

POLICY BRIEF 2

The Policy Dimensions of Inequality in Indonesia

Summary

The focus of recent social welfare policy in Indonesia has been on poverty reduction. High economic growth has been assumed to be a pre-condition of poverty reduction. For this assumption to be true we have to assume that economic inequality is relatively constant over time. This was found to be true in the past because asset ownership on the one hand and the system of wage payment or bargaining changed very slowly. This is no longer true today.

There are several reasons. First, globalisation has increased the speed of asset concentration as well widened the differences between skilled and unskilled wage differentials. Second, extensive decentralisation has limited the equalising role of central government assistance. Indonesian economic performance is dominated by a few resource rich districts. Third, sources of labour intensive growth such as low technology goods or green revolution are being reduced. Fourth, the knowledge economy of the future will continue to widen skill/non-skill wage differentials.

All of the above require a rethinking of public policy towards containing inequality. At present Indonesia has no explicit policy to deal with the possibility of growing inequality. This is a major policy gap. If ignored it may lay the foundations for major social conflict, especially in Indonesia's fast growing urban population. Historical experience from all over the world suggests that the roots of social conflict lie not so much in absolute poverty but in sudden changes of economic situation of specific groups in the population. These groups could be in the form of a particular class e.g. landless labourers, middle class etc, ethnic, or religious. Sudden increases in inequality combined with distress in particular communities and social groups as a result of fast changing economic circumstances may well increase the possibility of social conflict. This will in turn reduce investment and growth making the economic situation even worse.

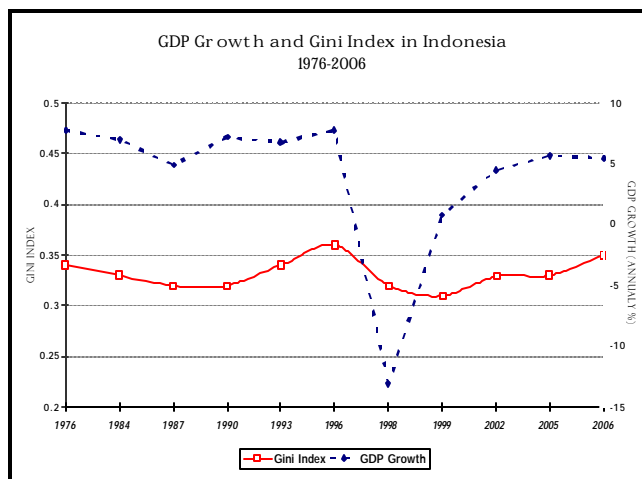
Growth, Poverty and Inequality

For much of the 1970s onwards economic development of South East countries was widely considered as nothing short of an economic miracle. This was not because these countries had accelerated their rate of growth from 2-3% to over 7-8 % per annum. Other countries especially the former USSR had also recorded high rates of growth for several decades in their history. The Asian achievement was considered a miracle because high economic growth was combined with relatively low levels of economic inequality. This was a miracle because it went against the economic theory put forwards by Nobel Laureate Kuznets who argued that in the course of development inequality would first get worse before it got better. The economic development of South East Asia was widely seen to have disproved this Kuznets "U" hypothesis. Since it was against all expectations the economic development of South East Asia was widely perceived as nothing short of an economic miracle.

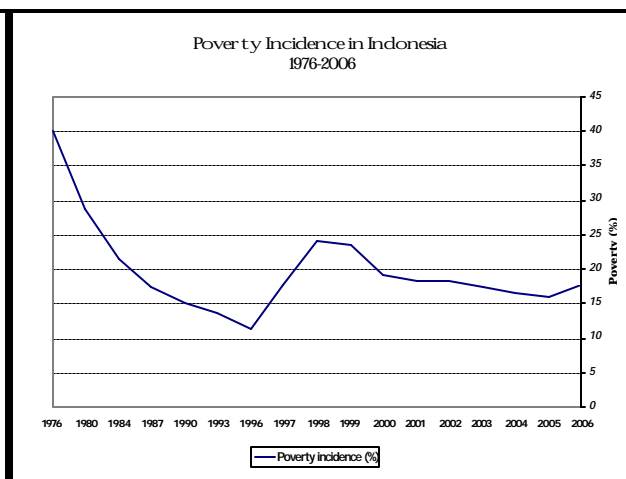
Indonesia was very much part of the miracle countries. Its level of economic inequality, measured by a summary statistical coefficient called a “gini” remained relatively low for much of the post independence period. Although there is some sign that Indonesia’s gini coefficient has begun to rise in the 1990s, it still remains much lower than many developing countries such as Brazil or more recently China. Gini coefficients for some selected countries (see appendix), illustrate Indonesia’s relative equality of income compared to many other large developing countries.

The above fact would also explain why high economic growth in Indonesia during the New Order period was accompanied by steadily falling shares of population below the national, 2100 calorie, poverty line. The logic is straight forward. If income was perfectly distributed along all households, then a 1% increase in national income would translated into a 1% increase in income of all households. As inequality worsens any increases in national income would be disproportionately weighted in favour of richer households. The result would be to lower the impact of economic growth on poverty reduction.

Graph 1



Graph 2



Source: Data constructed from International Monetary Fund, World Economic Outlook Database, April 2007 & BPS, various years.

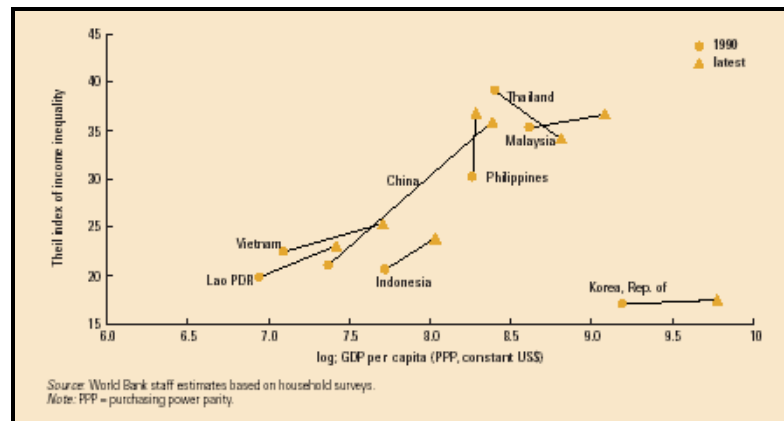
Thus, if inequality in Indonesia begins to increase the result would be to raise the rate of economic growth that is needed to reduce poverty below a certain national target. Measuring economic inequality accurately as well as forecasting how it might move in the future is central to estimating how fast an economic would have to grow to reduce absolute poverty below some pre-defined target.

Without a clear understanding of the nature of the growth process and anticipated movements in inequality, government promises to reduce poverty below some politically announced target will only lead to public frustration and disappointment. This is a particular problem in Indonesia where the practice of democratic government it itself new and is being tested in the public culture and belief.

Globalisation and the changing policy environment

Despite the above there are signs that the future will not be like the past. The advent of globalisation has changed the speed with which economic inequality can rise. This is shown not only by the experience of rich countries like the United Kingdom in the 1990s following capital market liberalisation but also in Eastern Europe and now China, Graph 3. In these countries gini coefficients have risen at historically unprecedented rates following economic liberalisation.

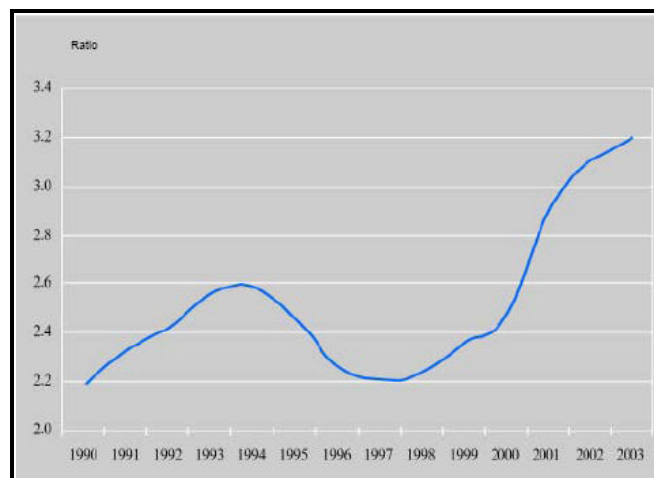
Graph 3 - Inequality Has Been Rising in Much of East Asia Since 1990



Source: World Bank East Asian Renaissance 2007

As graph 4 shows, income inequality has reached alarming proportions in China. A similar trend might well be taking place in India. It is strange that economic inequality in China is almost close to Brazil, widely perceived as a case the worst income distribution in the developing world.

Graph 4 - Changes in China's Urban-Rural Income Inequality, 1990 -2003



Source: China National Bureau of Statistics 2004

Economic inequality has now appeared sharply on the international policy agenda. This is signalled not only by sustained recent research on this subject by the IMF and the World but also by a major international conference organised by the United Nations in 2005 called the "Inequality Predicament."

The policy concern is not only due to the need to produce the maximum impact of economic growth on poverty reduction but also to reduce the dangers of social and political and economic instability. Multidisciplinary, international research on instability shows that it is not just absolute poverty that can destabilize social order and political systems but also the change of relative position of particular ethnic, religious or occupational groups during both periods of economic growth as well as economic shocks. Such political instability also prevents the construction of effective governance and credible national institutions.

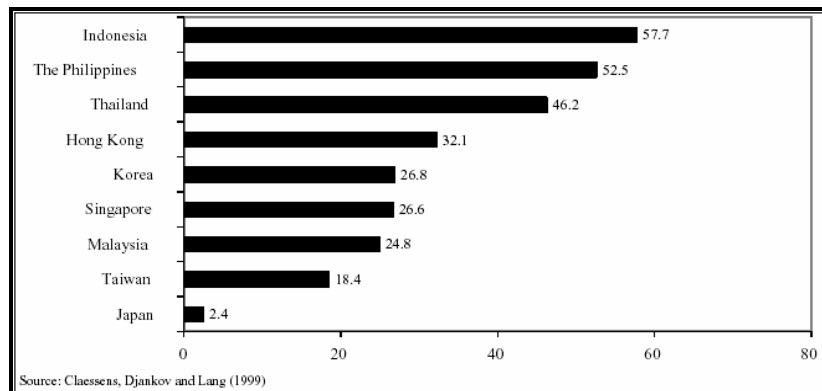
Inequality in Indonesia: need for an effective policy response

Indonesia is largely unprepared for this serious social and economic issue of the near future. There are three reasons for this. First, the measurement problems are likely to understate the actual degree of inequality. Second, it is yet to grasp that future growth is unlikely to replicate the labour intensive and low technology of the past. There is already much evidence from other countries e.g. India that in the knowledge economy growth can actually be jobless rather than job creating. Third, rapid political decentralisation in a context where the majority of districts are resource poor might actually increase rather than decrease the level of spatial inequality.

Measurement: the degree and trends in inequality

- Indonesia has massive asset concentration in the industrial sector, (graph 5). This is never factored in inequality estimates. The industrial sector, (as well as associated high income services such as banking, finance and communication), is the fastest growing segment of the economy.

Graph 5 - Market capitalization controlled by the top 10 families in selected countries, 1996



Source: Brasukra Sudjana and Satish Mishra (2004) Growth and Inequality in Indonesia Today: Implications for Future Development Policy, UNSFIR Working Paper.

- Gini coefficients are derived from SUSENAS household expenditure surveys. The consumption basket is biased in favor of lower income households. It does not capture the consumption basket of the richer population groups.
- No comprehensive estimates of inter-regional economic inequality have been carried out.
- As yet no reliable estimates of the effects of future growth on employment are available. Hence we cannot estimate the most vulnerable sectors and areas to prolonged unemployment.

Policy Response

In fact Indonesia is badly prepared to meet the emerging future challenge of growing inequality not only between the urban and rural, skilled and the unskilled, between resource rich and resource poor regions but also between one ethnic group and another. The situation needs to be corrected both rapidly and steadily. These are following recommended steps:

- Increase sharply research and evidence gathering on inequality in all its forms to close the severe information gap shown above
- Revise poverty reduction targets based on the results of such a comprehensive assessment of existing and future shifts in the degree of inequality
- Establish a set of inequality reduction or containment targets and the key policy instruments that might be used to reduced cases of acute inequality
- Give priority in the medium term to reducing inequalities in non-income dimensions of inequality such as level and quality of health care, basic education, and other key public services such as law and order etc to ensure a minimum universal threshold which can illustrate the basic constitutional equality of each citizen. A start has already been made in the first two National Human Development Reports
- Ensure that inequality figures prominently in all medium and long range planning documents along with the policy instruments which might be used to contain it.

Given the highly destabilising role of sharp changes in interpersonal, as well as inter-regional and inter-ethnic inequality, a national policy and guidelines on containing inequality is a necessary complement not only to promoting broad based growth but also of reducing the possibility of rising social conflict.

For further reading:

Sudjana, Brasukra and Mishra, Satish. 2004. *Growth and Inequality in Indonesia Today: Implications for Future Development Policy*. Jakarta. UNSFIR Discussion Paper Series No. 04/05.

Tanzi, Vito, Ke-Young Chu and Sanjeev Gupta (Eds.), 1999. *Economic Policy and Equity*. Washington D.C: IMF

United Nations. 2005a. *the Inequality in Predicament: Report on the World Social Situation*. New York: UN Publications.

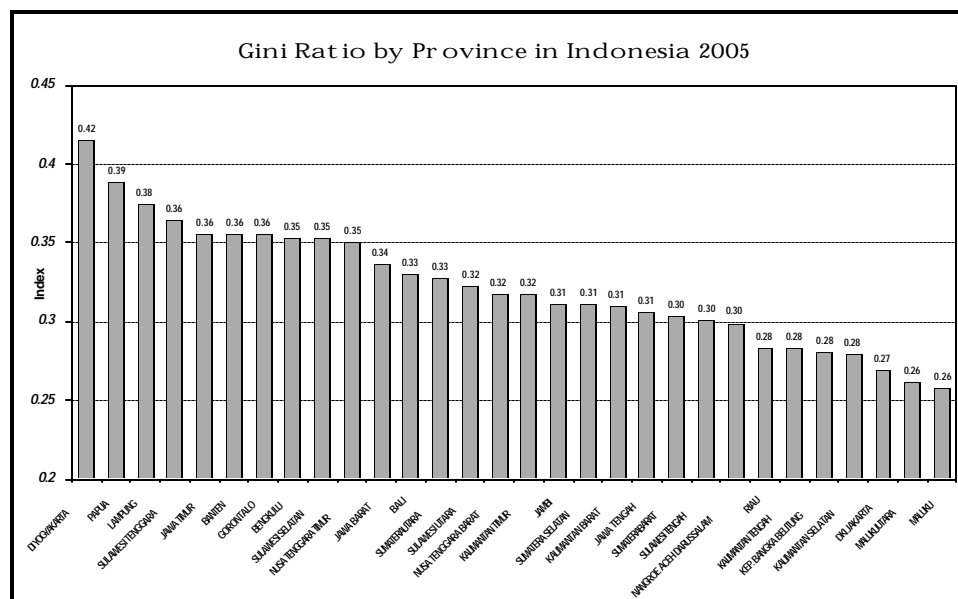
Appendix

Why has Economic Inequality been ignored so long?

Inequality is critical not just to assessing the statistical link between targeted rates of economic growth and poverty reduction. It is even more important in establishing social welfare programmes and allocations. The reasons are simple. In one way or actual or perceived inequality is central to almost all concepts of fairness and social justice. It lies at the core of any discussion of “equity” in modern economic literature.

Given its importance, it is surprising that economic equality remains a relatively ignored subject in Indonesian policy making. While inter-regional inequality has received some attention especially in the context of former INRPES infrastructure grants, inter-household and inter-personal inequality has been relatively ignored.

Inter-regional Inequality in Indonesia



Source: Data constructed from Selected Socio-economic Indicators of Indonesia, 2007

There were many good reasons for this in the past. Those reasons are less important today.

- In the period before the onset of globalisation, underlying factors affecting inequality such as distribution of assets such as land and machines, system of wage bargaining and frequency of wage payments and its adjustments, adjustments in social welfare entitlements by the state etc were seen to be relatively constant features of the economy, not subject to short term swings. For purposes of economic policy they were treated as constants rather than variables. In most economic forecasting models of the time they were taken as “given” rather than factors which could be influenced by normal economic policy.

- Income distribution changes in the short run could be made in favour of particular groups such as old age pensioners, single parent families etc through an adjustment of taxes and subsidies. The oil subsidy in Indonesia or the adjustment of food prices are some examples of such adjustment.

There were other reasons also in the context of South East Asia as well as in Indonesia why inequality remained relatively ignored by previous governments.

- Some countries as Korea and Taiwan, as well as main land China, undertook wider ranging land reforms as a way to equalise asset distribution in the country side. By reducing the inequality of the most important asset, land, in the early stages of development these countries hoped to eliminate the root causes of income inequality.
- In Indonesia, land fragmentation in Java, the absence of large urban centres which could concentrate wealth, the emergence of labour intensive technologies following the green revolution in rice and the rise of the footwear and textile industries led to the view that economic growth would be widely distributed. The result of high economic growth would be more on poverty reduction than on the worsening of inequality. Hence there was little for policy makers to worry about.
- Paradoxically, even the advent of the economic crisis to Indonesia in 1998 did not bring inequality to the front line of policy making. This was partly due to the belief that the economic crisis had affected urban large industry most and therefore might have even worked to reduce overall inequality. On the other hand, due to the crash of the rupiah and the resulting inflation in food prices, poverty was expected to have increased sharply. The greater policy problem was therefore perceived to be the containment of absolute poverty rather than the reduction of inequality. This belief was in any case reinforced by the prevailing professional assumption that in any case inequality only changes slowly over time.

Gini Index in Selected Countries, 1981-2004

Country	1981	1984	1987	1990	1993	1996	1999	2002	2004
Bangladesh	25.88	26.14	28.85	28.56	28.27	33.00	33.42	33.42	33.42
China-Rural	24.99	26.69	29.45	30.57	32.13	33.62	35.39	38.02	38.09
China-Urban	18.46	17.08	20.20	24.78	28.47	29.09	31.55	33.46	33.98
India-Rural	31.57	30.06	30.13	29.49	28.59	29.02	29.52	30.04	30.46
India-Urban	34.21	33.33	35.57	35.06	34.34	35.08	35.96	36.85	37.59
Indonesia	33.29	33.29	33.12	34.65	34.36	36.55	31.73	34.30	34.30
Sri Lanka	32.47	32.47	32.47	30.10	32.30	34.36	33.24	40.18	40.18
Russian Federation	23.8	23.8	23.8	23.8	48.34	46.15	43.59	39.9	39.9
Brazil	57.57	57.88	59.31	60.68	59.82	59.98	59.19	58.75	56.99
Peru	45.72	45.72	45.10	43.87	44.87	46.24	49.82	54.65	52.03

Source: World Bank Poverty Monitor <http://research.worldbank.org/PovcalNet/Jsp/index.jsp> & BPS, various years