LPEM FEB UI
UNIVERSITAS INDONESIA

Macroeconomics Analysis Series

Indonesia Economic Outlook

2025

Key Figures

GDP Growth (Q2 '24)
5.05%

Inflation (y.o.y, Sep '24)
1.84%

Credit Growth (y.o.y, Q2 '24)
12.53%

BI Rate (Oct '24)
6.00%

Current Account Balance (% GDP) (Q2 '23)
-0.9%

IDR/USD (Oct '24)
IDR15,575

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Macroeconomic, Finance and Political Economy Research Group

Jahen F. Rezki, Ph.D.
jahen.fr@ui.ac.id

Teuku Riefky
teuku.riefky@lpem-feui.org

Faradina Alifia Maizar
faradina.alifia@ui.ac.id

Difa Fitriani
difa.fitriani@ui.ac.id

Mervin Goklas Hamonangan
mervin.goklas@ui.ac.id

Hardy Salim
hardy.salim@ui.ac.id

Secular Stagnation

Highlights

- *GDP to grow 4.96% (estimated range 4.94%-4.98%) in Q3-2024, 5.00%-5.05% for FY2024, and 5.0% - 5.1% for FY2025.*
- *Indonesia's GDP grew slower from 5.11% (y.o.y) in Q1-2024 to 5.05% (y.o.y) in Q2-2024, driven by substantially slower growth of GoI's spending despite having several various seasonal boosts.*
- *11 out of 17 economic sectors experienced a growth decline in Q2-2024 relative to the previous quarter and most of the sectors that had a growth increase in Q2-2024 were driven by seasonal factors.*
- *Accounting for 53% of total economic activity, household consumption grew by 4.93% (y.o.y) in Q2-2024, a slight increase from 4.91% (y.o.y) in the previous quarter, driven by various national holiday periods.*
- *Indonesia experienced a five-month consecutive declining inflation rate in May to September 2024, hitting its lowest level in September 2024 since COVID-19 pandemic period.*
- *Inflation slowdown was mostly driven by supply-side factor as the occurrence of harvest season drove up the supply of food commodities, although the demand-side factor of weakening purchasing power also played a part.*
- *The trends in FDI and DDI diverged significantly in Q3-2024. FDI grew by 18.6% (y.o.y) in Q3-2024, an acceleration from 16.65% (y.o.y) in the previous quarter, while DDI growth decreased from 29.1% (y.o.y) to 11.6% (y.o.y) during the same period.*
- *In Q2-2024, current account recorded a low deficit of USD3.0 billion (0.9% of GDP), slightly higher than the USD 2.4 billion deficit (0.7% of GDP) in the previous quarter.*
- *Rupiah depreciated by 2.91% between September 30 and October 15, 2024, reaching IDR 15,575 per US dollar, following increased global uncertainty due to escalating geopolitical tensions in the Middle East.*

The latest development of Indonesia's economy might suggest the occurrence of secular stagnation. Having no new source of growth, Indonesia prolonged its long-term growth trend of around 5% since 2014 in the second quarter of 2024 (excluding the COVID-19 period). During the first half of 2024, Indonesia was not able to grow considerably beyond a 5% rate despite having two consecutive quarters with seasonal boosters. In Q1-2024, Indonesia held Presidential and legislative elections and had a Ramadhan period, while Ied Al-Fitr, religious and school holidays occurred in the second quarter of 2024. This phenomenon might suggest a more worrying condition as there might be a risk for Indonesia only to be able to grow below 5% without seasonal factors. Indonesia's GDP grew slower from 5.11% (y.o.y) in Q1-2024 to 5.05% (y.o.y) in Q2-2024. As GoI's spending significantly decelerated from the first quarter to the second quarter of 2024 after the effort to speed up infrastructure completion projects and enhanced spending preceding the election period, Indonesia's GDP growth declined. The dominance of government spending in the

growth figure might verify the lethargic productivity of economic sectors in Indonesia.

For the rest of 2024, Indonesia's economy might not be able to grow considerably before the occurrence of an end-of-year seasonal boost stemming from the Christmas and New Year holiday period. While the structural issues of worsening productivity have taken place for many years, it is rather more obvious in 2024. Without any structural transformation to be taken anytime soon, Indonesia will continue to rely on seasonal factors and might need bigger seasonal pushes just to stay growing at 5% rate. Besides domestic issues, external factors are also in play. Prolonged high geopolitical tension, the beginning of a monetary easing era, the reconfiguration of nations' economic agenda following the elections in various countries all over the globe, China's major stimulus disbursement, and potential disruptions in global value chains might complicate the growth trajectory of Indonesia for the year ahead.

Table 1: GDP Growth Forecast (y.o.y)

Q3-2024	FY2024	FY2025
4.94% - 4.98%	5.00% - 5.05%	5.0% - 5.1%

Considering these factors, we view Indonesia's GDP to grow by 4.96% (y.o.y) in Q3-2024 (estimate range from 4.94% to 4.98%), considering the ongoing weakening demand and no considerable seasonal factors in play. Furthermore, Indonesia's economy is expected to grow by 5.03% (estimated range from 5.00% to 5.05%) for the year 2024. In addition, even if GoI took a drastic turn by implementing meaningful structural transformation, the impact will be materialized in the medium-to long-run and might not have significant improvement in the growth figure of 2025. Thus, we estimate Indonesia's GDP to grow stagnantly by 5.1% (y.o.y) (estimate range from 5.0% to 5.1%) for FY2025.

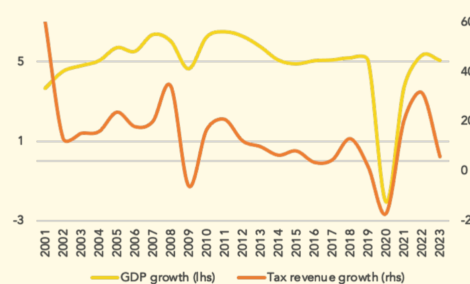
2025: VAT Rate Increase and Other Fiscal Adjustments

The State of Indonesia's Fiscal Capacity

Indonesia's Vision 2045 seeks to position the country as a fully developed nation and one of the world's top five economies. This vision, also known as Visi Indonesia 2045, outlines ambition to build superior human quality and master science and technology, improve people's welfare that is much better and more equitable, and realize national resilience and strong and authoritative governance. Achieving these goals requires a multifaceted approach, where robust fiscal capacity becomes foundational for sustainable and inclusive growth. Fiscal strength is not only crucial for growth but also acts as a buffer against economic shocks. A well-structured fiscal system allows Indonesia to respond effectively to crises and maintain social stability. For example, in response to the COVID-19 pandemic, Indonesia's fiscal policies were crucial in stabilizing the economy.

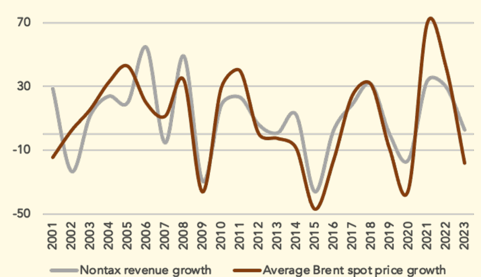
When examining fiscal capacity on the revenue side, it can be divided into two primary sources: tax revenue and nontax revenue. From **Figure A**, the close alignment between tax revenue growth and GDP growth suggests that tax revenue is highly sensitive to overall economic performance. This responsiveness means that during periods of economic expansion, such as in 2007 and between 2010–2012, tax revenue growth often outpaces GDP growth. Conversely, during economic slowdowns, such as the global financial crisis in 2009 or the COVID-19 pandemic in 2020, tax revenue declines even faster than GDP growth. This accelerated decline can be attributed to reduced business profits, lower consumer spending, and a contraction in employment, all of which diminish taxable income and corporate tax collections. In contrast, nontax revenue is heavily influenced by commodity prices. **Figure B** highlights the volatility of nontax revenue growth, closely tied to global oil price growth as represented by Brent spot price growth. The substantial fluctuations in nontax revenue growth, mirroring oil price cycles, indicate the country's reliance on natural resource revenues, which can pose fiscal risks during downturns in global commodity markets.

Figure A: Economic Growth and Tax Revenue Growth (% y.o.y)



Source: CEIC

Figure B: Nontax Revenue Growth and Annual Average Brent Spot Price Growth (%, y.o.y)



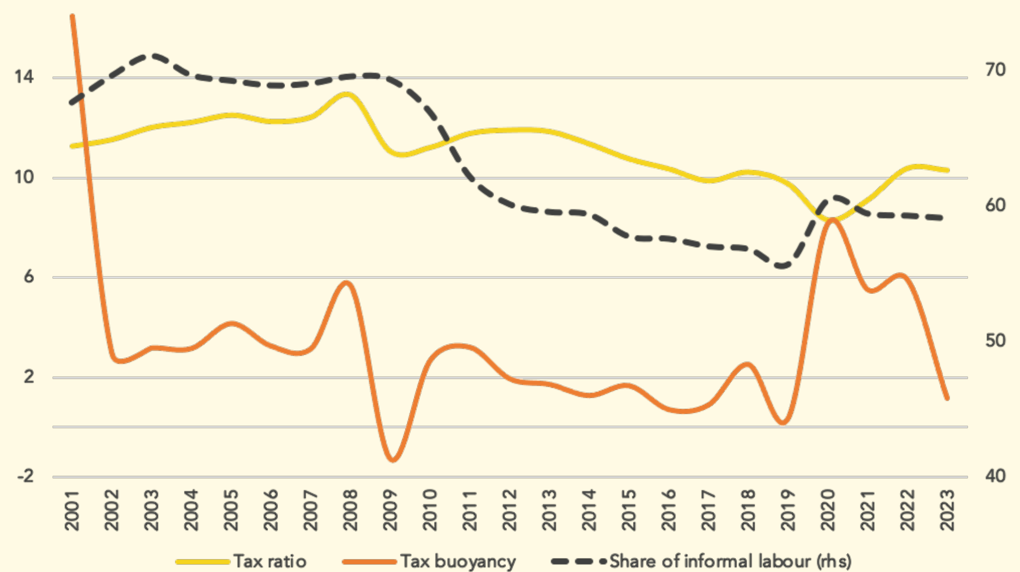
Source: CEIC

Given role of tax revenue in overall fiscal capacity, understanding the tax ratio, which measures the proportion of tax revenue to GDP becomes crucial for assessing a country's fiscal health. A higher tax ratio typically reflects a greater ability to fund public services and investments, which support sustained economic growth. Indonesia's tax ratio has exhibited fluctuations over the last 20 years (**Figure C**). From 2001 to 2008, the tax ratio showed a steady upward trend, rising from 11.27% to a peak of 13.31% in 2008, mainly driven by robust commodity prices. However, after 2008, the tax ratio declined, reaching a low of 9.12% in 2017, excluding the COVID-19 pandemic period of 2020-2021. In 2022, the tax ratio began to improve again, climbing to 10.39% before slightly decreasing to 10.31% in 2023. Despite these gradual improvements, the overall tax ratio remains below the levels seen earlier in the decade. When compared to neighbouring countries,

similar economies and the OECD average, Indonesia's tax ratio in 2022 was rather poor, outperforming only China in this regard (**Figure D**).

Several factors contribute to Indonesia's relatively low tax ratio. First, taxpayer compliance is notably lacking, alongside widespread tax avoidance practices among companies (Ismatika and Suwardi, 2023). Second, micro, small, and medium enterprises (MSMEs) dominate the Indonesian economy, accounting for over 60% of GDP. These enterprises are inherently challenging to reach under the current tax structure, which limits the GoI's ability to expand its tax base (Sari and Qibthiyyah, 2022). Third, the Indonesian economy contains a significant informal sector, where, despite a downward trend, more than 50% of the workforce remains employed informally (**Figure C**), making tax collection efforts even more difficult.

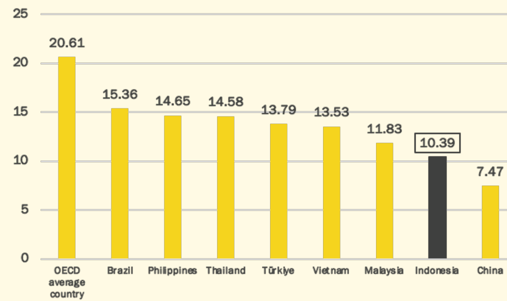
Figure C: Tax Ratio (%), Tax Buoyancy, and Share of Informal Labour (%)



Source: CEIC; LPEM FEB UI staff calculations

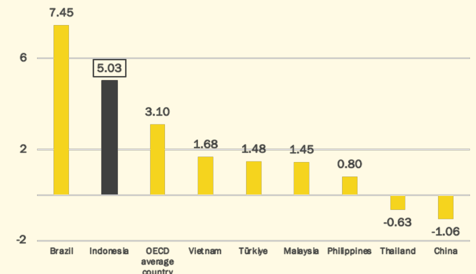
Tax buoyancy, which measures the responsiveness of tax revenue to changes in GDP, serves as another indicator of how effectively a tax system captures revenue growth relative to economic performance. From 2001 to 2008, Indonesia experienced generally favourable tax buoyancy, peaking in 2008 with a buoyancy of 5.68, indicating that tax revenue was increasing at a faster rate than GDP (**Figure C**). However, after 2008, fluctuations in tax buoyancy emerged, with a notable drop to -1.27 in 2009, reflecting a contraction in tax revenue despite economic growth. In subsequent years, many recorded values fell below 1, signifying challenges in translating economic growth into increased tax revenue. While tax buoyancy rose to 5.92 in 2022, indicating improved responsiveness, it decreased to 1.17 in 2023. When compared to neighbouring countries, similar economies, and the OECD average, Indonesia's tax buoyancy in 2022 was relatively strong, ranking only behind Brazil (**Figure D**). The inability of economic growth to generate higher tax revenue points to several systemic issues within Indonesia's fiscal structure, including a narrow tax base and low taxpayer compliance, particularly in the informal sector. Despite a decline in the share of informal labour, from an average of 69.11% between 2001 and 2010 to 58.47% between 2011 and 2019, tax buoyancy worsened, with an average buoyancy of 4.34 in the earlier period dropping to 1.59 in the latter (**Figure C**). Furthermore, challenges in tax administration, such as enforcement and resource limitations, continue to hinder effective revenue collection.

Figure D: Tax Ratios (%) for Selected Countries in 2022



Source: OECD

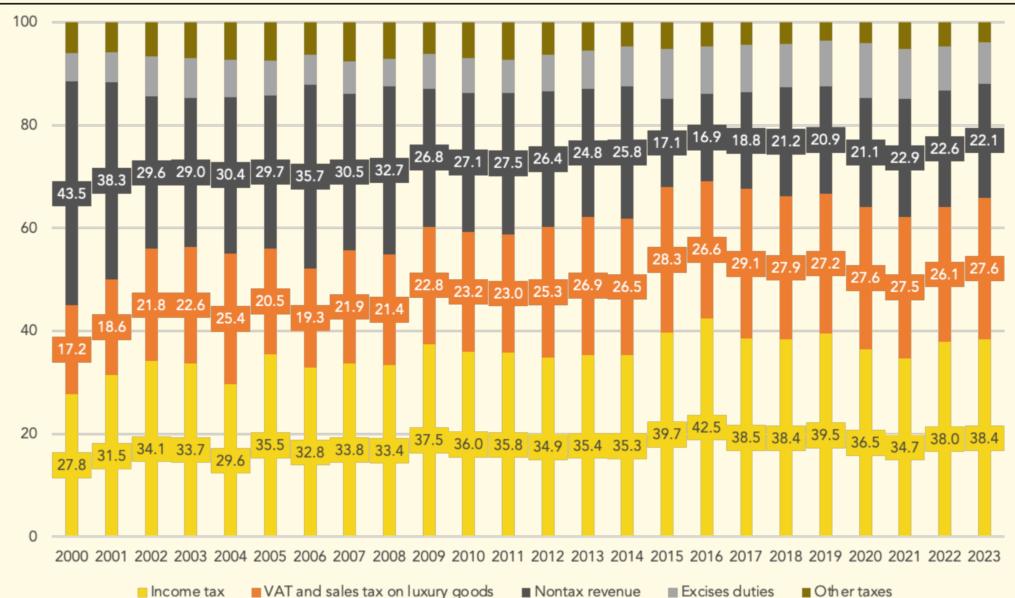
Figure E: Tax Buoyancy for Selected Countries in 2022*



Source: CEIC and OECD, LPEM FEB UI staff calculations
The OECD average is based on 2021 data due to the unavailability of more recent figures.

Trends in domestic revenue by source provides further insights into insights into the evolving composition of Indonesia's fiscal structure (**Figure F**). Over the years, the reliance on nontax revenue has seen fluctuations, particularly declining after 2009 and stabilizing at lower levels due to falling commodity prices, which has reduced dependency on volatile nontax sources, such as natural resources. Since 2010, excise duties have gradually risen, emerging as a more significant component of revenue. This shift reflects efforts to diversify revenue streams and enhance fiscal stability. Income tax and VAT remain the primary revenue contributors, accounting for approximately 28% to 40% and 17% to 29% of total revenue, respectively. VAT, in particular, has emerged as a vital part of Indonesia's revenue structure. Unlike income tax, which relies heavily on business profitability and employment levels, VAT covers a wider range of economic activities, making it less vulnerable to economic cycles. This broad reach enables VAT to consistently generate revenue, even during periods when other tax streams, such as income tax, face slowdowns due to economic challenges. The resilience of VAT highlights its crucial role in supporting Indonesia's fiscal health and underscores the need for its effective implementation and optimization to maintain stable revenue growth.

Figure F: Share of Domestic Revenue by Source (%)

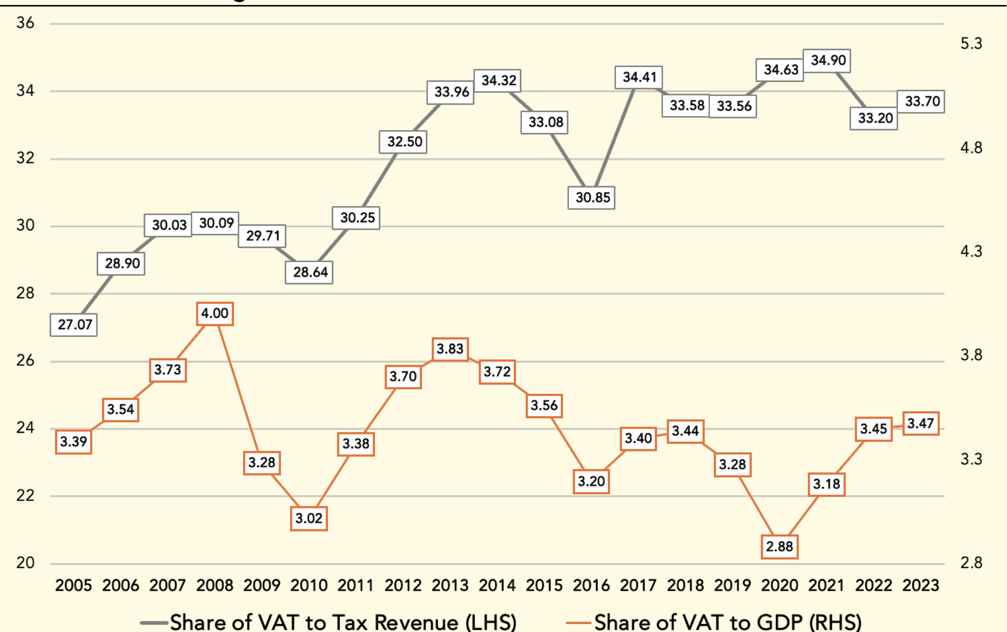


Source: CEIC

Diving Deeper into VAT Dynamics

A closer examination of Indonesia's VAT indicators over recent years highlights fluctuating trends that reflect broader economic patterns, with some notable divergences, particularly between 2015 and 2020. The share of VAT in overall tax revenue has an overall upward trend, showcasing the critical role of VAT for tax revenues, more pronounced over time (**Figure G**). However, the trend also includes a series of declines. Between 2008 and 2010, it declined steadily. In 2009, VAT revenue experienced negative growth, contracting more sharply than the overall tax revenue, which also declined but to a lesser extent. This suggests that VAT collections were more sensitive to the economic downturn caused by the global financial crisis, possibly due to negative import growth in 2009 and lower consumption growth in 2010 compared to 2008. A similar pattern emerged from 2014 to 2016, as seen on **Figure G**. During this period, Indonesia faced lower consumption growth and negative import growth in 2015-2016, which directly impacted VAT collections, especially on imported goods. Increased tax restitutions also played a role in suppressing VAT revenue growth. In 2016, VAT revenue growth turned negative, even though overall tax revenue continued to grow, indicating a significant underperformance of VAT collections during that year.

Figure G: Indonesia's VAT Indicators 2005-2023 (%)



Source: The Ministry of Finance, Republic of Indonesia; World Bank; LPEM FEB UI staff calculations

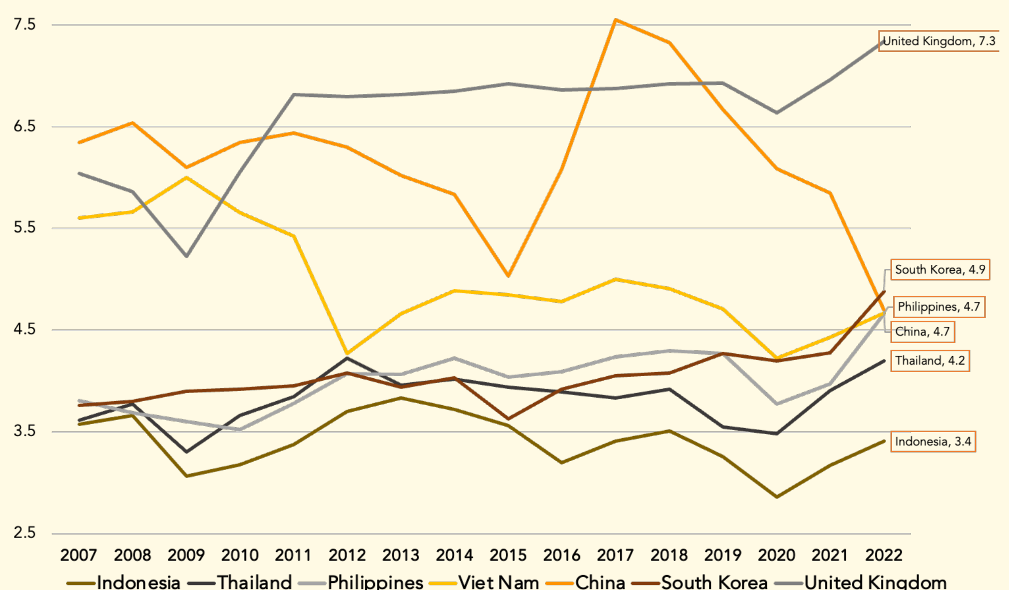
From 2017 to 2019, the share of VAT in tax revenue remained relatively stable. During 2018 and 2019, there was a significant shift toward capital-intensive projects in Indonesia. This shift reduced labor force absorption and led to an increase in the informal sector's share of the economy. Since the informal sector is harder to tax and often falls outside the VAT net, this development negatively impacted VAT revenue growth relative to GDP during these years. From 2019 to 2020, there was a noticeable increase in VAT's share of total tax revenue, even as the VAT-to-GDP ratio declined. This divergence is particularly noteworthy. The increase in VAT's share amid a declining VAT-to-GDP ratio suggests that while the overall economy contracted due to the COVID-19 pandemic, VAT revenue was less affected compared to other tax revenues. The decrease in growth was more concentrated on non-VAT revenues, as consumption proved less elastic than other economic activities affected by the health crisis. This led to VAT becoming a more prominent part of the tax revenue mix, despite the overall economic downturn.

Looking at the share of VAT relative to GDP, the ratio has remained fairly consistent, hovering around 3.1% to 3.8%, but with fluctuations tied to specific events (**Figure G**). Declines in this ratio have been linked to the global financial crisis in 2008-2010, lower consumption growth and negative import growth in 2014-2016, and structural shifts like the move toward capital-intensive projects in 2018 and 2019. The drop from 2019 to 2020 reflects the economic contraction caused by the pandemic, which affected overall GDP more than it did VAT collections.

Overall, while the VAT-to-GDP ratio has fluctuated, the increasing reliance on VAT as a source of tax revenue is evident, especially during economic downturns. The periods where VAT growth was lower compared to overall tax growth, such as in 2009 and 2016, highlight the sensitivity of VAT collections to economic factors like import growth and consumption patterns. The divergence observed between 2019 and 2020 underscores the structural aspects of Indonesia's tax system, where VAT has become a more prominent component of total tax revenue even when the economy faces significant challenges. This indicates that while VAT is becoming more critical for tax revenue (increased share of tax revenue), it has not always kept pace with the broader economy's growth (fluctuating share of GDP), highlighting the complex dynamics between tax policy, economic activity, and revenue collection.

Indonesia's VAT-to-GDP ratio stands relatively low compared to other countries, remaining stagnant over time while other nations have seen increases. **Figure H** shows Indonesia's initial comparability to its regional peers, yet Indonesia has struggled to keep pace. Within ASEAN, countries like Thailand, the Philippines, and Vietnam have experienced slight increases in their VAT-to-GDP ratios, positioning them above Indonesia in recent years. When looking more broadly across Asia, countries like China and Korea display notably higher VAT-to-GDP ratios, although China's ratio has slightly declined from 6.3% to 4.7% over time. In Europe, the United Kingdom showcases a much higher VAT-to-GDP ratio, emphasizing a significant gap between its performance and that of Indonesia.

Figure H: Share of VAT to GDP (%) Country Comparison 2007-2022

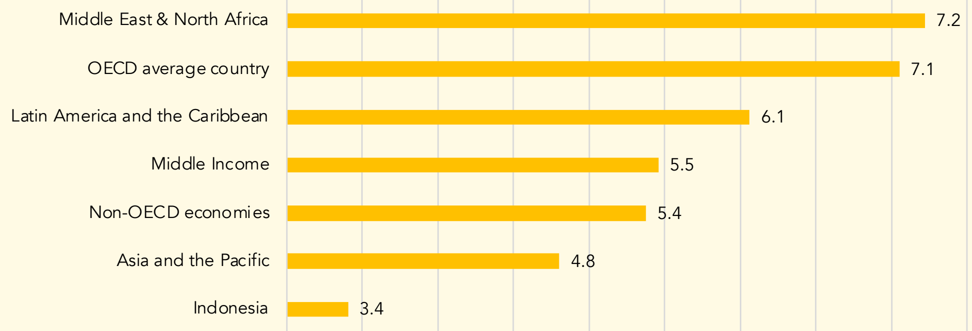


Source: OECD

Indonesia's VAT-to-GDP ratio also remains relatively low when compared with other classifications worldwide (**Figure I**). In a global context, regions such as Latin America and the Caribbean, the Asia-Pacific, and MENA (Middle East and North Africa) show considerably higher

VAT-to-GDP ratios. The OECD average has also seen growth, moving from 6.5% in 2012 to 7.1% by 2022. In contrast, the VAT-to-GDP ratio for non-OECD countries, which was once on par with Indonesia levels in 2002, has now significantly surpassed it, following a similar trend seen in middle-income countries.

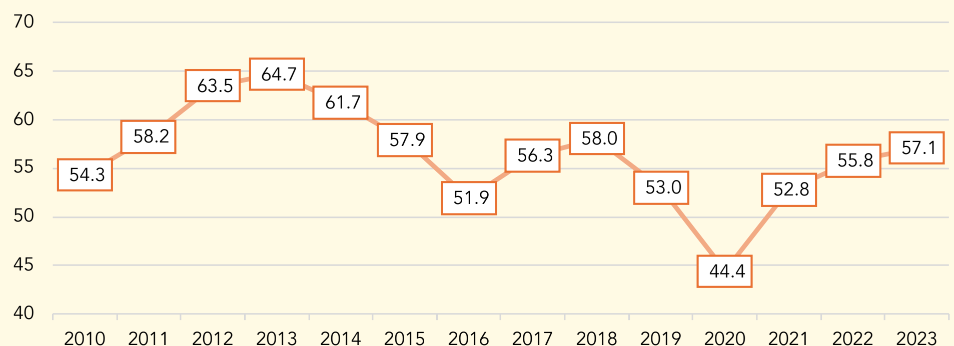
Figure I: Share of VAT to GDP (%) Group Comparison in 2022



Source: OECD

A deeper analysis using the VAT Revenue Ratio (VRR), developed by the OECD, reveals more about Indonesia's VAT collection effectiveness. The VRR compares the actual VAT revenue collected with the potential revenue that could be generated in an ideal scenario. For Indonesia, the VRR in 2023 is recorded at 57.1%, indicating that 42.9% of the potential VAT revenue remains uncollected as pointed out on **Figure J**. Observing historical trends, Indonesia's VRR has been gradually declining since 2013. The reasons behind this uncollected VAT revenue include both policy gaps, where VAT exemptions or reduced rates prevent maximization of potential revenue, and compliance gaps, where taxpayers fail to adhere fully to VAT requirements. The compliance gap often stems from informality within the economy, where unregistered businesses and transactions bypass VAT obligations, reducing actual revenue collected relative to its potential.

Figure J: Indonesia VAT Revenue Ratio (VRR) in 2010-2023 (%)



Source: ADB; LPEM FEB UI staff calculations

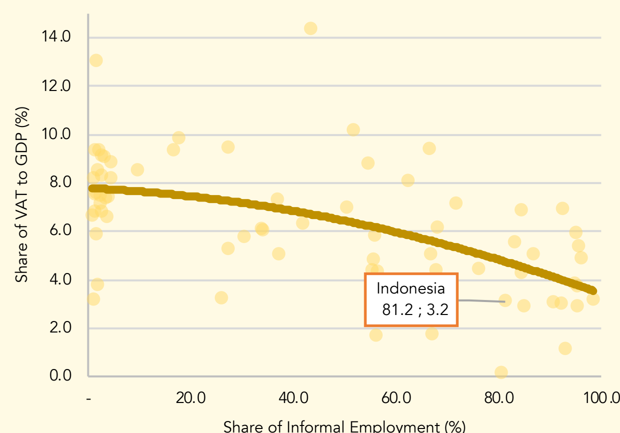
The prevalence of informal employment further complicates VAT performance, as depicted in **Figure K**, which highlights a negative correlation between the share of informal employment and the VAT-to-GDP ratio. As the share of informal labour in the economy increases, the VAT-to-GDP ratio tends to decrease. The trendline shows this inverse correlation, suggesting that higher levels of informal employment are associated with lower VAT collections relative to GDP. This relationship can be understood in the context of tax policy and economic structure. Informal employment generally involves economic activities that are outside formal tax systems, meaning that a larger informal sector results in a significant portion of economic transactions bypassing

VAT collection mechanisms. Informal businesses often operate without official registration, and their transactions remain untaxed, effectively reducing the potential VAT base.

Developing countries with limited tax capacity have shifted to favor VAT as it deemed to be a relatively easier and feasible tool to raise tax (Emran & Stiglitz, 2005; Hoseini, 2020). However, efficiency of VAT is often hindered by informality, which constitutes around 40% of economic activities in developing countries (Hoseini, 2020; Schneider et al., 2010). This leads to what De Paula & Scheinkman (2010) describe as a tendency for firms to conduct transactions with others of the same formal/informal status. Informal firms, not registered in the VAT administration, often engage in transactions with other informal firms to avoid VAT obligations across the supply chain. In such cases, when formal firms buy inputs from informal suppliers, they cannot obtain a tax invoice and, therefore, miss the tax credit from the upstream firm. This structure incentivizes informal firms to transact exclusively with other informal firms, which strengthens the informal sector and reduces the VAT base. Consequently, as informality rises, a substantial part of economic activity escapes VAT, leading to a lower VAT-to-GDP ratio. Countries with a high share of informal labour face challenges in expanding their tax base and often struggle to implement efficient VAT collection systems, as enforcement becomes complex within a predominantly informal economy. This negative relationship underscores a structural issue, as reducing informality could be essential to increasing VAT revenue, thereby strengthening public finances (Qibthiyyah, 2018). In contrast, countries with a lower share of informal employment tend to have stronger VAT-to-GDP ratios, as a larger share of economic transactions falls under the VAT system. **Figure K** highlights the broader economic impact of informality on government revenue and the importance of formalizing employment to enhance fiscal health.

Qibthiyyah & Arrachman (2018) found that VAT rate has a reversed U-shaped relationship to VAT revenues, confirming the Laffer Curve theory. It depicts VAT revenue does not always increase whenever the VAT rate increases. However, higher informality will reduce government flexibility in its effort to increase tax rate. The maximum VAT rate can be shifted lower as a result of higher informality in a country, as a result of chain effects on formalization (De Paula and Scheinkman, 2010). Furthermore, Waseem (2018) found that a large informal sector limits the taxation capacity of developing countries in two significant ways: (1) it directly restricts the tax base to a small group of formal taxpayers; and (2) the indirect effect of governments that often keep tax rates low, fearing that higher taxes might weaken the already limited formal sector.

Figure K: Country Scatter Plot
Share of Informal Employment and VAT-to-GDP Ratios*

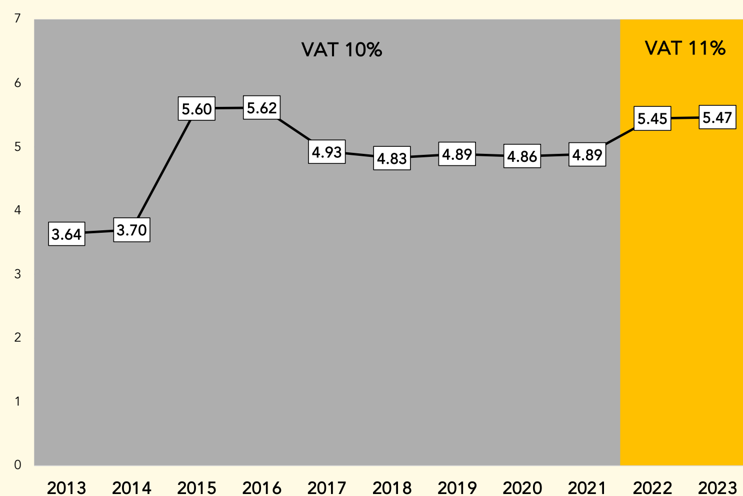


Source: OECD; ILO; LPEM FEB UI staff calculations
**Latest Period Available for Informal Share, 2021 for VAT-to-GDP*

Regressivity/Progressivity of VAT in Indonesia

The analysis of Indonesia's VAT indicators reveals the complex relationship between economic activity, policy, and VAT collection efficiency. Fluctuations in VAT-to-GDP ratios and comparisons with other countries illustrate that while VAT has become an increasingly important part of Indonesia's tax revenue, challenges persist. Building on this context, the report turns to a closer examination of how VAT is distributed across households. To estimate the share of VAT borne by households, this report utilizes the National Socioeconomic Survey (*Survei Sosial Ekonomi* Nasional/Susenas), which captures detailed consumption patterns across Indonesian households. Following the approach of Wicaksono et al. (2020), who estimated household VAT burdens by focusing on VAT-applicable nonfood components and excluding education and health services, this report adopts a more granular consumption component to include and exclude specific items that are subject to VAT, adjusting with the applicable regulation (the latest one is the Government Regulation No.49/2022). As shown by **Figure L**, estimated VAT burden has generally increased from 3.64% of total household expenditure in 2013 to 4.89% in 2021 (VAT rate was 10% during this period). In 2022, GoI adjusted VAT rate from 10% to 11% and there was a discernible increase in VAT burden after the implementation of VAT rate hike. With the average VAT burden of 4.88% in 2018-2021, VAT burden increased to 5.45% in 2022 and 5.47% in 2023.

Figure L: VAT Expenditure (% of Total Spending)



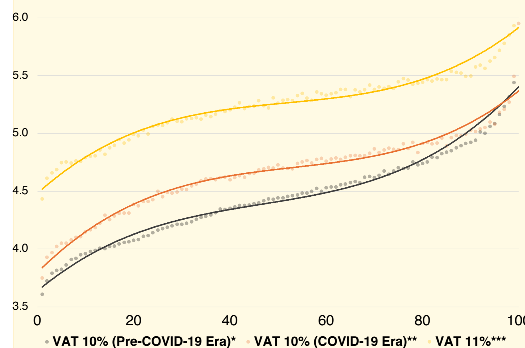
Source: National Socioeconomic Survey (Susenas); LPEM FEB UI staff calculations

In principle, poorer household have a higher share of consumption in their income and as household's income increase, the share of consumption decreases. As a consequence, VAT as a consumption-based tax is conceptually regressive since the VAT burden diminishes with rising income. However, in practice, VAT does not always follow this pattern. As shown by **Figure M**, VAT burden, measured as the share of estimated household VAT expenditure to total household expenditure, is higher for richer household. Between 2013 and 2019, with the VAT rate at 10%, the average VAT burden for the poorest 20% of households was approximately 3.93%, compared to 5.04% for the richest 20%. Similarly, during COVID-19 era, with the VAT rate remaining at 10%, the VAT burden was still progressive as the VAT burden for the poorest 20% is at 4.15%, while for the richest 20%, it was 5.10%. The rise in VAT burden during COVID-19 era might be caused by the bigger drop of income relative to consumption, which consequently increase the VAT expenditure share to total expenditure (as a proxy of income).

Furthermore, even after GoI raised VAT rate from 10% to 11% in 2022, the progressivity pattern of VAT burden across household still materialized. From 2022 to 2023, the average VAT burden for the poorest 20% was 4.79%, while for the richest 20%, it was 5.64%. The progressivity of VAT in Indonesia might be majorly influenced by the framework of VAT exemptions. Government Regulation No.49/2022 (amending and harmonizing several previous regulations related to VAT) exempting VAT for various goods and services that are considered as essentials, such as staple foods, education, and health. Considering that the proportion of spending allocated to basic needs decreases as income increases, VAT exemptions regime in Indonesia shapes the nature of VAT burden from regressive into a more progressive form.

However, the increase in the VAT rate in 2022 from 10% to 11% introduced a somewhat regressive impact. **Figure N** illustrates the change of VAT burden, or specifically comparing the VAT share in household expenditure at the 11% rate to the burden when the rate was 10%. When comparing the current VAT burden (2022-2023) to the pre-COVID-19 era (2013-2019), the rise in the VAT rate led to an increase of approximately 0.86 percentage points for the poorest 20% of households, while the richest 20% experienced a smaller increase of only 0.71percentage points. Similarly, when examining the burden during the current VAT rate of 11% against the 10% rate during the COVID-19 era (2020-2021), the VAT burden for the richest 20% rose by 0.55 percentage points, while it increased by 0.71% for the poorest 20 percentage points. Notably, households in the 20th to 22nd percentile felt the brunt of the VAT rate hike, with their burden increasing by 0.91 percentage points.

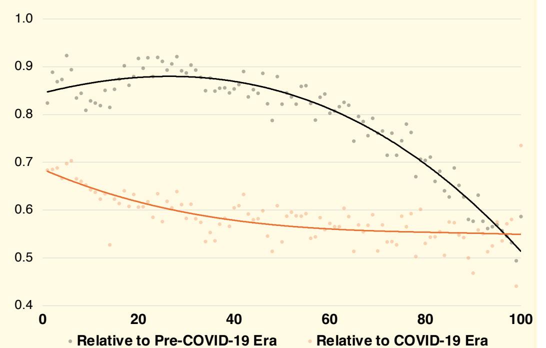
Figure M: Share of VAT Expenditure (% Spending) by Income Percentile



Source: National Socioeconomic Survey (Susenas); LPEM FEB UI staff calculations

*2013-2019 average; **2020-2021 average; ***2022-2023 average*

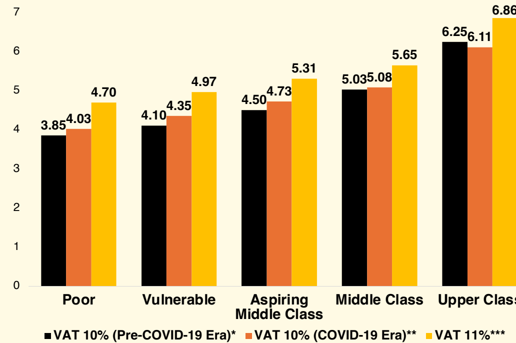
Figure N: Change of VAT Expenditure Share (percentage point) by Income Percentile



Source: National Socioeconomic Survey (Susenas); LPEM FEB UI staff calculations

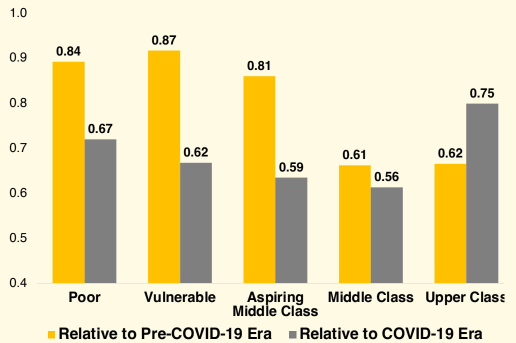
The progressive nature of VAT burden in Indonesia is also evident across income class. Before COVID-19, the VAT burden for the poorest households was 3.9%, with the burden consistently increasing among wealthier households, reaching 5.2% for the upper class (**Figure O**). Following the VAT rate hike, this progressivity remained intact, as the VAT burden for poorer households rose to 4.7%, while the upper class experienced a burden of approximately 6.9% of their total expenditure. However, the regressive impact of the increased VAT rate becomes apparent when examining the VAT burden by income class (**Figure P**). Compared to the pre-COVID-19 period with a 10% VAT rate, the current 11% rate resulted in smaller increases for the wealthiest households. Specifically, the VAT burden increased by 0.84 percentage points for the poorest, 0.87 percentage points for the vulnerable, and 0.61 percentage points for the aspiring middle class. In contrast, the rise in VAT burden was only 0.61 percentage points for the middle class and 0.62 percentage points for the upper class.

Figure O: Share of VAT Expenditure (% Spending) by Income Group



Source: National Socioeconomic Survey (Susenas); LPEM FEB UI staff calculations

Figure P: Change of VAT Expenditure Share percentage point) by Income Group



Source: National Socioeconomic Survey (Susenas); LPEM FEB UI staff calculations

The VAT Rate Adjustment from 10% to 12%

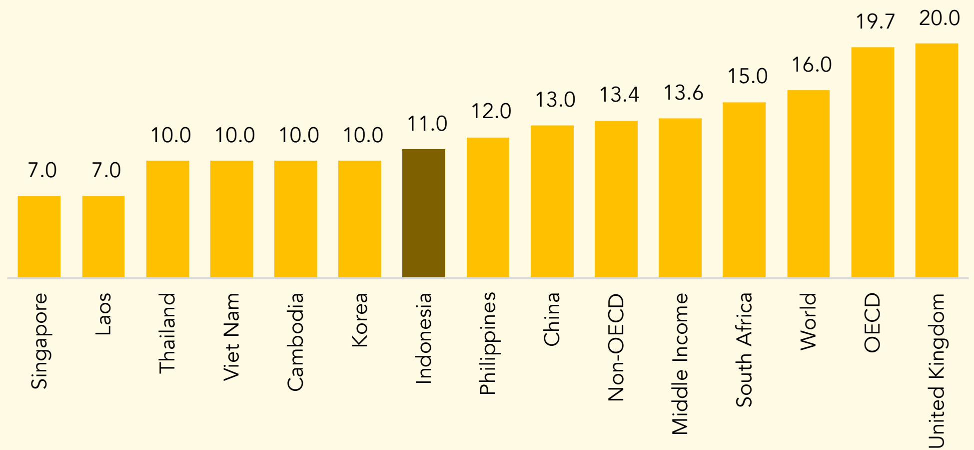
The GoI first introduced VAT through the enactment of Law No. 8 of 1983 on "Value-Added Tax and Tax on Luxury Goods." Initially set at a rate of 10%, VAT was implemented as part of a comprehensive tax reform aimed at replacing the existing sales tax, which had become both complex and inefficient due to its multiple-rate structure (Iswahyudi, 2018). VAT was designed with built-in flexibility, allowing the GoI to adjust rates for specific goods and services within a range of 5% to 15%, and for luxury items, rates could reach as high as 35%. The GoI also exempted several goods and services from the obligation of applied the VAT, such as the basic commodities, and health and education services, regulated by the Minister of Finance, Republic of Indonesia.

Since the initial enactment of the law, substantial reforms have taken place, with the Law was being amended three times in 1994, 2000, and 2009. The Omnibus Law of Job Creation in 2020, Law of Tax Harmonization in 2021, also played their role in shaping VAT reform in Indonesia. These efforts primarily focused on enhancing tax collection and improving compliance (Iswahyudi, 2017). The general VAT rate remained unchanged at 10%, while the VAT rates on luxury goods increased. The GoI continued to exclude certain goods and services from VAT, including those subjects to regional taxes, thereby broadening the range of exempted items.

The first increase in VAT occurred in 2022 with the enactment of the Tax Harmonization Law, which raised the VAT rate from 10% to 11% effective since April 1, 2022. The GoI also announced a further increase to 12% by 2025, aiming to strengthen tax revenue to better support public finance. Unlike income tax, which relies on reported income and is prone to underreporting (Hurst et al., 2014), VAT is consumption-based and easier to collect, as each transaction is documented by both buyer and seller. Additionally, because VAT is consumption-based, it does not discourage savings or reduce incentives to work, unlike some income-based taxes (Thomas, 2021).

At 11%, Indonesia's VAT rate remains below the average of its middle-income peers, while still ranks among the highest within ASEAN (**Figure Q**). A lower-than-average VAT rate, alongside a comparatively lower-than-average VAT/GDP ratio, indicates scope for increasing VAT revenue either through rate adjustments or improved collection efficiency. Should the GoI prioritize raising tax revenue, gradually increasing the VAT rate or narrowing exemptions could help align Indonesia's tax performance with that of its peers.

Figure Q: Comparison of VAT Rate for Selected Countries in 2022



Source: OECD; LPEM FEB UI staff calculations

Increasing the VAT rate presents multiple benefits for Indonesia's fiscal and economic stability. Firstly, this adjustment supports fiscal recovery in the post-pandemic landscape, aiding in the stabilization of the State Budget (APBN). During the COVID-19 pandemic, government expenditures surged due to social assistance programs, medical incentives, and vaccination initiatives, leading to a significant budget deficit. By raising the VAT rate, Indonesia can enhance its revenue, reduce reliance on borrowing, and work towards lowering the national debt that has accumulated during this period. Furthermore, increasing the VAT rate aligns Indonesia with global tax standards. The Minister of Finance Sri Mulyani Indrawati noted that the global average VAT rate hovers around 15%. Even with the planned increase to 12% by 2025, Indonesia will still fall below this benchmark, highlighting an opportunity to strengthen its fiscal position.

Raising the VAT rate, compared to other types of taxes, also fortifies the country's tax structure. As taxes constitute the largest source of state revenue, a higher VAT rate broadens this foundation, enabling the government to more reliably fund essential services such as healthcare, education, and infrastructure. A stronger tax base will better equip Indonesia to withstand future economic shocks without excessive reliance on debt. In addition, increasing the VAT rate is generally more practical than adjusting other tax measures. Since VAT is based on consumption, it has a broad base, and consumption transaction records are more readily available than income data. Taxing consumption also preserves work incentives, unlike income tax, which can disincentivize labor participation. Finally, from a practical standpoint, using the value of final sales and a single rate simplifies the collection process, reducing administrative complexity associated with tax compliance.

While increasing the VAT rate offers potential advantages, it also poses drawbacks. As a tax directly applied to goods and services, VAT can risk exacerbating inflationary pressures. A higher VAT rate typically results in immediate price increases for goods and services, raising the overall cost of living. This effect can be particularly challenging for low-income households, which may experience a reduction in purchasing power, leading to a decline in overall consumer spending and consumption. Additionally, the distributional effects of a VAT increase can disproportionately burden low-income households. Although lower-income earners spend a smaller share of their income on taxed goods and services (**Figure M**), recent experiences in Indonesia indicate that increases in living costs hit these households the hardest (**Figure N**). This scenario could exacerbate poverty levels and widen social inequalities, pushing more individuals below the poverty line and further straining vulnerable groups.

The impact on competitiveness is another concern, especially in sectors like tourism. Elevated VAT rates may deter international visitors who find Indonesia less cost-effective compared to neighboring countries with lower tax rates. This situation could also affect foreign investment, as investors often seek regions with more favorable tax environments. Additionally, the increased production costs associated with a higher VAT could diminish the competitiveness of Indonesian exports in global markets. Implementation challenges are also noteworthy. A VAT increase can lead to heightened tax evasion or avoidance, particularly in sectors characterized by high informality or limited oversight. This risk threatens to undermine government revenue objectives and complicate enforcement efforts, potentially offsetting the intended benefits of the VAT rate increase.

Fiscal Issue under New Administration (1): Establishment of National Revenue Authority (BPN)

With Indonesia's 11% value-added tax rate being relatively low compared to global peers, structural tax reform frequently becomes a topic of discussion. Aside from the issue of raising value-added tax base from 11% to 12%, the newly elected President of Indonesia pledged the concept of separating Ministry of Finance (MoF) with its revenue counterparts in electoral campaigns. However, this vision has not been further discussed since the new government took office and it arises pros and contras (Kompas, 2024). Furthermore, this is not the first time the idea of separating the MoF and creating autonomous or semi-autonomous state revenue institutions has been proposed. The concept was initially introduced during President Megawati's tenure (Tempo, 2023) and has been reviewed multiple times by President Jokowi's administration, but it has yet to come to fruition (Kompas, 2024).

One of the most visible tax reforms in low-income countries in recent decades has been the creation of semi-autonomous revenue authorities (SARAs). This approach has been used more in Africa and Latin America. However, the empirical evidence of its impact to collect more revenue, increase accountability and productivity, and boost voluntary compliance are still unclear (Lees, 2016). Sarr (2016) found considerable cross-country variation in performance and conclude that the implementation of a SARA did not significantly improve government revenues. Among the 20 countries surveyed, only five showed that SARAs consistently outperformed traditional MoF in revenue collection over the post-treatment period. Dom (2019) found no evidence for a systematic relationship between the establishment of a SARA and total tax revenue, or for particular tax types, based on long-run panel of 46 sub-Saharan African countries. Furthermore, the implementation of SARAs could not be considered to be a "quick fix" solution to improve tax performance (Jeppensen, 2021). Jeppensen (2021) found a positive effect of SARAs in sub-Saharan Africa on direct tax revenue, but no effect on indirect total tax revenue.

Despite these findings, several studies found positive impact of SARAs on certain cases. Von Haldenwang et al. (2014) took a local approach on municipal level in Peru. The study shows that municipalities with SARAs collect more revenue than those with traditional tax administration and have less variation in revenue around a long-term trend. Moreover, a country which adopts SARA models will have the potential for increasing tax ratio by 3-5% as a result of more effective and efficient tax authorities (Boewono Kristiaji & Poesoro, 2013). The debate on the impact of SARAs is further complicated as often they did not happen in isolation, but rather as a package of reforms in tax policy and administration (Lees, 2016).

The goal of establishing revenue authority is to improve the effectiveness and efficiency of tax administration (Junquera-Varela et al., 2019). According to IMF (2004), almost all revenues authorities have the mandate of assessing and collecting tax and duties and administering and enforcing the revenue laws, and further mandate to provide advice on tax laws to the MoF. South Africa was considered to be successful in establishing its semiautonomous revenue authority.

South Africa reformed its tax administration and granted the revenue authority greater autonomy in 1990s, resulting in progressive and successful tax collection and reached a 25% tax-ratio in 1997-2002. Key factors contributing to South Africa's success included a prominent level of cooperation between the government and higher-income groups (including corporations), substantial consultation with representatives from various stakeholders (state, political parties, business chambers, labor unions, etc.), and the adoption of a pay-as-you-earn withholding system (Junquera-Varela et al., 2019). According to Sarr (2016), South Africa was one out of five countries in which the creation of SARAs has a positive impact on revenue. The study also found that Peru and Kenya have failed to be as prosperous, wherein the creation of revenue authority does not seem to be a wise choice (Sarr, 2016).

Peru's strategy for tax administration reform involved separating the National Tax Administration Super Intendency (SUNAT) from the MoF in 1990. It was the first semi-autonomous revenue authority in Latin America and was initially regarded as successful. Tax ratio was recovered to 13% in 1997 from 9% in 1988 due to administrative and financial autonomy, personnel reform and generating public support. Although it initially achieved success, SUNAT subsequently faced several problems that limited its success, including a deteriorating tax policy, political interference, and weaknesses in the institutional environment. Moreover, establishing SARAs should be paired with corresponding adjustments in business processes to enhance compliance and taxpayer service delivery. The Kenya Revenue Authority (KRA), established in 1995, initially made minimal efforts to strengthen tax administration. Its three revenue departments (Income Tax, VAT, and Customs and Excise) continued to operate independently, with no changes implemented to improve compliance or taxpayer services.

Establishing a revenue authority as seen in other developing countries offers mixed lessons. Evidence on its effectiveness in raising revenue, improving accountability, and fostering compliance is inconclusive. Based on the implementation and experience on various countries, the establishment of revenue authority required a modernization in administration, ensuring political support and commitment, prevent corruption, strong coordination with MoF, and establish relationship with taxpayer.

Fiscal Issue under New Administration (2): "Fat Cabinet"

Just five days before the end of his term, Jokowi signed Law no.61/2024 and amended Law No. 39/2008 on State Ministries. One of the key changes in this law is that it removes the legal cap of number of ministries (previously it was capped to 34 ministries), enabling the new administration under President Prabowo Subianto to expand cabinet size. On October 21st, 2024, less than a week after the passing of Law no.61/2024, President-elect Prabowo Subianto officially inaugurated "Red and White Cabinet" of 48 ministries, comprising a total of 109 members, with 22 new ministries and agencies. Having 48 ministries, the number of ministries in Indonesia is in the current administration is the largest in the last 58 years. The last time Indonesia had more than 48 ministries was during the last year of President Soekarno's administration, which had 79 ministries under "Dwikora III Cabinet" back in 1966. The expansion of the number of ministries and agencies under President Subianto administration raised some concerns, including the potential increase in regulatory red tapes, policy incoherency, general inefficiency by the government's bureaucracy process, and fiscal burden.

Focusing on the fiscal implication of the cabinet size expansion, this report attempts to estimate the potential increase in fiscal burden to accommodate the number of cabinets. The scope of the estimation covers two components, namely central government's personnel expenditure and material expenditure. The estimation includes various items of those components that are considered will be considerably affected by the cabinet expansion (detail of included items are specified in Table 1). Assuming a conservative scenario that the increased size of cabinet only

increases its activities and budget by 5% to 20%[1], it is estimated that it will increase the state budget spending by IDR39.55 trillion to IDR158.21 trillion in 2025, or around 4.0% to 15.8% of total 2025 state budget (Table 1).

Table 1. Estimated Increase in State Budget due to Cabinet Size Expansion

	2010-2023 average growth rate	2023	2024e**	2025e**
*Selected Personnel Expenditure Items**	*%*		*IDR trillion*	
Salary and allowance for civil servants	*5.64%*	*86.44*	*91.31*	*96.46*
Salary and allowance for government officials	*5.42%*	*1.45*	*1.52*	*1.61*
Salary and allowance for noncivil servants employees	*43.76%*	*18.57*	*26.98*	*38.38*
Spending on honorarium	*0.33%*	*1.52*	*1.52*	*1.53*
Spending on overtime	*5.21%*	*0.91*	*0.95*	*1.00*
Spending on special allowances	*16.10%*	*84.74*	*98.39*	*114.24*
Spending on pension and discharged civil servants	*8.16%*	*140.28*	*151.73*	*164.11*
Spending on health insurance	*14.37%*	*11.15*	*12.75*	*14.58*
*Selected Material Expenditure Items**				
Spending on goods	*8.56%*	*149.98*	*162.82*	*176.76*
Spending on services	*11.57%*	*50.33*	*56.16*	*62.66*
Spending on maintenance	*15.01%*	*48.11*	*55.34*	*63.64*
Official travel expenses	*7.75%*	*48.31*	*52.05*	*56.08*
Total Selected Items		***641.78***	***711.24***	***791.04***

Source: CEIC; LPEM FEB UI staff calculations
**Central government's personnel and material expenditure items only includes those which are considered will be affected by cabinet size expansion.*
***Estimated value for 2024 2025 is calculated by multiplying its previous year's value with its average growth rate during 2010-2023.*

		Estimated Increase in the State Budget	
		in IDR trillion	% of 2025 State Budget
Scenario of increase in selected personnel and material expenditures (IDR791.04 trillion)	5%	39.55	4.0
	10%	79.10	7.9
	20%	158.21	15.8

Source: LPEM FEB UI (2024)

[1] 5% to 20% increase in related budget is considered conservative considering the increase in number of ministries is around 41% (from 34 to 48 ministries)

Rethinking Strategy to Boost Revenue

In order to boost tax ratio, various alternatives can be implemented without solely relying on raising tax rates, such as reducing informality, enhance trade openness, better administration system, and digging deeper into potential tax revenue from digital economy.

While increasing VAT rates can potentially boost revenue, higher VAT rates do not guarantee increased revenue, particularly in countries with substantial informal sectors (Qibthiyyah & Arrachman, 2018). High informality restricts the tax base, concentrating the tax burden on a small group of formal taxpayers. Addressing these limitations requires a primary focus on tackling the underlying causes of informality. Providing incentives for informal businesses to formalize (such as offering simplified tax regimes), streamlining business registration processes and reduce regulatory burdens, and launching awareness campaigns that emphasize the benefits of formalization can be the alternatives to lower informality in Indonesia's economy.

Enhancing trade openness is a viable strategy for boosting tax revenue, as higher role of international trade in the economy or openness associate with higher VAT revenues. Significant and positive effect of trade openness on VAT revenues was found in a study by Qibthiyyah & Arrachman (2018), as higher volume of international trade from import and export activities will grow domestic economic activities and positively affected VAT revenues. To leverage this potential, several policy actions can be implemented, such as simplifying customs procedures and reducing trade barriers to facilitate smoother transactions and encourage businesses to engage in international markets, enhancing the quality and transparency of trade policy formulation and implementation, and encouraging e-commerce platforms to facilitate cross-border trade for easier engagement for SMEs in export activities.

The improvement of tax administration is essential for enhancing tax revenue performance, which also has a positive effect on investment climate (IMF, 2008). Significant aspects of tax reforms in various countries emphasize the improvement of tax administration, with a focus on increasing its efficiency. Basri et al. (2020) found that intensifying tax administration efforts by relocating top firms in each region to specialized "Medium-Sized Taxpayer Offices" has significantly increased tax revenue from these firms, more than doubling it due to improved staff-to-taxpayer ratios. This finding underpinning the importance of increasing the staff-to-taxpayer ratio which will allow for more personalized attention and support for businesses, thereby fostering compliance. As an alternative, pursuing institutional reforms to boost the productivity of the MoF workforce and investing in digital infrastructure will modernize operations and enhance overall efficiency. Furthermore, establishing a coherent long-term taxation strategy can provide a stable framework for both taxpayers and tax authorities.

Exploring the potential for tax revenue from the digital economy is increasingly important to enhance fiscal resources. The MoF has indicated plans to investigate tax revenue opportunities from various digital economy sectors, including implementing a crypto tax on cryptocurrency asset trading, a fintech tax on loan interest paid by borrowers, and a tax on transactions involving the procurement of goods and services through the Government Procurement Information System (*Sistem Informasi Pengadaan Pemerintah*/SIPP) (MoF, 2024). To effectively tap into these revenue streams, reviewing and adapting existing tax policies to ensure they are aligned with the unique characteristics of the digital economy are necessary. The establishment of detailed tax regulation for digital sectors that are currently unregulated will provide clarity and facilitate compliance. This establishment should be underway by collaborating with industry stakeholders to design practical regulations that account for unique digital processes.

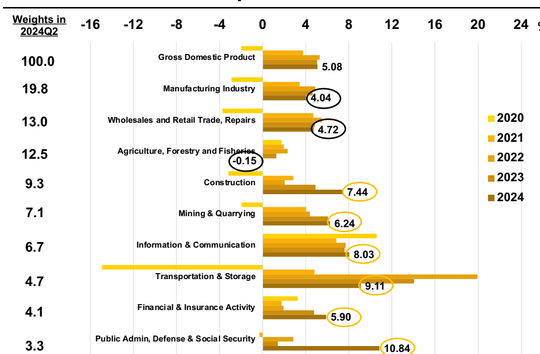
Lacking Source of Structural Growth Engine

Having no new source of growth, Indonesia prolonged its long-term growth figure of around 5% since 2014 in the second quarter of 2024 (excluding the COVID-19 period). During the first half of 2024, Indonesia was not able to grow considerably beyond a 5% rate despite having two consecutive quarters with seasonal boosters. In Q1-2024, Indonesia held Presidential and legislative elections and had a Ramadhan period, while Ied Al-Fitr, religious and school holidays occurred in the second quarter of 2024. This phenomenon might suggest a more worrying condition as there might be a risk for Indonesia to only be able to grow below 5% without seasonal factors. Indonesia's GDP grew slower from 5.11% (y.o.y) in Q1-2024 to 5.05% (y.o.y) in Q2-2024 (**Figure 1**). As GoI's spending significantly decelerated from the first quarter to the second quarter of 2024 after the effort to speed up infrastructure completion projects and enhanced spending preceding the election period, Indonesia's GDP growth declined. The dominance of government spending in the growth figure might verify the lethargic productivity of economic sectors in Indonesia.

"In Q2-2024, 11 out of 17 economic sectors experienced a growth decline relative to the previous quarter."

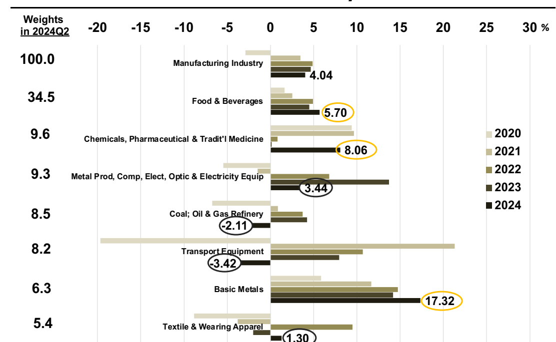
The occurrence of secular stagnation in Indonesia is rather conspicuous in terms of sectoral performance. In Q2-2024, 11 of 17 economic sectors experienced a decline in growth relative to the previous quarter (**Figure 2**). Furthermore, most of the sectors that had a growth increase in Q2-2024 were driven by seasonal factors. Various religious and public holidays increased domestic activity, which contributed to higher growth of several sectors, such as wholesale and retail trade, transportation and storage, accommodation and food and beverages activity, and electricity. Moreover, the shifting of the harvest period also brought back the growth of the agriculture sector into positive territory after it grew negatively in Q1-2024. On the other hand, persistent weakening and below-national growth of manufacturing sector continued to substantiate the existence of premature industrialization in Indonesia. Also, the growth slowdown of construction, water supply and waste management, business services, real estate, and social work activity could be driven by a significant growth decline in government spending and further implies the private sector's poor capability to spur economic growth.

Figure 1: Growth of GDP and the Main Industries, 2020-2024Q2



Source: CEIC

Figure 2: Growth of Manufacturing Sector and Its Subsectors, 2020-2024Q2



Source: CEIC

"In the second quarter of 2024, the production capacity utilization of manufacturing sector was only recorded 71.15%, reaching its lowest in the past 1.5 years."

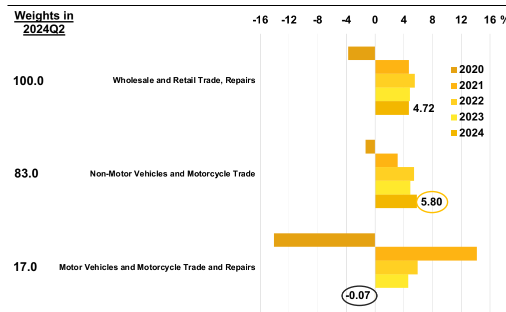
Growth of manufacturing sector decelerated considerably from 4.13% (y.o.y) in Q1-2024 to 3.95% (y.o.y) in Q2-2024 (**Figure 2**). While being the biggest sector in the Indonesia's economy, manufacturing sector's contribution to the overall GDP kept shrinking as it has been consistently grew below national GDP growth rate. In the second quarter of 2024, the production capacity utilization of manufacturing sector was only recorded 71.15%, reaching its lowest in the past 1.5 years. Mimicking the overal sectoral trends, most of the subsectors (10 out of 16) within manufacturing industry experienced a growth slowdown from Q1-2024 to Q2-2024. As the largest subsector, contributing over one-third of total manufacturing activity, the growth of food and beverages subsector slowed to 5.53% (y.o.y) in Q2-2024 from 5.87% (y.o.y) in the previous quarter. This decrease occurred despite strong domestic consumption driven by various public holidays.

The coal, oil and gas refinery subsector saw its third consecutive quarter of contraction, worsening from -1.41% (y.o.y) in Q1-2024 to -2.82% (y.o.y) in Q2-2024, primarily influenced by falling global prices. While its export quantity increased by 7.64% (y.o.y), the value of export actually declined by 3.76% (y.o.y) due to sharp drops in global coal and natural gas prices on an annual basis. Similarly, weak performance of the textile subsector also contributed to the deceleration of the overall manufacturing sector. In the past eight quarters, textile export value has grown negatively for six quarters. In the second quarter of 2024, textile export volume growth declined to 2.14% (y.o.y) from 7.01% (y.o.y) in the previous quarter while its value decreased from 2.44% (y.o.y) to -4.38% (y.o.y) in the same period. Low productivity of the textile subsector might be caused by the low competitiveness of domestic textile producers triggered by a set of industrial and trade policies that are not supportive of industrial growth. Consequently, production capacity utilization of the textile subsector was only 69.92% in Q2-2024, reaching its lowest level in 18 years, causing a massive wave of layoffs and factory closures throughout the year.

Other subsectors, including nonmetallic quarrying, leather products and paper subsectors, also showed growth declines between Q1-2024 to Q2-2024. Leather products and footwear subsector growth declined from 5.90% (y.o.y) to 1.93% (y.o.y). Nonmetallic quarrying decelerated from 9.98% (y.o.y) to -0.12% (y.o.y) following the drop in demand for cement products due to lower activity of construction sector while paper products subsector growth decreased from 6.13% (y.o.y) to 0.03% (y.o.y) due massive surge of imported chinese paper products, caused by lower tariff following the implementation of Regional Comprehensive Economic Partnership (RCEP). On the other hand, the growth slowdown of manufacturing sector was cushioned by a rather stellar performance of a few subsectors. Basic metal subsector growth increased from 16.57% (y.o.y) in Q1-2024 to 18.07% (y.o.y) in Q2-2024, prolonging the double-digit growth level for nine consecutive quarters. The expansion of this subsector is attributed to the rebound of various metal commodity prices, such as nickel and base metal, and increased exported nickel to China. Also, metal product and electronic subsector grew higher from 2.78% (y.o.y) to 4.11% (y.o.y) during the same period, thanks to higher export

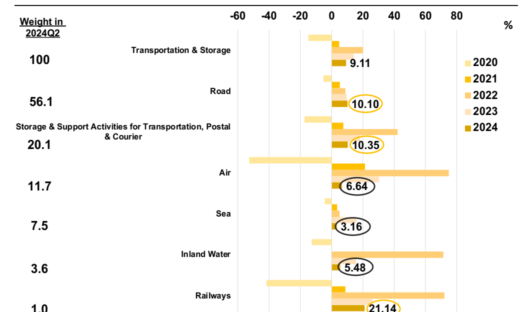
of home appliances into several new markets, such as Egypt. In Q2-2024, the export value of electronic equipment skyrocketed and recorded at 65.70% (y.o.y).

Figure 3: Growth of Wholesale and Retail Trade and Its Subsectors, 2020-2024Q2



Source: CEIC

Figure 4: Growth of Transport and Its Major Subsectors, 2020-2024Q2



Source: CEIC

Growth in the wholesale and retail trade sector growth increased from 4.59% (y.o.y) in Q1-2024 to 4.86% (y.o.y) in Q2-2024, mainly driven by the nonmotor vehicle trade subsector (**Figure 3**). This subsector, which commands an 83% share within the sector, saw growth rise from 5.67% (y.o.y) in Q1-2024 to 5.92% (y.o.y) in Q2-2024, supported by seasonal factors like Eid al-Fitr, Eid al-Adha and school holidays that boosted consumer spending. In contrast, the motor vehicle trade subsector continued to struggle, following a downward trend that began in Q2-2023. It recorded its first negative growth of 0.52% (y.o.y) in Q4-2023 and contracted again by 0.04% (y.o.y) in Q2-2024, showing a slight improvement from 0.11% (y.o.y) contraction in Q1-2024. The automotive industry, a major component of the motor vehicle trade subsector, shows a persistent decline in consumer and industry demand for vehicles. In Q2-2024, the growth of wholesale and retail car sales prolonged its negative trend for the fifth consecutive quarter. Wholesale car sales grew by -23.83% (y.o.y) in Q2-2024, moderating from -12.98% (y.o.y) in the previous quarter. The declining wholesale car sales reflected the pattern of weakening industrial demand for expansion. Similarly, retail car sales also grew negatively, though with a smaller magnitude, from -14.89% (y.o.y) in Q1-2024 to -12.84% (y.o.y) in Q2-2024, suggesting that the overall purchasing power has not yet recovered.

"The automotive industry, a major component of the motor vehicle trade subsector, shows a persistent decline in consumer and industry demand for vehicles."

The transportation and storage sector rebounded in Q2-2024, with growth rising from 8.66% (y.o.y) in Q1-2024 to 9.56% (y.o.y) (**Figure 4**). This marks the first period of growth acceleration after six quarters of gradual normalization. Following a post-COVID-19 low-base effect and pent-up demand, the sector peaked at 25.8% (y.o.y) in Q3-2022 before steadily moderating to an 8.66% (y.o.y) growth rate in Q1-2024. The current growth uptick was broad-based across subsectors, except for the sea and inland water transport subsector, which makes up 11.1% of the sector. Storage and support activities recorded substantial improvement, climbing from 9.32% (y.o.y) in Q1-2024 to 11.37% (y.o.y) in Q2-2024, driven by increased goods transport that reflects ongoing progress in wholesale and retail trade. The road transport

subsector also benefited from heightened economic activity around leisure events tied to religious holidays and school breaks, with growth rising to 10.27% (y.o.y) in Q2-2024 from 9.93% (y.o.y) in Q1-2024. Additionally, air and rail transport subsectors gained from increased long-distance travel associated with these seasonal factors. Air transport growth rose significantly from 4.91% (y.o.y) in Q1-2024 to 8.38% (y.o.y) in Q2-2024, while rail transport growth accelerated from 18.16% (y.o.y) to 24.11% (y.o.y) over the same period. Looking ahead, sectoral growth is expected to stabilize, given fewer holidays and long weekends for the remainder of 2024.

Indonesia's economy entered Q2-2024 with mixed performance across the rest of the sectors. The agriculture sector saw a notable improvement, moving from -3.54% (y.o.y) in Q1-2024 to 3.25% (y.o.y) in Q2-2024, driven by a shift in crop production. Previously impacted by El Niño, which delayed the typical March harvest until April, this recovery helped shift yields to Q2-2024. On the other hand, the ICT sector declined from 8.41% (y.o.y) in Q1-2024 to 7.66% (y.o.y) in Q2-2024, as post-election media activities slowed down. The construction sector also experienced a slight dip, decreasing from 7.59% (y.o.y) in Q1-2024 to 7.29% (y.o.y) in Q2-2024, reflecting the normalization of infrastructure spending after efforts to complete projects by Joko Widodo's administration in previous quarters. In contrast, the financial sector performed strongly, with its growth rising from 3.91% (y.o.y) to 7.90% (y.o.y), driven by the uptick in credit growth and investment realization. The rise in credit and investment realization growth was driven by higher business optimism, as shown by the Business Tendency Index (BTI), which grew from 14.11 in Q1-2024 to 17.2 points in Q2-2024. The rise in business optimism might be due to subsiding political uncertainty as the General Election results has been concluded. Meanwhile, the public administration sector saw a sharp drop, falling from 18.88% (y.o.y) in Q1-2024 to 2.79% (y.o.y) in Q2-2024. This slowdown reflects the winding down of multiple fiscal boosts, including election-related expenditures, infrastructure spending, social assistance programs, and disbursements of holiday allowance or the 13th-month salary for Eid al-Fitr.

"For the remainder of 2024, economic growth hinges on the new GoI's capability to deliver 'quick wins' while also strategically addressing structural issues to ensure medium- and long-term growth expansion."

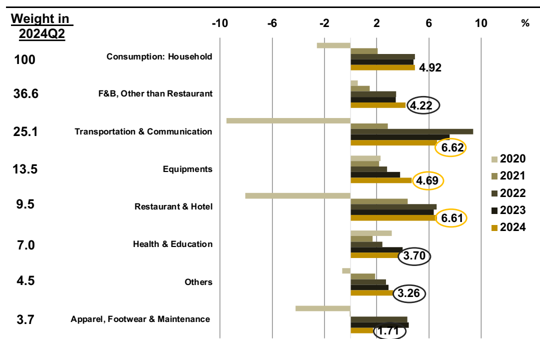
For the remainder of 2024, economic growth hinges on the new GoI's capability to deliver 'quick wins' while also strategically addressing structural issues to ensure medium- and long-term growth expansion. However, uncertainties persist, particularly regarding the pace and effectiveness of this transition, as well as external factors like geopolitical tensions and shifts in the global monetary landscape. With the new administration inaugurated in October, the focus will likely shift to ensuring continuity and stability, supporting a seamless economic transition through the final months of the year. While there is potential for steady economic growth, ensuring sustained and balanced growth will require addressing productivity challenges and delivering on key reforms.

Seasonal Influences on Household Consumption

"Religious celebrations combined with joint national holidays and the school break period contributed to the rise in household expenditures, particularly in the transportation & communication and restaurant & hotel subcomponents..."

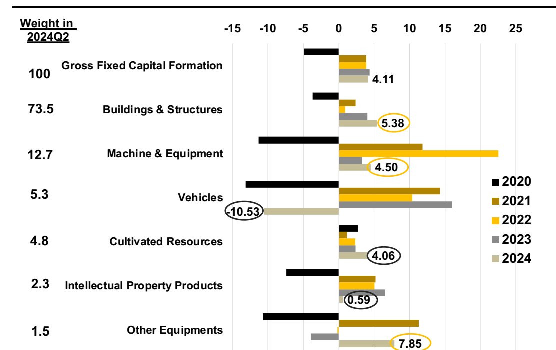
On the expenditure side, household consumption continues to be the primary driver of economic growth in Indonesia. Accounting for 53% of total economic activity, household consumption grew by 4.93% (y.o.y) in Q2-2024, a slight increase from 4.91% (y.o.y) in the previous quarter (**Figure 5**). Religious celebrations such as Eid Al-Fitr and Eid Al-Adha, combined with joint national holidays and the school break period, contributed to the rise in household expenditures, particularly in the transportation & communication and restaurant & hotel subcomponents due to increased travel and leisure activities. The transportation & communication component, which represents a quarter of total household consumption, saw growth increase from 6.41% (y.o.y) in Q1-2024 to 6.84% (y.o.y) in Q2-2024. Similarly, the restaurant & hotel component also experienced growth, rising from 6.43% (y.o.y) to 6.80% (y.o.y) over the same period. Seasonal effects were also evident in the health & education component, which anticipates increased spending with the onset of the academic year. The growth of health & education expenditures slightly increased from 3.69% (y.o.y) to 3.71% (y.o.y) from Q1-2024 to Q2-2024. Conversely, growth in household expenditure on durable goods has decelerated. This is illustrated by the spending trends in household equipment and apparel, footwear, and maintenance subcomponents. Expenditure growth on household equipment declined from 4.98% (y.o.y) to 4.40% (y.o.y) between Q1-2024 and Q2-2024, while apparel, footwear, and maintenance expenditures decreased slightly from 1.73% (y.o.y) to 1.68% (y.o.y) during the same period. This trend may indicate a weakening of general household purchasing power.

Figure 5: Growth of Household Consumption and its Components, 2020-2024Q2



Source: CEIC

Figure 6: Growth rate of Investment and Its Main Components, 2020-2024Q2



Source: CEIC

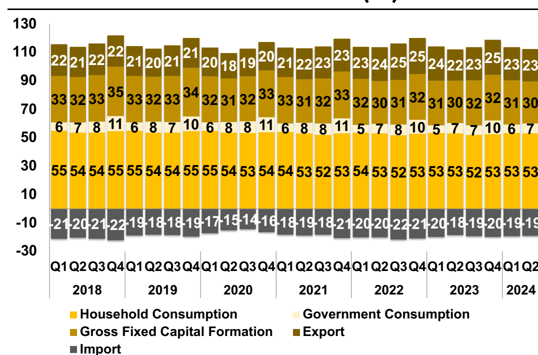
Gross fixed capital formation (GFCF) accelerated in Q2-2024, achieving a growth rate of 4.43% (y.o.y), up from 3.79% (y.o.y) in Q1-2024 (**Figure 6**). However, the growth rates among GFCF components varied significantly. Building and structures, the largest component of GFCF with a share of 73.5%, saw a normalization in growth, declining from 5.46% (y.o.y) in Q1-2024 to 5.31% (y.o.y) in Q2-2024, following a period during which the government expedited the completion of various infrastructure projects. Conversely, the growth of machinery and equipment capital

formation surged to 6.08% (y.o.y) in Q2-2024, a marked increase from 2.93% (y.o.y) in the previous quarter. This notable growth in this subcomponent aligns with an uptick in direct investment, indicating a revival of business and investor confidence as uncertainties eased following the conclusion of the General Election results. Additionally, vehicle capital formation recorded its second consecutive quarterly contraction, posting a growth rate of -7.73% (y.o.y) in Q2-2024, though this was an improvement from -13.33% (y.o.y) in the prior quarter. This trend highlights ongoing challenges within the automotive sector.

"As the real side of the economy exhibits signs of varied growth, credit performance has continued its upward trajectory, expanding by 12.53% (y.o.y) in Q2-2024, up from 11.84% (y.o.y) in Q1-2024."

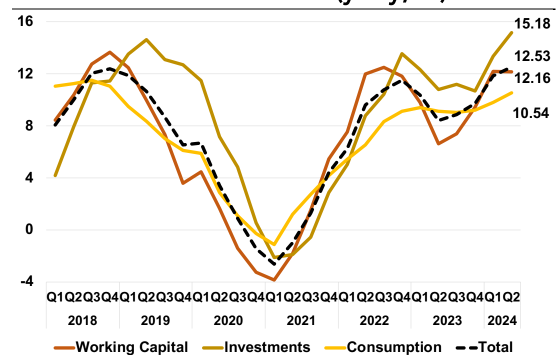
As the real side of the economy exhibits signs of varied growth, credit performance has continued its upward trajectory, expanding by 12.53% (y.o.y) in Q2-2024, up from 11.84% (y.o.y) in Q1-2024. This sustained acceleration in credit growth has been evident since Q2-2023, when it was recorded at 8.40% (y.o.y). Notably, credit expansion in the second quarter of 2024 surpassed the central bank's target. The increase in credit growth is partly attributed to Bank Indonesia's implementation of the Macroprudential Liquidity Incentive Policy (*Kebijakan Insentif Likuiditas Makroprudensial*/KLM), designed to stimulate credit growth in support of national economic expansion. The KLM achieves this by reducing banks' reserve requirements at Bank Indonesia, thereby enhancing their capacity to extend credit, particularly in key sectors such as mineral and coal processing, housing, and environmentally sustainable financing. Additionally, third-party funds rose by 8.45% (y.o.y) in Q2-2024, reflecting a strengthening liquidity position within the banking sector. On the demand side, credit growth has been driven by improved investment performance, with expectations for continued improvement as policy uncertainties diminish following the elections.

Figure 7: Shares of GDP Components, 2018Q1-2024Q2 (%)



Source: CEIC

Figure 8: Credit Growth by Purposes, 2018Q1-2024Q2 (y.o.y, %)



Source: CEIC

By purpose, investment credit recorded the highest growth rate in Q2-2024, increasing by 15.18% (y.o.y) (**Figure 8**). This continued the trend of double-digit growth for investment credit, which started at 12.20% (y.o.y) at the beginning of 2024 and represents one of the most significant annual growth figures since the onset of COVID-19. This trend aligns with machinery and equipment capital formation performance in Q2-2024. Working capital credit followed a similar trajectory, rising by 12.16% (y.o.y) in the second quarter, although this reflects a

slight decline from 12.20% (y.o.y) in Q1-2024. Additionally, consumption credit increased to 10.54% (y.o.y), marking its highest growth rate since the COVID-19 pandemic and exceeding the previous quarter's growth of 9.80% (y.o.y). This positive momentum corresponds with the Consumer Confidence Index (CCI), which rose from an average of 123.99 in Q1-2024 to 125.49 in Q2-2024.

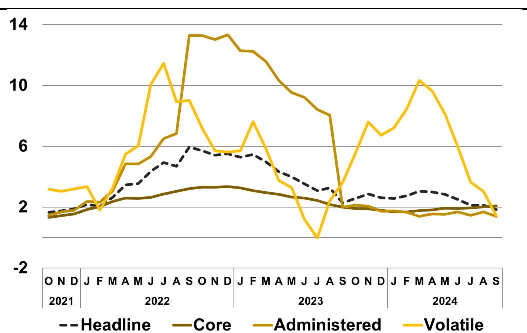
Inflation Falls to A New Low

Headline inflation in September 2024 fell to 1.84% (y.o.y), down from 2.12% (y.o.y) in previous month (**Figure 9**). This marks the fifth consecutive month of declining inflation and the lowest level since pandemic period in December 2021. The drop in inflation was primarily supply-driven, with a sharp decrease in volatile food prices, which fell by 1.61 percentage points, from 3.04% (y.o.y) in August 2024 to 1.43% (y.o.y) in September 2024. The decline in food prices was started in March 2024, aided by the harvest season for horticultural crops and government initiatives, such as improving food distribution, developing food kiosks, and fostering interregional cooperation.

"Headline inflation has recorded deflation for five straight months on a monthly basis, marking the first occurrence of such a trend since the 1998 economic crisis."

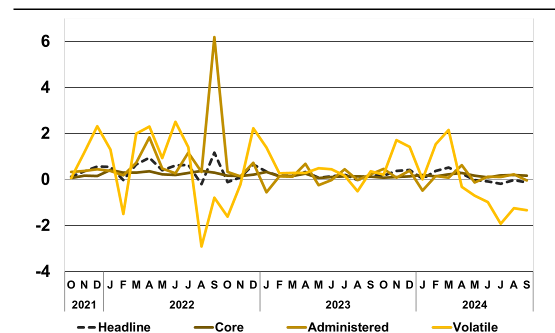
Across all components, administered and volatile prices saw a decline compared to the previous month. Administered price recorded a 1.40% (y.o.y) inflation rate, down from 1.68% (y.o.y) in August 2024, while volatile price saw a steeper drop to 1.43% (y.o.y) from 3.04% (y.o.y) in August 2024. The decrease in volatile prices was largely driven by increased crop supplies in harvest season, such as chilies, and falling prices for broiler chicken and eggs, which started dropping in July 2024 due to lower input costs and continued fluctuating in September. However, the annual core inflation encountered a slight increase to 2.09% (y.o.y) in September 2024 from 2.02% (y.o.y) in August 2024. In terms of expenditure categories, the rise was mainly attributed to personal care and other services, which posted a 6.25% (y.o.y) inflation rate, contributing 0.39 percentage points to headline inflation. The rise of global gold prices has likely influenced the inflation rate of personal care and other services categories, which has been increasing since the start of the year.

Figure 9: Inflation Rate (%, y.o.y)



Source: CEIC

Figure 10: Inflation Rate (%, m.t.m)



Source: CEIC

"While supply-side factors were the primary drivers of the slowdown, the role of weaker demand should not be disregarded."

Headline inflation has recorded deflation for five straight months on a monthly basis, marking the first occurrence of such a trend since the 1998 economic crisis. In September 2024, the deflation deepened to 0.12% (m.t.m) from 0.03% (m.t.m) in the previous month (**Figure 10**). The deflation is evident in administered and volatile prices, whilst core inflation decelerated. Core inflation, at 0.16% (m.t.m) in September, eased slightly from 0.20% (m.t.m) the previous month. Notably, core inflation has dropped three times in the past six months, raising concerns about reduced demand pressures and weakening consumer purchasing power, which have contributed to the continuation of monthly deflation. While supply-side factors were the primary drivers of the slowdown, the role of weaker demand should not be disregarded. The key contributors to September's core inflation included rising ground coffee prices due to strong demand and logistical challenges, higher education costs with the start of the new academic year, and surging gold prices. Global gold prices continued to rise in September as it was viewed as a safe-haven asset amid the U.S. Federal Reserve's interest rate cut. Administered price inflation, which was 0.23% (m.t.m) in August, saw a sharp drop, turning into deflation at 0.04% (m.t.m) in September. This was mainly driven by a decline in gasoline prices following adjustments in nonsubsidized fuel. Meanwhile, the volatile price component recorded its sixth deflation of the year, slightly deeper at 1.34% (m.t.m) in September compared to 1.24% (m.t.m) in August. The price drops in red chilies, bird's eye chilies, and broiler eggs contributed to this, resulted from increased supply during the harvest season and lower input costs for chicken broilers.

Looking ahead, inflation is expected to fluctuate moderately due to inflationary pressures driven by the weakening Rupiah, which began in early October. However, Bank Indonesia remains confident that inflation will stay within the target range of 1.5% to 3.5%. Despite this, consumer optimism has slightly declined, as reflected by the Consumer Confidence Index, which dipped to 123.5 in September from 124.4 in August. Bank Indonesia should be cautious of potential weakening demand. Although a rate cut was implemented last month, the focus should remain on stimulating aggregate demand if the current trend persists. These developments underscore the complex nature of inflationary pressures, requiring close monitoring and appropriate policy actions.

Foreign Direct Investment Rises with Strong Momentum in Green Sectors

In the third quarter of 2024, total investment realization reached IDR 431.48 trillion, accounting for 26.2% of the 2024 investment target of IDR1,650 trillion (**Figure 11**). This represents a growth of 15.3% (y.o.y), a deceleration from the 22.5% (y.o.y) growth observed in the previous quarter. Foreign Direct Investment (FDI) led the investment realization with a total of IDR232.7 trillion, contributing 53.9% to the overall investment figure. Meanwhile, Domestic Direct Investment (DDI) totaled IDR198.8 trillion, making up 46.1% of total investment realization. The trends in FDI and DDI diverged significantly during this period. FDI grew by 18.6% (y.o.y) in Q3-2024, an acceleration from 16.65% (y.o.y) in the previous quarter, continuing its

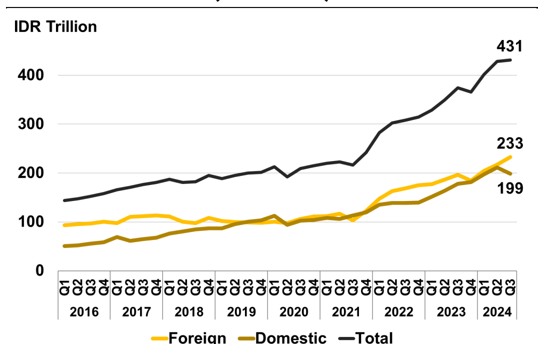
upward trend since Q4-2023, indicating a stable appetite among foreign investors. In contrast, DDI exhibited a downturn, with growth slowing to 11.6% (y.o.y) in Q3-2024, a significant decline from 29.1% (y.o.y) in the prior quarter. This marks the third consecutive quarter of reduced growth, primarily due to a slowdown in primary sector investments, particularly in forestry and mining, which peaked in Q1-2024. Cumulatively, from January to September 2024, investment realization reached IDR1,261 trillion, fulfilling 76.5% of the investment target for the year. This figure represents an increase of 19.8% (y.o.y) compared to the same period last year.

The transport, storage, and communication subsector led investment realization, totaling IDR58 trillion and accounting for 13.5% of total direct investment in Q3-2024. This subsector exhibited notable growth, with a 4-percentage-point increase in its contribution compared to the previous quarter. The basic metal industry, along with metal goods, nonmachinery, and related equipment, shifted to the second-largest investment subsector, attracting IDR55.9 trillion and representing 13% of total investment in Q3-2024. However, its share decreased by 4.7 percentage points compared to Q2-2024. Additionally, investment realization in the mining subsector reached IDR44.6 trillion, contributing 10.3% to the total investment in Q3-2024. These three subsectors have consistently dominated investment realization, reflecting significant activity in both domestic and foreign investment

"Significant projects boosting this quarter's FDI figures included new electric vehicle (EV) battery production…. This influx of direct investment aligns with Indonesia's initiatives to attract funding in sustainable sectors, or 'green investment'… "

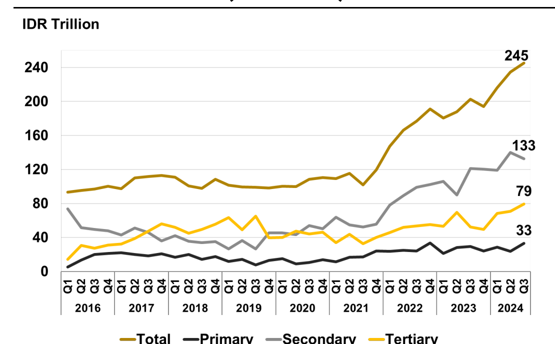
While investment realization in Q3-2024 remained concentrated in Java, the overall proportion was slightly lower than the total direct investment outside the island. Total investment realization in Java reached IDR212.7 trillion, accounting for 49.3% of the total investment, while IDR218.8 trillion came from outside Java, making up 50.7% of the total. Yearly growth in Java's investment realization was marginally higher than that outside the island, with Java growing at 15.9% (y.o.y) compared to 14.61% (y.o.y) for regions outside Java. Central Sulawesi, driven by downstream activities, remained the only province outside Java among the top five regions for investment realization, joining Jakarta, West Java, East Java, and Banten with total investments of IDR38.8 trillion, contributing 9% to national direct investment.

Figure 11: FDI and DDI (Nominal)



Source: CEIC

Figure 12: FDI Realization by Sectors (Nominal)



Source: CEIC

Analyzing FDI by country, Asia continued to be the primary source of foreign investment in the third quarter of 2024. Singapore led with an investment of USD5.5 billion, followed by Hong Kong with USD2.2 billion and China with USD1.9 billion. Significant projects boosting this quarter's FDI figures included new electric vehicle (EV) battery production facilities from South Korean and Chinese companies. This influx of direct investment aligns with Indonesia's initiatives to attract funding in sustainable sectors, or "green investment," essential for long-term economic resilience. However, the concentration of investments from Asian countries underscores the importance of diversifying Indonesia's FDI sources to mitigate potential regional economic downturns.

Oil Price Fluctuations Influence Trade Surplus and Capital Flow Shifts

In Q3-2024, Indonesia recorded its 19th consecutive quarterly trade surplus, amounting to USD6.66 billion, a 14.81% (y.o.y) decline from the same period last year, and a 17.19% (q.o.q) drop from Q2-2024 (**Figure 15**). While both exports and imports grew in Q3, imports increased faster than exports, reducing the trade surplus. Exports in Q3-2024 reached USD67.88 billion, up by 6.72% (y.o.y) and 8.12% (q.o.q). This growth was supported by the easing of copper concentrate export restrictions for several mining companies and rising palm oil prices in August and September 2024. Imports amounted to USD64.09 billion, increasing by 7.43% (y.o.y) and 9.02% (q.o.q). Rupiah's depreciation to around IDR 16,300 per USD by the end of July 2024 made imported goods more expensive in local currency, driving up dollar-denominated import values.

"Higher global palm oil prices boosted exports during August and September, while demand recovery from China and the US spurred machinery and electronics exports."

The rise in exports was mainly driven by nonoil and gas sectors, which totalled USD64.08 billion in Q3-2024, an increase of 7.43% (y.o.y) and 9.02% (q.o.q). Key contributors included vegetable and animal fats, machinery, electronics, and textiles (**Figure 13**). Higher global palm oil prices boosted exports during August and September, while demand recovery from China and the US spurred machinery and electronics exports. On the other hand, oil and gas exports declined by 3.91% (y.o.y) and 5.10% (q.o.q) in Q3-2024, reaching USD3.80 billion. The drop in oil and gas exports was largely driven by falling global oil prices. In Q3-2024, the average Brent spot price fell by 7.67% (y.o.y) or 5.52% (q.o.q), while the WTI spot price dropped by 7.08% (y.o.y) or 6.57% (q.o.q).

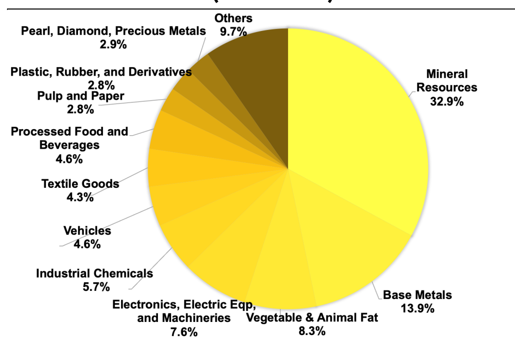
Imports followed a similar pattern. Nonoil and gas imports totalled USD52.49 billion in Q3-2024, up 12.48% (y.o.y) or 14.76% (q.o.q). The increase in nonoil and gas imports was driven by nearly all categories, with the exception of plant-based products, which showed negative growth both quarterly and annually (**Figure 14**). Additionally, plastics, rubber and derivatives, live animals and animal products, as well as works of art and antiques, recorded negative annual growth. Meanwhile, oil and gas imports decreased by 4.25% (y.o.y) and 2.98% (q.o.q) to USD8.74 billion, largely due to declining global energy prices.

"… higher energy prices might offer a silver lining by boosting Indonesia's export revenues from commodities …, which could partially offset the rising costs of oil imports."

Looking ahead, OPEC's decision to further cut oil production is likely to push global oil prices higher. For Indonesia, as a net oil importer, this could lead to an increased import bill, potentially narrowing the trade surplus. However, higher energy prices might offer a silver lining by boosting Indonesia's export revenues from commodities like coal and palm oil, which could partially offset the rising costs of oil imports. On the other hand, global economic headwinds, particularly weakening demand from key trading partners such as China, the EU, and the US, pose a challenge. Slowing growth in these economies could reduce Indonesia's exports, especially in commodities and manufactured goods, directly impacting export volumes and adding further strain to the trade balance. The impact of this weakening demand is already evident in Indonesia's manufacturing sector. In September 2024, the Purchasing Managers' Index (PMI) remained in the contraction zone at 49.2, though it slightly improved from 48.9 in August. This marked the third consecutive month of declining factory activity, driven by falling output and new orders. Notably, foreign orders contracted at their fastest pace since November 2022, reflecting weaker external demand. In response, Indonesian firms have cut back on purchasing activities, opting to rely on existing inventories to manage the slowdown.

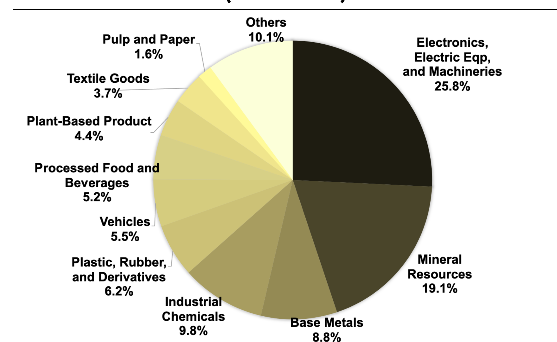
In the second quarter of 2024, current account recorded a low deficit of USD3.0 billion (0.9% of GDP), slightly higher than the USD 2.4 billion deficit (0.7% of GDP) in the previous quarter. This was supported by an increase in the goods trade surplus, with a narrower oil and gas trade deficit and stable nonoil and gas trade. Nonoil and gas exports grew, buoyed by rising commodity prices and stronger demand from key trading partners, while nonoil and gas imports remained stable due to resilient domestic economic activity. However, the services deficit widened, mainly due to higher travel expenses during the 2024 Hajj pilgrimage. The primary income balance also saw a larger deficit, driven by higher dividend and interest payments.

Figure 13: Indonesia Exports Profile (Q3-2024)



Source: CEIC

Figure 14: Indonesia Imports Profile (Q3-2024)



Source: CEIC

Although the Fed decided to cut interest rates in September 2024, prior to that, the global financial market was heavily influenced by the Fed's signals regarding potential rate reductions. Markets expected rate easing near the end of 2024, especially after June's lower-than-expected inflation data. In the July FOMC meeting, the Fed kept rates unchanged but hinted at a future cut. Before the

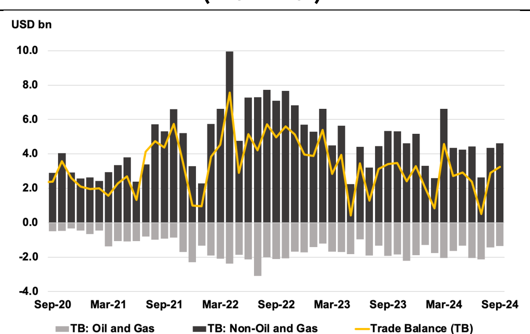
meeting, uncertainty and capital outflows from emerging markets like Indonesia led to Rupiah depreciation, reaching IDR 16,295 per USD by July's end. After the meeting, sentiment shifted, reversing capital flows. From August 1 to 30, 2024, Indonesia saw an inflow of USD 4.32 billion into its bond and stock markets, signaling renewed confidence.

In September 2024, the Fed made a significant policy shift by cutting interest rates by a larger-than-expected half a percentage point, bringing the federal funds rate down to a range of 4.75% to 5.00%. This marked the first easing of monetary policy in four and a half years, aimed at supporting economic growth amid signs of a slowing US. labor market. In August 2024, the US inflation decreased to 2.5% (y.o.y), down from 2.9% (y.o.y) in July, continuing a five-month trend of disinflation. Concurrently, the unemployment rate improved slightly to 4.2% in August, with job growth increasing from 89,000 in July to 142,000 in August. Domestically, Bank Indonesia also cut its interest rate to 6.00% during its September Board of Governors meeting, aligning with expectations of low inflation for 2024 and 2025, which remains within the target range of 2.5±1%. This decision was made to support ongoing economic growth and ensure the stability of the appreciating Rupiah. Bank Indonesia suggested that further rate cuts could be feasible depending on inflation trends and the strength of the Rupiah. Following these rate adjustments, Indonesia experienced a notable inflow of capital, totaling USD7.73 billion in September 2024, with USD 3.82 billion directed to the bond market and USD3.91 billion to stock market, continuing the positive trend established in August (**Figure 16**).

"Following these rate adjustments, Indonesia experienced a notable inflow of capital, totaling USD7.73 billion in September 2024, ..., continuing the positive trend established in August."

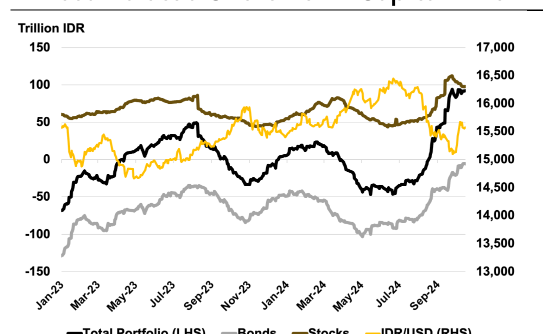
Fueled by the trend of capital inflows in Q3-2024, Rupiah appreciated by 1.69% (y.t.d) by the end of September 2024. Consequently, Indonesia's foreign exchange reserves rose to USD149.9 billion. These reserves are sufficient to cover 6.6 months of imports or 6.4 months of imports and foreign debt payments, exceeding the international adequacy standard of three months. In August 2024, Indonesia's foreign exchange reserves reached an all-time high of USD150.2 billion. This robust reserve level supports the resilience of the external sector and helps maintain macroeconomic and financial system stability.

Figure 15: Monthly Trade Balance (Nominal)



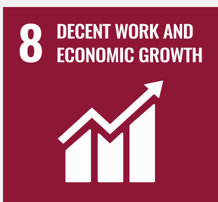
Source: CEIC

Figure 16: Exchange Rate and Accumulated Short-Term Capital Inflow



Source: CEIC

"… Bank Indonesia retains the flexibility for further rate cuts, if necessary, to stimulate demand, thus preventing inflation from declining further …."



As of October 2024, following increased global uncertainty due to escalating geopolitical tensions in the Middle East, capital has been flowing out of emerging markets, including Indonesia. Consequently, the Rupiah depreciated by 2.91% between September 30 and October 15, 2024, reaching IDR 15,575 per US dollar. This depreciation highlights the sensitivity of the Rupiah to global market dynamics and investor sentiment. In this challenging environment, the US dollar has gained strength against various currencies, further impacting the Rupiah. Market expectations regarding Federal Reserve monetary policy will continue to play a crucial role in shaping the currency's trajectory. The uncertainty surrounding potential rate adjustments by the Fed remains a risk factor for the Rupiah in the upcoming months. On the domestic front, inflation remains well-controlled, aligning with the targets set by Bank Indonesia, aided by stable food prices. Given the current economic conditions and manageable inflation, Bank Indonesia retains the flexibility for further rate cuts, if necessary, to stimulate demand, thus preventing inflation from declining further and stabilizing the currency amidst external pressures.