and 38.7 percent in more remote Papua. Services are also unequally distributed across regions, with an undersupply of facilities in remote areas. In Java the average distance of a household to the nearest public health clinic is 4 kilometers, whereas in Papua it is 32 kilometers. While 66 percent of the poorest quintile in Java/Bali have access to improved water, this number is 35 percent for Kalimantan and only 9 percent for Papua. A challenge faced by the government is that although poverty incidence is far higher in eastern Indonesia and in more remote areas, most of Indonesia's poor live in the densely populated western regions of the archipelago. For example, while the poverty incidence in Java/Bali is relatively low, the island is home to 57 percent of Indonesia's total poor, compared with Papua, which only has 3 percent of the poor.

**Figure 3 Poverty incidence and mass vary greatly across the Indonesian archipelago**





**An analysis of poverty and its determinants in Indonesia, as well of Indonesia's history in reducing poverty to date, points to three ways to fight poverty.**

The three means for helping people lift themselves out of poverty are economic growth, social services, and public expenditures. Each of these prongs addresses one or more of the three defining features of poverty in Indonesia: vulnerability, multidimensionality, and regional disparities (see Table 1 below). In other words, an effective poverty reduction strategy for Indonesia has three components:

- ***Making Economic Growth Work for the Poor.*** Economic growth has been, and will continue to be, fundamental to reducing poverty. First, making growth work for the poor is simultaneously key to linking the poor throughout various parts of the Indonesian archipelago to the growth process—whether it is across the rural-urban space or across the various regional and island groupings. So it is fundamental to addressing the issue of regional disparities. Second, to address the vulnerability characteristic of poverty associated with the dense concentration of income distribution in Indonesia, anything that can shift this distribution to the right will rapidly reduce the incidence of and vulnerability to income poverty.
- ***Making Social Services Work for the Poor.*** The delivery of social services to the poor—whether by the public or private sector—is essential to addressing poverty in Indonesia. First, this is key in addressing the non-income dimensions of poverty in Indonesia. Lagging human development indicators such as the high maternal mortality rate must be tackled by improving the quality of services that are made available to the poor. This goes beyond levels of public spending: it is about improving systems of accountability, service delivery mechanisms, and even government processes. Second, the nature of regional disparities transcends income disparity and is largely reflected in disparities in access to services which, in turn, results in disparities in human development outcomes across regions. Thus making services work for the poor is key to addressing the problem of regional disparities in poverty.
- ***Making Public Expenditure Work for the Poor.*** Besides economic growth and social services, the government, by targeting public spending to the poor, can assist them in countering income and non-income poverty. First, public spending can be used for helping those who are vulnerable to income poverty through a modern system of social protection that augments their own efforts to deal with economic uncertainty. Second, public spending can be used

to improve human development outcomes—hence, tackling the non-income multidimensional aspects of poverty. Making expenditures work for the poor is particularly pertinent now given the increased fiscal space that exists in today's Indonesia.

**Table 1 An approach for addressing Indonesia's poverty problems**

	Dimensions of Indonesian poverty		
	Vulnerability	Multidimensionality	Regional disparities
<b>Economic growth</b>	●		●
<b>Social services</b>	●	●	●
<b>Public expenditure</b>	●	●	●

*Note:* ● Indicates principal link between thematic area and the aspect of poverty; ● indicates an important linkage.

**This Overview highlights the top priority actions to address each of the three salient features of Indonesia's poverty problem.** It is not intended to be a comprehensive summary of this entire report, which provides a broad range of diagnostics and related policy implications. Likewise, neither does this Overview present the comprehensive set of policy prescriptions following from this report. Rather, this Overview section highlights the top priority actions under each of the three thematic prongs laid out above, in line with Table 1 above. It highlights policy priorities under Growth, Services and Expenditure where it is deemed that action under any of these areas would be most effective in addressing one of the three salient features of poverty in Indonesia.

## Making Economic Growth Work for the Poor

**For Indonesia, growth that benefits the poor has been, and will continue to be, the main route to poverty reduction.** From the 1970s through to the late 1990s, growth was rapid and it reached the poor: each percentage point increase in average expenditure resulted in a 0.3 percent reduction in the poverty headcount. Even since the crisis, growth has been the primary determinant of poverty reduction. However growth will need to accelerate and benefit the poor more if the government is to meet its poverty reduction targets. If the current rate and pattern of growth continues, Indonesia will not meet its poverty reduction target of 8.2 percent by 2009. In fact, if the current pattern of growth continues, the medium-term poverty reduction target of government will not be met even if growth were accelerated to the projected rate of 6.2 percent. To meet the government's poverty target, growth must become more pro-poor. For example, if the incomes of the poor grow at the same rate as those of the rich then the medium-term target can be broadly met.

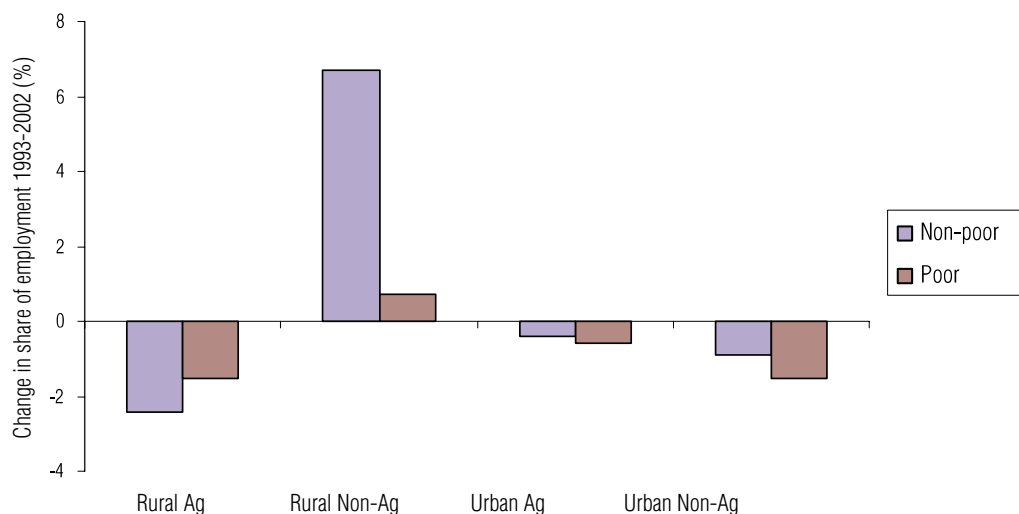
**Making growth work for the poor will require getting the poor onto effective pathways out of poverty.**

This will mean harnessing the structural transformation that is ongoing in Indonesia—albeit at a significantly slower rate than pre-crisis. This transformation is characterized by two phenomena. First, there is an ongoing shift from more rural-based to more urban-based activities. Indonesia has experienced rapid urbanization, with the population of Indonesia's cities nearly trebling in 25 years. This has stimulated a shift from rural to more urban-based activities, even when households have not in fact changed location (some 35 to 40 percent of urbanization). Urban markets are thus becoming increasingly important for both the rural and the urban poor. Second, there has been a marked shift from farm to more non-farm activities. In rural areas in particular, this has meant substantial growth in the share of employment in rural (or previously rural) non-farm enterprises (4 percent per year between 1993 and 2002). This transformation suggests two important pathways that households have taken out of poverty in Indonesia.

- **The first pathway out of poverty is improved agricultural productivity.** This could come from increasing productivity in small-scale agriculture or an increased shift to commercial farming. Agricultural productivity gains from the green revolution were one of the main drivers of growth in the three decades commencing with the 1970s. More recently, high world commodity prices have sustained output growth, while the shift of labor out of the sector has maintained the growth of labor productivity in agriculture. As a result, recent poverty diagnostics show that increases in agricultural incomes continue to be an important driver of reductions in poverty. Panel data between 1993 and 2000 show that 40 percent of agricultural workers in rural areas escaped poverty while staying in rural agriculture.
- **The second pathway out of poverty is increasing non-farm productivity,** whether this be in urban areas or rapidly urbanizing rural areas. In this regard, the transition through rural non-farm enterprises is an important stepping-stone to moving out of poverty, either by connecting rural enterprises to urban growth processes or, importantly, by these enterprises in the rural fringe being subsumed into urban areas. Between 1993 and 2002, the employment share of non-poor workers in rural non-farm employment increased by 6.7 percentage points, suggesting that increasing non-agricultural productivity in rural areas was an important pathway out of poverty. Moreover, many of these 'rural' areas were urban by the end of the period, showing the complementary roles of urbanization and productivity enhancements.

**A strategy to help the poor take advantage of economic growth has several elements.** First, it will be important to maintain macroeconomic stability: key to this are ensuring low inflation and a stable and competitive exchange rate. Countries that have had more macroeconomic shocks experience slower growth and poverty reduction than those with better macroeconomic management (World Bank, 2005a). Indonesia knows better than most countries the dreadful poverty impact of macroeconomic crises. Second, the poor have to be connected to opportunities for growth. Better access to roads, telecommunications, credit and formal sector employment are associated with significantly lower poverty. The benefit of being 'connected' is large, particularly in the case of formal sector employment outside of agriculture. Third, it will be important to invest in the capabilities of the poor. Part of the strategy for growth must be to invest in the poor so that they are well prepared to benefit from the opportunities for income growth that present themselves. In both rural and urban areas, higher levels of education of household heads are associated with higher levels of consumption. Investing in education for the poor will boost the capability of the poor to participate in growth.

**Figure 4 Rural non-farm activities have helped Indonesians leave poverty**



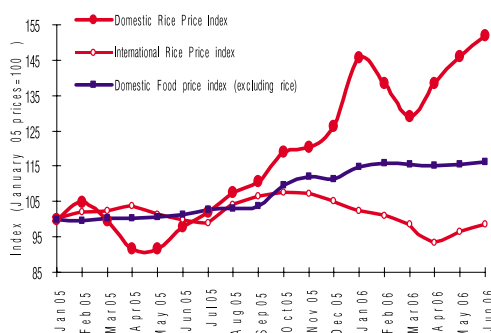
Source: Susenas 1993, 2002, rural/urban classification of 1993.

Three priority areas of action stand out:

- Revitalize agriculture and increase agricultural productivity.** With almost two-thirds of poor household heads still working in agriculture, boosting agricultural capability remains essential for broad-based poverty reduction. Analysis shows that households working in informal agriculture are most likely to be poor, with increases in consumption associated with moving to formal agriculture. Yet agriculture in Indonesia is not doing well. Despite labor productivity remaining buoyant with the outflow of labor from agriculture, agricultural total factor productivity growth has been negative since the early 1990s, from annual gains of 2.5 percent in 1968-92 to annual contractions of 0.1 percent from 1993 to 2000. The government can contribute to increasing agricultural productivity through: boosting investment in key infrastructure, notably farm-to-market roads and irrigation, while widening local water management; encouraging and supporting diversification into higher value-added crops; working with the private sector to ensure that exports meet world standards; boosting expenditure on agricultural research; and redesigning the decentralized extension service to allow for greater involvement of the private sector and civil society. These efforts to improve agricultural productivity should also include development of better marketing and information systems for rural-based businesses. Efforts to speed up land titling and more broadly ensure appropriate forms of secure tenure throughout the country will also help.
- Remove the ban on rice imports.** Lowering the rice price and creating greater price stability by removing the import ban on rice is the fastest way for the government to reduce poverty quickly. Rice is a critically important food commodity for all Indonesians but especially for the poor, constituting 24.1 percent of their consumption. *For the country as a whole, four out of five households are net consumers of rice, that is, they consume more rice than they produce.* The sharp surge in rice prices during the economic crisis, and then again in 2005-06, increased the total poverty rate. Indeed, it is estimated that the 33 percent increase in the rice price between February 2005 and March 2006 alone put around an additional 3.1 million people into poverty. This price increase was well beyond the food inflation rate showing that it was not primarily caused by the rise in the fuel prices (Figure 5). The rice ban could be replaced by a low tariff. In addition, targeted provision of rural infrastructure and agricultural research and extension services will help farmers improve rice productivity.

**Figure 5 Rice price increases hurt the poor**

**The domestic rice price overtook international prices (incl. the tariff) after December 2005 due to shortage in domestic supply**



Source: FAO, Border prices wholesale equivalent for Vietnam rice 25 percent, Jakarta wholesale price IR 64 III PIBC.

**Proportion of households that are net consumers of rice (%)**

	Rice farmers	All farmers	All Indonesians
<b>Urban</b>	<b>27.67</b>	<b>73.7</b>	<b>94.53</b>
Urban poor	25.26	67.32	85.79
Urban non-poor	28.49	75.91	95.51
<b>Rural</b>	<b>26.63</b>	<b>64.19</b>	<b>72.26</b>
Rural poor	33.17	68.1	72.14
Rural non-poor	25.17	63.17	72.28
<b>Total</b>	<b>26.77</b>	<b>65.44</b>	<b>82.74</b>
Poor	31.79	67.98	76.46
Non-poor	25.57	64.75	82.74

Source: Susenas, 2004.



- **Launch a rural roads program.** Access to infrastructure and roads is shown to be a key correlate of poverty. Having all-year passable roads is associated with higher expenditure levels in both urban (7.7 percent higher) and rural (3.1 percent higher) areas. Again, the less well connected regions of eastern Indonesia will see particularly strong gains from improved connections. The critical importance of infrastructure is also reflected in responses from small rural enterprises. In a firm-level survey, road access, the cost of transportation and the quality of roads all feature strongly in the top concerns of rural enterprises surveyed. Analysis shows that improving the quality of roads would be associated with a rise in the average proportion of income in a village coming from non-farm enterprise income and non-farm salaries and wages by 33 percentage points. Yet, only 61 percent of poor households have access to all-year passable roads (while 76 percent of non-poor household access these roads). Currently, around four-fifths of all roads now fall under the responsibility of district governments and 64 percent of these roads are considered to be in less than good condition. Moreover, the condition of district roads seems to be deteriorating as less money is allocated to maintenance. Tackling these cross-cutting constraints to investment could play a major role in connecting the poor to growth. It would be aimed directly at addressing the difficult issue of regional disparities, by linking regional disparate regions to growth processes. For district level roads, there is a need to increase financing, particularly for maintenance, through a concerted strategy. One option is a special DAK. These funds could be targeted (using poverty maps) to areas where access for the poor is worst. The DAK should also leverage and increase district-level funding for road maintenance. Another possibility is the development of a road fund at the district or provincial level along with the establishment of a district-level road management system.

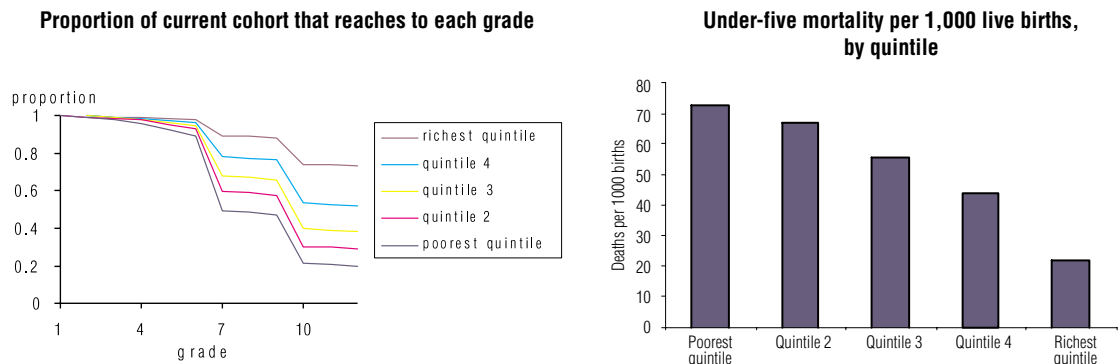
## Making Services Work for the Poor

**Making services work for the poor requires improving institutional accountability systems and introducing incentives to improve service delivery in order to improve human development outcomes.** Currently, poor service delivery lies at the center of weak human development outcomes, or non-income 'multidimensional' poverty, such as poor quality of health and educational care. According to survey data, 44 percent of households in the poorest quintile with children enrolled in school reported difficulties in financing junior secondary education. The poor pay 7.2 percent of their total expenditure for each enrolled student at junior secondary level. On the demand side, to address this issue the government should consider programs of targeted transfers, such as scholarships or conditional cash transfers linked to attendance to junior secondary school (and vocational schools). Junior secondary school capacity in Indonesia provides learning opportunities on average to only some 84 percent of potential students in the 13 to 15 age group. Likewise, huge regional disparities in these indicators are reflections of differential access to these services across regions. The government needs to focus on making services work for the poor to address the multidimensional aspect of poverty and high regional disparities in these indicators. With regard to addressing the multidimensional aspects of poverty, efforts should be aimed at improving service delivery especially with a view to improving quality.

**The other area of focus is improved access of the poor to services to reduce regional disparities in human development indicators.** The variability in access to services across the country is a fundamental driver of regional inequalities in poverty-related outcomes. While in some regions, such as Central Java, school capacity exceeds 100 percent, in East Nusa Tenggara and South Sumatra the average coverage of school capacity is below 60 percent of the number of potential students, indicating a lower degree of access. And the average distance to junior secondary schools in Java is 1.9 km while in Papua the average distance is 16.6 km (Podes, 2005). Of the junior secondary schools available, a ministry survey in 2004 found 27.3 percent of their classrooms to be damaged in some way. More junior secondary classrooms and schools need to be made available, and one way this can be achieved is by converting primary schools where there is excess supply.

**In education, a key issue is the high drop-out rate among the poor as they transition from primary to junior secondary level.** The main problem is the lack of access among the poor to junior secondary schools and to vocational schools. Lack of access is both physical and financial. Financial access is limited due to the high level of fees that creates a barrier to the poor's education at junior secondary level. The share of poor children who complete primary school is 89 percent, but only 55 percent of poor children complete junior secondary. Yet, diagnostics show that the returns to education increase with increasing levels of schooling. In 2002, the increase in urban (rural) male wages resulting from an additional year of schooling for someone who had only one year of schooling already was 8.3 percent (6.0 percent); after five years of schooling, the return was 10.0 percent (7.6 percent) and after eight years of schooling it was 11.1 percent (8.8 percent).

**Figure 6 Inequality in outcomes remains high**



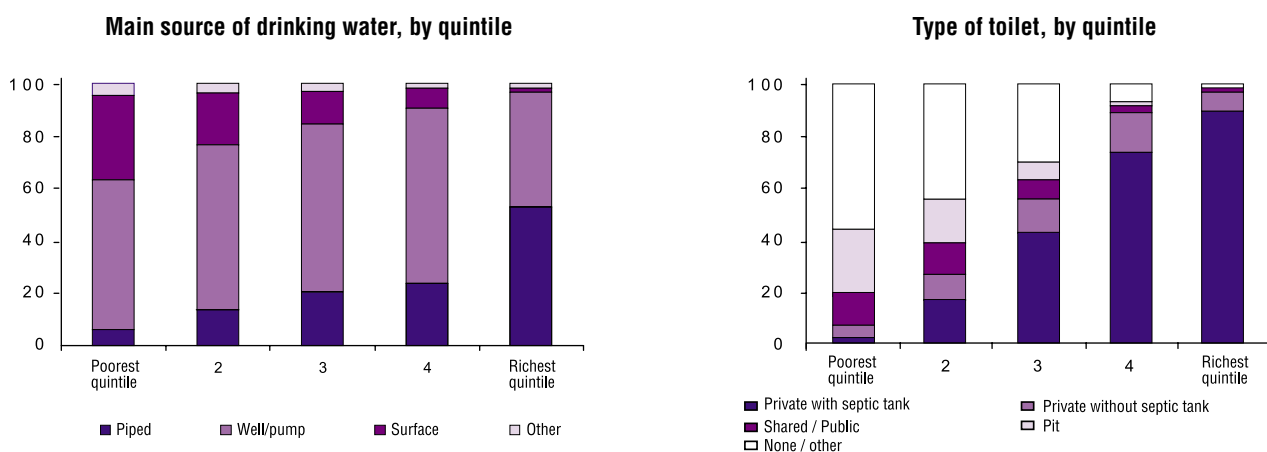
Source: Enrollment data are from analysis of data from Susenas 2004, current cohort defined as between 20 and 25 years of age. Mortality and water and sanitation are from analysis of data from Demographic and Health Survey 2002/2003.

**Improving attainment among the poor at the junior secondary school level will require both supply- and demand-side interventions.** On the supply side, teacher management policies that deploy greater numbers to remote areas are needed. Remote schools have higher student-teacher ratios, and a recent study showed that despite the general teacher oversupply in Indonesia, 74 percent of remote schools are below entitlement. Likewise, despite the large allocation to teacher salaries in the budget, teachers' monthly salaries are low. While spending on salaries is 50 percent of total educational spending, teachers are paid 21 percent less than workers with equivalent qualifications. On the demand side, junior secondary schools and vocational training schools (SMKs) can be made more affordable for the poor by targeting transfers to poor students through scholarships or conditional cash transfers (CCTs).

**Better primary healthcare requires better incentives for both the poor and for providers.** Chaudhury et al (2005) found that absenteeism among health workers in Indonesia is 40 percent, even higher than in Bangladesh and Uganda. A governance and decentralization survey found that only 30 percent of primary health clinics visited had complete stocks of medicines. For higher-level healthcare, affordability is an issue and targeted programs would make sense, such as a health insurance program. It will be important to build on this recently launched program—based on recent assessments, findings point to the need to improve targeting and open up service provision. Progress in reducing maternal mortality lies in increasing the proportion of births attended by skilled professionals, increasing the proportion of institutional deliveries and improving access to 24-hour obstetric care. Currently, only 72 percent of births are attended by skilled personnel in Indonesia nationally, compared with 97 percent in Malaysia and China and 99 percent in Thailand. Increasing deliveries with skilled staff in attendance in health clinics will require action on four fronts: increasing the availability of skilled midwives in remote areas; improving the affordability of care by skilled professionals; increasing awareness, especially among women, of the importance of skilled midwifery at birth; and improving the quality of skilled birth attendant services.

**Indonesia needs to address the shortfalls facing the poor in accessing safe water and sanitation.** An estimated 50 million rural poor are not connected to piped water and of that number six million pay higher rates (in excess of those charged the state water utility company). For rural areas, the existing community management supply model that has been shown to work should be expanded. This currently covers 25-30 percent of the rural population, but could be expanded to cover the 50 million people currently without adequate water supply. In urban areas, levels of access to utility supply are lower in the poorest quintile, but the district water utilities (PDAM) service to all households is also limited. In practice, the urban poor obtain their water from many sources, primarily non-network water and self-supply. For urban areas, supply must be strengthened by improving capacity and incentives for water utilities (PDAMs) to plan, deliver and monitor service delivery. In addition, PDAMs need to be mandated and given incentives to scale up services to areas inhabited by the poor. Consideration needs to be given to designing appropriate tariff structures for the poor who benefit from current connections, or who will have future connections. The coverage of sanitation services in Indonesia is the worst in the region, with less than 1 percent of all Indonesians accessing piped sewerage systems. Survey data show that 80 percent of the rural poor and 59 percent of the urban poor have no access to adequate sanitation. It is estimated that the cost of poor sanitation is about 2.6 percent of GDP, while public spending on water and sanitation together is less than 0.2 percent of GDP. Two immediate options are the development of a national strategy to increase sanitation financing, and local government investment in sanitation infrastructure at the neighborhood and city levels, for example through a specific DAK for sanitation, or by including sanitation services in minimum service standards.

**Figure 7 Inequality in services remains high**



Source: Enrollment data are from analysis of data from Susenas 2004, current cohort defined as between 20 to 25 years of age. Mortality and water and sanitation are from analysis of data from Demographic and Health Survey 2002/2003.

Three priority areas for action stand out:

- Clarify functional responsibilities for the provision of services.** The lack of clarity of responsibilities is paralyzing accountability in service delivery. The financing and provision of services is based on bureaucratic instructions, providing relatively little actual autonomy to either providers or beneficiaries. A typical government health clinic has eight sources of cash income and 34 operational budgets, many of which are provided in kind by the central or local government. The central government should limit its role to policy-making, staffing issues, information and developing core national service-delivery standards. Provincial level governments should focus on fixing regional standards, building capacity at the district level and implementing cross-district services, while at the district level governments should be responsible for planning and budgeting, and ensuring implementation of service delivery. Providers should be expected to monitor outcomes for the services they provide. Communities should be empowered to provide feedback to those providers, possibly even managing their own targeted programs and helping to build/maintain local infrastructure.

- **Improve civil service staffing and management in social sectors.** The government needs to review and provide clarity in the regulatory framework and incentives for organizational and personnel management by instituting a less rigid employment regime and abolishing the system of structural and functional positions and the rigid ranking of posts. While civil service reform is not easy, it is a vital component to ‘unsticking’ service delivery. A recent study involved making surprise visits on more than 100 primary schools and health centers in Indonesia. The study found absenteeism rates of 10 percent among teachers and 40 percent among health workers. Indonesia had the highest health-worker absenteeism rate of all the countries included in this global study. Not only does high absenteeism reduce quality, but it also reduces the demand for public health services. Creating more robust and predictable incentives for staff will also help, as has been proven in the case of some frontline service providers (see Box 2).
- **Provide stronger incentives for service providers.** The provision of clear, predictable rewards and sanctions is necessary to provide a framework that will systematically promote good behavior and outcomes by service providers. Incentives can take the form of performance contracts or incentive payments for good results. One specific option is to pilot the use of service agreements—a contract between a public service provider and local government that specifies the services that will be delivered, and the resources that will be provided to do so. In addition, local governments can work with private providers as partners in delivering good quality services to the poor. For example, almost 60 percent of all healthcare visits were to private facilities or providers in 2004. The poor use private services not only because they are often cheaper, but they are perceived to be of higher quality. Many local governments are working creatively to provide incentives for improved educational outcomes and healthcare (see Box 2 below). On the demand side, conditional cash transfers (CCTs) can help where behavioral change is required to enhance demand, such as child well-being and nutrition status check-ups, and child immunization

### Box 2 Better incentives and information can change the behavior of service providers

Numerous experiments using incentives for local service providers have been conducted in Indonesia in recent years. In some cases, there was a marked change in the behavior of service providers in response to changed incentives. For example:

In Tanah Datar district, West Sumatra, a scheme was launched in 2002 to provide stronger incentives to English teachers and headmasters by offering them study tours of Australia, Malaysia, and Singapore if they promised to follow up with changed practices. Teachers returning from study trips had to submit a group report to the *bupati*, with follow-up observations and recommendations:

- The trips increased the motivation to improve conditions in schools. These included stronger discipline of teachers, students, and parents; smaller class sizes; providing classes in computer skills and English; changing the teaching methodology; and, consulting with students.
- The trips effected changes in teaching methodology. One English teacher began teaching her classes in English rather than Indonesian following her trip to Australia. She has also begun using a ‘student agenda,’ in which students record their activities in English, as well as what they have learned from them, as an aid in teaching.
- The trips increased interest in student performance. Teaching hours increased, due to both school-based management and the stronger incentives policy; on average students now study about 15 hours more a week. To demonstrate his commitment to raising student test scores, one headmaster even signed an agreement with his school committee stating that if scores at his school were not above a certain level he would resign.

In Jembrana district, Bali, health sector reforms created a new health insurance program (Jaminan Kesehatan Jembrana). The program provided free primary healthcare for all enrolled citizens and free secondary care for all poor members. It also enhanced client choice by enabling members to choose between private and public healthcare providers, both of whom were reimbursed under the scheme. In addition to increasing coverage of health services, the scheme directly affected the behavior of public health staff, who had to compete for clients with private providers in the wake of this reform. As a result, public providers measurably improved their client orientation by sending mobile clinics and doctors to remote areas at least once a month (rather than just providing health education in these remote areas, as they previously had); improving medicine packaging; and providing ‘full smile’ reception for patients. In addition, the management board of the project supervised quality control for reimbursements by both creating a clear set of service standards for all providers and investigating cases of malfeasance.

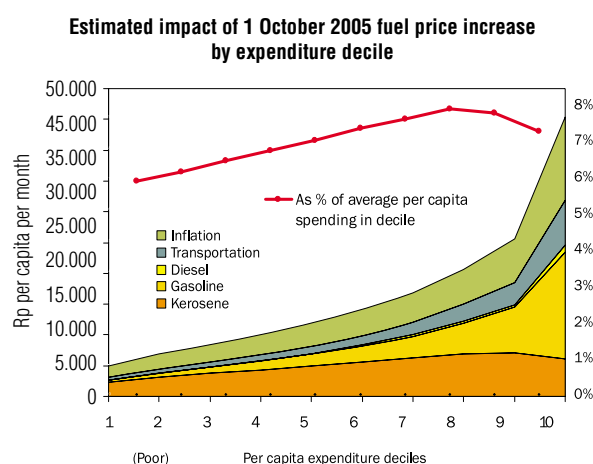
As part of the Safe Motherhood Program in Pemalang district, Central Java, poor women were issued vouchers that they could exchange for prenatal care from midwives. The midwives were usually responsible for distributing these vouchers. With the added incentive of additional fees earned from clients with vouchers, midwives substantially increased the number of poor women they treated. This had the additional beneficial impact of introducing poor women to the formal health system and inducing them to seek out healthcare from formal providers more frequently.

Source: Leisher and Nachuk, 2006.

## Making Public Expenditure Work for the Poor

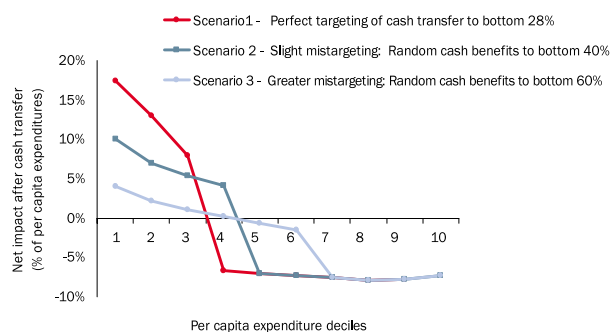
**By reducing fuel subsidies, Indonesia has taken a big step towards making public expenditure more pro-poor.** The fuel subsidy—a universal price subsidy—represented the biggest subsidy or transfer to households in recent years: it was, de facto, the centerpiece of Indonesia’s social protection scheme until 2005. By fixing fuel prices at subsidized levels well below world prices, the government effectively supported a transfer to fuel-consuming households, protecting them from fluctuations in world prices. Between 1998 and 2005, fuel subsidies averaged three-quarters of the total subsidies and transfers that constituted Indonesia’s social protection system. However, spending on fuel subsidies benefited mainly middle and higher income groups that consumed more fuel. Figure 8 depicts the regressive incidence of the fuel subsidy, had the government not changed the domestic price of fuel in 2005. In total, the benefits accruing to the richest 10 percent from fuel subsidies were more than five times those accruing to the poorest 10 percent

**Figure 8** Regressive fuel subsidies have been replaced by progressive cash transfers



Source: Susenas 2004, World Bank staff calculations.

Estimated impact of 1 October 2005 fuel price increase by expenditure decile as a percentage of mean household expenditures in decile



Source: Susenas 2004, World Bank staff calculations.

**Government can make good use of the increased public resources.** To date, public expenditure has not always been successful at effectively addressing the constraints that still hinder the poor and keep them mired in poverty. At a time when the government has increased fiscal space following the reallocation of regressive fuel subsidies, it is all the more important to ensure that this expenditure makes a real impact on the poor. The government now has a window of opportunity to begin addressing the high level of vulnerability of the poor in Indonesia by channeling spending into social protection systems that mitigate this vulnerability. An important component of this reallocation of public spending is through focusing on ways to improve the incomes of the poor, especially in view of the fact that 49 percent of Indonesians earn less than US\$2-a-day. Public spending that can have a direct impact by boosting income levels will also have a commensurate impact on poverty. One priority that stands out—which the government is already moving to address—is the scaling-up of community driven development (CDD).

**Public resources can be targeted better.** While the CDD approach will allow for a broad focus in addressing widespread vulnerability, it will also be vital to use public expenditure to target the very poorest, who lag behind in terms of the non-income, multidimensional aspects of poverty. Only through a more effective targeted approach in public spending can the government achieve progress in these human development indicators. In particular, the government should press ahead with the piloting of targeting transfer to the poor. This could be done through CCTs aimed at the delivery high-quality services to where they are needed most. Public expenditure can also be a sharp instrument for addressing the issue of regional disparities in both the income and non-income dimensions of poverty. In view of the wide disparities that continue to exist across the country, there is a need to make the current system of transfers from the center to the regions more pro-poor, and to build capacity and create incentives within local governments to improve their focus on pro-poor policy implementation.

**Local government capacity is uneven, and is now the binding constraint to poverty reduction.** About one-third of total public expenditure is allocated and spent at the district level. While this is a sign that decentralization is working, the problem is that many local governments are facing difficulties in the planning, budgeting, and execution of this spending. One indication of these difficulties is the increasing level of local government surpluses witnessed in recent years. There is therefore a growing and increasingly urgent need for a concerted effort to improve the capacity of local governments, and the civil servants who work for them, to plan, budget and implement programs for service delivery and poverty reduction. Once again, this is an issue that could be usefully complimented through incentives at the district level to encourage local governments to both spend more efficiently and also in a more pro-poor way. For example, the central government could induce improvements in service delivery with increased funding for those districts achieving certain targets in service delivery. However, this will require a strong commitment towards building a partnership between local and central governments and a long-term strategy to address capacity issues.

Three priority areas for action stand out:

- **Scale up Indonesia’s successful community-driven development (CDD) programs.** Community-driven development projects, such as Kecamatan Development Program, or KDP, have a history of success in Indonesia. The CDD approach has yielded high rates of return on investment; it addresses in an integrated fashion the binding constraints to poverty reduction at the village level—whether these are village roads, water and sanitation systems, or other constraints to poverty and well-being—and it targets poorer areas. Indeed, evidence from community-level infrastructure projects constructed as part of the KDP project shows that economic internal rates of return are between 22 and 47 percent and were 56 percent cheaper than equivalent roads built through government contracts. The CDD approach also empowers the poor by giving them a say in how community resources are spent. For example, community-driven programs have been shown to assist with labor-intensive approaches to the construction and maintenance of village and *kecamatan* roads. Moreover, given a choice of investments, villagers in these programs tend to choose infrastructure programs: some 67 percent of total spending chosen by these communities goes to the

communities. Indonesia should aggressively scale up its CDD approach to cover the entire nation. It is estimated that such a national program could be up and running within three years. The government's recent announcement to launch a community-based development program nationally can be a key component of a vigorous poverty reduction strategy. While mitigating the vulnerability of the poor, it will address regional disparities in incomes through employment creation, as well as helping to connect the poor to growth through the development of rural infrastructure.

- **Pilot demand-side programs that improve service quality and encourage behavioral change.** In particular, CCT programs can be effective in addressing key multi-dimensional poverty goals for poor families, for instance in terms of preventative basic healthcare and nutrition, and in education. By placing targeted spending in the hands of poor households, this will motivate poor families to demand the services they require to meet program conditions and motivate service providers. CCT programs could therefore be targeted to ensure that children and expectant mothers receive critical healthcare services. Equally important in improving outcomes among the poorest households will be CCTs aimed at inducing families to enroll their children at school and maintain regular school attendance. In view of the detailed design and planning that would be necessary for such a program in Indonesia, CCTs should be piloted for extremely poor, rural households and, if successful, scaled up gradually. Success would depend on developing: (i) a beneficiary roster with family demographic data; (ii) a policy and procedures to verify compliance, and to deal with non-compliance; (iii) assessment of the availability of relevant health and education services to address any anticipated supply-side issues; and (iv) a complaints, resolution and appeals system. While this approach has proved to be successful in other countries, given that a CCT program has never been tried in Indonesia the government should assess the effectiveness of such a program before scaling up.
- **Make both the DAU and the DAK more pro-poor.** The General Allocation Fund (DAU) is not structured to target areas with high poverty incidence—indeed, there is no correlation between DAU transfers and poverty rates. Given that the DAU provides on average about two-thirds of sub-national revenues, it is important that the 'fiscal-gap' formula be refined to increase the weighting of the poverty variable already contained in the formula. In addition, the recent requirement that the DAU must first cover fully the wage bill of all local governments crowds out other spending, especially at a time when salaries have surged to more than 50 percent of DAU allocations. Meanwhile, the Special Allocation Fund (DAK) is not being used for its intended purpose—the delivery of basic services in lagging regions. First, the DAK is small, comprising only 3 percent of central government transfers to the sub-national governments in 2005. Second, the DAK is spread across sectors and regions too thinly, in addition to often being earmarked for investment in facilities and infrastructure regardless of whether these are constraints to pro-poor outcomes. Indeed, with the exception of the health sector, poverty indicators are not used to determine DAK allocations. With the DAK doubling in 2006 and due to rise by a further 25 percent to Rp 14.4 trillion in 2007, this presents an enormous opportunity to address priority needs in resource-deficient districts and sectors. In particular, the DAK is a powerful instrument that should be used to support the pathways out of poverty and improved service delivery in lagging regions. To this end, the DAK should be used to leverage local government resources by revising the matching-funding requirement, which at present only requires a minimum 10 percent matching funds. The government should consider introducing performance-oriented incentives to improve the efficiency and effectiveness of DAK funding. For example, the allocation of an education DAK could be conditional on a pre-defined increase in junior secondary completion rates. Key areas in which to consider such leverage would be in sanitation, which is in crisis in Indonesia with only 1 percent of Indonesians having access to piped sewerage systems, and in rural road maintenance, which has still to recover to its pre-crisis levels.

## Priorities for Poverty Reduction

Three transformations are taking place in Indonesia, each of which can be more or less pro-poor. This report suggests policy measures that can make these changes rapidly reduce poverty.

- First, as it grows, Indonesia’s economy is being transformed from one with agriculture as its mainstay to one that will rely more on services and industry. The priority for making this growth work for the poor is a friendlier rural investment climate, principally through better rural roads.
- Second, as democracy takes hold, the government is being transformed from one where social services were delivered centrally to one that will rely more on local governments. The priority for making services work for the poor is stronger capacity of local governments and better incentives for service providers.
- Third, as Indonesia integrates internationally, its system of social protection is being modernized so that Indonesia is both socially equitable and economically competitive. The priority for making public expenditure work for the poor is to shift from intervening in markets for commodities that the poor consume (such as fuel and rice) to providing targeted income support to poor households, and using the fiscal space to improve critical services such as education, health, safe water, and sanitation.

**Table 3** Nine steps towards a poverty-free Indonesia

	Key dimensions of Indonesian poverty		
	Reducing vulnerability to income poverty	Reducing non-income poverty	Reducing regional disparities in poverty
<b>Making Growth Work for the Poor</b>	1. Revise rice policy 2. Revitalize agriculture		3. Rural roads program
<b>Making Services Work for the Poor</b>		1. Improve incentives for service providers	2. Clarify functional responsibilities. 3. Improve local capacity
<b>Making Expenditures Work for the Poor</b>	1. Scale up CDD programs	2. Pilot CCTs for the poor	3. Make DAU and DAK pro-poor

## II Priorities for Poverty Reduction: An Agenda for Action

To conclude, Indonesia’s persisting but specific poverty problems, coupled with the government’s priorities and its fiscal resources to address them, now positions the country to make significant headway in reducing poverty. The question is: where to start in addressing such a broad, multidisciplinary and interwoven issue as poverty reduction on a national scale? Action is urgently required in several areas in order to address the four poverty-reducing imperatives in Indonesia of (i) reducing income poverty through growth, (ii) strengthening human capabilities, and (iii) reducing vulnerabilities and risks among poorer households, while also (iv) strengthening the institutional framework to do so and to make public action more pro-poor. In the view of the authors of this report, and with these four areas in mind, the following 16 actions should be viewed as priorities to be addressed at the soonest opportunity going forward.

1. **Remove the ban on rice imports.** Lowering the rice price and creating greater price stability by removing the import ban on rice is the fastest way for the government to reduce poverty quickly. The ban should be replaced by a low specific tariff. Allowing general importation subject to a tariff will be a far more effective mechanism for stabilizing rice prices and preventing the large increases in the rice price that are so damaging to the poor. In addition, targeted



provision of rural infrastructure, and agricultural research and extension services will help marginal farmers improve productivity or diversify into other higher-margin crops.

2. **Invest in education with a focus on improving access and affordability of secondary schools and vocational training among the poor, while improving the quality and efficiency of primary schools.**

To improve attainment among the poor at the junior secondary school level will require supply- and demand-side interventions. On the supply side, more junior secondary classrooms and schools need to be made available. This can be done by converting primary schools where there is excess supply. On the demand side, junior secondary schools and vocational training schools (SMKs) can be made more affordable for the poor by targeting transfers to poor students through scholarships or CCTs. To improve the quality of primary education, a priority action will be to undertake a program to improve teacher management so that fewer but better-quality teachers are present in schools and are also deployed in greater numbers to remote areas.

3. **Invest in health with a focus of improving the quality of primary healthcare-public and private—and access to higher level healthcare.**

The issue of public service delivery quality continues to require concerted efforts to improve provider accountability and civil service staffing. The poor are using the private sector as an alternative for primary healthcare, and efforts should be made to improve the quality of the private sector through regulatory and training programs. On the demand side, CCTs can help specifically in interventions where behavioral change is required to enhance demand, such as child well-being and nutrition status check-ups, and child immunization. For higher-level healthcare, affordability is an issue and targeted programs would make sense, such as a health insurance program. It will be important to build on and improve the recently launched program based on recent assessments, which points to the need to improve targeting and open up service provision.

4. **A focused effort is required to address Indonesia's shockingly high maternal mortality rate.**

The key to reducing maternal mortality is to increase the proportion of births attended by skilled professionals. Traditional birth attendants remain the principal choice of childbirth assistance provider for the poor in Indonesia as a result of both demand and supply constraints. First, in order to increase demand for skilled professionals there is a need for a national campaign informing communities of the benefits of professionally assisted birth delivery. To improve affordability of skilled professionals, the government needs to increase demand-side financing through voucher or health-card schemes. The health insurance system could also allow for a transport stipend for delivery at health clinics for prenatal visits and delivery. Second, on the supply side, formal and in-service training can be expanded for village midwives who are often the first line of defense, especially in more remote areas. To increase the availability of skilled midwives in remote areas—a goal that will not be easy to achieve—one approach may be to offer formal courses to train new skilled midwives.

5. **Improve the quality of water accessed by the poor using separate strategies for rural and urban areas.**

For rural areas, the existing community management supply model that has been shown to work should be expanded. This currently covers 25-30 percent of the rural population, but could be expanded to cover the 50 million people currently without adequate water supply. For urban areas, supply must be strengthened by improving capacity and incentives for water utilities (PDAMs) to plan, deliver and monitor service delivery. In addition, PDAMs need to be mandated and given incentives to scale up services to marginal areas inhabited by the poor. Consideration needs to be given to designing appropriate tariff structures for the poor who benefit from current or future connections. Consideration also needs to be given to enabling the poor to benefit if they do not have connections, such as geographic targeting or lower service level subsidies (e.g. promoting access to standpipes), which would also encourage incremental service improvements at lower cost to the poor.

6. **Address the sanitation crisis facing Indonesia and its poor.** Improving sanitation requires a two-pronged approach: stimulating demand while improving service delivery on the supply side. On the demand side, there is a lack of recognition of the widespread benefits of good sanitation. The government should undertake a simple national public awareness campaign aimed at improving sanitation practices by all and stimulating demand and pressure for change—a relatively low cost measure with potentially high returns. On the supply side, service delivery must be improved. A critical starting point is to finance increased but sustainable investment in sanitation. Two immediate options are: development of a national strategy to increase sanitation financing among all players; and, local government investment in sanitation infrastructure at the neighborhood and city-wide levels, for example through a specific DAK for sanitation, or including sanitation services in minimum service standards.
  
7. **Launch a large-scale program to invest in rural and village-level roads.** For district level roads, there is a need to increase financing, particularly for maintenance, through a concerted strategy. One option is a special DAK. These funds could be targeted (using poverty maps) to areas where access for the poor is worst. The DAK should leverage and increase district-level funding for road maintenance. Another possibility is the development of a road fund at the district or provincial level along with the establishment of a district-level road management system. Community-driven programs have been shown to assist with labor-intensive approaches to the construction and maintenance of village and *kecamatan* roads. Scaling up such approaches will be useful to improving the access of the rural poor to markets.
  
8. **Scale up to national level Indonesia’s successful community-driven development (CDD) approach.** Community-driven development projects (such as KDP) have had a history of success in Indonesia. The CDD approach has been shown to have high rates of return on investment; it addresses in an integrated fashion binding constraints to poverty reduction at the village level (whether it be village roads, water and sanitation, or other constraints to poverty and well-being); and it targets poorer areas and has had a demonstrable impact on poverty reduction. While doing so, the CDD approach also empowers the poor to have a say in how community resources are spent. Importantly, the approach is easily replicable. Indonesia should quickly scale up its CDD approach to cover the entire nation. It is estimated that such a national program could be up and running within three years.
  
9. **Complete development of a comprehensive social protection system that addresses the risks and vulnerabilities faced by the poor and near-poor.** A new social protection program for Indonesia can be made to address the four main risks and vulnerabilities faced by the poor in the country. Four programs could be considered to constitute a social protection system. First, a CCT program could be used to target cash to poorer households while making this cash conditional on households or communities achieving certain human development conditions. These conditions can be those that are related to high priority outcomes for Indonesia and that mitigate against the tendency of households to cope with shocks by reducing spending on health and education, especially of children. Second, a workfare program could be considered to mitigate against unforeseen shocks to household income. For this to be successful it would need to self-target at a low relevant ‘safety net’ wage below the current minimum wage. Third, a health insurance program targeted to the poor and near-poor can help these households deal with health shocks—one of the most prevalent household level shocks that throw families into poverty. It would make sense to build this program around improvements of the newly launched health for the poor scheme. Fourth, policies to ensure low prices of staple commodities, such as rice, will be key to a comprehensive social protection policy. In developing such a social protection scheme, several complimentary actions will be key. There is scope for improving the current household targeting database. This should be done as a matter of priority, using a combination of geographic targeting and revised household proxy means-testing. While developing more effective and better-targeted social protection schemes will be key, so too will be the phasing-out of a number of programs that have been shown to be ineffective, either from a targeting, cost-effectiveness, or impact stand-point.

10. **Revitalize agriculture through investments in infrastructure and rebuilding research and extension services.** With almost two-thirds of poor household heads still working in agriculture, boosting agricultural capability remains essential for broad-based poverty reduction. There are several ways for government to contribute: boosting investment in key infrastructure, notably farm-to-market roads and irrigation, while widening local water management; encouraging and supporting diversification into higher value-added crops; working with the private sector to ensure that exports meet world standards; boosting expenditure on agricultural research; and redesigning the decentralized extension service to allow for greater involvement of the private sector and civil society. These efforts to improve agricultural productivity should also include development of better marketing and information systems for rural-based businesses.
11. **Accelerate land titling and reallocate degraded and deforested land to productive uses.** Only about 25 percent of Indonesia's estimated 80 million land parcels have been registered in the 40 years since land registration began. At the current pace of registration, it will be difficult for land registration to catch up with the growing number of parcels. The government needs to redouble its efforts to speed up land titling and more broadly ensure secure appropriate forms of tenure throughout the country. In addition, reallocating degraded, deforested land to productive uses by smallholders and the poor is one way of rationalizing land use and reducing poverty. Moreover, reclassifying Production Forest and Conversion Forest areas that are already allocated for productive economic uses will allow for more productive land-use and ownership patterns and could also lead to increased tree cover and protection of the land.
12. **Make labor regulations more flexible. Stimulating faster growth of formal sector employment is key to reducing poverty because of the impact that this has on wages in the informal labor market.** But there is ample evidence that the 'jobless' recovery since the financial crisis is largely a product of a poor investment climate for formal-sector firms. The National Manpower Law No. 13/2003 is a significant contributing factor to this. Existing labor regulations are inherently 'anti-poor', largely because they discourage the employment of younger and unskilled workers, forcing them into the informal, unprotected sector. The government is right to have commissioned a thorough review of Indonesia's labor laws. It should strive to build a new social contract with respect to minimum wages, severance pay and methods for settling industrial labor disputes. Such a social contract should be developed with a view to substantially reducing the costs associated with employment, particularly of younger and female workers, while protecting and enforcing basic labor rights and conditions appropriate to Indonesia's stage of development.
13. **Extend the reach of financial services to the poor and boost access to commercial credit for micro and small businesses.** Surveys suggest that potential exists to almost double microfinance lending if ways can be found to address the constraints faced by households and firms that would qualify for loans and wish to borrow, but do not currently do so. One approach to doing this would be to develop a P4K (Income Generating Project for Marginal Farmers and Fishermen)-style outreach program for financing the household enterprises of rural low-income households. In addition, the government could encourage the development of free online savings products for poor households in underserved areas as a way of supporting capital accumulation and commerce. To stimulate local-level growth, the



government should help small businesses gain access to commercial credit by improving the debtor information system. Developing this system to include repayment records both for loans, and ultimately other forms of regular payments too, would help small businesses access credit by using their good repayment history as an asset.

14. **Improve the poverty focus of national planning and budgeting for service delivery.** Several steps can be taken at the national level. First, with regard to planning and budgeting, a concerted effort is needed to ensure that sector work-programs line up with national planning priorities. Cabinet and central ministries should sign off on the final budget after parliamentary deliberations to ensure that it is in line with government priorities. Second, it is imperative for poverty reduction and service delivery that there is better clarity in functional responsibilities for the provision of specific services. This lack of clarity is paralyzing accountability in service delivery and must be addressed without delay. Third, a civil service reform process needs to be started that allows for the aligning of staff and incentives to match with functional responsibilities, and increases the quality of staff by moving to a merit-based system. Fourth, the intergovernmental fiscal framework can be better used to attain national poverty reduction objectives. Most importantly, government should design and pilot several performance-based DAK instruments, targeted to achieve key outcomes and possibly targeted to poorer areas. This should leverage increased local government funds for national priorities where there are perceived externalities. Key areas on which to start may be sanitation and rural road maintenance.
15. **Undertake a major capacity-building initiative to strengthen local government capacity to plan, budget, and implement programs for poverty reduction.** After decentralization, about one-third of total public expenditures are allocated and implemented at the district level. Yet local governments have weak capacity to plan, budget, and execute spending of these funds, particularly in a pro-poor fashion. In recent years, this is reflected in increased surpluses run by local governments. For more effective and pro-poor spending to take place, there needs to be a substantial improvement in the capacity of local governments, and the civil servants who work for them, to plan, budget and implement programs for service delivery and poverty reduction. It may be useful to complement this with actions aimed at changing incentives at the district level, for example by publicizing service performance and budget availability. Performance-based transfers from the central government could also induce improved service delivery. This is no quick-fix action, but it is a necessary condition for decentralization to work for the poor. The central government will need to work in partnership with local governments to develop a systematic, long-term strategy and program aimed at addressing these capacity issues. There is substantial scope to leverage support from international partners to address this broad, challenging and long-term agenda.
16. **Strengthen poverty monitoring and assessments of poverty programs.** Poverty monitoring needs to be strengthened on several fronts. The capacity and budget of the Central Bureau of Statistics (BPS) needs to be enhanced following cuts during the crisis in order to improve coverage and quality of data. Poverty monitoring can be enhanced through more systematic use of qualitative measures and through improved monitoring over the course of the year by tracking market prices. A strategy is needed to reinstate regular, quality monitoring of administrative data (e.g. in health, education) in the context of decentralization by allocating responsibility and budgets for this task. Likewise, consideration is needed of what minimum poverty data requirements are necessary for decision-makers at the district level and how these data are to be collected. For decentralized decision-making, more use can and should be made of small-area poverty maps. The government needs to assess and evaluate poverty programs more systematically with a view to either improve them, scale them up, or eliminate them. Process and impact evaluations are both important. Assessments underway of the four large PKPS-BBM fuel subsidy reallocation-funded poverty programs are an important precedent in this regard. These assessments should be used to make program decisions and similar good practice needs to be applied more systematically to other programs.

### III Poverty Reduction Policy Matrix

#### Making Growth Work for the Poor: Connecting the Poor to Opportunities

Policy Area	Key Issues and Constraints	Specific Actions	Priority	Action time	Impact time
Growth/macro stability	Growth that benefits the poor is the single most effective means of achieving poverty reduction.	Implement the required package of reforms to improve the investment climate and increase employment-generating growth.	****	MT	MT
	Macro price stability and low inflation matter to the poor. Export competitiveness is important for maintaining growth.	Ensure a stable and competitive exchange rate.	*****	ST	MT
	Trade restrictions, especially the rice import ban, hurt the poor. Due to the current import ban, rice prices increase whenever the domestic supply of rice is insufficient to meet national demand.	Remove the import ban on rice to reduce price fluctuations when domestic supply is low.	*****	ST	ST
Agricultural productivity	Higher agricultural productivity is a key pathway out of poverty (with two-thirds of poor household heads still working in agriculture). However, in recent years, productivity growth in the agricultural sector has been too low.	Revitalize agriculture through investments in infrastructure and the rebuilding of research and extension services. Improve productivity for rice farmers and the livestock economy through better irrigation and management of inputs. Promote partnerships between traders, processors and producers in a system of effective self-regulation.	****	MT	ST
		Accelerate land titling and reallocate degraded and reforested land to productive uses.	****	MT	MT
		Support expansion of export commodities through improved quality of beverage crops and global campaigns.	***	MT	MT
		Promote diversification into higher-value crops with improved technical assistance to small farmers.	***	MT	MT
		Access to good quality roads is one of the strongest correlates of household welfare in Indonesia. After the crisis, the poor's access to roads has deteriorated as a result of lower investment in road infrastructure.	*****	ST	MT
Rural roads	Decentralization has created disincentives for the allocation of resources towards road investments/maintenance because benefits are captured beyond the district responsible for spending.	Introduce a district-level Road Management System to govern planning and budgeting, and ensure that budgeting is adequate and well-targeted.	***	ST	MT/LT
	Lack of maintenance is the primary problem characterizing the sector with recent spending being biased towards national networks and new road construction.	Scale up community-based approaches for the construction and maintenance of village and <i>kecamatan</i> roads paying special attention to technical assistance and facilitation.	*****	ST	MT

<p>High minimum wages may reduce the ability of the poor to find jobs in both formal and informal sectors. Real minimum wages have risen sharply in recent years. Severance pay regulations may also restrict mobility in the formal sector labor market.</p>	<p>Implement further study on the impact of minimum wages on the formal and informal employment of the poor.</p>	***	ST	ST
<p>Labor markets</p>	<p>Review and revise of Indonesia's labor laws/regulations at both the national and local level. Introduce a new social contract with respect to minimum wages, severance pay and methods for settling industrial labor disputes.</p>	****	ST	MT
	<p><i>Microfinance:</i> there is still great potential value in connecting households to the financial system for the first time. Few Indonesian institutions wish to actively target the enterprising poor.</p>	<p>Extend the reach of financial services to the poor and boost access to commercial credit for micro and small enterprises. Support for one or more outreach initiatives aimed at connecting new micro-borrowers to the financial system. Possibly subsidize some of the cost of group formation, supervision and institutionalization. Promote all banks to have basic no-fee savings products available.</p>	**	ST
<p>Financial services</p>	<p><i>Financial services:</i> Secure savings mechanisms are valuable to the poor. The anti-poverty benefits of savings are largely for the next generation.</p>	**	ST	MT
	<p><i>Enterprise credit:</i> Many enterprises are credit-constrained. SMEs often mention credit as one of their top two business constraints.</p>	<p>Encourage more transparency among commercial banks (and BPRs) in order to better determine how much lending has actually gone towards micro/small enterprises.</p>	*	ST

ST: Short-term

MT: Medium-term

LT: Long-term

## Making Spending Work for the Poor: Investing in the Assets and Capabilities of the Poor

Policy Area	Key Issues and Constraints	Specific Actions	Priority	Action time	Impact time
Education	Educational investment needs to focus on the skills and employability of the growing young population in Indonesia. For those working in non-farm activities in both rural and urban areas, the priority is boosting their capability to obtain better jobs.	Invest in education with a focus on improving access and affordability of secondary schools and vocational training among the poor, while improving quality and efficiency of primary schools.	****	MT	MT/LT
	The return to education is higher for higher levels of schooling, so focusing educational investment only on primary education is no longer enough.	Improve access of the poor to secondary schools, vocational training schools and private training centers through targeted programs.	****	ST	ST/MT
	Affordability: in Indonesia, school fees and other expenses create barriers to the poor's access to education, particularly at the junior secondary school level.	Implement targeted scholarship or cash transfer programs to improve school enrollments. Reduce schools' requirements on uniforms and extra costs.	****	ST	ST/MT
	Teaching quality is low and any improvement in the quality of schooling, especially at the primary school level, is pro-poor given the current distribution of average benefits	Focus on teacher quality and investing in textbooks and in-class teaching materials for improving teaching quality.	****	ST	MT
	Supply-side constraints exist especially above the junior secondary school level and at the primary school level in remote areas.	Continue to convert some primary school buildings with low student numbers into junior secondary schools, while selectively building new secondary schools.	**	ST	MT
Health	Improving affordable access to quality healthcare is among the priorities of a poverty reduction strategy. In recent years, there have been incremental increases in health spending. However, most of the funding has gone to secondary care at hospitals. Most health spending continues to come from private sources in Indonesia.	Invest in health with a focus of improving quality of primary health facilities—public and private—and access to higher level healthcare.	****	MT	MT
	The quality of basic healthcare remains low with very high absenteeism rates among public health professionals. The demand for public health services is low as a result.	Improve quality of care provided in basic community healthcare clinics (Puskesmas). Focus on systemic problems in health personnel management and review incentive structures within the sector.	****	MT	MT
	The poor heavily utilize private providers, especially in rural areas where they have little access to other services.	Invest in the training of private (as well as public) paramedics and midwives particularly those that serve in remote areas	***	ST	MT
	The poor do not benefit from the subsidies that go to secondary and tertiary healthcare at hospitals, since their access to these facilities is limited. At the same time, health shocks are a particularly important source of vulnerability among poorer households in Indonesia.	Facilitate the linking up of these providers to the health insurance scheme for the poor so that the poor can continue to use the providers of their choice in a more affordable way. Invest in demand-side activities that increase the access of the poor to in-patient care so that the poor can benefit from spending on hospitals. Make sure PT Askes has the right incentive structure to socialize the new health insurance scheme and to target the poor.	****	ST	MT
			****	ST	MT

<p><b>Tobacco</b> constitutes a major expenditure item for the poor and damages their health and finances. Despite this high adverse impact, public perceptions of tobacco and the industry remain largely positive.</p>	<p>Implement a widespread anti-smoking campaign specifically targeting the poor.</p>	<p>****</p>	<p>ST</p>	<p>MT</p>
<p><b>Maternal mortality:</b> Indonesia has very high maternal mortality rate at 307 per 100,000 live births.</p>	<p>Increase the availability and quality of skilled birth attendants in remote areas.</p>	<p>***</p>	<p>ST</p>	<p>MT</p>
<p>The poor still rely heavily on the services of traditional midwives (<i>dukun</i>) for child deliveries due to lack of awareness, as well as difficulties in access and affordability of skilled midwives.</p>	<p>Increase the proportion of institutional deliveries, as well as access to 24-hour emergency obstetric care by improving the availability of facilities, affordability of these services and the condition of infrastructure (such as roads) around these facilities.</p>	<p>***</p>	<p>MT</p>	<p>MT</p>
<p><b>Malnutrition:</b> One-fourth of all children under the five are malnourished in Indonesia.</p>	<p>Improve affordability of care by skilled professionals by linking them into the health insurance schemes (such as through PT Askes ) implemented by government.</p>	<p>***</p>	<p>ST</p>	<p>MT</p>
<p>Despite reductions in poverty in recent years, the malnutrition rate has remained stagnant.</p>	<p>Implement a wide-scale awareness campaign on the importance of skilled midwifery.</p>	<p>***</p>	<p>ST</p>	<p>MT</p>
<p>Access levels to public water services are low and self-provision characterizes the sector. Government expenditures on water and sanitation services are low.</p>	<p>Carry out further research into the causes of high malnutrition in Indonesia.</p>	<p>***</p>	<p>ST</p>	<p>ST</p>
<p>Most water is not delivered, especially in rural areas, and household and community provision dominate the sector.</p>	<p>Invest in information campaigns about benefits of exclusive breastfeeding for child nutrition.</p>	<p>***</p>	<p>ST</p>	<p>MT</p>
<p>The urban water sector is in a state of crisis in terms of delivery to the poor. More than 80 percent of the urban poorest quintile does not have access to piped water. Subsidy mechanisms do not target the poor, because they are not usually connected to utility networks.</p>	<p>Subsidize fortified foods with multi-micronutrients and iodized salt.</p>	<p>**</p>	<p>ST</p>	<p>ST</p>
<p>Government expenditures on water and sanitation services are low.</p>	<p>Improve quality of water accessed by the poor by using separate strategies for rural and urban areas:</p>	<p>****</p>	<p>ST</p>	<p>MT</p>
<p>Community provision dominate the sector.</p>	<p>In rural areas, replicate the community-management supply model to reach those people without adequate water supply.</p>	<p>****</p>	<p>ST</p>	<p>MT</p>
<p>The urban water sector is in a state of crisis in terms of delivery to the poor. More than 80 percent of the urban poorest quintile does not have access to piped water. Subsidy mechanisms do not target the poor, because they are not usually connected to utility networks.</p>	<p>Devote more attention to the development of sustainable management systems, alternative technologies, cost recovery and economies of scale.</p>	<p>****</p>	<p>ST</p>	<p>MT</p>
<p>Subsidy mechanisms do not target the poor, because they are not usually connected to utility networks.</p>	<p>In urban areas, strengthen capacity and establish incentive structures for water utilities (PDAMs) for planning, delivery and monitoring of service delivery.</p>	<p>****</p>	<p>ST</p>	<p>MT</p>
<p>Government expenditures on water and sanitation services are low.</p>	<p>Give mandate and incentives to PDAMs for scaling-up services to marginal areas inhabited by the urban poor.</p>	<p>****</p>	<p>ST</p>	<p>MT</p>

Specific health issues

Water



<p>The coverage of sanitation services in terms of piped sewage disposal is very low and there is a major failure in sanitation adequacy.</p>	<p>Address the sanitation crisis facing Indonesia and its poor.</p>	<p>MT</p>
<p>Less than 1 percent of Indonesians have access to piped sewage disposal and 60 percent of the urban poor do not have access to a septic tank.</p>	<p>Simulate demand for sanitation through an awareness-building campaign and leverage the private sector's expenditure on hygiene through stronger political leadership.</p>	<p>MT</p>
<p>Low sanitation coverage has significant health and environmental impacts, especially for the poor, but demand for sanitation remains weak.</p>	<p>Finance increased but sustainable investment in sanitation by developing a national strategy to increase sanitation financing among all players, for example through a DAK for sanitation.</p>	<p>MT</p>

Sanitation

## Making Social Protection Work for the Poor: Reducing Vulnerabilities of the Poor

Policy Area	Key Issues and Constraints	Specific Actions	Priority	Action time	Impact time
Addressing the risks and vulnerabilities of the poor	Although poverty in Indonesia is relatively low, vulnerability to poverty remains high. There is a high level of ‘churning’ around the poverty line, causing many of the near-poor to move in and out of poverty.	Complete development of a comprehensive social protection system that addresses the risks and vulnerabilities faced by the poor and near-poor.	***	ST	MT/LT
	The existing social protection system is mostly dominated by regressive price subsidies for fuel and does not respond to the risks and vulnerabilities faced by the poor.	Move away from price subsidies on fuel towards smaller and more targeted social protection schemes based on the needs of the poor.	*****	ST	MT/LT
	1. Risks to earnings capacity and income are significantly greater among poorer households.  2. Factors that pose risks during infancy, early childhood and among school-aged children are significantly more frequently observed among the poor. In the absence of coping mechanisms, poorer households may be forced into bad coping.  3. Health shocks are a particularly important source of vulnerability among poorer households in Indonesia.	Bring together welfare programs and build a national but modest in size system of welfare with wages set below the minimum-wage, in order to help the poor cope with transitory shocks to income caused by the loss of a job. Ensure that in the setting-up of such a program wage levels are not manipulated by political pressure. Develop targeted voucher or cash transfer schemes (such as CCTs) that enhance the ability of the poor to cope with shocks and allow them to smooth consumption without reducing investment in the human capital of future generations. Build on and improving the targeting of the existing health insurance schemes for the poor to increase the access of the poor to in-patient hospital care, as well as subsidize the poor’s use of selected private providers.	*  ***  ***	MT  ST  ST	MT  MT  MT
Rice policy	Rice is the most important commodity for the poor: the poor spend almost a quarter of their budget just on rice. Over three-quarters of the poor are net consumers of rice. The price of rice is one of the most important determinants of poverty at the household level in Indonesia.	Remove the ban on rice imports.  Replace the rice import ban with an appropriate level of tariff that allows for the free trade of rice.	*****  *****	ST  ST	ST  ST
	Targeting is a particular challenge in Indonesia, with significant clustering around the poverty line, large numbers of poor moving in and out of poverty and low inequality. This makes it difficult to identify the poor, especially in rural areas.  Cultural norms, which foster sharing program benefits ( <i>bagi rata</i> ) at the community level, have also contributed to weak targeting.  Indonesia recently put together a unified targeting registry for the UCT program, which recent evaluations show can be improved.	Further develop the current targeting system. Build on both geographic targeting of areas, as well as systems for household targeting. Vary the type of targeting used (community vs household level) by program type and levels of poverty/inequality in a particular setting.  Involve communities in targeting the poor in order to tap into local information and improve targeting effectiveness. Socialize the target group well in order to reduce the sharing of program benefits. Verify, update and refine the existing poverty database. Keep this database as an ‘organic’ registry of the poor.	***  ***  ***  ***  ***	ST  ST  ST  MT  MT  ST/MT	ST  ST  ST  MT  MT  MT

## Making Government Work for the Poor: Improving Service Delivery

Policy Area	Key Issues and Constraints	Specific Actions	Priority	Action time	Impact time
Policy, planning and budgeting systems	Poverty reduction priorities are currently not linked with sectoral plans and budgets, and there is low capacity and incentives for pro-poor planning and budgeting.	Improve the poverty focus of national planning and budgeting for service delivery. Ensure that the cabinet's stated objectives are reflected in budgets. Introduce a results-orientation focused upon poverty reduction objectives for all ministries.	****	ST	ST
	More than one-third of all government spending is now at the local government level as of 2006.	Develop local-level capacity for pro-poor planning and budgeting.	****	MT	MT/LT
	The transfers to districts are not necessarily distributed to target poorer areas.	Revise the DAU transfer to make it more pro-poor by including a stronger poverty component within the fiscal gap formula.	**	ST	MT
	The central government currently does not leverage local government resources and provide incentives for spending at the local level towards national priorities.	Use the recently doubled DAK to prioritize poverty reduction, and leverage local government funding through matched grants. In this way, also target poor areas or areas with low outcome indicators in the specific program area.	****	ST	MT
Institutional accountability	Lacking clarity of functions between central and sub-national governments hinders the ability of all levels of government and service providers to serve the poor.	Clarify functions between central and local governments and within government units, whereby the responsibilities are distributed in the following way: <i>Central government:</i> Has core functions of policy-making, staffing, information and setting standards. <i>Provincial government:</i> Fixes regional targets and standards, builds capacity, and implements cross-district services. <i>District government:</i> Develops local plans and budgets, implements services.	****	ST	MT/LT
	Significant challenges exist in reforming the civil service. Staff have little incentive to perform effectively and the rigidity of the staffing system hinders the flexible hiring, transfer and promotion of good people. Citizen and civil voice are critical in improving institutional accountability but a number of blockages hinder the new participatory process being adopted by government.	Focus on civil service reform by addressing hiring practices, capacity building, sanctions and rewards.  Strengthen citizen and civil society voice at both the national and local levels	***	MT/LT	MT/LT

Assessment and monitoring of poverty reduction

In order to monitor progress towards poverty reduction goals, data collection and use needs to be improved.

Strengthen poverty monitoring and assessments of poverty programs. \*\*\* ST MT

Make better use of existing and emerging data sources to both better understand poverty and program impact. \*\*\* ST MT

Strengthen systems to both understand and analyze poverty in the decentralized context. \*\*\* ST MT

Use poverty maps in program targeting. \*\*\* ST MT

Link monitoring findings more effectively with feedback to, and design of, sectoral programs, and for use by local governments. Develop approaches to better feed information collected into program design. \*\*\* ST MT