

Indonesia: East Java Growth Diagnostic - Identifying the Binding Constraints to Growth in Indonesia's Second Largest Growth Pole

1. Objective(s) of the proposed work

The main objective of this study is to understand the determinants and constraints to growth in the East Java/ Surabaya region, one of the most dynamic and economically important regions in Indonesia, containing as it does the country's second largest city. This growth diagnostic proposal will therefore focus on the constraints to sustainable and inclusive growth by taking into account the constraints on the ability of the poor and other vulnerable groups to contribute and benefit from growth. The study will include a series of policy recommendations to improve the growth performance in this region.

Context

East Java is one of the wealthiest provinces in Indonesia, with a GDP per capita of Rp 14.5 million. It is occupied by 16 percent of Indonesia population and is highly urbanized. The economy grew on average 5.1 percent between 2001 and 2007, similar to the national average. East Java contributes to around 15 percent of Indonesia's economy, second only to the contribution of Jakarta, the country's capital. A large share of its economy is based on manufacturing and services sectors representing 57 percent of the economy.

East Java scores relatively well in terms of availability of labor and quality and supply of physical infrastructure.¹ It had one of the lowest regional minimum wages in the country in 2007 (Rp 448,500 vs. Rp 673,300 national average) and relatively high education levels. Selected key indicators suggest that East Java has relatively better infrastructure than the national level. Nearly all households have access to electricity (97 percent) in East Java compared with national level of 76 percent. East Java also has a higher percentage of roads in good condition (33 percent) than the national level, at 22 percent.

The trends in poverty rates and unemployment levels in East Java suggest that economic growth in the past five years has not been pro-poor and pro-job. Although economic growth increased from 3.8 percent to 6.1 percent between 2002 and 2007, the poverty rate only declined by 2 percent. In 2007, East Java's poverty rate of 20 percent was still above the national average of 17 percent. East Java experienced a rapid increase in unemployment during the Asian economic crisis and did not recover as quickly as Jakarta. The unemployment rate reached 7.4 percent in 2007 compared to only 3.3 percent pre-1997.

Despite being the second largest region in the country in term of population and size of the economy, and its relatively strong standing in terms of infrastructure and human capital, the region is failing to become a regional hub of growth and development. This is similarly the case with other regions with high population density (Medan, Makassar). Economic growth has been relatively stable in the past four years within the range of 5.8 to 6.1 percent. Investment levels are low in East Java, representing only 16 percent of GRDP compared with 25 percent for Indonesia as a whole. A large share of investment in Indonesia is highly concentrated in Jakarta and the surrounding areas (67 percent), while East Java represents only 3 percent. Figure 1 (annex) shows the concentration of economic activity in Indonesia, with a clear and dominant peak in Jakarta and West Java.

Within this context, the study attempts to understand better what is constraining higher growth and investment in East Java and through this provide support to the provincial government. The findings could be useful not only for East Java, but also for other regions in Indonesia that are not performing their role as regional growth poles.

¹ KPOD, The Asia Foundation, and USAID (2008). "Local Economic Governance in Indonesia: A Survey of Businesses in 243 Regencies/Cities in Indonesia". Jakarta.

2. Technical and innovative aspects of the proposed work

The study will follow the growth diagnostic methodology developed by Hausmann, Rodrik, and Velasco (2005). Growth diagnostics provide a framework for identifying, among the many problems that might plague an economy and prevent its growth, which one(s) is(are) the most binding and thus should be the immediate focus of economic policy. This approach acknowledges that specific country or regional contexts call for different policy actions to be adopted.

The team's approach to growth diagnostics will be concerned with inclusive and sustainable growth. This approach focuses on a kind of economic growth that is broad-based across sectors and includes the majority of the workforce, notably the poor as producers and consumers. The general framework is based on four steps, which are: (i) growth inquiry: identify the drivers and constraints of economic growth, (ii) growth hypothesis: propose a set of hypotheses about the binding constraints to growth, (iii) growth diagnostic: test the hypotheses formulated in step 2 and identify the most binding constraint, and (iv) growth policy: develop a short list of policy interventions most likely to alleviate the binding constraint.

The team has already identified data from a variety of sources to conduct this analysis which are available in the World Bank Office Jakarta database and publication and surveys conducted by National Bureau of Statistics and other external institutions. Data on regional accounts (by production sector and expenditure), geographical condition, governance, as well as infrastructure and human capital outcomes, will be collected to support the analysis. In addition, the team also intends to use data at the micro level such as household consumption data (Susenas), a labor market survey (Sakernas) as well as a village survey (Podes). Industrial, investment, finance and economics statistics from BPS, Bank Indonesia and other sources will also be utilized.

The study will be using a participatory and collaborative effort. A substantive part of the analysis will be carried out by local research institutes or local universities. This will strengthen the capacity of local institutions and encourage local ownership of the report. The World Bank Office Jakarta team will provide the necessary technical guidance, quality control, and liaison with government counterparts.

3. Relevance to country priorities

As part of the analytical support that the World Bank is providing to BAPPENAS in the preparation of the next Medium Term Development Plan (RPJM) for 2010-2014, the World Bank presented key findings of the *World Development Report 2009: Reshaping Economic Geography*. Following this discussion, the government is interested in further exploring and understanding the potential and challenges of potential growth poles in Indonesia (e.g. East Java/ Surabaya). This proposed analytical work is also aligned with East Java's Medium Term Development Plan where its top priorities are poverty reduction and job creation through inclusive economic development. Therefore, understanding the binding constraints to growth in East Java prominent urban center is essential to be able to provide appropriate policy advice to both central government and East Java province.

This growth diagnostic work is in line with the World Banks' current Country Partnership Strategy (CPS) for Indonesia FY 2009-2012. One of its core engagements is supporting *sub-national government institutions and systems*. Through close engagement with sub-national government, this diagnostic work can form a basis for developing a close partnership with selected regions which will form a foundation in "Investing in Indonesia's Institutions". A strong partnership built during the process with East Java can inform the Bank in exploring options for future direct engagements with other sub-national governments.

The World Bank has been engaging with sub-national governments through several initiatives such as lending operations and analytic works. PREM is currently undertaking Aceh Growth Diagnostics which focuses on identifying the binding constraints to growth in a post-conflict and post-disaster environment. The team will benefit from this experience and will apply appropriate methodology in a different context and challenges. The SDN unit is preparing the Local Government and Decentralization project aiming at

improving sub-national government efforts in the use and effectiveness of specific grant (DAK) through incentive mechanism and capacity building as well as a comprehensive study on regional and urban development focusing on several metropolitan cities in Indonesia. This proposed analytic work seeks to achieve significant synergies with other on-going initiatives

4. Linkages with knowledge sharing, dissemination, and capacity building

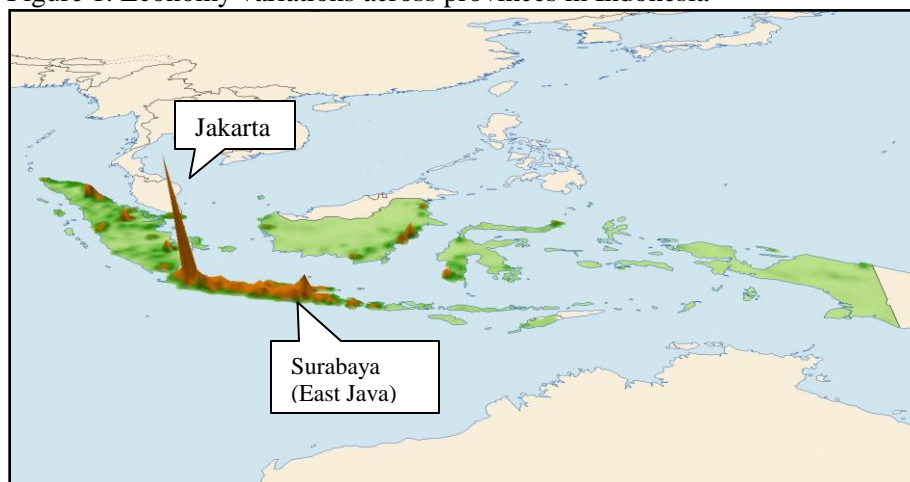
The team will work closely with the fiscal decentralization pillar of the multi-donor Decentralization Support Facility in Indonesia and will therefore be in a unique position to disseminate the findings of this study to a very wide audience including: key government officials both in central and regional government; leading NGOs and research institutions, including regional universities; other donors and their networks (through the DSF); and the private sector. Dissemination activities will include a workshop on local level growth, presentation of the technical results and the policy conclusions to selected policymakers at both national and regional levels.

5. Client and donor engagement

The Director for Regional Development of Bappenas, Regional Development Board (Bappeda) and Regional Investment Board (BKPM) of East Java will be closely involved and consulted throughout the process. The team will also explore possibility to engage with local academics from leading universities in East Java such as Airlangga University and Brawijaya University. This will result in increased capacity in local institutions and will also provide the study with the in-depth local knowledge that is key for a high-quality growth diagnostic study. Based on our close relationship with donors in the multi-donor Decentralization Support Facility (DSF) and other donors that have programs at the sub-national level (e.g., CIDA), the team will explore the possibilities of engaging interested donors.

Annex

Figure 1. Economy variations across provinces in Indonesia



Source: Central Bureau of Statistic