

INDONESIA'S RISING DIVIDE



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A Word From *the* Country Director

Rodrigo A. Chaves
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Indonesia has undergone a remarkable transformation over the past 15 years. The national poverty rate was halved, from 24 percent in 1999 to 11.3 percent in 2014. Growth averaged at 6 percent annually for a decade up until 2015. Internationally, Indonesia also joined the G-20 as Southeast Asia's only representative.

But the quest for widely shared prosperity is not over. Indonesia is at risk of leaving its poor and vulnerable behind. Poverty reduction has begun to stagnate, with a near zero decline in 2014. Income inequality is rapidly rising and up to one third of it is explained by inequality of opportunities. Healthy and well educated children live side by side with children who suffer from malnutrition, learn little when they are in school, and drop out too early. And there are stark inequalities between regions; for example, 6 percent of children in Jakarta do not have access to proper sanitation while, at the same time, 98 percent of children in rural Papua have no access. This kind of inequality dims the prospects of important segments of society for generations.

The Government of Indonesia has rightly identified inequality as an obstacle to sustainable development and has set targets to reduce it. In support of this public policy objective, the World Bank embarked on research to better understand why inequality is rising in Indonesia, why it matters, and what can be done about it. This work is the result of partnerships between many government agencies and The World Bank. The study enjoyed the financial support from the Australian Department of Foreign Affairs and Trade.

Inequality is complex, impacting many facets of life and involving many actors. We hope that this report will encourage public policy based on evidence and informed by experiences from countries that have successfully reduced inequality.

In the country Indonesians deserve and want, extreme poverty is eliminated. In the Indonesia its people dream of, the poor and vulnerable have more opportunities to enjoy 'shared prosperity'. This is not an agenda of redistributing an economy of a fixed size. Indonesians need to expand the size of the pie, and keep expanding it and sharing it, to ensure that the welfare of all, and especially the most vulnerable, rises as quickly as possible.

The task of slowing – or even reversing – the trend of rising inequality is a large challenge, and one that will take time to achieve. But we believe that by standing together – the government, alongside civil society and the private sector, with the support of development partners – the country will be able to make a difference for current and future generations who deserve a fair opportunity for a better life.

We at the World Bank Group stand ready to continue supporting these objectives.



INDONESIA'S RISING

WHY INEQUALITY IS RISING,
WHY IT MATTERS
AND WHAT CAN BE DONE

March 2016, World Bank



D I V I D E

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List of Abbreviations, Acronyms & Indonesian Terms

| TERM | DEFINITION |
|----------|--|
| AEC | ASEAN Economic Community |
| APBN | Anggaran Pendapatan dan Belanja Negara (Central Government Budget) |
| ASEAN | Association of Southeast Asian Nations |
| ave. | average |
| Bappenas | Badan Perencanaan Pembangunan Nasional (National Development Planning Agency) |
| BCC | Behavioral Change Communication |
| BCG | Bacillus Calmette-Guerin vaccine |
| bidan | midwife |
| BKKBD | Badan Kependudukan dan Keluarga Berencana Daerah (Regional Population and Family Planning Agency) |
| BKKBN | Badan Kependudukan dan Keluarga Berencana Nasional (National Population and Family Planning Board) |
| BKPM | Badan Koordinasi Penanaman Modal (Investment Coordinating Agency) |
| BOP | Bantuan Operasional Pendidikan (Operational Assistance for Education) |
| BOS | Bantuan Operasional Sekolah (Operational Assistance for Schools) |
| BOSDA | Bantuan Operasional Sekolah Daerah (Operational Assistance for Schools from Local Government) |
| BPJS | Badan Penyelenggara Jaminan Sosial (Social Security Organizing Body) |
| BPS | Badan Pusat Statistik (Central Statistics Agency) |
| Bulog | Badan Urusan Logistik (Logistics Agency) |
| CMRS | Crisis Monitoring and Response System |
| CPI | Consumer Price Index |
| DAK | Dana Alokasi Khusus (Special Allocation Fund) |
| DHS | Indonesia Demographic and Health Survey |
| DKI | Daerah Khusus Ibukota (Special Capital Region) |
| DPT | Diphtheria, Pertussis, and Tetanus vaccine |
| ECD | Early Childhood Development |
| EI | Effectiveness Index |
| FHH | Female-Headed Household |

| | |
|------------------|--|
| GDP | Gross Domestic Product |
| GIC | Growth Incidence Curve |
| HH/hh | Household |
| ICT | Information and communications technology |
| IDR | Indonesian Rupiah |
| IEC | Information education and communication |
| IFLS | Indonesia Family Life Survey |
| IMF | International Monetary Fund |
| IT | Information technology |
| IUD | Intrauterine Device |
| Jamkesmas | Jaminan Kesehatan Masyarakat (Public Health Insurance) |
| JCI | Jakarta Composite Index |
| JKN | Jaminan Kesehatan Nasional (National Health Insurance) |
| kabupaten | regency |
| KIP | Kartu Indonesia Pintar (Indonesia Smart Card) |
| km | kilometer |
| kotamadya | mid-size city |
| LSI | Lembaga Survei Indonesia (Indonesian Survey Institute) |
| MHH | Male-Headed Household |
| MP3EI | Master Plan Percepatan dan Perluasan Pembangunan Ekonomi Indonesia (Master Plan for the Acceleration and Expansion of Economic Development in Indonesia) |
| MSS | Minimum service standards |
| NCD | Non-communicable disease |
| NES | National education standards |
| NGO | Non-government organization |
| NTR | Non-tax revenue |
| NVMS | National Violence Monitoring System |

| | |
|----------------------|---|
| OECD | Organisation for Economic Co-operation and Development |
| OP | Operasi Pasar (Market Operation) |
| ORT | Oral Rehydration Therapy |
| OSS | One-stop service |
| PISA | Programme for International Student Assessment |
| PKH | Program Keluarga Harapan (Family Hope Program) |
| PLKB | Petugas Lapangan Keluarga Berencana (Family Planning Field Official) |
| PNPM-Generasi | PNPM Generasi Sehat dan Cerdas (PNPM Healthy and Smart Generation Program) |
| PNPM-Mandiri | Program Nasional Pemberdayaan Masyarakat Mandiri (National Community Empowerment Program) |
| PNPM-Rural | Program Nasional Pemberdayaan Masyarakat Rural (National Rural Community Empowerment Program) |
| Podes | Sensus Potensi Desa (Village Potential Census) |
| Posyandu | Pos Pelayanan Terpadu (Integrated Service Post) |
| PTT | Pegawai tidak tetap (contract employee) |
| Puskesmas | Pusat Kesehatan Masyarakat (Public Health Centre) |
| Q1 | Quintile 1, i.e., poorest 20 percent |
| Q2 | Quintile 2, i.e., second poorest 20 percent |
| Q3 | Quintile 3, i.e. middle 20 percent |
| Q4 | Quintile 4, i.e., second richest 20 percent |
| Q5 | Quintile 5, i.e., richest 20 percent |
| Raskin | Subsidi Beras Bagi Masyarakat Berpendapatan Rendah (Rice Subsidies for Low Income People) |
| RPJM-N | Rencana Pembangunan Jangka Menengah Nasional (National Medium-Term Development Plan) |
| Sakernas | Survei Angkatan Kerja Nasional (National Labor Force Survey) |
| SBM | School-based management |
| SD | Sekolah Dasar (Primary School) |
| SJSN | Sistem Jaminan Sosial Nasional (National Social Security System) |
| SKPD-KB | Satuan Kerja Perangkat Daerah - Keluarga Berencana (Regional Family Planning Work Unit) |
| SMA | Sekolah Menengah Atas (Senior Secondary School) |

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INE



Overview

RISING

RISING INEQUALITY IS CREATING AN INDONESIA THAT IS MORE DIVIDED THAN EVER BEFORE. Fifteen years of sustained economic growth in Indonesia have helped to reduce poverty and create a growing middle class. However, growth over the past decade has primarily benefited the richest 20 percent and left the remaining 80 percent of the population—about 205 million people—behind. With rising disparities in living conditions and an increased concentration of wealth in the hands of the few, Indonesia's level of inequality is now considered to be relatively high and is climbing faster than most of its East Asian neighbors.

URGENT ACTION IS NEEDED, NOT ONLY BECAUSE INEQUALITY IS OFTEN UNFAIR, BUT ALSO BECAUSE IT MAY LEAD TO SLOWER GROWTH AND POVERTY REDUCTION, AND AN INCREASED RISK OF CONFLICT. A certain degree of inequality can be positive, by rewarding those who work hard, innovate and take risks. But income inequality is unfair when not everyone has the same initial opportunities in life. The consequences of doing nothing and allowing inequality to grow unchecked could be serious, giving rise to slower economic growth and poverty reduction, and increasing the risk of conflict. Most Indonesians are now aware of the issue and believe that the Government should take action.

QUALITY



Allowing inequality to grow unchecked could give rise to slower economic growth and poverty reduction, and increase the risk of conflict.

THERE ARE FOUR MAIN DRIVERS OF INEQUALITY IN INDONESIA THAT AFFECT BOTH CURRENT AND FUTURE GENERATIONS. Taking action requires a better understanding of why inequality is rising. So in partnership with the Government of Indonesia and supported by the Australian Department of Foreign Affairs and Trade, the World Bank conducted a research project that explored this question and identified four main causes.

Inequality of opportunity

Poorer children often have an unfair start in life, undermining their ability to succeed later. At least one-third of inequality is due to factors outside an individual's control.

Unequal jobs

The labor market is divided between high-skilled workers who receive increasing wages, and the rest of the workforce that does not have the opportunity to develop these skills and is trapped in low-productivity, informal, and low-wage jobs.

High wealth concentration

A minority of Indonesians are benefitting from the possession of financial assets—sometimes acquired through corrupt means—that, in turn, drives inequality higher both today and in the future.

Low resiliency

Shocks are becoming increasingly more common and disproportionately affect poor and vulnerable households, eroding their ability to earn incomes and invest in the health and education needed to climb up the economic ladder.

PUBLIC POLICIES CAN HELP INDONESIA TO BREAK THE INTERGENERATIONAL CYCLE OF INEQUALITY.

High inequality is not inevitable; policymakers can reduce inequality by tackling those factors exacerbating inequality that lie outside an individual's control. The World Bank recommends four key actions:

Improving local service delivery

A key to a better start for the next generation lies in enhanced local service delivery, which can improve health, education and family planning opportunities for all.

Promoting better jobs and skills training opportunities for the workforce

Skills training programs can improve the competitiveness of workers who have missed out on a quality education. Also, the Government can help to create better jobs through greater investment in infrastructure, a more conducive investment climate and a less rigid regulatory approach.

Ensuring protection from shocks

Government policies can reduce the frequency and severity of shocks, as well as provide coping mechanisms to ensure that all households have access to adequate protection when shocks do occur.

Using taxes and government spending to reduce inequality now and in the future

Specific fiscal policies could focus on increasing spending on infrastructure, health and education, social assistance and social insurance. Such improved public spending could also be supported by a fairer taxation system designed to address some of the current tax regulations that encourage the concentration of wealth.

IN 2015, INDONESIA STANDS AS AN INCREASINGLY DIVIDED COUNTRY, UNEQUAL IN MANY WAYS. There is a growing income divide between the richest 10 percent and the rest of the population, and this gap is driven by many other types of inequality in Indonesia. People are divided into haves and have-nots from before birth. Some children are born healthy and grow up well in their early years; many do not. Some children go to school and receive a quality education; many do not. This means that some young adults enter the workforce with the right skills that are increasingly needed and rewarded

in today's modern and dynamic economy; most do not and are trapped in low-productivity and low-wage jobs. Some families have access to formal safety nets that can protect them from the many shocks that occur in life; many do not. And a fortunate few Indonesians have access to financial and physical assets (such as land and property) that increase their wealth over time. This wealth is passed down from generation to generation, both in the form of money and physical assets, and through greater access to better health and education. As a result, inequalities are being compounded and deepened over time.

EXECUTIVE SUMMARY¹

THIS REPORT ASKS WHY INEQUALITY IS INCREASING, WHY IT MATTERS, AND WHAT CAN BE DONE. The first section examines the trend in inequality, which is already relatively high in Indonesia and rising more rapidly than in many neighboring countries. It also discusses why it matters; a degree of inequality can be positive, by providing rewards for hard work and innovation. However, when inequality is too high this can be bad for economic growth, slow down poverty reduction, and undermine social harmony. The second section seeks to understand what is driving rising inequality in Indonesia. Why are more children not growing up healthy and leaving school with the right skills when there are more schools and health centers than ever before? Why are so many

workers unable to move low-wage jobs to more productive jobs where they should be better paid? How do shocks prevent many hardworking Indonesians from climbing up the economic ladder? And why might the increasing concentration of wealth in a few hands be driving inequality higher, both today and tomorrow, as well as potentially undermining economic growth and leading to policy-making which promotes the narrow interest of a few rather than the majority? The final section looks at what can be done to prevent the country from becoming even more divided. This section suggests ways to avoid an Indonesia in which relatively few people are healthy, happy and prosperous, and many more can only aspire to a better life but are unable to attain it.

¹This Executive Summary summarizes the key messages of the main report. The report, in turn, draws on a series of technical background papers that are individually referenced.



TRENDS IN INEQUALITY IN INDONESIA

Inequality is increasing, with most economic growth being enjoyed by relatively few Indonesians

INEQUALITY IN INDONESIA IS RISING RAPIDLY. By most measures, inequality in Indonesia has reached historically high levels. In 2002, the richest 10 percent of Indonesians consumed as much as the poorest 42 percent combined; by 2014, they consumed as much as the poorest 54 percent. A popular measure of inequality is the Gini coefficient, where 0 represents complete equality and 100 represents complete inequality. During the 1997-98 Asian financial crisis, while poverty increased sharply the Gini also fell; everyone was affected, but the richest segments were hit the hardest by the crisis. Since then, the Gini has increased from 30 points in 2000 to 41 points in 2014, its highest recorded level (Figure ES.1). Even this elevated level, however, is likely to be underestimated because household surveys tend to fail to capture the richest households.² Once relatively moderate by international standards, Indonesia's level of inequality is now becoming high and climbing faster than most of its East Asian neighbors (Figure ES.2).

FIFTEEN YEARS OF SUSTAINED GROWTH HAVE HELPED TO REDUCE POVERTY AND CREATE A GROWING CLASS OF ECONOMICALLY SECURE HOUSEHOLDS.

After recovering from the Asian financial crisis,

Indonesia's real GDP per capita grew at an annual average rate of 5.4 percent between 2000 and 2014. This growth helped to pull many out of poverty; the poverty rate more than halved from 24 percent during the crisis to 11 percent by 2014. Growth has also helped to create a stronger middle class than ever before; there are now 45 million people (the richest 18 percent of all Indonesians) who are economically secure and enjoy a higher quality of life. They comprise the fastest growing segment of the population, increasing at 10 percent per year since 2002 (Figure ES.3).³

HOWEVER, THOSE INDONESIANS WHO ARE NOW ECONOMICALLY SECURE ARE STARTING TO LEAVE THE OTHER 205 MILLION BEHIND. The benefits of economic growth have been enjoyed largely by the growing consumer class. Between 2003 and 2010, consumption per person of the richest 10 percent of Indonesians grew at over 6 percent per year after adjusting for inflation, but grew at less than 2 percent per year for the poorest 40 percent. This contributed to a slowdown in the pace of poverty reduction, with the number of poor people falling by only 2 percent per year since 2002, and the numbers of those vulnerable to poverty falling barely at all (Figure ES.3).

² The World Bank, Bank Indonesia and Ministry of Finance are collaborating on a project to estimate more accurately the number of middle and upper class Indonesians. The findings are published in "Finding the Hidden Rich: New approaches to measure top income households in Indonesia" (World Bank, forthcoming (c)).

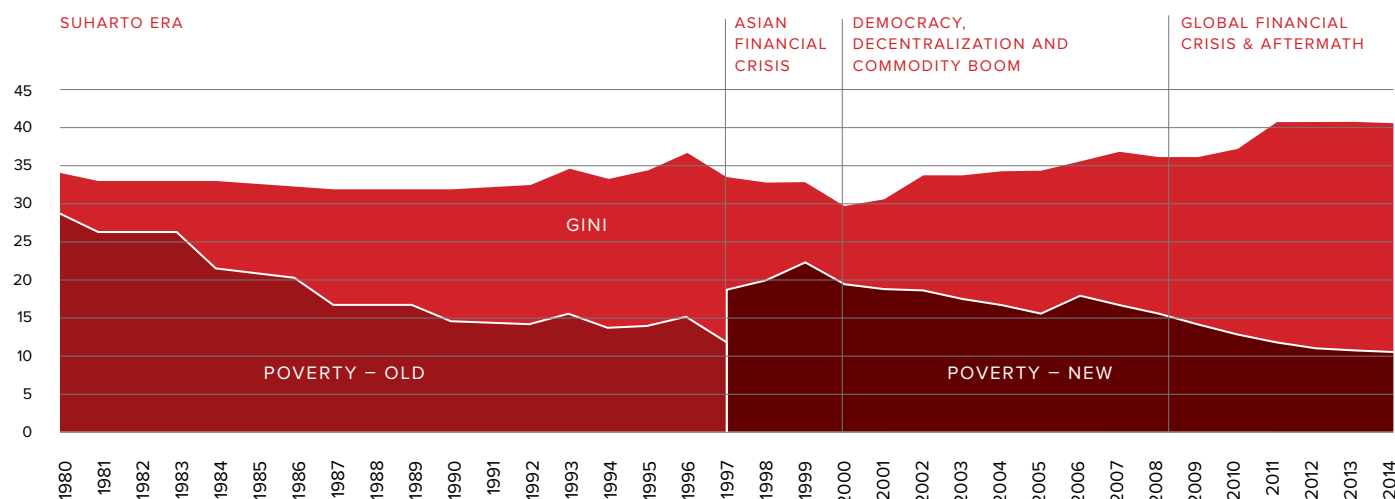
³ For this report, households in the middle class in Indonesia are defined as those who are economically secure from poverty and vulnerability; the economic security line in 2014 was about IDR 1 million in consumption per person per month. See note to chart and the report "Indonesia's New Climbers: Who are the middle class and what does it mean for the country?" (World Bank, forthcoming (a)).

After a long period of stability, the Gini began rising, then fell with the Asian financial crisis, before rising sharply since the recovery. (fig ES.1)

Gini coefficient (points) and national poverty rate (percent) 1980–2014

SOURCE BPS, Susenas and World Bank calculations

NOTE Nominal consumption Gini. The national poverty line was changed in 1998, and the 1996 rate calculated under both the new and old methodologies.



The increase in the Gini in Indonesia over the past two decades is one of the highest in the region. (fig ES.2)

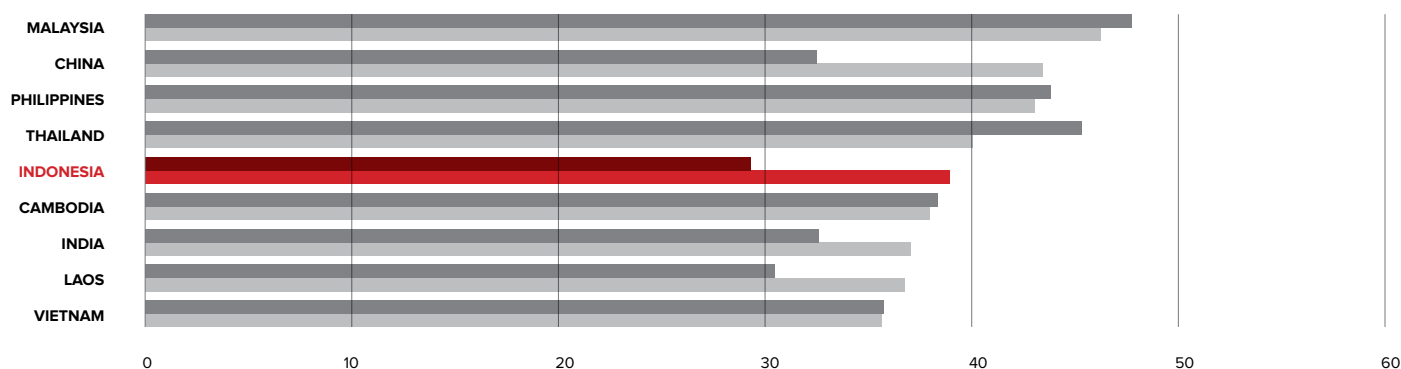
Gini coefficient in East Asia 1990s & 2000s

90'S

00'S

NOTE Consumption Ginis for all countries except Malaysia, which uses income. The periods for each country are: Indonesia 1990-2011; Malaysia 1992-2009; Lao PDR 1992-2008; China 1990-2008; Vietnam 1992-2008; Thailand 1990-2009; the Philippines 1991-2009; and Cambodia 1994-2008.

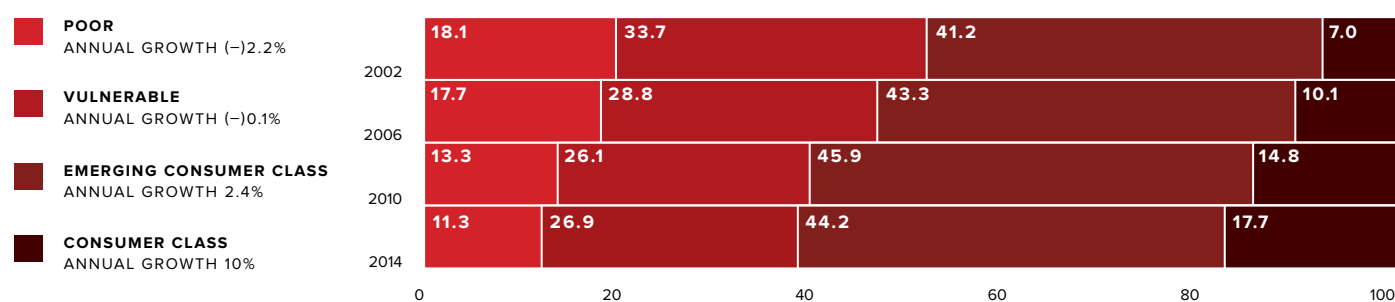
SOURCE Kanbur, Rhee and Zhuang (2014) *Inequality in Asia and the Pacific*, from PovCalNet.



An economically secure “consumer” class has grown strongly at 10 percent per year since 2002, and now includes nearly one in five Indonesians. However, reductions in poverty and vulnerability have been very small. (fig ES.3)

Population share by class, 2002–2014 (percent)

SOURCE Susenas and World Bank calculations. The poor are below the national poverty line of around IDR 300,000 per person per month. The vulnerable have a greater than 10 percent chance of being poor the next year and are under 1.5 times the poverty line. The consumer class is economically secure, with a less than 10 percent chance of being poor or vulnerable next year, and consume more than IDR 1 million per person per month. The emerging consumer class is safe from poverty but not vulnerability and lie between the vulnerability and economic security lines. See World Bank (forthcoming (b)) for more details.



WHY INEQUALITY MATTERS

Income inequality can be unfair when not everyone has the same initial opportunities in life

INCOME INEQUALITY IS NOT ALWAYS A BAD THING; IT CAN PROVIDE REWARDS FOR THOSE WHO WORK HARD AND TAKE RISKS.

Hard work and innovation benefit society by creating new goods and services that everyone can enjoy, as well as contributing to a larger economy. This, in turn, can supply the Government with a greater ability to provide public services to all. If this results in a gap between those hard workers and those who work less hard, then some income inequality may be justified and even desirable. Many Indonesians share this view. When asked in a 2014 survey whether inequality is ever acceptable, 74 percent say that “inequality is sometimes acceptable” as long as wealth acquisition is fair and meritocratic, prices are affordable, and the poor are protected.⁴

INEQUALITY CAN BE UNFAIR, HOWEVER, WHEN IT IS DUE TO FACTORS BEYOND THE CONTROL OF INDIVIDUALS.

There are many forms of inequality. There are economic inequalities of income, wealth and consumption. There is also inequality of opportunity, when not everyone has access to the same opportunities in life. Factors beyond the control of an individual—where you are born, how educated or wealthy your parents are, and what access to public services you had access to when you were growing up—can have a major influence on how your life turns out. Having a healthy start in life and a quality education are fundamental prerequisites for getting a good job and earning a decent living in the future. When economic inequality arises because of ‘inequality of opportunity’—that is, when not everyone has a fair start in life—it is

unfair. Other factors outside an individual’s control that can affect incomes, standards of living and inequality, include government policies, such as food import restrictions that increase the cost of living most for the poor, or patterns of government taxation and spending that do not collect and channel sufficient resources to help the poor and vulnerable, or those without equal access.

HIGH LEVELS OF INEQUALITY MAY SLOW ECONOMIC GROWTH, WHILE MORE EQUAL COUNTRIES MAY GROW FASTER.

High inequality may reduce economic growth for all if poorer people are unable to properly invest in their children’s development, if people fail to exit poverty and vulnerability and move into the consumer class, and if people fail to find productive jobs. Recent research indicates that a higher Gini leads to lower and less stable economic growth. Moreover, when the share of total income held by the richest 20 percent of people increases by 5 percentage points, economic growth falls by 0.4 of a percentage point. At the same time, when the share of total income held by the poorest 20 percent of people increases by 5 percentage points, growth increases by 1.9 percentage points. Increased income shares for the second- and third-poorest quintiles have also been shown to increase economic growth.

HIGH INEQUALITY CAN ALSO HAVE SOCIAL COSTS, WHICH MAY EXACERBATE CONFLICT.

When people perceive that there are large differences in income and wealth, this can create social tensions and disharmony, which can in turn create conflict. Indeed, districts with higher levels of inequality than the average in Indonesia have 1.6 times the rates of conflict compared with districts with lower levels of inequality. As we shall see in the following section,

⁴ For a detailed exploration of what Indonesians think about inequality and what should be done, see the background paper: A Perceived Divide: How Indonesians think about inequality and what should be done (World Bank, 2015a).

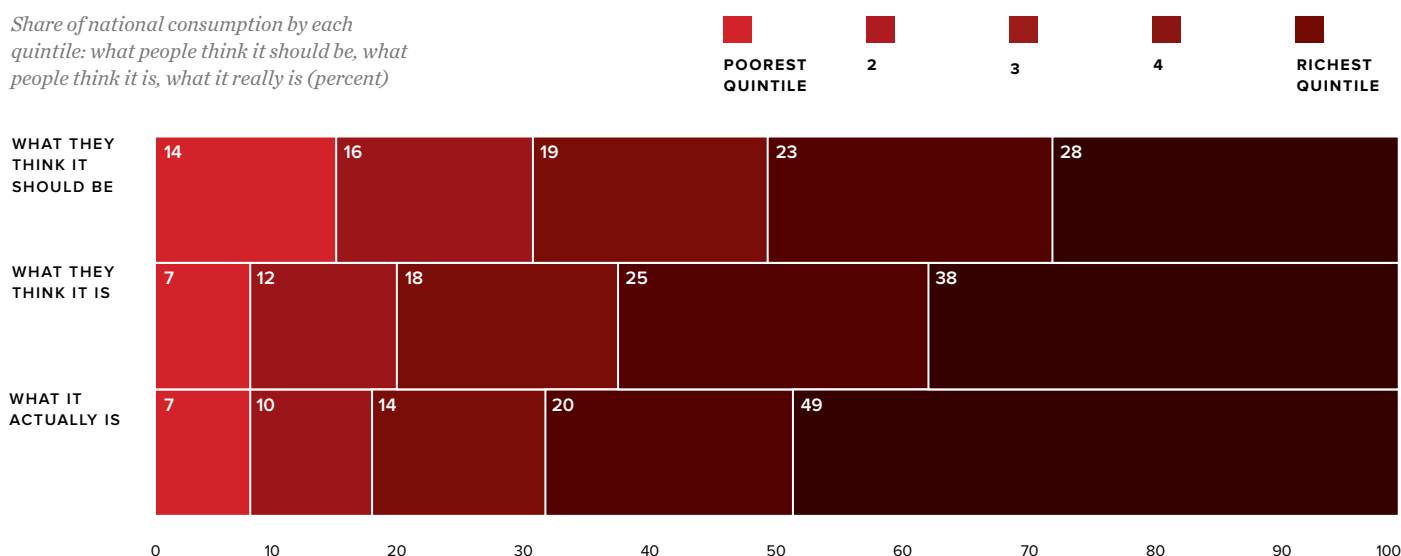
Indonesians already think inequality is too high and should be reduced. Conflict in turn can reduce economic growth through labor disruption and lower investment. Furthermore, if inequality is due to rent-seeking behavior—people trying to capture existing resources without generating new wealth through productive activities—then

this also has costs; individuals seek favorable treatment and protection of their position, leading to the misallocation of resources, corruption and nepotism, all of which have high social and economic costs, including a loss of confidence in public institutions.

Not only do surveyed Indonesians believe inequality should be lower than it is now, but in reality inequality is even higher than they think that it currently is. (fig ES.4)

SOURCE World Bank (2015a) using LSI 2014 and Susenas 2014 data

Share of national consumption by each quintile: what people think it should be, what people think it is, what it really is (percent)



Public concern towards inequality and demand for government action are rising

INDONESIANS THINK THAT INEQUALITY IS NOW TOO HIGH. People surveyed, on average, indicate a preference for a more equal country, in which the richest fifth accounts for 28 percent of all consumption. However, those surveyed estimate that, currently, the richest fifth of Indonesians account for 38 percent of all consumption. But, while most respondents already think Indonesia is too unequal, in fact inequality is even higher than most Indonesians perceive: national data indicate that the richest fifth actually enjoys 49 percent of all household consumption.

GIVEN THIS PERCEPTION, MOST INDONESIANS THINK THAT URGENT ACTION IS NEEDED, which is why inequality has become a major public issue. Inequality was a key issue in the run-up to the Indonesian presidential elections in July 2014, with major national and international media outlets reporting on rising inequality and both presidential candidates making public

statements about strategies to reduce inequality. They have the support of the public; 47 percent of those surveyed say it is “very urgent” for the Government to address inequality, while another 41 percent think it is “quite urgent.”

TAKING ACTION WILL REQUIRE A BETTER UNDERSTANDING OF WHY INEQUALITY IS RISING, WHY THIS MATTERS, AND WHAT CAN BE DONE ABOUT IT. In partnership with the Government of Indonesia and supported by the Australian Department of Foreign Affairs and Trade, the World Bank conducted a research project to examine inequality and its drivers in Indonesia. The purpose of the project was to support the Government in gaining a better understanding of this emerging issue and being better able to make policy decisions, informed by rigorous research and evidence, on how to respond. This section of the summary of the report examines recent trends in inequality and why these may be of concern. The next section looks into the reasons why inequality is rising and why a policy response is needed. The fourth and final section considers what government policymakers can do to address increasing inequality.

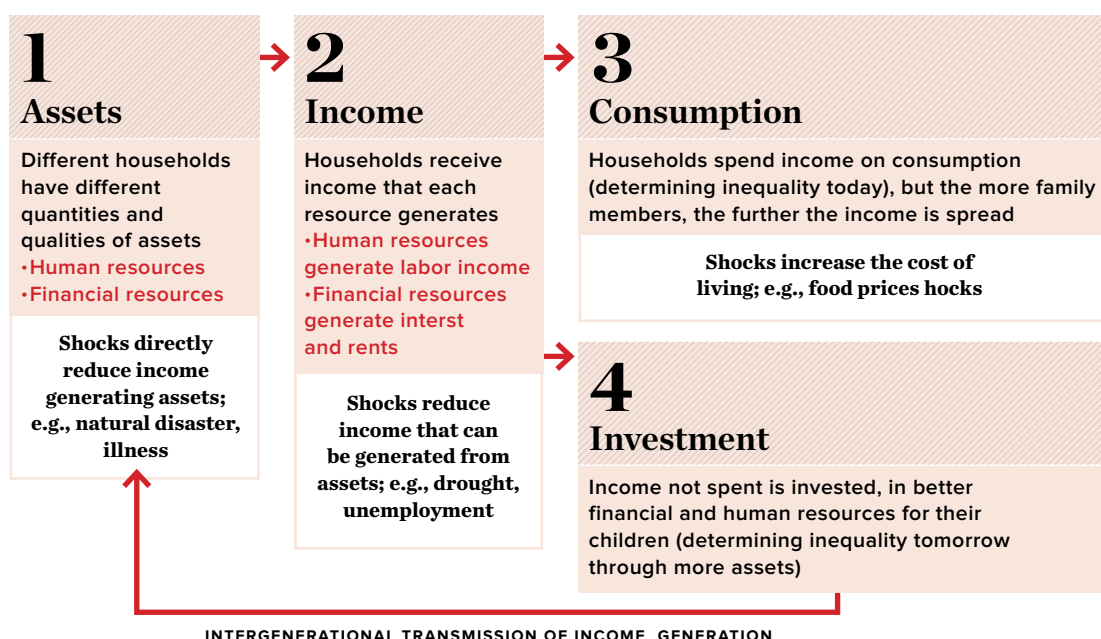
WHY INEQUALITY IS RISING

TO UNDERSTAND WHAT DRIVES INEQUALITY IN INDONESIA AND WHY IT IS RISING, WE NEED TO UNDERSTAND THE DIFFERENT RESOURCES THAT DIFFERENT HOUSEHOLDS HAVE AND HOW THEY GENERATE INCOME FROM THEM (Figure ES.5). Households use different resources to earn income. They use their labor to earn wages and salaries, but they can also earn income from financial and physical assets. Understanding why some households have better jobs and earn more, and why some households have more financial assets and earn more, is key to understanding why inequality is rising. Inequality is also influenced by how this income is spent: how much is consumed (and over how many people it is shared) and how much is saved. In addition, shocks and disasters can suddenly erode household assets and incomes so it is important to understand why richer households are more resilient in the face of such events.

THERE ARE FOUR MAIN DRIVERS OF INEQUALITY IN INDONESIA THAT AFFECT BOTH CURRENT AND FUTURE GENERATIONS. Applying the framework above, we find that there are four main drivers of inequality in Indonesia. First, inequality of opportunity means that not everyone develops the skills needed to secure well-paying jobs. Second, with an increasing emphasis on the right skills in a modern economy, the rewards for those who do find good jobs are increasing. At the same time, those without the necessary skills are becoming trapped in informal or low-productivity and low-wage jobs. Together these factors mean that wage inequality is increasing. Third, the increasing concentration of financial resources in the hands of just a few wealthy households means higher income inequality today and reinforces human and financial resource inequality in the next generation. Fourth, shocks can affect inequality at any stage of the framework by eroding a household's ability to earn an income, save, and invest in health and education. In the following section we explore each of these drivers in turn.

An income-generating asset framework can help us think about why inequality arises. The framework applies across generations and can deepen inequality over time. (fig ES.5)

Understanding inequality through an income-generating asset framework with a reinforcing feedback loop



01

An unequal start to life means an unequal life in the future

INEQUALITY OF OPPORTUNITY FROM BIRTH CAN EXPLAIN A SUBSTANTIAL AMOUNT OF INCOME INEQUALITY IN LATER LIFE.⁵

Adult income or consumption inequality is unfair when it is driven by inequality of opportunity at an early age: the conditions that children are born into and have no ability to change. One-third of all consumption inequality in Indonesia is due to a small number of factors that are outside of an individual's control. The most important factor is parents' education and, to a lesser extent, where they were born. Differences in gender explain relatively little of the level of inequality in Indonesia.

INEQUALITY OF OPPORTUNITY BEGINS WHEN MORE THAN ONE IN THREE INDONESIAN CHILDREN FAILS TO GET A HEALTHY START. Differences in the quality of a household's human resources—their most important asset—drive a large degree of consumption inequality in Indonesia. These differences start even before birth. Some children from poorer households do not receive proper nutrition during the critical development stages—

from when they are still in the womb and up until they are two years old. As a result, these children are stunted, failing to reach the right height for their age. They develop their cognitive skills more slowly, reach lower educational levels, and earn less as adults, compared with children who grow up healthy. This is one of the most important development challenges for Indonesia, where 37 percent of children are stunted—a much higher level than Indonesia's regional peers (Figure ES.6).

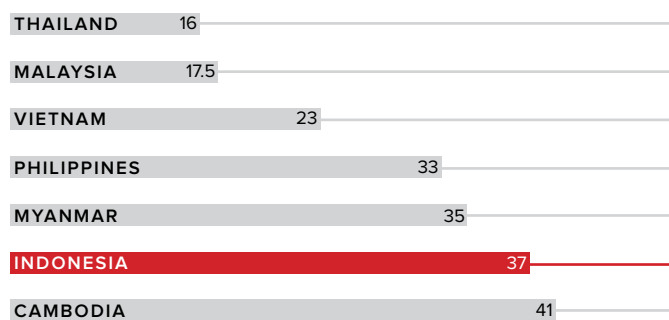
THE PERSISTENTLY HIGH RATES OF CHILDHOOD STUNTING COME IN PART FROM UNEQUAL ACCESS TO NUTRITION, CLEAN WATER, PROPER SANITATION AND QUALITY HEALTH SERVICES. Many poor children are not properly breastfed and poorer children are the least likely to be fed the micronutrients they need. While most start the immunization process, few of them finish it. Also, many children lack access to clean water and proper sanitation, which increases the risk of illness and affects nutrition. Gaps in access to health care have been closing over time but remain significant (Figure ES.7). More importantly, a quality gap persists; facilities in many places lack both the basic amenities, as well as the trained and competent personnel required to deliver the basic health services mandated by law. One reason is that, up until recently, Indonesia had the fifth-lowest level of health spending relative to GDP in the world, although this has been increasing under the new Jokowi administration.

Children's health and nutrition in the first two years will affect them for the rest of their lives

Childhood stunting is strongly linked to worse mortality, cognitive, education, and adult income and health outcomes. Stunting is much higher in Indonesia than most neighboring countries. (fig ES.6)

SOURCE
WHO Child
Nutrition
Indicators.

Stunting by country (percent)

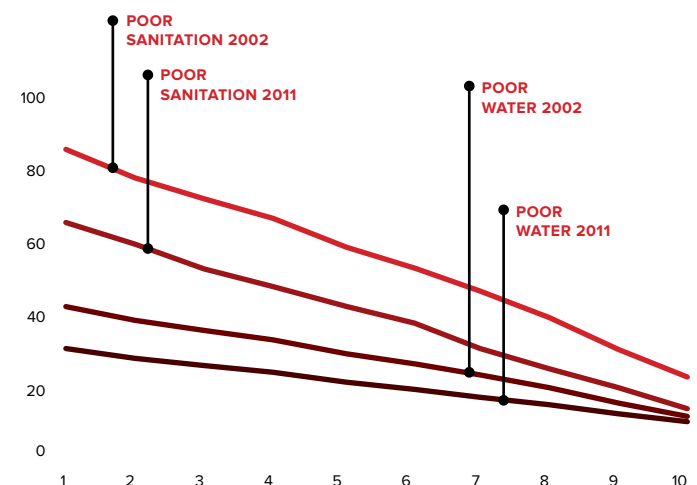


⁵ For a more detailed look at how inequality of opportunity for children leads to income inequality as adults, see the background paper “An Unfair Start: How unequal opportunities affect Indonesia's children” (World Bank, 2015b).

Gaps in access to better child health are closing (such as in water in sanitation, as shown), although quality levels remain persistently low in many places. (fig ES.7)

Lack of access to clean water and proper sanitation by household per capita consumption decile (percent)

SOURCE
Susenas



Poorer families tend to be larger, which means that resources are spread thinly

THE FAMILY SIZE OF POORER HOUSEHOLDS SHRANK FASTER THAN RICHER HOUSEHOLDS DURING THE 1990S, WHICH HELPED TO MODERATE INEQUALITY. Having more family members in a household means fewer resources available per person. Poorer households tend to be larger with more children, so not only do they have lower incomes than richer households, but their consumption per person is even less. However, due to an effective national family planning campaign since the 1970s, the family size of poorer households shrank faster than richer households during the 1990s. This meant inequality was lower than it would otherwise have been. With poorer households having fewer children to spread their income over, their per capita consumption rose faster and the Gini was 2.5 points lower than it would have been if relative household sizes had been the same in 2002 as they were in 1993.

THIS TREND REVERSED DURING THE 2000S; THE FAMILY SIZE OF RICHER HOUSEHOLDS HAS FALLEN WHILE POORER HOUSEHOLDS HAVE REMAINED THE SAME SIZE, CONTRIBUTING SIGNIFICANTLY TO RISING INEQUALITY. Between 2002 and 2014, the average household size of the poorer half of Indonesians remained stable, while that of the richer half of Indonesians continued to fall, albeit more slowly than in the 1990s. This contributed to the increase in inequality over this period. If reductions in household size for the poor and rich had continued to follow the same pattern as between 1993 and 2002, the Gini would have been 4 points lower in 2014, at 37 rather than 41.

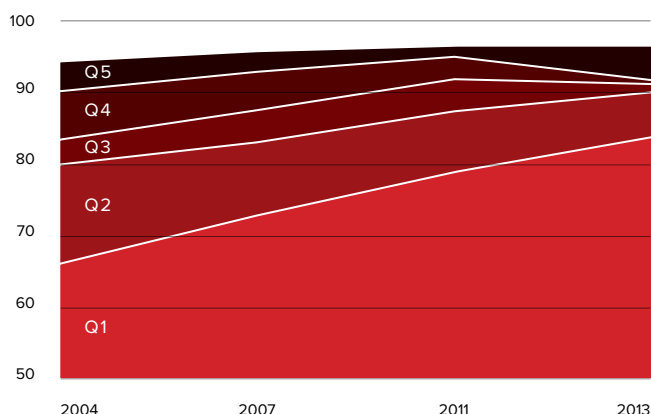
A KEY REASON FOR THIS IS THAT THE EFFECTIVENESS OF FAMILY PLANNING IN INDONESIA HAS DECLINED OVER THE PAST DECADE. The use of contraceptives is roughly the same now as it was a decade ago. While the unmet need for contraception is not particularly high compared with other countries, it remains a major reproductive health issue and has shown little signs of falling in recent years. Moreover, this reflects unequal access to proper family planning between the rich and the poor, especially for longer-term methods such as IUDs (intrauterine devices), which are more effective in limiting family size. Decentralization, a lack of political support at the local level, and regulatory deficiencies have all served to weaken family planning. First, the National Family Planning Agency (BKKBN), previously a strong, centrally-run agency, has struggled to maintain its effectiveness in a decentralized Indonesia, where significant responsibilities for implementation and monitoring have been devolved to local governments (districts and municipalities). Second, budget support from local governments has declined.

FURTHERMORE, THESE DEMOGRAPHIC CHANGES WILL HAVE A BEARING ON OPPORTUNITIES FOR THE NEXT GENERATION. Not only has the reversal of family size trends for richer and poorer households contributed to higher consumption inequality today, it will also affect consumption inequality in the future. Smaller family sizes for richer households bring a number of benefits that will be of advantage to their children compared with those from poorer households. Smaller families

The enrolment gap between richer and poorer children has been closing over time... (fig ES.8)

Enrolment of 13-15 year olds by parents' per capita consumption quintile

SOURCE
Susenas
2012

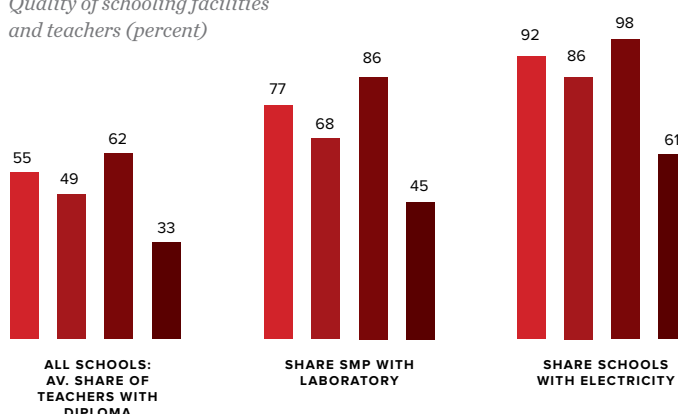


...but increasing enrolment rates mask differences in the quality of education across schools and regions... (fig ES.9)

Quality of schooling facilities and teachers (percent)

Legend:
National (Red)
Rural (Dark Red)
Urban (Dark Brown)
Maluku/Papua (Black)

SOURCE
Podes 2011
Infrastructure Survey



can contribute to better maternal and child health outcomes, while a longer gap between children allows the mother's body to recover and deliver more nutrients, helping babies to be born at a healthy weight. It also means that more attention can be devoted to each child, helping to prepare them better for entering preschool. Reduced rates of teenage pregnancy can decrease maternal and child mortality rates, as well as the incidence of low birth weight. Healthier children born into richer families in turn can increase inequality tomorrow because they have had a better start in life.

INEQUALITY OF OPPORTUNITY DEEPENS WHEN NOT EVERY CHILD GETS A GOOD START IN SCHOOL.

Children living outside of Java or in rural areas, especially the poor, are less likely to attend early childhood development programs, when learning begins. By primary school, however, enrolment is nearly universal, and the junior secondary enrolment gap between richer and poorer children has been closing over time (Figure ES.8). Nonetheless, poorer children are not making the transition to the next schooling level at the same rate as richer children; enrolment rates for the richest 20 percent of children are only 9 percentage points higher than for the poorest 20 percent in year six (the last year of primary), but 21 percentage points higher in year seven (the beginning of junior high).

THE BIGGEST CHALLENGE TO AN EQUAL START FOR ALL IS THE QUALITY OF EDUCATION.

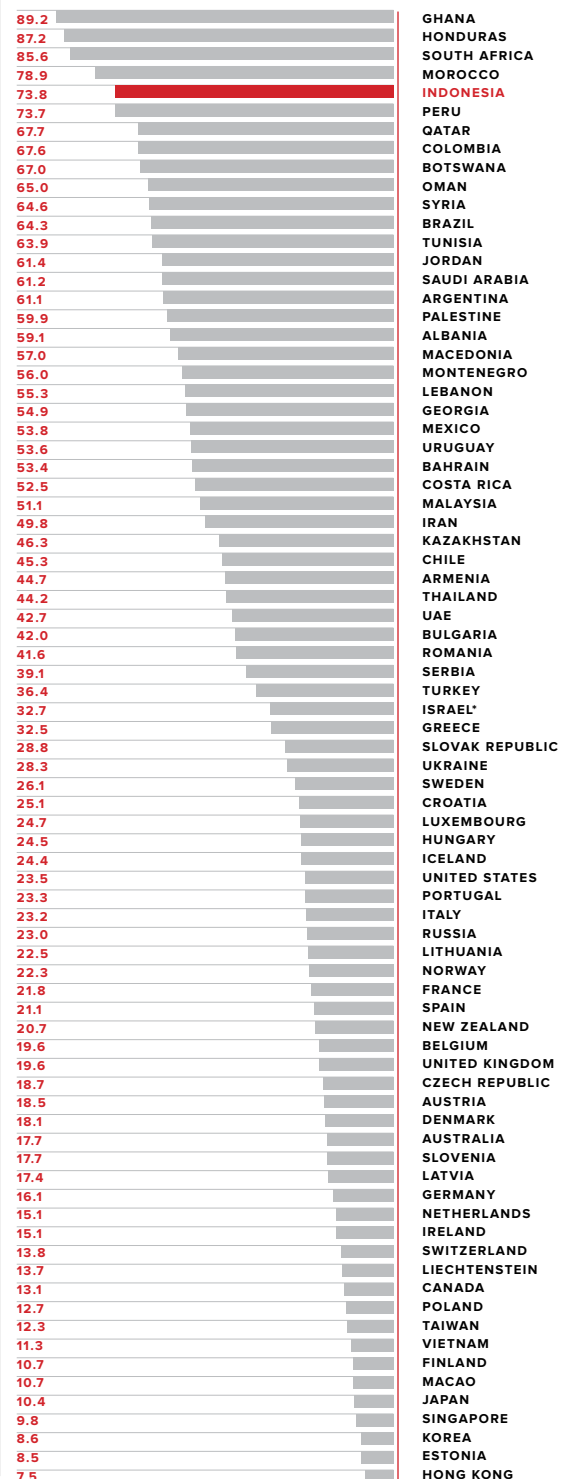
Rural schools and those in eastern Indonesia are less likely to have trained teachers or proper facilities, and teacher absenteeism is also a problem in some places (Figure ES.9). Even if poorer children stay in school, disparities in educational quality persist, so that the value of receiving a complete education is often less than it is for better off children. This negatively affects the learning outcomes of remote and poorer students. For example, Grade 3 children in Java read 26 words faster per minute than those in Nusa Tenggara, Maluku or Papua. Similarly, richer children read 18 words faster than poorer children. In turn, the low quality of education for the disadvantaged (the majority of Indonesian children) drives the low average quality of educational outcomes; 74 percent of Indonesian 15-year-old children do not achieve even Level 2 basic skills (a score of 420) on PISA international mathematics and science tests, the fifth worst score out of 82 countries (Figure ES.10).

While enrolment rates for poorer children have improved, they often do not receive the same quality of education

...which in turn contributes to Indonesia having some of the worst international test scores in science and mathematics (fig ES.10)

SOURCE
OECD 2015

Percentage of 15-year olds with international PISA mathematics and science scores below Level 2 (basic skills, 420 points)



DESPITE CLOSING GAPS IN ACCESS TO CRITICAL EDUCATION AND HEALTH OPPORTUNITIES, INEQUALITY CONTINUES TO INCREASE, WITH THE ROLE OF CIRCUMSTANCES AT BIRTH REMAINING SIGNIFICANT.

The significant economic and education expansions that Indonesians enjoyed in the 1960s and 1970s meant that the role that birth circumstances played, through factors such as parents' education and where you were born and raised, fell from explaining 39 percent of today's consumption inequality for people born

in the 1950s to 34 percent for those born in the 1970s. However, this decline has stopped and may even be reversing for those born in the 1980s and onwards. This is partly because access to quality services remains unequal, even if physical access gaps have closed. Therefore, the skills gap between advantaged and disadvantaged children remains. But this alone would not lead to rising inequality. Instead, the persistent skills gap is combining with an increasing gap between the earnings for the skilled and unskilled to drive inequality higher.

02

Two labor markets: increasing wages for the few skilled workers and a low-productivity and low-wage job trap for everyone else

IN TODAY'S DYNAMIC AND GLOBALIZED ECONOMY, TECHNOLOGICAL ADVANCES, ESPECIALLY IN INFORMATION TECHNOLOGY, MEAN THAT SKILLS ARE BECOMING MORE IMPORTANT. Technological progress has brought significant benefits in recent decades, with cheaper transportation and cheaper goods, greater access to markets for those in remote areas, and improved communication and knowledge sharing. The new technologies underpinning these advances require increasingly higher skill levels to use and improve. As a consequence, the demand for skilled workers in many sectors has increased in most countries around the world. These skilled workers tend to be those children who completed school and benefitted from a high quality education in the first place, highlighting the consequences of unequal opportunity from birth.

IN INDONESIA, EMPLOYERS ARE INCREASINGLY DEMANDING MORE SKILLED WORKERS, BUT ARE STRUGGLING TO FIND THEM. Employers in Indonesia are also looking for workers with higher skill levels. The proportion of jobs requiring senior high school or tertiary education has increased over the past decade from 22 percent in 2002 to 35 percent in 2013 (Figure ES.11). But education levels are not the same as skills. Despite increasing educational attainment in Indonesia,

over half of all firms surveyed in manufacturing and services outside of education say that finding professionals is "hard" or "very hard," and 40 to 50 percent of them say their staff lack thinking, behavioral, computer and language skills (Figure ES.12).

AT THE SAME TIME, THERE ARE FEW TRAINING OPPORTUNITIES FOR THOSE WHO LEAVE SCHOOL WITHOUT THE SKILLS THEY NEED. Much of the Indonesian workforce leaves school without basic skills because of incomplete and poor quality education. There are limited opportunities for such workers to develop these skills later in life. Less than 1 percent of youths aged 19 to 24 years old have attended training courses in engineering, IT or languages, in part, for the first two, because of limited supply. At the same time, there are few on-the-job learning opportunities either, since most firms are small- or medium-sized enterprises (SMEs) and training provision is simply too costly. Few firms in Indonesia are providing such training, particularly compared with the rest of East Asia and elsewhere in the world. Around 70 percent of firms in East Asia employing more than 100 workers offer formal training; in Indonesia less than 40 percent do, and the gap increases for SMEs compared with the region. With limited access to 'second-chance' skills training opportunities, these workers find it difficult to improve their skills and find better jobs.

AS A CONSEQUENCE, WAGES FOR SKILLED WORKERS HAVE BEEN INCREASING FASTER THAN THOSE FOR UNSKILLED WORKERS. There is an increasing wage gap between

⁶ Labor productivity is measured here as the value of GDP output in the sector divided by the number of workers. Worker productivity ranges from around IDR 20 million of GDP in very low productivity sectors, such as agriculture, to IDR 100-200 million in higher productivity sectors in manufacturing and financial services, to over IDR 500 million in non-oil and gas mining.

Increasing demand for and shortage of skilled workers is driving their wages higher

skilled and unskilled workers. Wages in higher productivity sectors that demand more skill, such as financial services, telecommunications and some manufacturing sectors, have risen faster than in those in lower productivity sectors. On average, every extra IDR 200 million of annual labor productivity enjoyed by a sector corresponded to 1 percentage point of higher real wage growth each year between 2001 and 2014.⁶ In this labor market, workers from richer households, where they are more likely to be better educated and more skilled, are benefitting from higher wages.

ISING SKILLED WAGES ARE NOT NECESSARILY A PROBLEM AS HIGHER DEMAND FOR SKILLS IS A POSITIVE SIGN IN AN ECONOMY, BUT THEY ARE A PROBLEM IF NOT EVERYONE HAS THE SAME OPPORTUNITY TO DEVELOP THOSE SKILLS. As a country seeks to make the transition from lower middle-income to higher middle-income, it is important that its economy evolves and sectors and firms move up the value chain into more advanced goods and services. As this process occurs, firms will demand a higher degree of skill from workers. So, higher skilled wages can be a positive sign that an economy is making this transition. That is, higher skilled wages by themselves are not necessarily a problem. However, when not everyone has the chance to develop these skills, because of the sort of inequality of opportunity that we have just seen is widespread in Indonesia, in this case higher skilled wages become a driver of higher long-run inequality.

WITH MOST EXISTING AND NEW JOBS BEING IN LOW-PRODUCTIVITY SECTORS, MOST WORKERS ARE TRAPPED IN LOW-PAYING JOBS, WHICH ARE OFTEN IN THE AGRICULTURAL AND INFORMAL SECTORS.

Between 2001 and 2012, a total of over 20 million new jobs were created. Employment creation, however, has been concentrated in low-productivity, non-skill-intensive sectors. Out of total employment growth, 30 percent occurred in community, social and personal services and 28 percent in wholesale, trade and retail, while manufacturing contributed only to 16 percent of total growth (3.3 million jobs).

THESE WORKERS HAVE DIM PROSPECTS SINCE UNDERINVESTMENT IN INFRASTRUCTURE AND A POOR INVESTMENT CLIMATE ARE SLOWING DOWN THE CREATION OF MORE PRODUCTIVE JOBS.

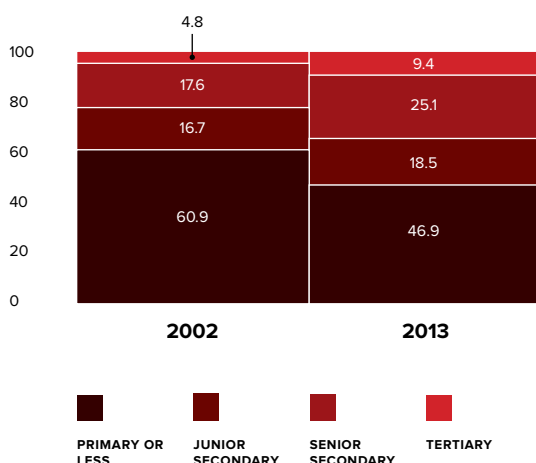
Underinvestment in infrastructure and a poor investment climate have been major constraints to creating more and better jobs. Investment in infrastructure collapsed during the Asian financial crisis and has still not fully recovered. Total annual infrastructure investment declined from an average 7 percent during 1995-97 to around 3-4 percent of GDP in recent years, compared with over 7 percent in Thailand and Vietnam, and 10 percent in China over the past decade. Despite rising government spending in recent years, Indonesia's core infrastructure stock, such as road networks, ports, electricity, and telecommunication facilities, has not kept pace with economic growth. Indonesia

Less than 1 percent of youths have attended training courses in engineering, IT, or languages

The proportion of employment requiring higher education levels has been increasing (fig ES.11)

SOURCE Sakernas, World Bank calculations

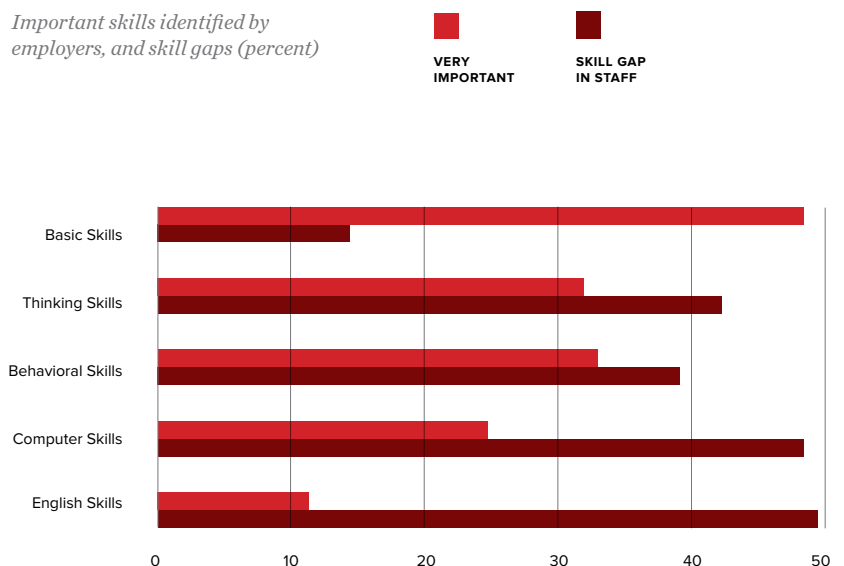
Employment by education level, 2002-13 (percent)



Nearly half of employers surveyed identified skill gaps in staff (fig ES.12)

SOURCE World Bank (2011) Skills for the Labor Market in Indonesia.

Important skills identified by employers, and skill gaps (percent)



has lost more than 1 percentage point of additional annual GDP growth due to underinvestment in infrastructure. Problems with transportation are among the worst business constraints for manufacturing firms and prohibitive transport costs undermine their competitiveness. Raw material producers find themselves unable to tap growing opportunities linked to final consumer demand, while it is cheaper to import oranges from China than to source them from Kalimantan. At the same time, obtaining business licenses is very complicated, expensive and time-consuming. Indonesia ranks 114th out of 189 countries in the World Bank's Ease of Doing Business index, worse than Malaysia (18th), Thailand (26th), Vietnam (78th), China (90th) and the Philippines (95th). For example, obtaining the licenses necessary to start a new business in manufacturing takes 794 days by law, although actual implementation can be slower still. And it takes 101 days to obtain an electricity connection in Indonesia, compared with 35 days in Thailand.

INDONESIA'S LABOR MARKET REGULATIONS ALSO DISCOURAGE FORMAL JOB CREATION AND HINDER WORKERS FROM MOVING INTO MORE PRODUCTIVE SECTORS.

Indonesia has some of the most rigid labor regulations in the region. It requires a minimum severance pay of at least 100 weeks of wages. At the same time, the minimum wage-setting process has resulted in large increases; in 2013, 25 provinces increased their minimum wage by an average of 30 percent and Jakarta increased it by 44 percent. This has taken minimum wages in Indonesia to levels that are even higher than those in Thailand and Vietnam, as well as China and the Philippines, despite having one of the region's lowest levels of labor productivity. With the enacting of a new regulation as we go to print, a new minimum wage setting formula based on inflation and annual GDP growth will now be used. While this is promising, it fails to address productivity and still allows discretionary adjustments by provincial governors, continuing the uncertainty. High severance and an uncertain minimum wage negotiation process have meant that firms are less likely to employ workers formally. Most companies respond by not using formal contracts, resorting instead to short-term contracts or relying on intermediary firms that provide outsourced workers. In fact, around one-third of Indonesian employees are still working without a contract. Furthermore, while paid work recently reached 45 percent of total employment, a more in-depth look shows that only one-fifth of

them consist of employees who are paid above the minimum wage and who are not working in casual type of jobs.

AT THE SAME TIME, THE LEGISLATION PROTECTS ONLY A SMALL NUMBER OF WORKERS.

Most workers receive no severance payments at all (66 percent), while those who do receive payments usually receive less than they are entitled to; only 7 percent of fired workers receive the full payment. Furthermore, as a consequence of these regulations, workers find it difficult to move from informal to formal jobs, as formal employers consider the high costs of dismissal and the uncertainty over minimum wage increases when hiring. Noncompliance with labor regulations is likely to reinforce labor market segmentation and wage inequality, adding to the persistence of low-quality and low-productivity jobs.

INEQUALITY OF OPPORTUNITY IN HEALTH AND EDUCATION COMBINED WITH INCREASING RETURNS TO SKILL ARE TOGETHER INCREASING INEQUALITY.

Despite increasing enrolment rates for poorer and disadvantaged children, they often still suffer from poor quality education, as well as cognitive disadvantages from stunting during early childhood. This means that they are not obtaining the skills needed to take advantage of the increasing demand for skilled workers and the increasing rewards that come with it. Since most of the other jobs being created are of low productivity and often informal, these workers are trapped in low-wage jobs. At the same time, equipped with skills, workers from richer households are benefitting from a labor market with a skills shortage.

THE WIDENING WAGE GAP BETWEEN FEW SKILLED WORKERS AND THE UNSKILLED MAJORITY IS ONE OF THE MAIN DRIVERS OF INCREASING INEQUALITY IN THE PAST DECADE.

The increasing skilled wage gap is reflected in higher wage inequality. The Gini coefficient for primary wages increased by around 5 points over the 2000s, contributing to higher inequality. In fact, around 28 percent of the increase in consumption inequality in the 2000s can be explained by increasing returns to education. Since there is a wide degree of variation in skill within each level of education, the contribution of increasing returns to skill, rather than education, is likely to be even higher.

The richest 1 percent own half of all the country's wealth

03

High wealth concentration and its consequences

AN INCREASING CONCENTRATION OF WEALTH IN THE HANDS OF A FEW MEANS THAT INCOME FROM FINANCIAL AND PHYSICAL ASSETS IS ALSO DRIVING INEQUALITY HIGHER.

Households earn income not only through jobs but also financial and physical assets. The share of income generated by labor has been falling and the share generated by capital, such as financial and property assets, has been increasing—in Indonesia as elsewhere in the world. In Indonesia, this partly reflects the strong returns to these assets over the past decade. It is largely rich households, however, that have access to these resources. The richest 10 percent of Indonesians own an estimated 77 percent of all the country's wealth. In fact, the richest 1 percent own half of all the country's wealth (Figure ES.13), which is the second-highest level (along with Thailand) after Russia from a set of 38 countries. This means that income from financial and physical assets benefits fewer households in Indonesia than in many other countries.

FURTHERMORE, ACCUMULATED WEALTH GENERATES EVEN HIGHER INCOMES IN THE FUTURE, DRIVING INEQUALITY STILL HIGHER. Financial and physical assets are generating higher incomes for only a few wealthy households in Indonesia, and these households are then saving this income as even more wealth. The share of wealth owned by the richest 10 percent in Indonesia increased by 7 percentage points between 2007 and 2014, in the top 10 of 46 countries over that period. These increased assets today will also generate even higher incomes tomorrow.

SOME WEALTH ACCUMULATION IS PARTLY DUE TO DIFFERENCES IN HOW LABOR AND CAPITAL INCOMES ARE TAXED. Increasing wealth concentration is due, in part, to differences in the way income tax is collected from labor and capital. For example, dividend withholding tax is only 10 percent (and earned interest withholding is only 20 percent), lower than all but one labor income tax rate and considerably lower than the 30 percent top marginal tax rate that most dividend earners would otherwise be paying. At

A small number of Indonesians are benefitting from financial and physical assets—sometimes acquired through corrupt means—that, in turn, drives higher inequality in the future

Indonesia has one of the highest concentrations of wealth out of 38 countries with available data (fig ES.13)

SOURCE
Credit Suisse
(2014)

Share of total wealth held by richest 1 percent of households (percent)



the same time, the significant capital gains that have been made from the housing and stock markets are theoretically subject to personal income tax, but are not subject to withholding taxes. With weak monitoring and compliance on personal income taxes, low withholding rates often mean less tax paid. Meanwhile, for many workers, income tax on salaries is withheld by the employer, ensuring a degree of compliance for labor income. As a consequence, around 95 percent of personal income taxes (around 20 percent of total income taxes; corporate income tax makes up the rest) are collected by withholding, mostly on salaries, and only the remaining 5 percent from capital income.

OTHER WEALTH ACCUMULATION MAY BE DUE TO VARIOUS FORMS OF CORRUPTION.

For some, their financial and physical assets are gained through personal connections and corrupt practices; in 2014 Indonesia's Corruption Perception Index, which measures perceptions of public sector corruption around the world, was a lowly 34 out of 100 (where 0 means very corrupt and 100 very clean), ranking it 107th out of 175 countries. This suggests that some of the wealth accumulation has occurred through corruption—or at least is perceived to have been accumulated this way.

HOWEVER, IN SOME AREAS, PARTICULARLY THE POLITICAL ECONOMY OF INDONESIA'S INSTITUTIONS AND THE NATURE OF

CORRUPTION, NOT ENOUGH IS KNOWN ABOUT THE NATURE OF THE PROBLEM AND THE BEST ACTIONS TO TAKE.

Not enough is known about the nature of corruption in Indonesia and how it drives inequality. Public perceptions suggest that it is widespread, and high profile cases provide vivid examples of how the rules of game are being biased in favor of insiders or circumvented altogether without legal consequences. Both forms of corruption seem highly likely to be linked to inequality through lower growth, high wealth concentration and policymaking that exacerbates inequality (for example, rigid labor markets that prevent productive job creation or switching, or import restrictions that drive food prices higher). However, an analysis of the political economy is needed to identify the underlying causes. Which aspects of the political, economic, and legal framework in Indonesia provide the incentives for such rent-seeking to take place? That is, how are policies made, by whom and for whose benefit? When is corruption or rent-seeking due to a lack of appropriate checks and balances? And when is it due to a lack of enforcement of these checks (whether through discretion on investigation and prosecution of potential corruption or the outright subversion of the legal process through judicial capture)?

04

Shocks erode a household's ability to earn and save, as well as invest in health and education

THERE ARE MANY SHOCKS THAT CAN ERODE HOUSEHOLD RESOURCES AND INCOMES.

Households can be affected by economic, health, social and political shocks, as well as natural disasters. These shocks reduce household income

through a number of channels. They can affect the underlying assets that generate income; a natural disaster, for example, might destroy the livestock or equipment used to make a living. Shocks can also reduce the income that comes from these assets; a drought might reduce a harvest. They can also reduce how far that income goes in the case of food price shocks; soaring rice prices linked to rice import restrictions in 2006 saw poverty rise by 2 percentage points. And they can reduce tomorrow's income by depleting today's assets (for example, selling a sewing machine to pay for hospital care) or by preventing accumulating assets for the future (for example, lack of income due to losing a job).

MANY INDONESIANS RELY ON FRIENDS AND FAMILY TO DEAL WITH THESE SHOCKS RATHER THAN FORMAL MECHANISMS.

Civil servants and the wealthy have access to health and employment insurance that they can

Shocks disproportionately affect poor and vulnerable households, which can prevent them from climbing up the economic ladder

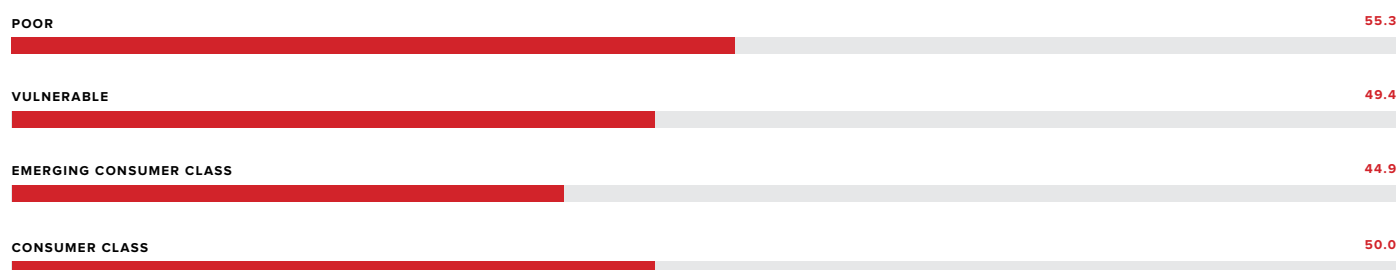
rely on during shocks. While the Government covers health insurance premiums for the poor and vulnerable, these programs are not always effective because beneficiaries do not always know what services they are eligible for, or cannot access them because of limitations in the supply of services. Also, for many workers who are neither poor nor rich but who work in the informal sector, the expansion of health insurance coverage to these households may be many years away (Figure ES.14). When people do not have access to formal coping mechanisms in times of shock, they usually turn to family and friends. However, this typically does not provide enough support to fully cope, and does not work when a shock such as a natural disaster hits an entire community. When informal borrowing is not enough, households may resort to steps that reduce their future income, such as selling productive assets or pulling children out of school.

SHOCKS HURT THE INCOMES OF ALL INDONESIANS, BUT GIVEN THAT RICHER HOUSEHOLDS ARE MORE RESILIENT

THEY ARE LESS LIKELY TO BE ADVERSELY AFFECTED, WHILE VULNERABLE HOUSEHOLDS COULD FALL BACK INTO POVERTY. With vulnerability high in Indonesia, small shocks can easily reduce incomes. While 28 million Indonesians live below the poverty line, a further 68 million live less than 50 percent above it (Figure ES.15). As a consequence, small shocks can easily send the vulnerable back into poverty; in fact, around half of the poor each year were not poor the year before. Even non-vulnerable Indonesians can be badly affected by shocks such as illness and disease or unemployment if they do not have access to insurance or other coping mechanisms. As a consequence, over a 14-year period, most Indonesians have experienced considerable ups and downs in terms of their income. In contrast to this common situation, a majority of the richest fifth of households have been able to remain secure in this top quintile over this same period of time (notwithstanding the fact that, having the most financial assets, they were most affected by the Asian financial crisis when inequality actually fell).

Fewer than half of all Indonesians have health insurance (fig ES.14)

Access to health insurance (percent)



There are more than twice as many vulnerable Indonesians as there are poor, living less than 50 percent above the poverty line, who fall easily into poverty if they suffer a shock (fig ES.15)

Poverty and vulnerability rates in Indonesia, 2014 (percent)



SOURCE Susenas and World Bank (2015a). **NOTE** The poor are under the national poverty line, around PPPUS\$1.30; the vulnerable are under 1.5 times the poverty line, around US\$1.90; the emerging consumer class are under 3.5 times the poverty line, around US\$4.50; and the consumer class are above this. See World Bank (forthcoming (a)) for details.

REDUCING INEQUALITY

High inequality is not inevitable; policymakers can reduce it by tackling inequality that is due to factors outside an individual's control

HIGH AND RISING INEQUALITY IS NOT AN INEVITABLE PART OF THE DEVELOPMENT PROCESS; REGIONAL NEIGHBORS HAVE GROWN ECONOMICALLY WITHOUT INCREASING THE DISPARITY BETWEEN RICH AND POOR. Inequality has been rising quickly in Indonesia at the same time as it has remained stable or has actually fallen in other fast growing East Asian neighbors such as Malaysia, Thailand and Vietnam. This indicates that rising inequality is not an unavoidable byproduct of rapid growth. In fact, some countries, such as Brazil, have been able to slow and eventually reverse rising inequality through a planned policy approach (Box ES.1).

PUBLIC POLICIES CAN HELP TO REDUCE THE IMPACT OF FACTORS OUTSIDE AN INDIVIDUAL'S CONTROL THAT AFFECT THEIR OUTCOMES, ENSURING THAT PEOPLE ARE NO LONGER DIVIDED INTO THE HAVES AND HAVE-NOTS FROM BEFORE BIRTH. Not all inequality needs to be addressed; the Government can aim to address inequality due to factors outside an individual's control, while leaving the inequality that rewards individuals for hard work, risk-taking and innovation. This means breaking the cycle of intergenerational transmission of poverty and inequality. All children need to be born healthy, grow up well in their early years, go to school and get a quality education, and enter the workforce with the right skills for today's modern and dynamic economy. In addition, all families need access to mechanisms that can protect them from the many shocks that can occur in life. More Indonesians need to gain access over time to financial and physical wealth, and pay a fair share of tax on the income they generate. To do this, policymakers have a range of instruments at their disposal. The best tools are those that both address the main drivers of rising inequality and are politically feasible.

THE FINAL SECTION OF THE REPORT EXAMINES SOME OF THESE TOOLS AND HIGHLIGHTS PRIORITY ACTIONS. The remainder of the Executive Summary proposes:

- Improving local service delivery to provide equal opportunity for all: A key to a better start for future generations is improved local service delivery, which can improve health, education and family planning opportunities for all.
- Promoting better jobs and skills training opportunities for the workforce: Today's workers who had an unfair start can still improve their skills. When they do, the Government can help to make sure there are better jobs available through a more conducive investment climate and less rigid but more effective worker protection regulations.
- Ensuring protection from shocks: Government policies can reduce the frequency and severity of shocks, as well as provide the coping mechanisms to ensure all households have access to adequate protection to the shocks when they do occur.
- Using taxes and government spending to reduce inequality now and in the future: This final priority is a pre-requisite for the first three. Setting the right fiscal policy to increase spending on infrastructure, health and education, social assistance and social insurance, will allow the Government to create more equal opportunities for the future and better jobs now, as well as ways for households to protect themselves. That is, the first three priority actions are only possible if sufficient and effective spending decisions are made. At the same time, how taxes are raised to fund this spending can be used to reduce inequality today, as well as potentially address some of the unfair aspects of wealth concentration.

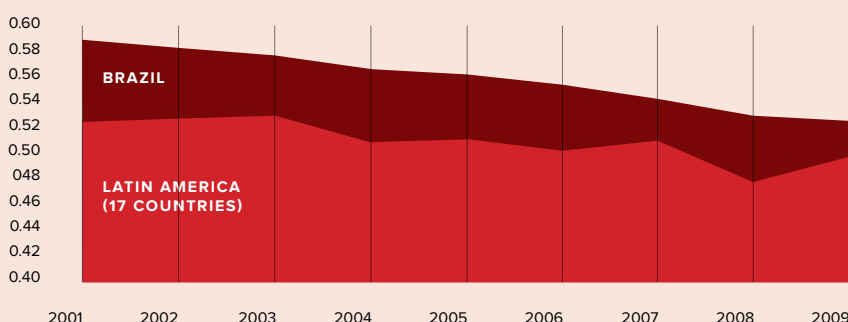
BOX ES.1

How Brazil reduced inequality

Brazil was effective in reducing inequality in the 2000s, albeit from a very unequal starting point. Between 2001 and 2009, Brazil's income Gini coefficient fell by 5 points, from 58.8 to 53.7.⁷ This was a greater fall than average in the Latin American region, which also saw declining inequality over the 2000s.

With Brazil having many similarities to the Indonesian context, there are a number of relevant lessons to be learned on how inequality can be reduced. Brazil resembles Indonesia in a number of ways: it has a large, natural resource-based economy that has enjoyed strong growth over the 2000s; it has a highly decentralized political system; it has already made the transition to become an upper middle-income country as Indonesia is in the processing of now doing; and it suffers from high income inequality and inequalities of opportunity. Given this context, the four drivers behind falling inequality in Brazil should be of interest to Indonesia: (i) macroeconomic stability; (ii) an expansion of primary and secondary education; (iii) pro-poor social spending; and (iv) an expansion of social assistance.

Gini Coefficient in Brazil and Latin America (fig ES.16)



Macroeconomic stability and economic growth have benefitted the poor.

Since the poor do not have access to the financial instruments that would protect them from inflation, a stable macroeconomic environment that keeps prices low has benefitted the poor and vulnerable in Brazil. At the same time, strong economic expansion has driven job creation, allowing poorer households to earn better incomes.

Expansion in primary and secondary education has changed the labor force profile.

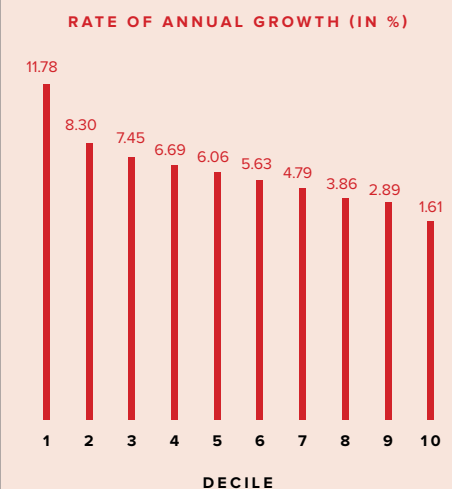
Brazil's inequality in labor income had been driven in large part by inequality in education. Brazil began a concerted policy effort to expand education for poorer households. This expansion was highly successful; in 1993, a child of a father with no formal education would complete four years of schooling, whereas now students complete 9-11 years, regardless of parents' education. As more workers become skilled, they benefit from higher wages. At the same time, this means there are fewer unskilled workers. With economic growth also increasing demand for unskilled workers, unskilled wages increased as well. It has been estimated that the falling wage differences between skilled and unskilled labor represents two-thirds of the fall in inequality.

A move towards more pro-poor social spending, and a significant expansion in social assistance, also contributed to falling inequality. Nearly half of

all government spending is social spending, including cash transfers, health and education. An important role in reducing inequality was played by a large expansion in social assistance spending. Increased contributory and non-contributory government transfers accounted for around 30 percent of the Gini reduction between 2001 and 2009. Most important was the expansion of *Bolsa Familia*, Brazil's conditional cash transfer program, similar to PKH in Indonesia. Unlike PKH, which covers only about 5 percent of households in Indonesia, Bolsa Familia has grown to cover 25 percent of Brazilian households, and is viewed as the most cost-effective contribution in reaching the poor and reducing inequality.

⁷ Income Ginis are higher than consumption Ginis because rich households save more income, meaning consumption is more equally distributed than income. The Indonesian income Gini was 6.4 points higher than the consumption Gini, based on the average difference for the three years when both income and consumption Ginis were collected in Indonesia (1984, 1990 and 1993).

Growth Incidence Curve for Brazil, 2001-2009 (fig ES.17)



AVERAGE OF INCOME PER CAPITA GROWTH RATES

5.91%

Other programs such as *Benefício de Prestação Continuada* (non-contributory pensions) provide greater benefit levels than *Bolsa Família*, but play less of a role in reducing inequality, while generous formal and public sector social security programs have been highly regressive.

As a consequence of these policies, poorer Brazilians saw the highest increases in income over the period.

Average income growth for the poorer half of the Brazilian population was above the national average, and

particularly benefitted the poorest, whose annual average per capita income growth of nearly 12 percent was twice the national average and 10 times that of the richest 10 percent.

The Brazilian case illustrates that significant reductions in inequality are possible. It is clear that Indonesia can go beyond slowing the increase in inequality, and can actually begin to reduce inequality itself, provided that: (i) it becomes a key government priority; (ii) a coherent and explicit strategy is developed; (iii) accountability for

overseeing and implementing this strategy is a key responsibility for a senior government minister with a strong mandate from the President himself; (iv) new major policy proposals in all ministries and agencies are examined for possible effects on inequality; and (v) key policies and programs aiming to reduce inequality are well-designed, funded and implemented.

01 Local service delivery

In addition to adequate funding, the most important policy action underpinning a better start in life for all is improved local service delivery

IN A DECENTRALIZED INDONESIA, EFFECTIVE DELIVERY OF QUALITY SERVICES BY LOCAL GOVERNMENTS IS ESSENTIAL IF OPPORTUNITIES ARE TO BE ENJOYED BY ALL. Since democratization and decentralization, the financial and political powers of local governments have increased dramatically. So too have their responsibilities. With much of the authority for key services that provide the opportunities for a good start in life, such as health, water and sanitation, nutrition and family planning, now being under local government control or influence, more must be done to ensure they have the means, capacity and incentives to provide or support these services in an effective manner.

Key policy actions can underpin improvements in all areas of local service delivery. Local service delivery can be improved by building the capacities of local governments to deliver services, moving towards a more performance-based transfer system and providing the tools for citizens to monitor local service delivery. Some cross-sectoral priorities for improving local service delivery include: changes in the way central budgeting allocations are made; changes in the incentives local budgeting face; applying incentives for achieving local delivery standards; and increased demand for public accountability. In particular, we look at how this might be achieved in health, education and family planning.

ONE OF THE MOST IMPORTANT STEPS IN ADDRESSING INEQUALITIES OF OPPORTUNITY BEGINS WITH IMPROVING THE ACCESS OF POORER HOUSEHOLDS TO QUALITY HEALTH SERVICES.

Achieving the right start for children of poorer households requires having access to quality health services during the early development stages, without which such children will be disadvantaged for the rest of their lives. More spending on health could help to reduce gaps in access. However, the priority is improving the quality of health services. Specific actions include:

- **Increased health financing, with targeted DAK investments and built-in incentives, to equip local health facilities to deliver results.** First, recent increases in public health spending should be sustained; Indonesia had the fifth-lowest health spending to GDP ratio out of 188 countries, at just 1.2 percent of GDP in 2014 (including spending on the national social security health system), before recent increases announced in the 2016 budget. But public health spending could also be improved by making local governments more accountable and better able to deliver health services on the ground. One approach is to use targeted investments combined with incentives to deliver results. For example, multi-year *Dana Alokasi Khusus* (DAK, or special funding for national priorities) transfers to district governments could be linked to measurable gaps in key health services relative to basic standards, such as those related to maternal and child health. District government contributions could be reimbursed based on evidence that these services are being provided,

and subsequent DAK allocations could be based not only on gaps but also progress in closing them. Districts that underperform could be supported, provided that the problem is a weak capacity to deliver.

- **Producing sufficient competent health workers and ensuring enough of them are deployed to disadvantaged areas.** There are a number of ways to improve the number, quality and distribution of health workers. Producing the right number begins with better information about the dynamics of the health workforce at the national and sub-national levels, using modern planning methods for health workforce production and deployment to reflect real demand, and greater involvement by the private sector. Quality can be improved through limiting the recruitment of public servants to those who have been certified according to national standards and limiting the reimbursement of services for patients with health insurance to those services that have been provided by certified health personnel in both the public and private sector. At the same time, the certification, accreditation and licensing of health workers and health professional education can be improved. Finally, deploying sufficient qualified workers to disadvantaged areas requires a public sector emphasis on the placement of medical doctors in rural underserved areas to increase the efficient use of public money, and trying different incentives to encourage health workers to work in remote areas than the ones used to date. For example, rather than financial incentives to attract workers to rural and remote areas, a period of working in these areas could be required of all doctors as part of their national accreditation, as is required in Australia, or public scholarships to medical professionals could require a one- to two-year period of working in disadvantaged areas.
- **Creating demand for health and sanitation services through a strengthening of community health workers (Posyandu cadres).** Increasing demand and knowledge for maternal, child health, and water and sanitation services can be promoted through: education, social encouragement and pressure, and incentives, including better socialization of the importance of vital behaviors; outreach from local health officials, trusted community leaders and NGOs; and incentives through conditional cash transfers such as PKH (*Program Keluarga Harapan*) or other social assistance programs. In particular, increased professionalization of Posyandu

cadres is important, through improved training quality, performance-based incentives, and strong supervision from Puskesmas (sub-district health centers). These cadres should visit every community to make sure that pregnant women receive routine prenatal care, mothers bring children for immunization, and other basic steps are taken to reduce the threat of illness, as well as the high costs of late treatment. With respect to stunting and nutrition, Posyandu cadres can play a key role in ensuring effective Behavioral Change Communication (BCC), especially through tailored personal counseling focusing on improved caring practices for maternal care and feeding behaviors for infants and young children. As shown in other countries, regular home visits to provide individualized support to mothers are key. Posyandu training pilots under PNPM Generasi could be further scaled up.

GAPS IN ACCESS TO SCHOOLS ARE GRADUALLY BEING CLOSED, BUT THIS NEEDS TO BE ACCOMPANIED BY IMPROVEMENTS IN THE QUALITY OF EDUCATION IN ORDER TO REDUCE INEQUALITY. Enrolment gaps between the rich and poor have been closing over time, but the contribution of inequality of opportunity to overall inequality has not fallen because of a persisting quality gap. This is also an important factor that is holding back higher economic growth. Encouraging all children to stay in school until at least the end of high school is an important step, which means improving access in some areas, and improving the targeting, coverage, benefit levels and uptake of scholarships for poorer households everywhere, with inducements for students to transition to the next schooling level. Nonetheless, there will be greater reductions in inequality of opportunity, as well as much greater gains to economic growth, if the quality gap is addressed (the benefits in terms of growth have been estimated for Indonesia to be around seven times higher for closing the quality gap than for closing the access gap). Broad whole-school management and pedagogic reforms that have worked in other countries may be needed, and follow-up efforts will also be required to determine the constraints to these types of reform in Indonesia. However, specific actions that can help include:

- **Ensuring adequate financing of schools, particularly in disadvantaged areas, to attain minimum quality standards.** A recent World Bank

Indonesia had the fifth-lowest health spending to GDP ratio out of 188 countries



report identifies a number of options to improve BOS (Bantuan Operasional Sekolah), including: (i) linking funding more directly to education standards in order to signal the importance of using BOS resources to fulfill these standards; (ii) revising the list of eligible items under BOS to provide schools with the flexibility to invest in quality enhancing inputs; (iii) adjusting the

value of BOS periodically to account for regional price differences and inflation to ensure that all schools can meet operating standards; (iv) using the BOS formula to provide more funding to schools serving poor and vulnerable children; and (v) phasing out the use of BOS resources to support the 'out-of-pocket' expenses of poor students in favor of existing targeted programs,



Adequate funding of public family planning programs is critical

such as KIP (Kartu Indonesia Pintar). At the same time, local governments can be encouraged to use their operational support to schools (Bantuan Operasional Sekolah Daerah, or BOSDA) in ways that complement BOS; BOS enables the meeting of minimum service standards while BOSDA can enable schools to meet higher national education standards. Recent reforms in DKI Jakarta suggest

one potential approach, by combining an equity component (rather than equal spending per person, schools in the Thousand Islands sub-district receive more funding because of the higher costs of service provision) and an incentive component (schools in the top quarter with respect to the level and increase in national test scores receive an extra allocation the following year). In addition, the targeted and performance-based DAK investments proposed in health could also be adopted for education based on district-level education gaps.

• **Increasing the competency of teachers everywhere, and ensuring sufficient distribution to disadvantaged areas.** Strategies could include: (i) greater selectivity at entry and exit (through the use of competency tests) and institutional accrediting to help ensure an adequate supply of competent teachers; (ii) recruitment and deployment of competent teachers, particularly in disadvantaged areas, by combining financial incentives, bonding schemes and group-based postings; (iii) stronger professional development and support; and (iv) greater teacher accountability, such as through the use of annual appraisal and competency tests to determine career progression, and tying contract renewal to performance.

TARGETED GOVERNMENT EFFORTS WOULD HELP IN PROVIDING POORER FAMILIES WITH EQUITABLE ACCESS TO FAMILY PLANNING SERVICES SO THAT THEY CAN CONTROL THE SIZE OF THEIR HOUSEHOLDS. Family sizes will fall as economic growth in Indonesia continues, alongside urbanization and increasing enrolment rates. Efforts are needed, however, to target poorer households so that they do not fall further behind due to higher fertility rates. This will require reducing inequalities in the knowledge, use, access and quality of family planning services, as well as ensuring that family planning is seen as a vital right. The private sector is used by 73 percent of Indonesian family planning users, so its ability to provide effective services to most Indonesians needs to be strengthened, not weakened. However, the private sector is unlikely to reach all poorer households sufficiently since it is difficult and costly to reach marginalized and poorer groups. Therefore, greater central and local government efforts are required to revitalize family planning programs, with strategies to target those who need them most. Specific actions include:

96 percent of Indonesians have access to skilled birth delivery, yet a quarter of all births are unskilled deliveries

- **Promoting the concept of family planning as a right for all.** One of the drivers of the reversals in fertility trends has been increasing rates of teenage pregnancy. This comes in part from social pressures against the provision of contraceptives to adolescents and the unmarried. At the same time, increased rates of early marriage are also leading to earlier births and larger families. Ensuring that all have access to family planning is essential.
- **Helping the private sector to deliver effective family planning, while enabling public programs to fill gaps in coverage.** With most Indonesians using private family planning services, the ability of the private sector to support family planning needs to be strengthened. Improved infrastructure and logistics would extend the reach of the private sector into more remote areas that are currently underserved and reduce the need for public provision. The Government should also examine how it can encourage private services to shift back towards longer-term and permanent methods for those families that have already reached their ideal size; these methods are more effective for this objective than short-term methods. At a minimum, current initiatives to criminalize the private provision of contraceptives are likely to further exacerbate current fertility trends. At the same time, with poorer households unable to access private sector services, adequate funding of public family planning programs is critical. With family planning budgeting now a local prerogative, a central agreement between the National Family Planning Agency (*Badan Kependudukan dan Keluarga Berencana Nasional*, or BKKBN) and the Ministry of Home Affairs (which oversees local government issues) on family planning financing is vital. Local champions of family planning need to receive technical assistance and local family planning boards could be established in more districts under existing regulations. The use of DAK could be altered to allow family planning spending to focus less on infrastructure and more on operational expenses, such as training of midwives and contraceptive supplies.
- **Developing local strategies for revitalizing targeted family planning services.** Clear government strategies could improve the provision of family planning information and services, focusing on marginalized and poorer target groups. An effective strategy would include a clear delineation of roles and responsibilities for local government, the Ministry of Health, and the

BKKBN, and focus on: improving the provision of family planning information and services; and promoting contraceptive use by couples from poorer and marginalized groups in planning their families. More effort is then needed to address the unmet contraceptive needs of economically disadvantaged couples, including through socialization; the provision of contraceptive services that are affordable for poorer households; and increasing the number of midwives who are qualified to insert IUDs and implants.

- **Even when households have access to services, they do not always use them.** New approaches need to be piloted to better understand what can encourage them to adopt the right behaviors. Inequality of opportunity is not always about lack of access. 96 percent of Indonesians have access to skilled birth delivery, yet a quarter of all births are unskilled deliveries, heightening the risk of maternal mortality. Earlier born children in a family are more likely to be fully immunized than those born later, indicating that access to health care is not the problem, but that household motivation for the right behavior drops over time. Stunting is partly due to household behaviors, such as curtailed exclusive breastfeeding and the introduction of the wrong complementary foods. Knowledge can be addressed through the strengthening of Posyandu cadres discussed earlier, but changes in behavior will also need new and innovative approaches tested in the field, potentially through such non-state actors as NGOs and the private sector.

02

Improving the skills of today's workers and providing them with better access to productive employment

INDONESIA COULD CREATE BETTER JOBS BY ADDRESSING THE BARRIERS AND CONSTRAINTS TO PRODUCTIVITY GROWTH, PARTICULARLY THROUGH BETTER INFRASTRUCTURE AND GREATER COMPETITIVENESS. One key area of reform is improving infrastructure, connectivity, and logistics, discussed in detail in a subsequent section. Beyond that, Indonesia's Ease of Doing Business



In the long run, only improved access to quality health and education will reduce unequal access to good jobs; in the short run, more can be done to improve the skills of today's workers and create more productive jobs

ranking requires constant improvement, as well as access to finance for small firms looking to expand. Both the manufacturing sector and the agricultural sector can be a major source of productive, semi-skilled jobs for poor and vulnerable workers, and consequently there is added emphasis on revitalizing those sectors.

INDONESIA COULD ALSO IMPLEMENT A “GRAND BARGAIN” BETWEEN GOVERNMENT, EMPLOYERS, AND LABOR UNIONS TO OVERHAUL LABOR MARKET REGULATIONS AND PROVIDE MORE EFFECTIVE WORKER PROTECTION. Current labor market regulations and worker protection in Indonesia are considered among the most rigid in the region and discourage formal job creation, but also result in low *de*

facto protection. Piecemeal reform of individual regulations and programs is difficult due to the perceived zero-sum nature of any change in industrial relations. For this reason an overall grand bargain may be needed in order to create a thorough set of reforms that is perceived to be beneficial to employers, labor unions, and to job seekers.

REFORMS IN INDONESIA’S SKILLS TRAINING SYSTEM CAN ALLOW WORKERS TO UPGRADE THEIR SKILLS AND ACCESS BETTER JOBS.

Provision of incentives to employers for needs-based and results-oriented training, ideally in partnership with training providers, can generate a greater degree of involvement by the private sector. Adjusting the level of subsidies to account

for the type of workers being trained, for instance women, youth and people living with disabilities, can address inequalities. A partnership with the private sector, particularly in the provision and financing of training, thus frees up public funds to expand the training system to all provinces and disadvantaged regions.

03

Strengthening social protection to help households cope with shocks

PROTECTING HOUSEHOLDS FROM SHOCKS REQUIRES ACTION ON MANY FRONTS.

Households face shocks from many sources. Further work could be done to assess the types of shocks that affect Indonesians the most (such as catastrophic natural events, longer-term environmental effects from climate change, personal health catastrophes, or diseases that affect livestock). This research could then inform the type of policy actions that will be required to address such shocks, including coping with natural disasters, building an effective social insurance system and ensuring adequate health services, particularly in poorer areas. In addition, the policy actions below could have a particularly strong impact on reducing inequality through protecting the poor and vulnerable.

GOVERNMENT POLICIES COULD MITIGATE THE EFFECT OF HIGHER FOOD PRICES ON THE POOR AND VULNERABLE. There are a number of policy areas where the Government can promote stability to prevent shocks from occurring. One important area that affects the poor is food prices, especially for rice. Domestic rice production has slowed in recent decades for a number of reasons—including slow mechanization and poor infrastructure and connectivity—and increased public spending has not spurred agricultural production. At the same time, price stabilization policies have not proved effective and may have even contributed to the problem; the current rice import regime is particularly harmful, with imports being restricted to the National Logistics Agency (Badan Urusan Logistik, or Bulog), a reluctance to import due to a national rice self-sufficiency goal by 2017, and poor data indicating constant rice surpluses despite a shortage of

stocks and high prices, driving trader speculation. Effective rice security will require an effective early warning system and reliable real-time information about prices, stocks and flows of rice. Over the longer term, achieving a sustained improvement in Indonesia's rice security will require increasing productivity through long-term structural improvements in the agriculture sector.

EFFECTIVE SOCIAL ASSISTANCE WOULD NOT ONLY BOOST INCOMES BUT ALSO ENABLE THE POOR AND VULNERABLE TO DEAL BETTER WITH SHOCKS.

For those unable to cope with shocks themselves or access contributory social insurance, stronger social assistance is needed. Safety nets also have an immediate impact on reducing poverty and inequality. Indonesia has been building and expanding a social assistance framework since the Asian financial crisis. However, these programs are not fully effective in protecting the poor and vulnerable. Further reforms should focus on: improving the targeting of these programs, which currently target chronic poverty rather than poverty due to shocks; expanding the coverage and benefit packages of programs that work so that they provide adequate protection to all vulnerable households; and adding new programs to fill in the gaps for those risks that do not currently have adequate protection (a public works program providing short-term employment, for example).

IN ADDITION, FOR THE NEWLY IMPLEMENTED SOCIAL INSURANCE PROGRAMS, ESPECIALLY HEALTH, IT IS



IMPORTANT THAT SUFFICIENT SUPPLY OF SERVICES ACCOMPANIES EXPANSION IN COVERAGE.

Access to preventative and treatment health services for all Indonesians is vital to help protect against the range of illnesses and accidents that can have catastrophic impacts on household incomes, spending and savings. While around 90 million Indonesians, many of them poor and vulnerable, have their premiums covered by the Government, there are just as many more people, who while often not living below the vulnerability line would nonetheless be badly affected by a serious health shock. Many of these people work in the informal sector, do not currently pay premiums, and are not yet covered. Reaching these households will be the main step in achieving universal health coverage. However, coverage alone does not provide adequate protection against shocks if there is not a corresponding availability of quality health services for all. The financing and health worker recommendations discussed under local service delivery are just as necessary to protect against shocks as they are to provide a healthy start for all children.

KNOWING WHERE, WHEN AND HOW TO RESPOND WHEN CRISES HIT IS ALSO KEY.

In the past, during the global financial crisis of 2008-09, for example, Indonesia lacked the monitoring system to know in a quick manner where negative effects were being experienced and by whom, and responses were less effective as these were often slow and uncoordinated. Developing a Crisis Monitoring and Response System (CMRS) is essential for detecting the effects of a crisis

and responding appropriately. Such a system has three components: (i) a permanent and relatively real-time monitoring system at both the national and household levels; (ii) a pre-agreed protocol for when, where, and which response will be initiated; and (iii) pre-agreed institutional arrangements on planning, coordination, funding and disbursement and monitoring and evaluation. The monitoring component has already been developed and implemented by the Secretariat of the National Team for the Acceleration of Poverty Reduction (TNP2K), but future action needs to focus on response protocols and institutional arrangements. A CMRS that links closely to existing disaster management tools will help to adjust public protection and support programs to deliver the right protection to the right people.

04 Using government taxes and spending to address inequality now and in the future

A FOCUS ON FISCAL POLICY IS REQUIRED TO ADDRESS INEQUALITY IN THE LONG TERM.

Addressing inequality of opportunity and providing better jobs in the long run requires government spending. Many of the policies that can reduce inequality of opportunity need significant government investment: increased health spending and continued funding of

The Government can address inequality through how it chooses to raise and spend revenue





education, greater investment in infrastructure, and increased social assistance coverage, benefits and social security for all. Aligning government budgets behind these priorities is one key role that fiscal policy can play in addressing long-term inequalities due to factors outside of an individual's control.

HOWEVER, FISCAL POLICY COULD ALSO BE USED TO ADDRESS INEQUALITY IN THE SHORT TERM. In general, this is not currently practiced in Indonesia, but it could be. Many of the policy actions to be discussed will only have an effect on inequality in the long term, such

as increased child health and nutrition, better quality of education and skills development, higher labor productivity and an environment that favors job creation. However, the design of overall fiscal policy could also impact inequality in the short term through a number of channels. Different households can have their current income affected in different ways through the Government's choice of taxes, transfers, subsidies and in-kind services. In a number of countries, the Gini has declined substantially after accounting for fiscal policy. For example, Brazil's Gini is 14 points lower after all government taxes and spending are taken into account, compared with the Gini based

on market income alone. However, in Indonesia net changes to household income from taxes and transfers leave the Gini coefficient almost unchanged. For example, when including in-kind health and education spending, the Gini only drops a modest two points⁸. Aligning fiscal policy to support lower inequality requires:

- **Spending in the right areas: social assistance, health and infrastructure.** The key channel for reducing inequality is the right spending. Indonesia has historically spent much on policies that do the least to reduce inequality, such as subsidies, and little on those policies that have the greatest effect, such as social assistance programs like PKH (a conditional cash transfer), BSM (now Kartu Indonesia Pintar, or KIP, a scholarship program for the poor), and health. Redirecting spending to these more equitable areas is vital. However, spending can also be made more pro-poor. The current spending on education, health and social assistance does not reduce inequality as much as it does in other countries. In addition, a large part of the proposed increase in health spending in 2016 (up to 5 percent of all spending) is devoted to the national health insurance system (Jaminan Kesehatan Nasional, or JKN). This currently skews spending towards large hospitals in the major cities, which tends to benefit richer households more, whereas spending on greater primary health care would be more pro-poor.

- **Infrastructure is of key importance, as it supports policies to address inequality in all other areas.** The planned reallocation of fuel subsidy savings into greater investments in infrastructure is also critical. Infrastructure spending can increase access to services; a quarter of Indonesia's urban populations and more than half of rural dwellers have poor access to transport. Improving transport will greatly assist efforts to increase access to family planning services, maternal and child health services, and schooling. It will also reduce transportation costs and increase connectivity and productivity. This will have multiple benefits. Transportation problems are a major constraint for manufacturing. Reducing these constraints will increase productivity and competitiveness, help to create more and better jobs, and bring local raw material producers closer to domestic markets. For instance, it is currently cheaper to import oranges from China than to source them from Kalimantan. Increased connectivity for remote areas and reduced logistics costs in general will

also help to reduce the high and volatile rice and other staple food prices, which disproportionately affect the poor. Finally, it has been estimated that Indonesia is losing more than 1 percentage point of additional annual GDP growth due to under-investment in infrastructure, chiefly transportation. Removing this constraint would lead to more jobs, higher household income and consumption, and greater fiscal resources for government spending on programs, all of which would also help to level the playing field for everyone.

- **While fiscal policy could be used to address inequality now, this should be done in a sustainable fashion, with spending growth not outstripping revenue growth.** When too much is spent on redistribution and other social spending relative to revenues, the fiscal framework can become unsustainable. Indonesia can afford to spend more on social spending, but it is important that expansions in spending are not based on unrealistic increases in revenues, which is a risk both for the 2015 budget and the 2015-19 National Medium-Term Development Plan (Rencana Pembangunan Jangka Menengah Nasional, or RPJMN). Significant reforms will be required to increase revenues. If "business as usual" is assumed, with no significant reforms on revenue policy or administration, baseline revenue for 2015-19 is projected to stay level at between 13.3 to 13.5 percent of GDP. If not legally constrained to keep the fiscal deficit below 3.0 percent of GDP (i.e., the fiscal rule), this would otherwise mean that the deficit would reach 4.6 percent of GDP in 2015, rising to 6.0 percent of GDP by 2019. Unless additional fiscal space is created, the Government will have to dramatically cut back on the planned (and needed) increased spending on development and inequality priorities.

- **The revenue mix used to achieve fiscal sustainability can also influence inequality today.** The Government can pay for inequality-reducing spending in a number of ways. An important consideration is who pays different taxes and non-tax revenues and how this affects inequality. There are approaches that both raise revenue and mitigate inequality for indirect taxes such as value-added tax (VAT) and luxury taxes, personal and corporate income taxes, and non-tax revenue from resources.

⁸ See Jellema, Wai-Poi and Afkar (2015) "The Distributional Impact of Fiscal Policy in Indonesia" and Ministry of Finance and World Bank (2015) "Taxes and Public Spending in Indonesia: Who pays and who benefits?"



OUR CONCLUSION

URGENT ACTION IS NEEDED TODAY AND AN IMMEDIATE IMPACT IS POSSIBLE. Remedial action takes time to take effect, which means beginning now. Beginning now can also capitalize on both the political will that currently exists to tackle inequality, as well as the current popular support for taking action (88 percent of Indonesians surveyed think that addressing inequality is either “very urgent” or “quite urgent”). Moreover, there is danger in delaying. With many wealthier Indonesians opting out of public health, education and other services, there is a risk that they will be neither strong proponents for better public service delivery, nor supportive of increased and fairer public spending on these services, funded through taxation.

ADDRESSING INEQUALITY IS LARGELY A LONG-TERM EFFORT THAT DEMANDS A LONG-TERM POLICY COMMITMENT. Inequality generally changes slowly over time, so a rapid reduction in the short term is unlikely. Some key policies for addressing inequality, such as more equal opportunities in health and education for today’s children combined with better jobs tomorrow, will take a generation to bear fruit. Nonetheless, addressing inequality cannot be done without breaking the inter-generational transmission of poverty and inequality, a policy objective that has widespread support. This will require pursuing equality of opportunity as quickly as possible, which in turn will need higher revenue collection, then a redirection of spending, leading to better targeting and delivery of services, and improved quality of those services.





RISING INEQUALITY¹⁰

The Recent Trend and Why It Matters

1.1
**The recent trend in
inequality**
37

1.2
**Does inequality
matter?**
42

¹⁰ This section summarizes the detailed analysis of various background papers. See World Bank (2015a) for evidence and analysis of people's perceptions and preferences relating to inequality. See World Bank (2015b) for evidence and analysis of how unequal access to services and other opportunities are. Also see World Bank (forthcoming (c)) on "Top Incomes in Indonesia." Main findings are summarized in World Bank (2014b).

1.1.

THE RECENT TREND IN INEQUALITY

Inequality has been increasing in Indonesia as strong economic growth has not been shared equally by all

INEQUALITY HAS BEEN INCREASING IN INDONESIA SINCE 2000. BY ANY MEASURE OF INEQUALITY, THE DISPARITY BETWEEN THE ECONOMIC LIVING STANDARDS OF DIFFERENT HOUSEHOLDS HAS BEEN INCREASING.

In 2002, the richest 10 percent of Indonesians consumed as much in total as the poorest 42 percent, while by 2014, they consumed as much as the poorest 54 percent. Real per capita consumption (after adjusting for inflation) grew by only 12 percent between 2002 and 2014 for the poorest 10 percent of Indonesians, by an average of 25 percent for the poorest 80 percent, but by 56 percent for the second-richest 10 percent and a massive 74 percent for the richest 10 percent (Figure 1.1). Of a number of ways of measuring inequality (see Box 1.1), the most popular measure is the Gini coefficient, where 0 represents complete equality and 100 represents complete inequality¹¹. In Indonesia, the Gini coefficient increased from 30 points in 2000—relatively moderate by international standards—to 41 points in 2014, a fairly sharp increase over that period of time.

MOREOVER, THE DEGREE OF INEQUALITY IS UNDERESTIMATED. In the household survey data used to calculate inequality, only 2 million Indonesians consume more than IDR 4 million per month, which is only 0.8 percent of the population. Only 218,000 consume more than IDR 10 million per month, or less than 0.1 percent of the population¹². These numbers appear

surprisingly low. Furthermore, around half of the cars registered with the state police (5 million cars) do not appear in the survey data¹³. This suggests that if more of the wealthier Indonesians were captured in the survey data, measured inequality would be even higher¹⁴. Moreover, when corruption is high, many of the gains from that corruption—and its contribution to inequality—may be hidden. Indonesia's ranking of 107 out of 175 on the Corruption Perceptions Index (a lower ranking means a country is perceived as more corrupt) also suggests that some income inequality due to corruption is not being captured (Transparency International 2015).

THE RECENT INCREASE IS A DEPARTURE FROM HISTORICAL TRENDS AND INEQUALITY IS NOW THE HIGHEST LEVEL IT HAS EVER BEEN SINCE MEASURES BEGAN.

The Gini coefficient was relatively stable during the second half of the Suharto era, although it was beginning to increase in the period leading up to the Asian financial crisis of 1997-98. With richer households being the hardest hit during the crisis and also the slowest to recover, the Gini actually fell between 1996 and 2000. However, in the subsequent period of democratization, decentralization and commodities boom-fueled economic growth, the Gini rose significantly from 30 in 2000 just after the Asian financial crisis to 37 by the time of the global financial crisis of 2008-09. Indonesia managed to weather this more recent crisis and

¹¹ It is often expressed instead as a proportion between 0 and 1.

¹² Susenas household monthly per capita consumption, adjusted by provincial urban-rural differences in cost of living, as measured by BPS poverty lines. A similar result is obtained if nominal consumption is used instead.

¹³ There are 11.5 million passenger cars registered with the police. Assuming around 1 million of these are for commercial use or

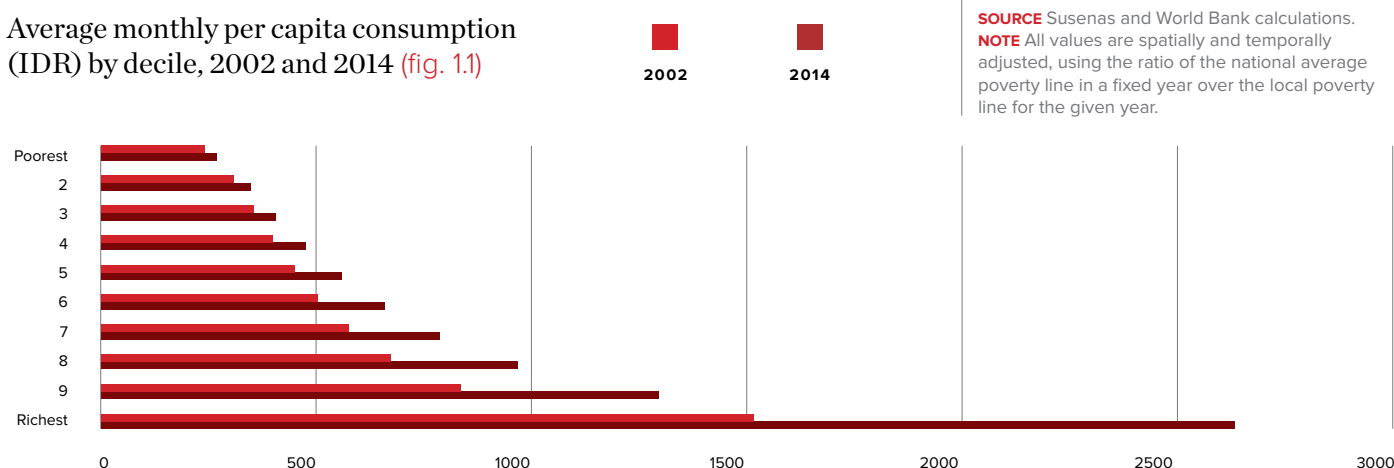
represent second cars in a household (relatively rare in Indonesia), then around 10.5 million households in Indonesia own passenger cars, of which only 5.6 million appear in Susenas.

¹⁴ One of the background papers attempts to quantify how many wealthier Indonesians are missing in the survey data, and to estimate a more accurate measure of inequality. See World Bank (forthcoming (c)) "Top Incomes in Indonesia."

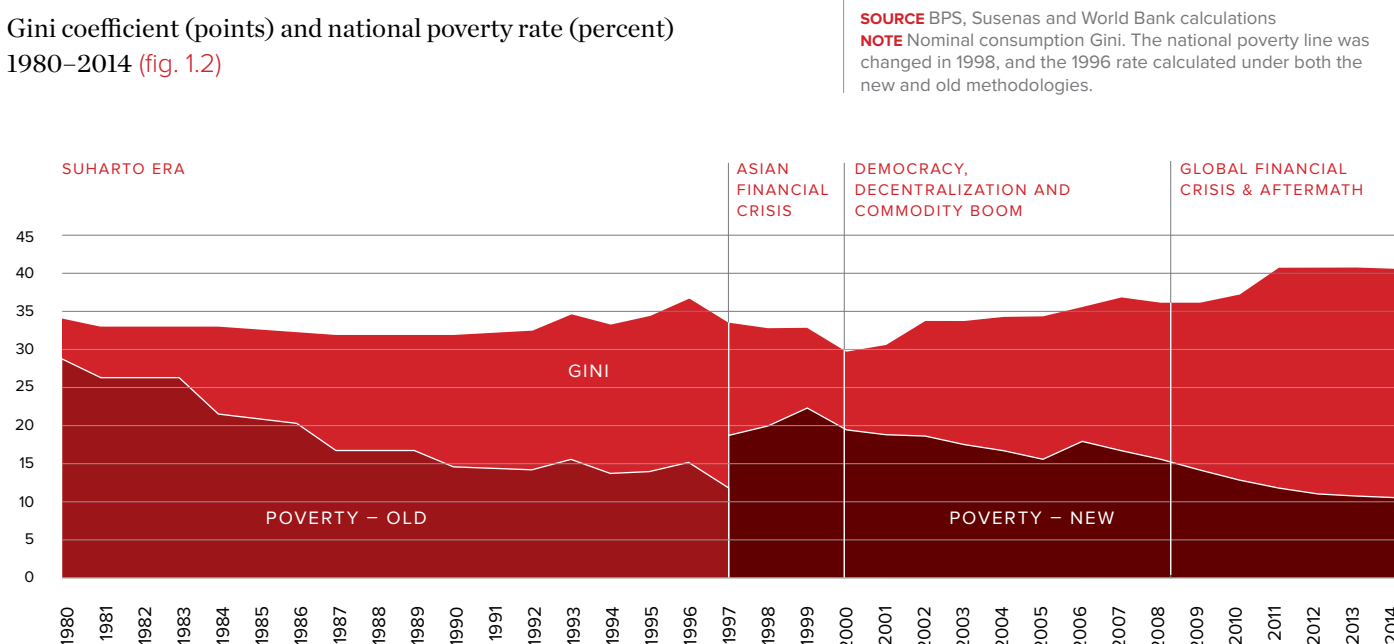
sustain robust growth, but inequality has continued to increase since then, with the Gini reaching 41 by 2014 (Figure 1.2). However, the Gini has remained stable at 41 since 2011, and there may be reason

to believe that at least some of the large increase between 2010 and 2011 was due to changes in survey methodologies (see Box 1.1).

Average monthly per capita consumption (IDR) by decile, 2002 and 2014 (fig. 1.1)



Gini coefficient (points) and national poverty rate (percent) 1980–2014 (fig. 1.2)

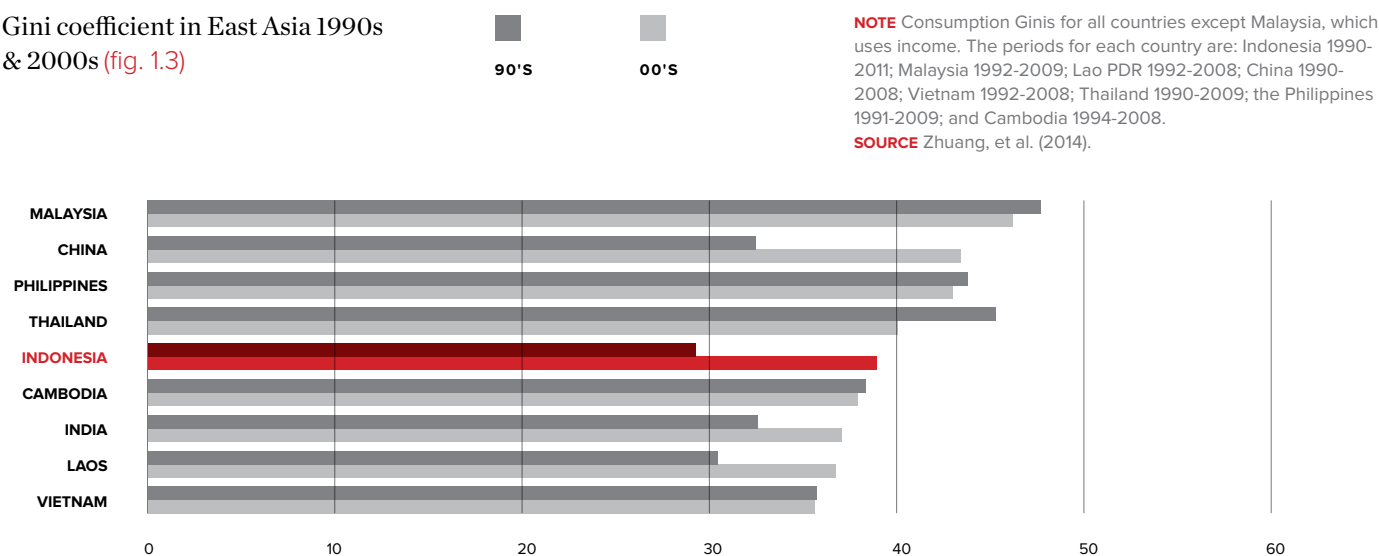


BY REGIONAL STANDARDS, INDONESIA'S LEVEL OF INEQUALITY IS RISING QUICKLY, ALTHOUGH IT IS NOT YET AS HIGH AS IN SOME DEVELOPING COUNTRIES. At the beginning of the 1990s, Indonesia had the lowest Gini coefficient in the region (Figure 1.3). However, by the late 2000s, it had caught up, or nearly so, with most other countries in the region. This was because the size of the increase in the Gini over this period was second-largest only to China, and most of Indonesia's increase has been in the past decade alone. Moreover, inequality was rising quickly in Indonesia at the same time as

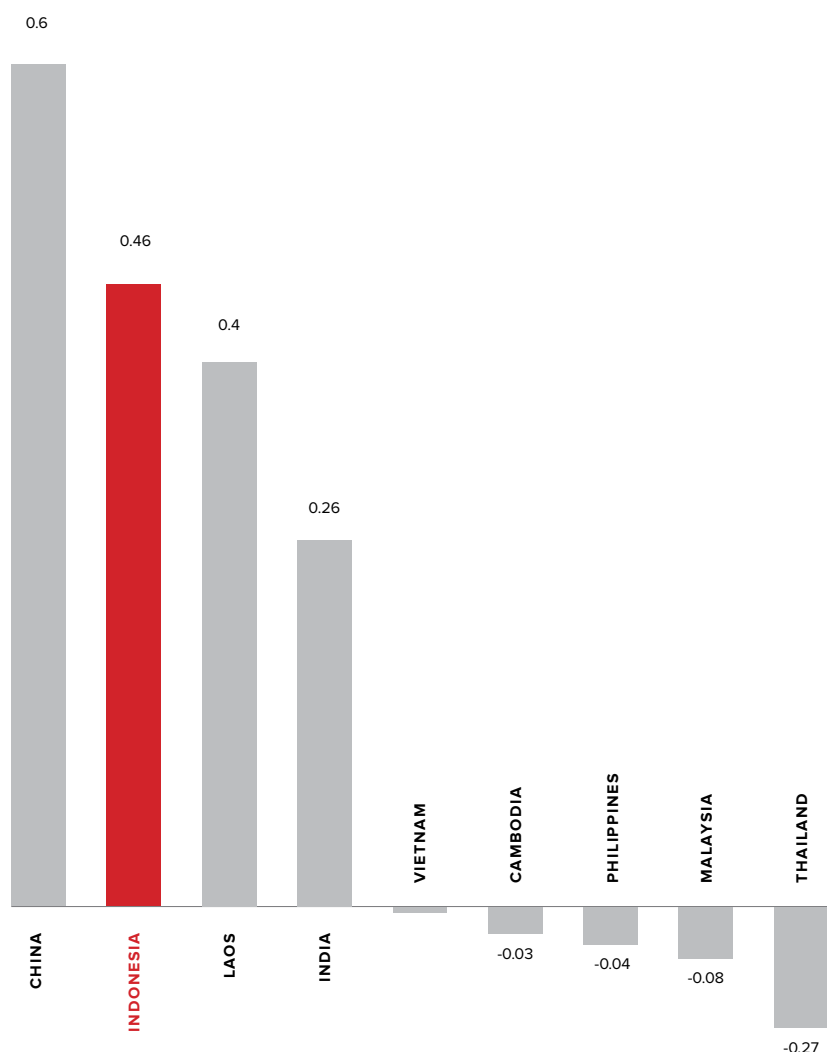
it was stable or falling in fast-growing East Asian neighbors such as Malaysia, Thailand and Vietnam (Figure 1.4). This speed of increase is also rapid by world standards, although inequality remains higher in a number of other lower middle-income countries, particularly in Latin America (Figure 1.5).

¹⁵ The Ginis for Indonesia in Figure 1.3 and Figure 1.5 differ slightly from the Ginis in Figure 1.2. The regional comparisons are based on calculations from PovcalNet, and while they use the same underlying household survey data, the methodology differs from calculating the Gini directly from the underlying data, as the official Indonesian Gini has been.

Gini coefficient in East Asia 1990s
& 2000s (fig. 1.3)



Annualized point change in Gini
coefficient in East Asia, 1990s and
2000s (fig. 1.4)



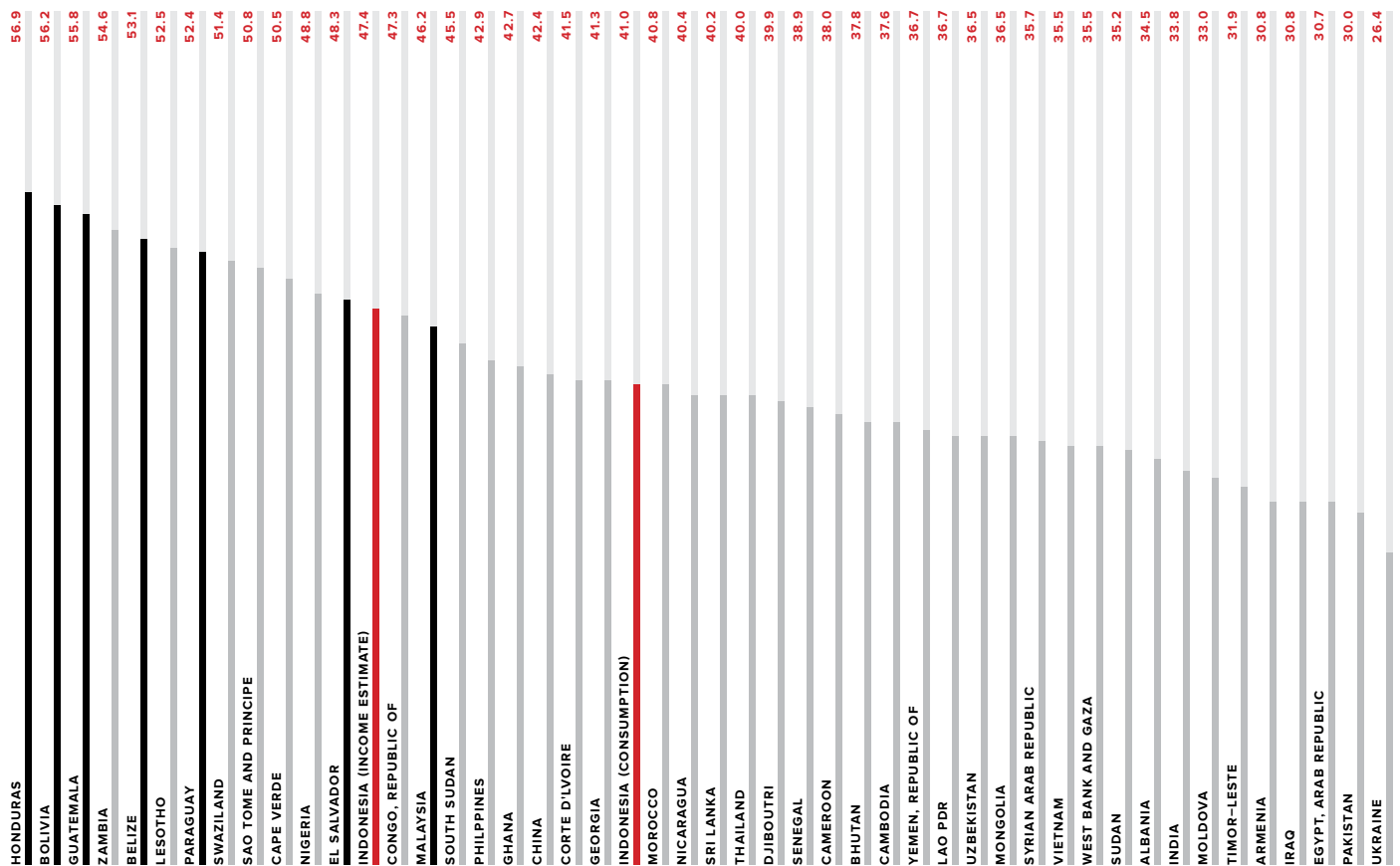
FIFTEEN YEARS OF SUSTAINED GROWTH HAVE REDUCED POVERTY AND CREATED A GROWING CLASS OF ECONOMICALLY SECURE HOUSEHOLDS.

After recovering from the 1997-98 Asian financial crisis, Indonesia's real GDP per capita grew at an annual average rate of 5.4 percent between 2000 and 2014. This robust growth rate helped to pull many out of poverty; the poverty rate more than halved from 24 percent during the Asian financial crisis down to 11 percent by 2014. Growth has also helped to create a stronger middle class than ever before; there are now 45 million people (the richest 18 percent of all Indonesians) who are economically secure and enjoying a higher quality of life. They are the fastest growing segment of the population, at 10 percent per year since 2002 (Figure 1.6)¹⁶.

HOWEVER, THE ECONOMICALLY SECURE ARE NOW LEAVING THE OTHER 205 MILLION BEHIND.

The benefits of economic growth have been enjoyed largely by the growing middle class. Between 2003 and 2010, consumption per person for the richest 10 percent of Indonesians grew at over 6 percent per year after adjusting for inflation, but grew at less than 2 percent per year for the poorest 40 percent. This has contributed both to a slowdown in the pace of poverty reduction, with the number of poor people falling by only 2 percent per year since 2002, and the number of those vulnerable to poverty falling barely at all (Figure 1.6).

¹⁶ For this report, households in the middle class in Indonesia are defined as those who are economically secure from poverty and vulnerability. See note to chart and World Bank (forthcoming (a)) for more details.

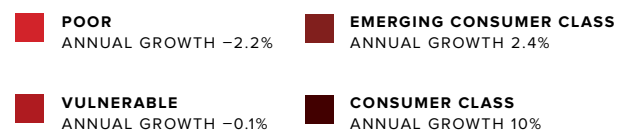


Gini coefficients for lower middle-income countries (fig. 1.5)

SOURCE World Development Indicators, most recent year available.

NOTE Income Ginis are in black, consumption Ginis are in grey. Indonesian income Gini is estimated as the consumption Gini plus 6.4 points, which is the average increase in Gini from consumption to income for the three years when both income and consumption Ginis were collected in Indonesia (1984, 1990 and 1993).

Population share by class 2002–2014 (fig. 1.6)



SOURCE Susenas and World Bank calculations. The poor are below the national poverty line of around IDR 300,000 per person per month. The vulnerable have a greater than 10 percent chance of being poor the next year and are under 1.5 times the poverty line. The consumer class is economically secure, with a less than 10 percent chance of being poor or vulnerable next year, and consume more than IDR 1 million per person per month. The emerging consumer class is safe from poverty but not vulnerable and lie between the vulnerability and economic security lines. See World Bank (2015b) for more details.

BOX 1.1

Measuring inequality

Measures of Inequality.

The Gini coefficient is the most commonly used measure of inequality. It lies between 0 (perfect equality) and 1 (perfect inequality), with a usual range between 0.3 and 0.5. Often this is expressed in points, as in this report, between 0 and 100. Gini coefficients are typically calculated from income or consumption distributions (with consumption distributions usually being more equal than their income counterparts, by an average of 6.6 points; Deininger and Squire 1996). The Gini is constructed from the Lorenz curve, shown on the right, which compares the cumulative frequency curve of the actual distribution (consumption in the case of Indonesia) with the cumulative frequency curve that would result if all individuals had the same consumption. The Gini is calculated as $A/(A+B)$, where A and B are the areas as indicated on the chart. While the Gini satisfies many of the desirable properties of an inequality measure, it is not easily decomposable or additive across groups, so that the national Gini is not equal to the sum of Ginis at the sub-national level (e.g., urban-rural or regional). Commonly used inequality measures that

have all the desirable properties are the Theil indices, belonging to the family of generalized entropy inequality measures. The general formula is given by:

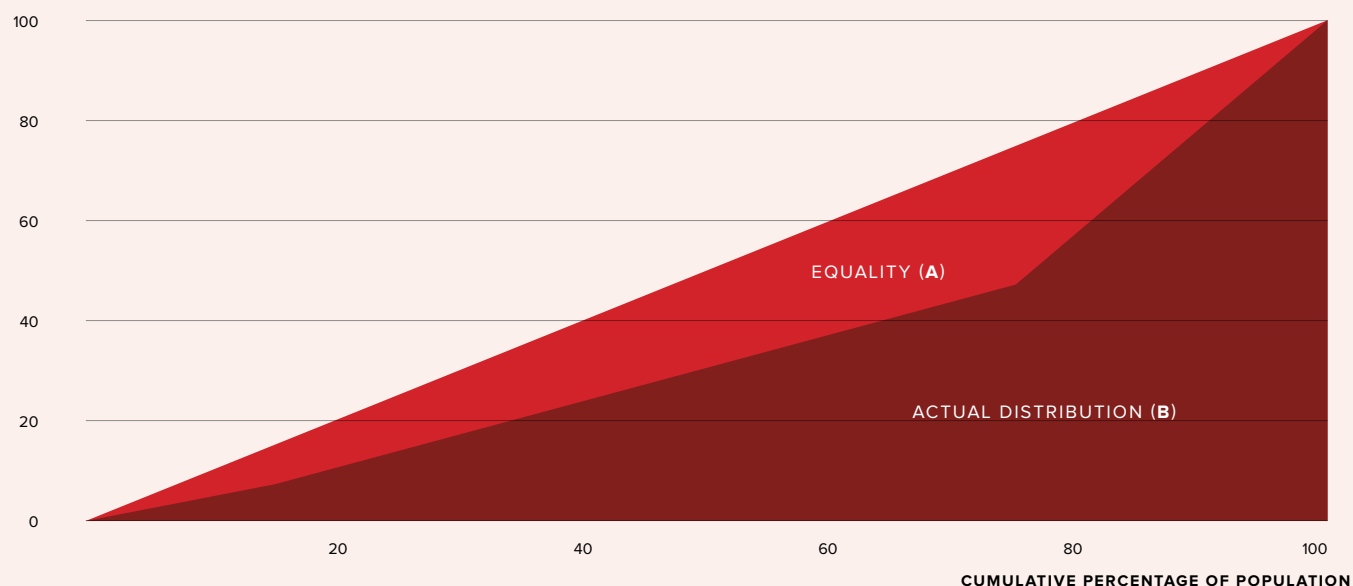
$$GE(\alpha) = \frac{1}{\alpha(\alpha - 1)} \left[\frac{1}{N} \sum_{i=1}^N \left(\frac{y_i}{\bar{y}} \right)^\alpha - 1 \right]$$

where y_i is the consumption for person i , \bar{y} is the mean consumption per person, and α is a parameter which represents the weight given to distances between consumptions at different parts of the income distribution and can take any real value. GE measures can take values between zero and infinity, with zero representing equality and higher values representing higher levels of inequality. For lower values of α , the measure is more sensitive to changes in the lower tail of the distribution, and for higher values of α , the measure is more sensitive to changes that affect the upper tail. The most common values of α used are 0, 1, and 2. Theil's T index is $GE(1)$ and Theil's L index is $GE(0)$, also known as the mean log deviation measure. For more information on the Gini coefficient For more information on the Gini coefficient and Theil measures, see Haughton and Khandker (2009) *Handbook on Poverty and Inequality*.

Measuring Indonesian Inequality with Household Survey Data.

Household consumption inequality (and official poverty) is measured in Indonesia using the National Socio-economic Survey (Susenas), which is a nationally representative household survey conducted annually. The sampling methodology changed significantly in 2011, with the number of primary sampling units (Census Blocks) surveyed roughly doubling, and the number of households surveyed in each Census Block roughly halving. While this keeps the total sample size nationally and for each district the same, it means a greater variety of neighborhoods are included. As a consequence of the new sampling methodology, the poverty and inequality series are not strictly comparable between 2010 and before and 2011 and after. This may explain the unusually large jump in inequality seen between 2010 and 2011. It is possible that the new methodology captures more of the richer households who may have been missing in earlier rounds.

CUMULATIVE PERCENTAGE OF CONSUMPTION



DOES INEQUALITY MATTER?

1.2

Not all inequality is bad, but inequality can be unfair when not everyone has the same initial opportunities

INEQUALITY IS NOT ALWAYS A BAD THING; IT CAN PROVIDE REWARDS FOR THOSE WHO WORK HARD AND TAKE RISKS. Hard work and innovation benefit society by creating new goods and services that everyone can enjoy, as well as contributing to a larger economy. This, in turn, can provide the Government with a greater ability to provide public services to all. If this results in an income gap between those hard workers and those who work less hard, then some inequality may be justified and even desirable. Many Indonesians share this view. When asked in a 2014 survey whether inequality is ever acceptable, 74 percent say that “inequality is sometimes acceptable” so long as wealth acquisition is fair and meritocratic (LSI 2014).

INEQUALITY CAN BE UNFAIR AND HARMFUL, HOWEVER, WHEN IT IS CAUSED BY FACTORS BEYOND THE CONTROL OF INDIVIDUALS. Not all Indonesians have the same opportunities in life. Factors beyond the control of an individual—where you are born, how educated or wealthy your parents are, and what access to public services you had when you were growing up—can have a major influence on how your life turns out. Getting a healthy start in life and a quality education are fundamental prerequisites for getting a good job and earning a decent living in the future. Inequality of opportunity occurs when not everyone has a fair start in life that, consequently, prevents those individuals from reaching their potential, resulting in unequal outcomes. Other factors outside of an individual’s control that can affect incomes, standards of living and inequality include government policies, such as food import restrictions that increase the cost of living most for the poor, or patterns of government taxes and spending that do not collect and channel sufficient resources to help those who need them most.

HIGH LEVELS OF INEQUALITY MAY SLOW ECONOMIC GROWTH, WHILE MORE EQUAL COUNTRIES MAY GROW FASTER. High inequality may reduce economic growth for all, if poorer people are unable to properly invest in their children’s development, if people fail to exit poverty and vulnerability and move into the consumer class, and if people fail to find productive jobs. Recent research (Dabla-Norris, et al. 2015) indicates that a higher Gini coefficient leads to lower and less stable economic growth¹⁷. Moreover, when the share of total income held by the richest 20 percent of people increases by 5 percentage points, economic growth falls by 0.4 of a percentage point. At the same time, when the share of total income held by the poorest 20 percent of people increases by 5 percentage points, growth increases by 1.9 percentage points. Increased income shares for the second- and third-poorest 20 percent of the population also increases growth.

INEQUALITY HURTS ECONOMIC GROWTH WHEN IT IS DUE TO A LACK OF GOOD JOBS. Many of the poor cannot find good jobs because they lack sufficient education. At the same time, many non-poor with better education still cannot find productive work (Figure 1.8). Most of the jobs created since 2001, and indeed most current jobs, are in low-productivity sectors. This undermines economic growth, as it fails to maximize today’s labor force’s productive potential at the exact time when the demographic dividend is peaking.

INEQUALITY CAN HURT GROWTH IN OTHER WAYS AS WELL. High levels of inequality can

¹⁷ There is some other empirical support to higher inequality being related to lower growth (for example, Berg and Ostry 2011), although cross-country evidence has been inconclusive (Banerjee and Duflo 2003).

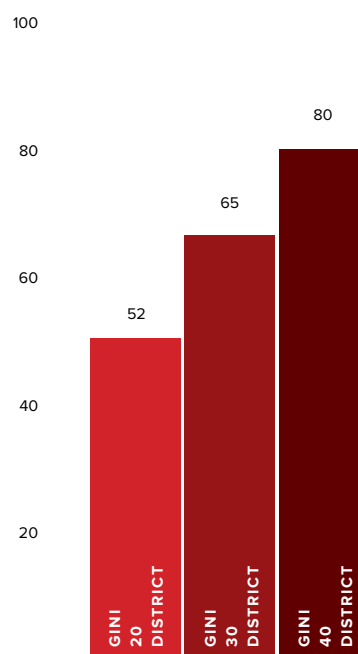
High inequality can also lead to slower growth and poverty reduction, and increased conflict

harm growth through a number of channels. First, increased social instability can affect the economy by deterring investment and disturbing labor relations¹⁸. Second, the inability of the poorest 40 percent to exit vulnerability and move into the middle class weakens future middle class-driven consumption growth. Moreover, if consumption growth of the poorest 40 percent remains below the national average, then the resulting higher inequality may also reduce economic growth through a number of other channels¹⁹. In the presence of credit market imperfections, investment in human capital may be lower (Galor and Zeira 1993), as may entrepreneurial activity (Banerjee and Newman 1993).

RISING INEQUALITY ALSO HINDERS PROGRESS IN REDUCING POVERTY. Between 2003 and 2010, poverty fell from 17.4 percent to 12.0 percent, a decline of 5.4 percentage points. However, because much of the economic growth during this period was enjoyed by the rich, consumption of the poor rose slowly. What would have happened to poverty if economic growth had been shared equally across all households? In fact, there was sufficient economic growth to have pulled everyone under the line out of poverty; that means, official poverty would have fallen to zero if average consumption growth over the period had been enjoyed by all²⁰. Of course, Indonesia may not have experienced the same rate of economic growth in the equal-sharing scenario, but it is clear that the unequal growth pattern of the 2000s meant that poverty fell more slowly than would have otherwise been the case.

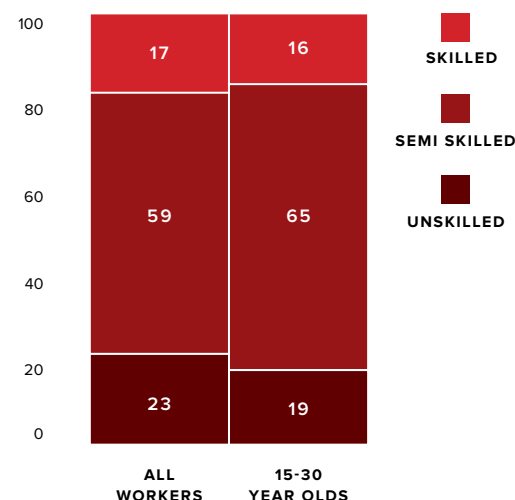
HIGH INEQUALITY CAN ALSO HAVE NEGATIVE EFFECTS ON INDONESIA'S SOCIAL COHESION. Recent research (Pierskalla and Sacks 2015) has found that districts with higher inequality have more conflict. Based on the data used in that study, it is estimated that the average number of conflict events in districts with medium inequality (Gini of 30) is 25 percent higher than in districts with low inequality (Gini of 20); conflict in high inequality districts (Gini of 40) is 54 percent higher than low inequality districts (Figure 1.7).

Average conflict incidents for low, medium and high inequality districts (fig. 1.7)



SOURCE
Calculated from NVMS conflict database covering 14 provinces from 1997-2013 (year coverage varies from province to province) and DAPOER used in Pierskalla and Sacks (2015).

Type of jobs for senior secondary school graduates (fig. 1.8)



SOURCE
Sakernas 2001-10 and World Bank calculations.

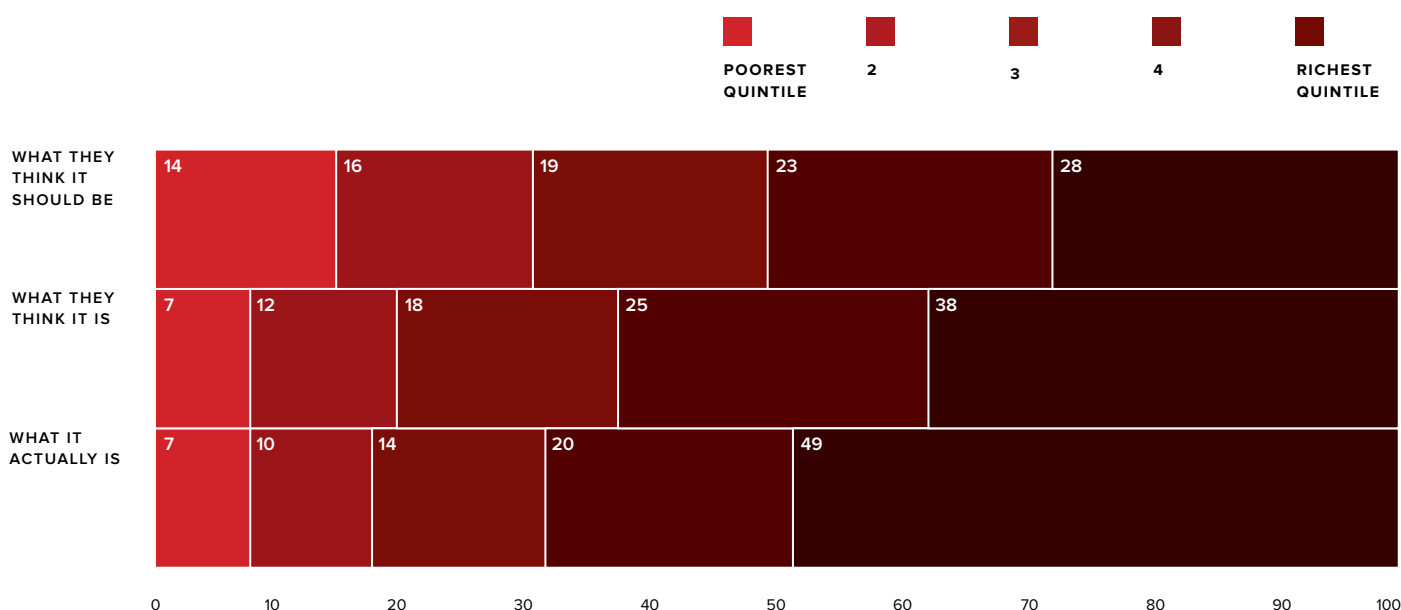
¹⁸ See Gupta (1990), Keefer and Knack (2002) on the effects of political instability on economic growth, and Alesina and Rodrik (1994), Alesina and Perotti (1994) and Persson and Tabellini (1994) on links between political economy and economic growth.

¹⁹ See also Mason (1988) on unproductive investments, Marshall (1988) on demand patterns, Galor and Zang (1997) and Kremer and Chen (2002) on fertility, Murphy, et. al. (1989) and Mani (2001) on domestic market size.

²⁰ This is the result of a Datt-Ravallion decomposition. 2003 is used as the base year for the decomposition. There is a large residual which cannot be interpreted strictly as due to growth or changes in the distribution. Conservatively, all of the residual is allocated to redistribution, so growth component estimate represents the lower bound. Even under these conservative assumptions, poverty would have been reduced to zero.

Share of national consumption by each quintile:
what people think it should be, what people think it
is, what it really is (percent) (fig. 1.9)

SOURCE World Bank (2015a)
using LSI (2014) data



Most Indonesians think inequality is already too high and needs to be addressed urgently

MOST INDONESIANS WILL TOLERATE A DEGREE OF INEQUALITY. When people were asked whether inequality is ever acceptable, 74 percent say that “inequality is sometimes acceptable” (LSI 2014). While there are a number of conditions in which people feel that inequality is acceptable (World Bank 2015a), generally this is when wealth acquisition is fair and meritocratic, and when the rest of the country is benefitting through affordable food prices and lower poverty rates.

HOWEVER, MANY PEOPLE THINK INEQUALITY IS TOO HIGH. Most people surveyed think that inequality is too high. They estimate that the richest fifth of Indonesians account for 38 percent of all consumption, while they think it should only be 28 percent. Conversely, they estimate that the poorest fifth receive only 7 percent and think it should be more like 14 percent (Figure 1.9).

IN FACT, INEQUALITY IS EVEN HIGHER THAN MOST INDONESIANS THINK. National household consumption survey data show that the richest fifth actually performs 49 percent of all consumption, compared with the 38 percent that most Indonesians think the level of consumption really is, and the 28 percent they believe it should be (Figure 1.9).

MOST INDONESIANS THINK THAT ADDRESSING INEQUALITY IS AN URGENT PRIORITY. Of those surveyed, 47 percent say it is “very urgent” for the Government to address inequality, and another 41 percent feel it is “quite urgent” (LSI 2014).

TO UNDERSTAND WHAT DRIVES INEQUALITY IN INDONESIA AND THEREFORE HOW TO ADDRESS IT, THIS REPORT CONSIDERS THE DIFFERENT RESOURCES THAT HOUSEHOLDS HAVE AND HOW THEY GENERATE INCOME FROM THESE RESOURCES. Households use different resources to earn income. They use their labor to earn wages and salaries, but they can also earn income from financial and property assets. Understanding why some households have better jobs and earn more, and why some households have more financial assets and earn more, is key to understanding why inequality is rising.





WHY INEQUALITY IS RISING

| | | | | |
|---|--|--|---|--|
| 2.1 A framework for understanding inequality 47 | 2.2 Why an unfair start in life holds the poor back 53 | 2.3 Why a widening gap between skilled and unskilled wages is increasing inequality 71 | 2.4 Why financial and physical assets are helping the rich pull away from the rest 81 | 2.5 Why shocks make it even harder for many to catch up 87 |
|---|--|--|---|--|

This section examines the main drivers of inequality. The section starts by trying to understand why consumption is growing faster for richer households than other households by laying out a framework for understanding how households generate income. The heart of the section looks at the main drivers of income inequality: how an unfair start in life means that some families do not develop their human resources as well as they could; how this means that only some can benefit from the differences in wages for skilled and unskilled workers; how a small number of Indonesians are benefitting from financial resources; and how differences in vulnerability to shocks and the ability to cope with them prevent

many Indonesians from being able to climb up the economic ladder. The rest of this section is divided into five parts:

- 1 A framework for understanding inequality;
- 2 Why an unfair start holds the poor back;
- 3 Why a widening gap between skilled and unskilled wages is increasing inequality;
- 4 Why financial assets are helping the rich pull away from the rest; and
- 5 Why shocks make it even harder for many poor or vulnerable Indonesians to catch up.

2.1

A FRAMEWORK FOR UNDERSTANDING INEQUALITY

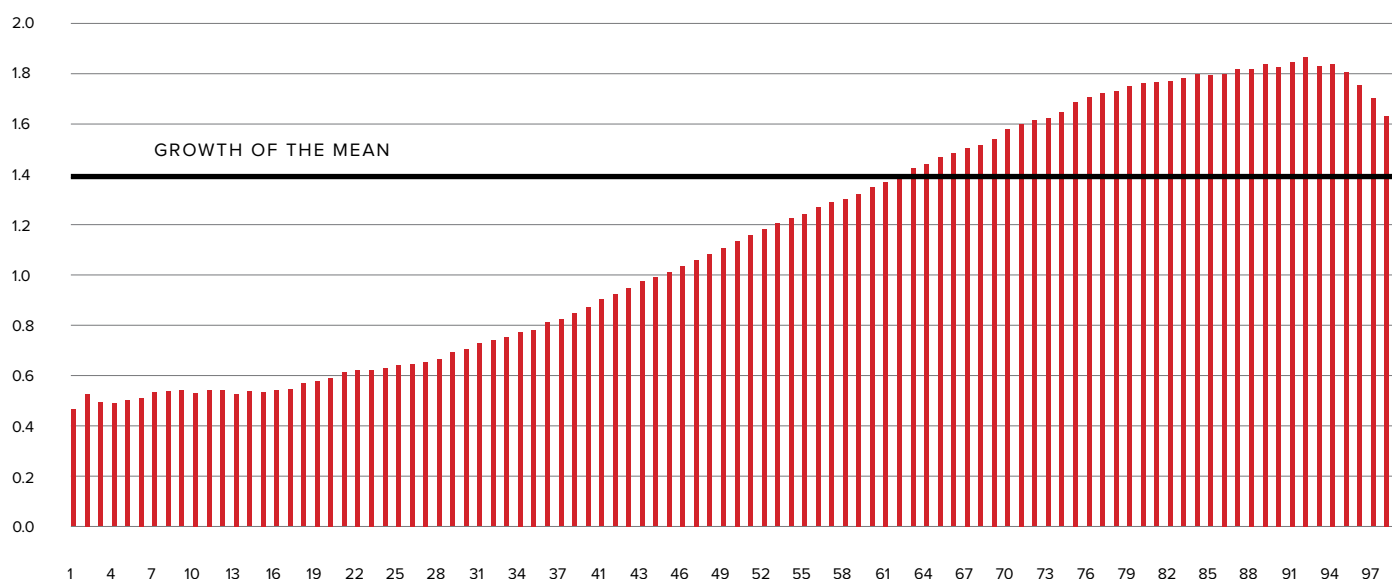
Recent economic growth has been enjoyed more by richer households than the rest

INEQUALITY IS RISING BECAUSE INCOMES FOR RICHER HOUSEHOLDS ARE GROWING FASTER THAN THOSE FOR THE POOR AND THOSE IN THE MIDDLE. Over the period of 1996 to 2010, average annual growth in household consumption grew three times faster for the richest

households than the poorest ones (Figure 2.1 and Box 2.1). The poorest 60 percent of households had consumption growth below the mean, and growth for the poor and vulnerable was close to zero in real terms.

Growth incidence curve by household per capita consumption percentile, 1996-2010 (fig. 2.1)

SOURCE Susenas and World Bank calculations



BOX 2.1**Understanding inequality with growth incidence curves**

Growth incidence curves provide an analysis of the annualized growth rate of household per capita consumption by percentile over given periods. They are useful for providing a context within which to evaluate poverty reduction performance. In reflecting the changing consumption patterns of the poorest to the richest, they indicate the extent to which growth is pro-poor.

Growth incidence curves are constructed by simply calculating growth in real per capita household consumption for each percentile of the consumption distribution over a particular period, and plotting these growth rates by percentile. In the analysis presented here, the current per capita consumption expenditure was adjusted to real value using the

urban poverty line of the Special Capital Region of Jakarta (DKI Jakarta) in 2007 as the base year. Technically, to obtain the real per capita consumption expenditure in other provinces, the current or nominal term of the per capita consumption expenditure for that province in any period was multiplied by the poverty line of DKI Jakarta 2007 and divided by the poverty line of that province for the related period. (Indonesia uses 65 poverty lines, an urban line for DKI Jakarta, and an urban and rural line for each of the other 32 provinces)

WHY ARE INCOMES FOR THE RICH GROWING FASTER THAN THOSE FOR THE POOR AND THOSE IN THE MIDDLE? To understand why the incomes of the rich have grown faster than those of the poor and those in the middle, we must examine the different drivers of income.

HOUSEHOLDS EARN MONEY BY GENERATING INCOME FROM THEIR RESOURCES.

Households potentially have access to a number of resources or assets. These include not only land and financial investments, but also their labor. Each of these assets can generate an income (a return). The labor from human resources earns a wage; physical and financial assets earn a return (rents from land and housing, interest or dividends on investments); and physical and financial assets can also increase incomes by gaining in value.

DIFFERENCES IN WHO HAS THESE RESOURCES AND HOW MUCH THEY EARN LEAD TO INEQUALITY. Income inequality can arise because not everyone has equal access to resources. Richer households may be more educated than poorer households, so they have more valuable labor. They may also have better access to good jobs. Poorer households often have no physical or financial investments, or they have less value than for richer households (e.g., land and housing with an informal title). Income inequality can also arise because not everyone receives the same income on each asset. Poorer households whose savings are in cash do not receive interest; richer households who have access to financial markets receive interest and

maybe dividends. Poor households with unskilled labor receive a lower wage than richer, more educated, more skilled labor.

DIFFERENCES IN HOW THIS INCOME IS USED—HOW MUCH IS CONSUMED AND BY HOW MANY, AND HOW MUCH IS SAVED FOR THE FUTURE—ALSO AFFECTS INEQUALITY.

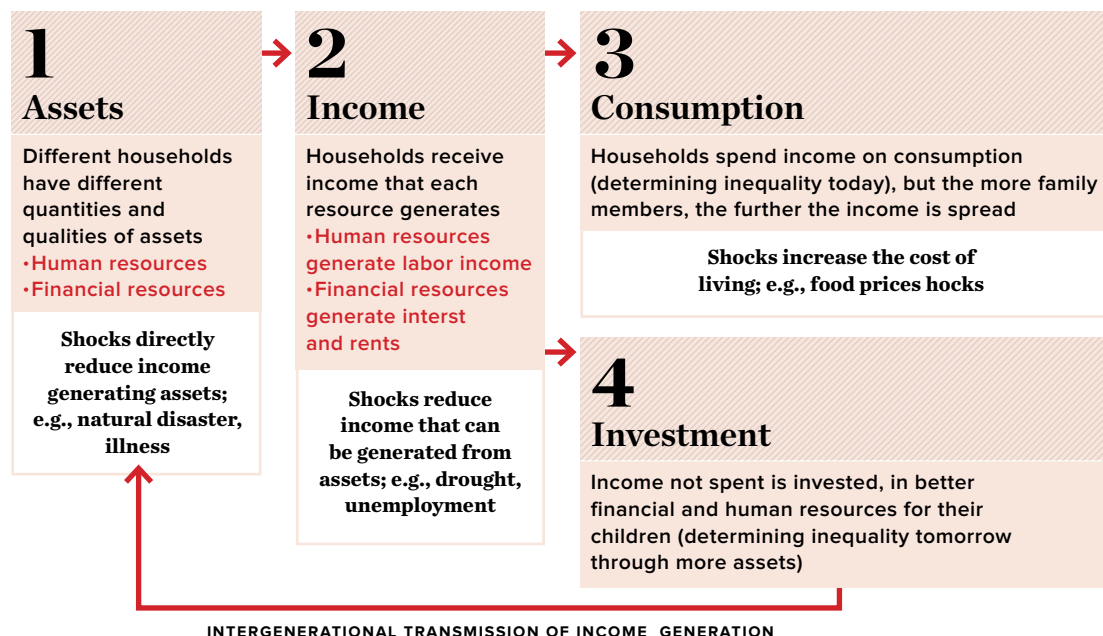
Once income has been earned, inequality is also influenced by how many people in the household that income has to support; poorer households tend to have more children than richer ones, meaning that their meager incomes have to stretch even further. However, as countries develop and become richer, fertility rates tend to fall. This can affect how inequality changes over time. If the size of poor households falls faster than the size of rich households, with no change in incomes, then inequality will also fall, and vice versa. Finally, unequal incomes today can lead to even more unequal incomes tomorrow through two reinforcing feedback loops—richer households save more of their higher incomes now, accumulating even more savings, which leads to even higher income in the future, or they invest in better health and education for their children, also raising their income-earning ability.²¹

Figure 2.2 outlines this process.

Inequality can be understood through a framework of assets

²¹ Compounding the investment gap is the trade-off between human capital investment and time for poorer households. Wealthier Indonesians can pay fees to seek care in the private sector and bypass long queues in the public sector. Poorer Indonesians cannot afford these fees and must pay for their care in person-time, even in the face of substantial opportunity cost. For example, while a poor woman must take a day off of work to seek ante-natal care, including arriving at the facility before it opens, queuing for several hours, and leaving the facility around 3:00pm—a total time investment of six hours—a somewhat wealthier woman can pay out-of-pocket and receive an appointment after work (lower opportunity cost) with a total time investment of one hour or less. Time away from work affects the accumulation of human capital as well as wages.

Understanding inequality through an income-generating asset framework with a reinforcing feedback loop (fig.2.2)



HOUSEHOLD RESOURCES AND INCOMES ARE ALSO VULNERABLE TO SHOCKS. All households face risks in life. Richer households may have a better chance of avoiding them (for example, taking preventative health measures) and will cope with them better. Shocks can reduce household income at all points of the income-generating process (Figure 2.2). Shocks can affect the underlying assets that generate income; a natural disaster might destroy the livestock or equipment used to make a living. They can reduce the income that comes from these assets; a drought might make a harvest meager. And they can reduce tomorrow's income by depleting today's assets (for example, selling a sewing machine to pay for hospital care) or by preventing accumulating assets for the future (for example, lack of income due to losing a job). At the same time, shocks that increase the cost of living, such as food price shocks, decrease the quality and quantity of goods and services a fixed income can buy.

FOUR CASE STUDIES ILLUSTRATE HOW THIS FRAMEWORK MIGHT WORK FOR DIFFERENT PARTS OF THE CONSUMPTION

DISTRIBUTION. Approximately 38 percent of Indonesians were poor or vulnerable (Figure 1.6) in 2014. Putri's case is an illustrative example of the types of assets the poor and vulnerable have, the incomes they generate, and how shocks may affect them.²² Similar to 44 percent of Indonesians, Fitri has escaped vulnerability but is not yet economically secure; she is one of the emerging consumer class who could still fall back into vulnerability, but who are starting to earn disposable income. Dewi represents the 18 percent of Indonesians who are now economically secure from poverty and vulnerability, and form the new middle class, while Siti is part of the Indonesian upper class, whose numbers are not yet well understood.²³

THE POOR HAVE LIMITED RESOURCES, EARN LOW INCOMES FROM THEM, SAVE LITTLE FOR THE FUTURE, AND ARE THE MOST VULNERABLE TO SHOCKS. Putri (Box 2.2) only completed primary school. Because of her low education, she works part-time at a warung (roadside food stall) and receives a low informal wage. She does own a small plot of land, which a neighbor uses to produce rice; the neighbor keeps

Shocks can reduce household income at all points

²² The following cases are illustrative examples only and not real case studies.

²³ However, see World Bank (forthcoming (c)) for a first attempt at estimating these numbers.

half the rice, while Putri's household consumes the other half. Because Putri has four children, the rice from the land is not enough, and they need to buy extra from the market, so recent rice price shocks have hurt them. Over time, the land has seen small increases in value, but the lack of a formal title means that the land value is limited and it cannot be used as collateral to borrow to start a small business. Putri has a small amount of savings that she keeps at home for hard times. With inflation and no interest earnings, the value of these savings is actually falling over time, and because she dips into the savings frequently through the year, the sum does not grow. Putri also has social connections—friends and family in the local community—and she has relied upon these people in the past to borrow money when her children's tuition fees were due. Ongoing social activities reinforce these networks. Putri has free health insurance from the Government, but does not know what it covers and there is no health center near her anyway. If she or her one of her children falls sick, she will either have to borrow from her family or sell her land to meet the health care costs.

THE EMERGING CONSUMER CLASS ARE ACCUMULATING MORE EDUCATION AND SOME SAVINGS. Fitri (Box 2.3) is a member of Indonesia's largest class, the emerging consumer class, who are above the vulnerability line but are not yet economically secure, with a greater than 10 percent chance of being vulnerable next year. She completed junior high school and used her social connections to get a job on an assembly line at a small, locally-owned factory which, because it is a small business, does not comply with minimum wage laws. Fitri has a small amount of savings that she keeps in a basic bank account for emergencies. These savings slowly accumulate over time, as she manages to save part of her salary. Fitri does not have health insurance, because she is not poor enough to receive free health insurance from the Government, and her informal job means that she does not make contributions to the public health insurance system either.

THE MIDDLE CLASS HAVE IMPROVING ASSETS, HIGHER INCOMES AND BETTER SAVINGS. Dewi is part of the Indonesian middle class (Box 2.4). She completed high school and works as a civil servant with a good salary and benefits. She is also receiving ongoing training and skills certification through her work. She does not own any land or housing, but does have savings that are invested in the bank and earn interest. Over time her savings are accumulating and she is also eligible for retirement benefits. Like Putri, she has a network of friends and family in Jakarta, which helped her to find her job. Dewi and her husband have two children, which means they can spend a little more on their education than if she had a larger family. Dewi has health insurance in case illness strikes, but if she were to lose her job she would need to dip into her savings.

RICHER INDONESIANS HAVE GOOD RESOURCES AND EARN HIGH INCOMES FROM THEM. They also use this income to save, which in turn leads to higher income tomorrow. Siti is a member of Indonesia's upper class (Box 2.5). She finished university and is about to enroll in an MBA program in the United States. She receives a high salary for managing her own company, which makes a good profit. She also has investments in mutual funds and the stock market, which have seen strong returns in recent years. She reinvests the company profits back into the business to grow it, and continues to accumulate financial capital over time, which in turn earns even more income the following year. Siti is well-connected to the business and political elites, and has used these connections to secure lucrative licenses and contracts for her company. Siti and her husband have one child, who is now attending university in Europe. A combination of savings, insurance and preventative measures means that Siti is the least affected by shocks.

BOX.2.2**Putri is poor with limited assets and low returns**

| Assets | Intensity of Use | Returns | Accumulation |
|---|--|---|--|
| HUMAN CAPITAL SD education | Works part-time at a warung | Receives low informal wage | None |
| PHYSICAL CAPITAL small area of land | Neighbor uses land to produce rice; Putri cannot use it as collateral (absence of legal title) | Neighbor keeps half rice, Putri's household consumes rest | Small increase in value of land, but marginal because of lack of title and development |
| FINANCIAL CAPITAL small savings kept at home | Unused; kept to smooth consumption in the case of a shock | Negative due to inflation | None. Savings depleted and renewed throughout the year |
| SOCIAL CAPITAL family and friend networks in local community | Used to borrow money when children's tuition is due | Allows some investment in son's education | Ongoing social activities reinforces networks |

BOX.2.3**Fitri is an emerging consumer with minor asset accumulation**

| Assets | Intensity of Use | Returns | Accumulation |
|---|---|--|---|
| HUMAN CAPITAL SMP education | Works on a small-scale factory assembly line | Receives fixed salary below minimum wage as non-unionized | None, because the factory doesn't offer training |
| PHYSICAL CAPITAL None | None | None | None |
| FINANCIAL CAPITAL small savings, no pension fund | Unused; kept to smooth consumption in the case of a shock | Small interest payment from basic savings account | Salary savings |
| SOCIAL CAPITAL family and friend networks from local community, factory worker union | Used friend network to get factory job | Factory job gives higher income than the informal alternatives | Ongoing social activities and involvement in union activities reinforces networks |

BOX.2.4

Dewi is part of the economically secure middle class with improving assets

| Assets | Intensity of Use | Returns | Accumulation |
|---|----------------------------------|--|--|
| HUMAN CAPITAL SMA | Works as a civil servant | Receives good salary and benefits | On-going training and certification |
| PHYSICAL CAPITAL None | None | Neighbor keeps half rice, Putri's household consumes rest | Small increase in value of land, but marginal because of lack of title and development |
| FINANCIAL CAPITAL savings; retirement benefits | Invested in bank | Interest received on savings | Salary saved |
| SOCIAL CAPITAL family and friend networks in Jakarta | Used to obtain civil servant job | Enables good formal sector wage with benefits, relative to informal sector | Ongoing social and work activities reinforces networks |

BOX.2.5

Siti is upper class with many assets and high returns

| Assets | Intensity of Use | Returns | Accumulation |
|--|---|--|--|
| HUMAN CAPITAL Tertiary Education | Manages her own company | Receives a high salary | Is enrolling in a US MBA |
| PHYSICAL CAPITAL owns apartments and houses | Lives in one house and rents out the others | Enjoys high imputed rent and receives good rental income | Apartments and houses are increasing quickly in value |
| FINANCIAL CAPITAL savings; mutual funds; stocks; equity in company | Invested in financial sector and own company | Interest received on savings, high returns from funds and stocks; profits from company | Dividends and capital gains reinvested; company profits re-invested in expansion |
| SOCIAL CAPITAL well-connected to business and governing elites | Uses connections to secure lucrative licenses and contracts for her company | Company makes high profits from licenses and contracts | Extends and reinforces elite network through company contracts |

2.2

WHY AN UNFAIR START IN LIFE HOLDS THE POOR BACK

2.2.1

A significant degree of overall inequality is explained by circumstances at birth

PEOPLE ARE A HOUSEHOLD'S MOST IMPORTANT RESOURCE. All households have people, and the majority of households generate most of their income from working and earning an income from their labor. Differences in the quality of these human resources, and in the incomes they can earn, drive a large degree of inequality in Indonesia.

HOWEVER, FACTORS OUTSIDE OF PEOPLE'S CONTROL—THEIR CIRCUMSTANCES AT BIRTH—CAN AFFECT HOW THEY DEVELOP THEIR HUMAN RESOURCES. Differences in people's circumstances at birth and while young have a strong influence on how their human resources develop, and ultimately their later income. And when these differences are due to an unfair start in life—unequal access to services and opportunities—then it makes it very difficult for the poor and vulnerable to catch up later on.

IN FACT, ONE-THIRD OF ALL INEQUALITY CAN BE EXPLAINED BY JUST FOUR CIRCUMSTANCES AT BIRTH. The differences in household consumption in Indonesia can be divided into those due to differences between different groups, for example, differences between average urban and rural consumption, and differences within different groups, for example, differences within urban households themselves, or within rural households themselves. [Figure 2.3](#) looks at how much household consumption inequality can be explained by average differences

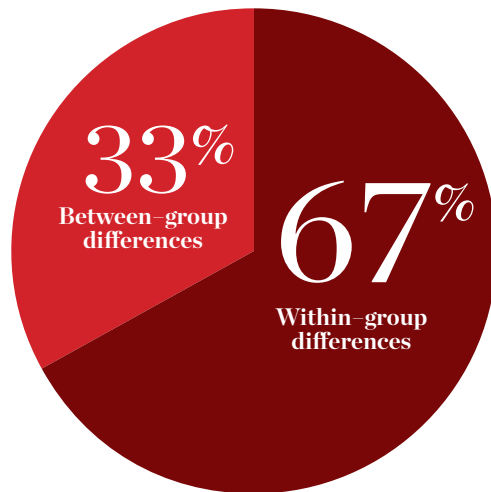
between groups based on four circumstances of birth: the province they were born in, whether they were born in an urban or rural district, the gender of the head of household, and an indicator of their parents' education. Around one-third of all inequality is due to these differences in birth circumstances, primarily parents' education ²⁴ and somewhat location of birth; gender has little effect.²⁵

MOREOVER, THE CONTRIBUTION OF THESE ELEMENTS OF INEQUALITY OF OPPORTUNITY TO OVERALL INEQUALITY IS NO LONGER FALLING. When differences in consumption inequality due to these four birth circumstances are examined separately for people born in different decades, the role that these circumstances has played over time can be seen. For people born in the 1950s, the role of birth circumstances was the highest, explaining 39 percent of today's differences in consumption inequality. However, this began to fall, to 37 percent for people born in the 1960s, who were still children when Indonesia first began its long-run economic expansion, and to 34 percent for those born in the 1970s, who were the first to benefit from Indonesia's massive primary school expansion of that decade (Duflo 2001). However, for those born in the 1980s and later, despite increasing access to services, the role of these birth circumstances in overall inequality has stopped falling and even begun to increase ([Figure 2.4](#)).

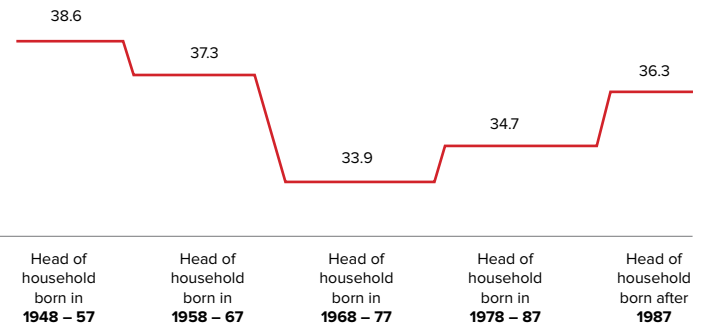
²⁴ Adults' own education is used as an imperfect proxy for their parents' education, which is not in the data. However, analysis of Indonesian Family Life Survey shows that parents' education and income are very important determinants of children's educational outcomes, as are availability of schools, all of which are themselves birth circumstances.

²⁵ Outcome of a decomposition of Theil L (GE(0)) Index (all individuals) into within- and between-group differences, where the groups are head of household gender, a proxy for parents' education, province of birth and whether the birth location was fully urban (whether kotamadya or kabupaten). Adults' own education is taken as a proxy for their parents' education, which are not in the data. Analysis of IFLS data shows that parents' education and income are important determinants of children's educational outcomes, as are availability of schools, all of which are themselves birth circumstances. In separate decompositions, the between-group contributions were 26 percent for education, 8 percent for province of birth, 9 percent for a fully urban birth, and 0.03 percent for gender.

Percentage of consumption inequality due to differences between and within groups with different birth circumstances (fig. 2.3)



Percentage of consumption inequality due to differences between and within groups with different birth circumstances, by Head of Household cohort (fig. 2.4)



SOURCE Susenas and World Bank calculations. Note: Decomposition of Theil L (GE(0)) Index (all individuals) into within and between group differences. Birth circumstances are head of household gender, parents' education,* province of birth and whether the birth location was fully urban (whether kotamadya or kabupaten). *Adults' own education is taken as a proxy for their parents' education, which are not in the data. However, analysis of IFLS data shows that parents' education and income are important determinants of children's educational outcomes, as are availability of schools, all of which are themselves birth circumstances. Non-birth circumstances include children's effort.

2.2.2

An unfair start begins with differences in child health

TO BE ABLE TO EARN A DECENT INCOME AS AN ADULT, CHILDREN NEED TO GET THE RIGHT START IN LIFE. Getting a healthy start is one of the most important factors that allows a child to succeed later in life. Children who grow up well-nourished in the womb and up until 2 years old reach the right height for their age. These children are more likely to develop better cognitive skills, reach a higher educational attainment, earn higher incomes, and enjoy better health as adults, compared with children who grow up stunted (Alderman and Behrman 2004; Victora et al. 2008).

GETTING THE RIGHT START MEANS THAT ALL CHILDREN SHOULD RECEIVE THE SAME OPPORTUNITIES, REGARDLESS OF WHERE THEY ARE BORN OR WHO THEIR PARENTS ARE. The likelihood of a healthy child is improved through use of ante- and post-natal checks by the mother, child growth monitoring and nutrition

education, immunization, access to clean water and proper hygienic sanitation (especially around meal preparation), access to and the use of proper treatments for diarrhea, and growing up in a clean house of good condition (World Bank 2015b).

HOWEVER, INDONESIA HAS RELATIVELY HIGH RATES OF CHILD MORTALITY AND MALNUTRITION, particularly among the poor and those living in rural areas. Indonesia has made significant progress in reducing infant and child mortality, but the rates remain high compared with regional neighbors (Figure 2.5), and rural children, the poor and those born to mothers with low education are most at risk. Moreover, stunting, the most important form of malnutrition, is particularly high in Indonesia (Figure 2.6), and is higher for children whose parents have low education (Figure 2.7)

Getting a healthy start is one of the most important factors that allows a child to succeed later in life

Not all children get a healthy start

A HEALTHY START FOR BABIES BEGINS WITH ANTE- AND POST-NATAL CARE FOR MOTHERS, BUT NOT ALL ARE THAT LUCKY.²⁶

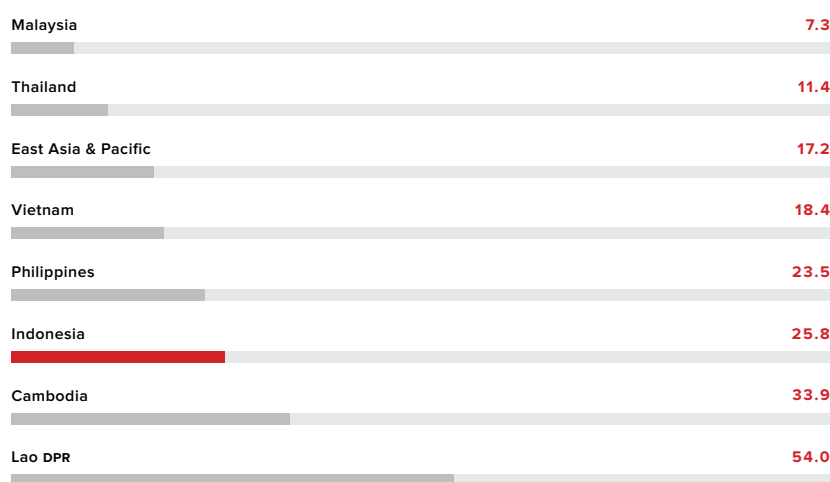
Proper health care during and after pregnancy plays a role not only in keeping the mother healthy, but also the child. Proper health and nutrition for the mother means proper nutrition for the unborn child. Moreover, post-natal health check-ups can reinforce key breastfeeding behaviors and possibly identify newborns at risk. However, use of ante-natal and particularly post-natal care is lower for poorer households (Figure 2.8), putting these newborns at risk of a bad start in life. One reason for this is that poorer and rural households are far less likely to have a skilled birth attendant

(Figure 2.9 and Figure 2.10) or institutional delivery, which increase the chances of post-natal care (96 percent of mothers who give birth at a facility go on to receive post-natal care; World Bank 2014d).

MOST CHILDREN BEGIN THE IMMUNIZATION PROCESS BUT DO NOT FINISH IT, PARTICULARLY CHILDREN FROM POOR HOUSEHOLDS.

After being born healthy, children still need protection from disease. However, while most children start the immunization process, around one-third of children do not complete the process and remain vulnerable to disease. Poorer children are particularly at risk (Figure 2.11).

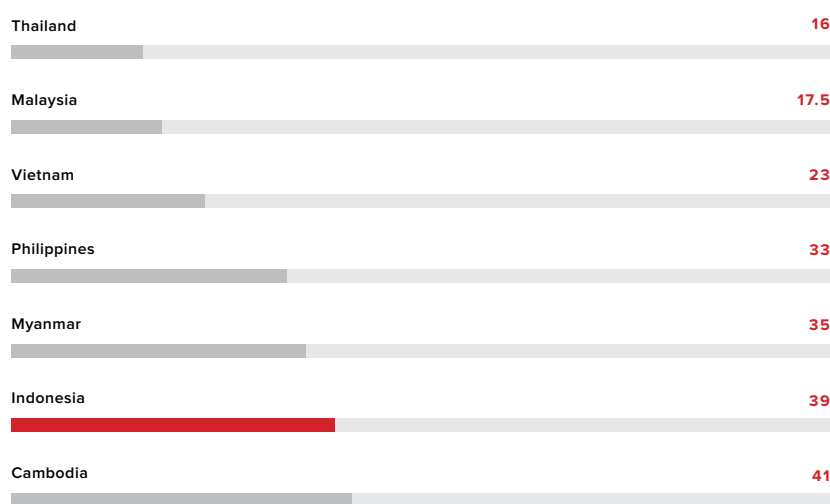
Infant mortality (per 1,000 live births) (fig. 2.5)



SOURCE WDI 2012.

NOTE Infant mortality is ages 0-1 years.

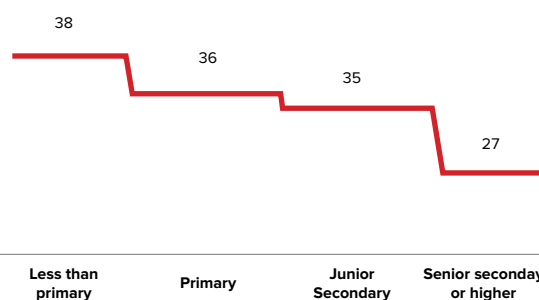
Stunting by country (percent) (fig. 2.6)



SOURCE WHO Child Nutrition Indicators

²⁶ Discussion on access to health services and quality issues draws from World Bank (2014a).

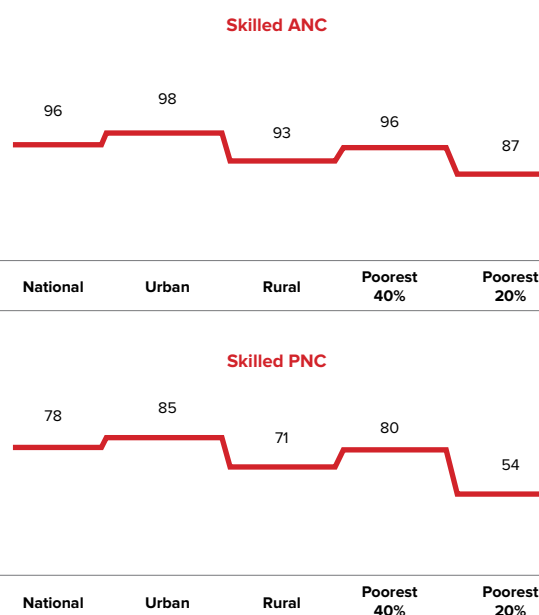
Probability of stunting by parents' education (percent) (fig. 2.7)



SOURCE IFLS and World Bank calculations.

NOTE Extreme stunting as <-2 standard deviations z-score height-for-age using 2006 WHO standards, children 0-5 years old.

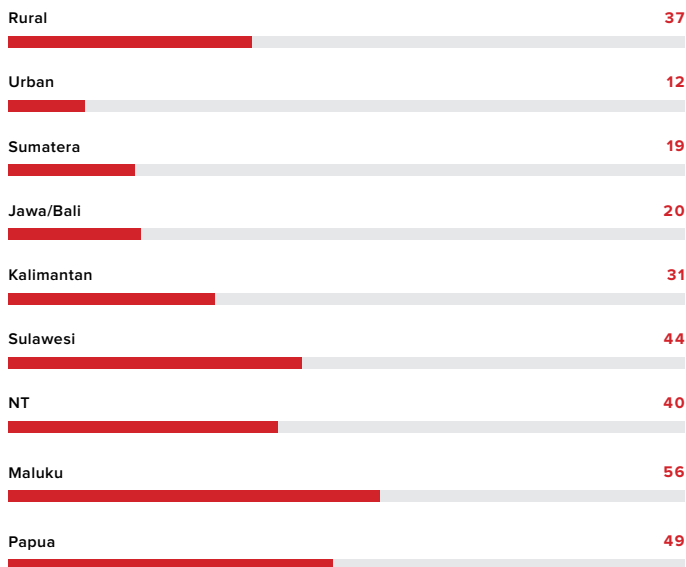
Skilled first ante-natal and post-natal care usage (percent) (fig. 2.8)



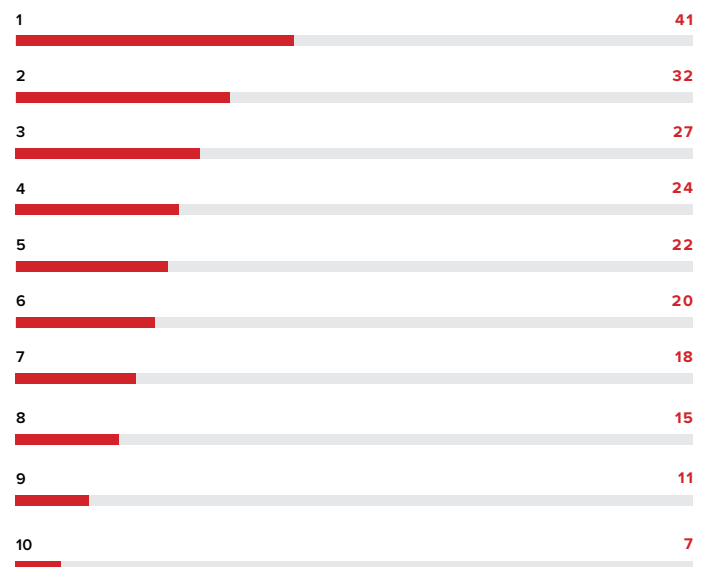
SOURCE Susenas 2012, World Bank 2014d.

Unskilled deliveries by region
(percent) (fig. 2.9)

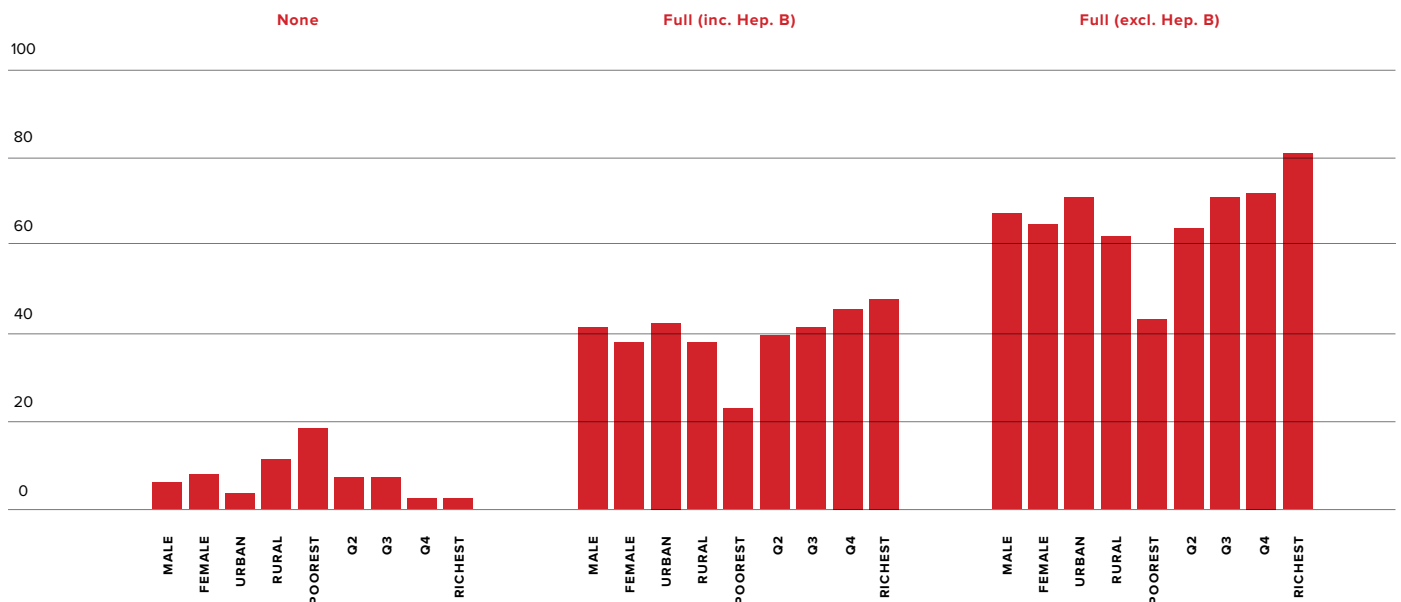
SOURCE WDI 2012.
NOTE Infant mortality is ages
0-1 years.

Unskilled deliveries by per capita consumption
decile (percent) (fig. 2.10)

SOURCE
Susenas 2011.

Complete immunization rates by different
populations (percent) (fig. 2.11)

SOURCE DHS 2012.
NOTE Complete immunization according to WHO guidelines means one dose
of BCG vaccine, three doses each of DPT and polio vaccines, and one dose of
measles vaccine. In 1997 Indonesia added four doses of Hepatitis B vaccine.

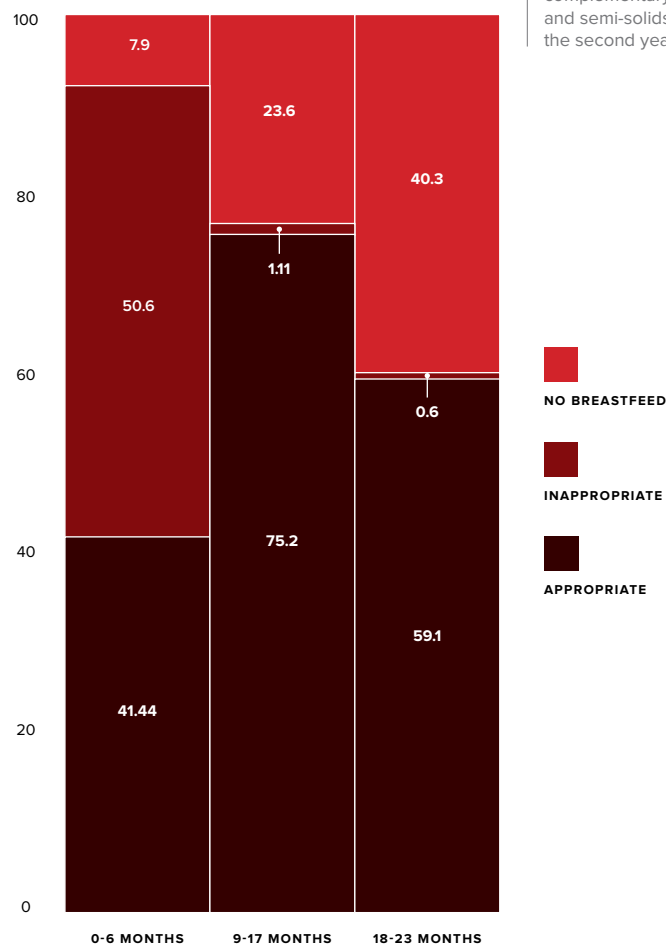


**MANY INFANTS AND YOUNG CHILDREN
ARE NOT FED PROPERLY, AND POORER
CHILDREN ARE MOST AT RISK.**

Age-appropriate breastfeeding is vital for proper child growth. However, fewer than half of infants aged 0-6 months are breastfed appropriately; instead of exclusive breastfeeding, they are fed

food as well. Many older children who should be receiving complementary feeding are no longer being breastfed (Figure 2.12). Moreover, many children are not receiving micronutrients and deworming treatments, which can also affect their development. The rates of such treatment are lowest among the poor (Figure 2.13).

Age-appropriate breastfeeding by age (percent) (fig. 2.12)



SOURCE Susenas 2012 for 0-6 months; DHS 2012 for others.

NOTE Age appropriate breastfeeding is exclusive breastfeeding until 6 months, and then breastfeeding with complementary foods (solids and semi-solids) until well into the second year of life.

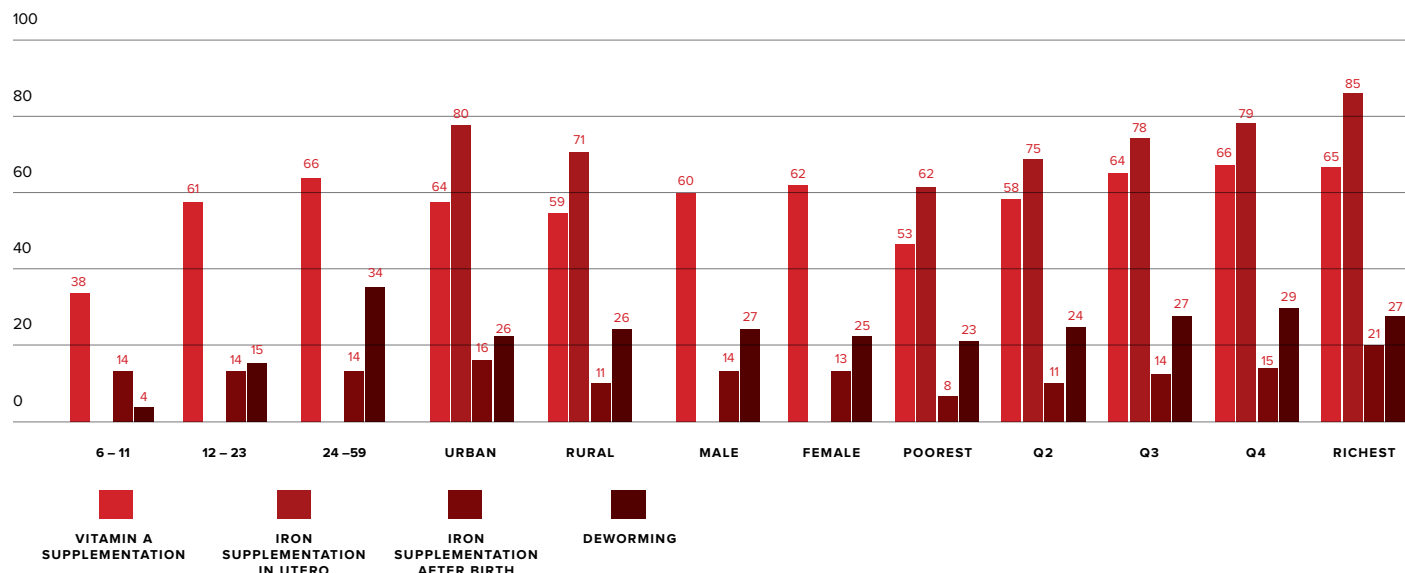
ADEQUATE NUTRITION IS OFTEN NOT ACCOMPANIED BY GOOD HYGIENE AND SANITATION, AND PROPER TREATMENT OF DIARRHEA.

Even if children are being fed enough and fed correctly, their growth and development will be impaired if they are exposed to poor hygiene in food preparation and improper sanitation, which can increase the risk of diarrhea. The gap between richer and poorer access to clean water and proper sanitation has been closing over time (Figure 2.14). Nonetheless, around 1 in 6 children aged 0-5 years have had diarrhea in the past two weeks. Furthermore, many of those that do suffer from diarrhea are not being treated properly with oral rehydration therapy (ORT), with female children more at risk (Figure 2.15).

ACCESS TO HEALTH FACILITIES HAS IMPROVED BUT REMAINS A SERIOUS CHALLENGE IN SOME REGIONS (WORLD BANK 2014A).

Access to health facilities has improved significantly in the past decade, with the number of hospitals nearly doubling and the number of public health clinics (Pusat Kesehatan Masyarakat, or Puskesmas) up by almost 30 percent. However, the number of in-patient beds per capita is still only half of the WHO's recommendation of 25 beds per 10,000 people, with significant provincial variation as well. Moreover, while the median distance to a health facility in nationally was only 5km in 2011, it was over 30km in provinces such as West Papua,

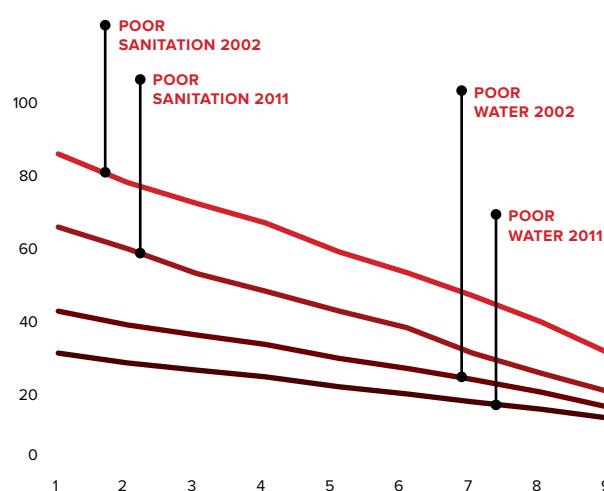
Micronutrient intake and deworming by different populations (percent) (fig. 2.13)



SOURCE DHS 2012.

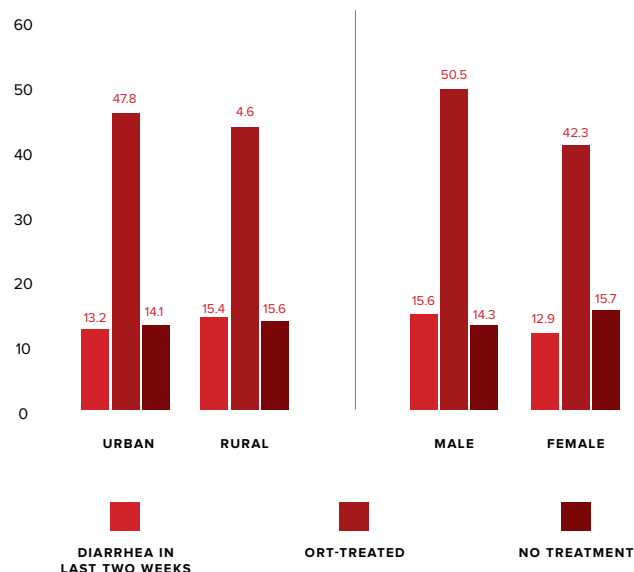
NOTE Deworming is important for nutrient uptake. Iron supplementation in utero indicator is whether mother took any iron supplementation during pregnancy.

Lack of access to clean water and proper sanitation by household per capita consumption decile (percent) (fig. 2.14)



SOURCE Susenas

Diarrhea incidence and treatment (percent) (fig. 2.15)



SOURCE DHS 2012.

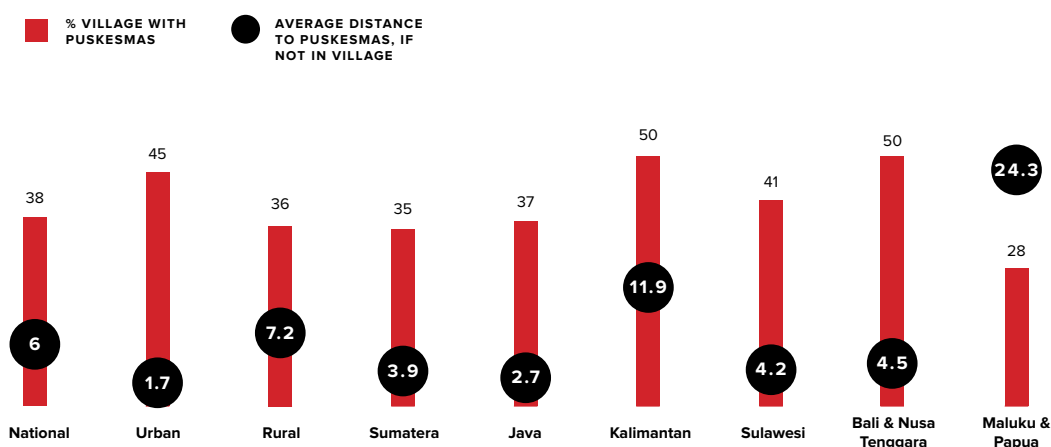
NOTE Diarrhea is incidence in last two weeks out of all children 0-59 months; treatment indicators are out of all children with diarrhea.

Papua and Maluku (Figure 2.16). At the same time, over 40 percent of people in West Sulawesi, Maluku and West Kalimantan took more than one hour to reach a public hospital, compared with 18 percent nationally.

HEALTH FACILITIES ARE NOT WELL EQUIPPED TO PROVIDE THE BASIC HEALTH SERVICES MANDATED BY LAW, INCLUDING THOSE THAT AFFECT EARLY CHILD HEALTH, PARTICULARLY IN EASTERN INDONESIA (WORLD BANK 2014A). The general service readiness of health facilities to provide basic health services at minimum standards is highly variable across provinces, especially in the

eastern Indonesia (Figure 2.17). This readiness was measured by 38 indicators covering basic amenities, basic equipment, standard precautions for infection prevention, diagnostic capacity and essential medicines. Not a single Puskesmas was ready on all 38 indicators, and only half in Papua and Maluku reported 80 percent readiness. Of particular concern, there are significant deficiencies in key services that affect whether a child gets a healthy start. Deficiencies in service readiness are significant in key program areas that influence initial child health, including family planning (see later section), antenatal care, basic obstetric care and routine childhood immunization.²⁷

Availability of Puskesmas health centers (percent of villages with Puskesmas) and distance to Puskesmas if not in village (km) (fig. 2.16)



SOURCE Podes 2011 Infrastructure Survey, reported in World Bank 2014d

²⁷ See Figure 40 and Table 8, World Bank (2014a).

Selected service indicator scores and general service readiness index for Puskesmas by province, 2011 (fig. 2.17)

SOURCE Ministry of Health from 2011 health facility census, reported in World Bank (2014a).

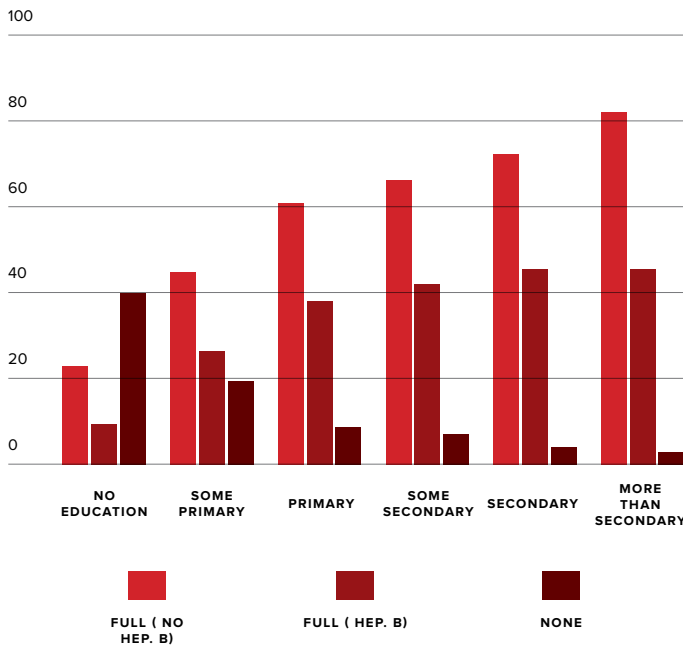
| | | Basic Amenities | Basic Equipment | Standard Precaution | Diagnostic Capacity | Essential Medicine | Overall index |
|--|--------------------|-----------------|-----------------|---------------------|---------------------|--------------------|---------------|
| | DI Aceh | 70.9 | 80.3 | 65.2 | 64.2 | 63.0 | 67.9 |
| | North Sumatera | 68.5 | 79.6 | 60.3 | 37.3 | 64.8 | 61.2 |
| | West Sumatera | 76.8 | 81.5 | 69.9 | 77.6 | 74.7 | 75.9 |
| | Riau | 69.0 | 81.8 | 64.2 | 69.7 | 71.1 | 71.0 |
| | Jambi | 70.5 | 83.2 | 62.4 | 71.5 | 71.2 | 71.6 |
| | South Sumatera | 68.6 | 84.5 | 65.6 | 59.0 | 72.3 | 69.7 |
| | Bengkulu | 66.5 | 83.9 | 59.4 | 49.3 | 65.1 | 64.0 |
| | Lampung | 71.9 | 81.7 | 67.9 | 62.9 | 72.5 | 71.0 |
| | Bangka Belitung | 77.3 | 84.5 | 76.7 | 75.7 | 67.5 | 75.4 |
| | Riau Island | 76.7 | 84.9 | 69.7 | 75.0 | 78.2 | 76.8 |
| | DKI Jakarta | 87.0 | 84.1 | 76.4 | 20.2 | 69.7 | 65.7 |
| | West Java | 76.3 | 85.9 | 79.1 | 58.4 | 74.0 | 74.0 |
| | Central Java | 84.5 | 86.4 | 84.8 | 80.0 | 77.9 | 82.2 |
| | DI Yogyakarta | 88.1 | 87.3 | 95.0 | 96.5 | 74.5 | 87.4 |
| | East java | 83.6 | 87.7 | 85.7 | 78.0 | 77.9 | 82.0 |
| | Banten | 76.4 | 86.7 | 78.0 | 55.6 | 69.0 | 72.1 |
| | Bali | 83.6 | 88.3 | 85.5 | 68.3 | 72.1 | 78.5 |
| | West Nusa Tenggara | 76.2 | 87.8 | 74.9 | 84.3 | 76.9 | 79.7 |
| | East Nusa Tenggara | 63.6 | 86.2 | 65.0 | 53.6 | 63.5 | 65.3 |
| | West Kalimantan | 66.8 | 84.9 | 65.9 | 71.8 | 68.0 | 70.9 |
| | Central Kalimantan | 73.4 | 85.3 | 64.0 | 56.1 | 70.7 | 69.2 |
| | South Kalimantan | 77.2 | 86.3 | 75.6 | 84.3 | 75.6 | 79.5 |
| | East Kalimantan | 76.2 | 82.9 | 71.2 | 68.7 | 69.5 | 73.0 |
| | North Sulawesi | 69.7 | 81.5 | 61.5 | 35.8 | 60.1 | 60.4 |
| | Central Sulawesi | 66.2 | 82.0 | 52.2 | 54.9 | 57.1 | 61.4 |
| | South Sulawesi | 72.4 | 82.5 | 67.3 | 65.6 | 66.1 | 70.1 |
| | Southeast Sulawesi | 65.7 | 80.8 | 58.3 | 35.3 | 65.5 | 60.3 |
| | Gorontalo | 71.2 | 84.2 | 68.2 | 39.4 | 61.2 | 63.3 |
| | West Sulawesi | 55.3 | 81.1 | 49.5 | 55.3 | 47.1 | 56.4 |
| | Maluku | 62.4 | 71.2 | 46.6 | 35.6 | 53.3 | 52.7 |
| | North Maluku | 58.9 | 81.5 | 56.7 | 44.9 | 60.8 | 59.9 |
| | West Papua | 55.1 | 75.4 | 49.2 | 34.8 | 63.9 | 55.3 |
| | Papua | 53.5 | 72.0 | 41.6 | 29.3 | 56.8 | 50.0 |
| | Indonesia Avg. | 73.9 | 83.7 | 70.7 | 60.6 | 69.9 | 71.1 |

FURTHERMORE, WHILE THE NUMBER OF HEALTH WORKERS HAS INCREASED RAPIDLY TO NEAR INTERNATIONAL STANDARDS, THEY ARE DISTRIBUTED VERY UNEQUALLY AND POOR COMPETENCY REMAINS AN ISSUE (WORLD BANK 2014A). The core health worker to population ratio of 2.2 per 1,000 people is now close to the level of 2.3 level recommended by the WHO. However, many Puskesmas do not have a doctor, especially in eastern Indonesia, and only three provinces have achieved the WHO's recommendation of one physician per 1,000 people, and specialist physician availability is largely biased in favor of Java. There are also significant shortages in key health worker positions in the public sector despite the large number of nursing graduates. Moreover, health worker quality remains an issue; Rokx et al.

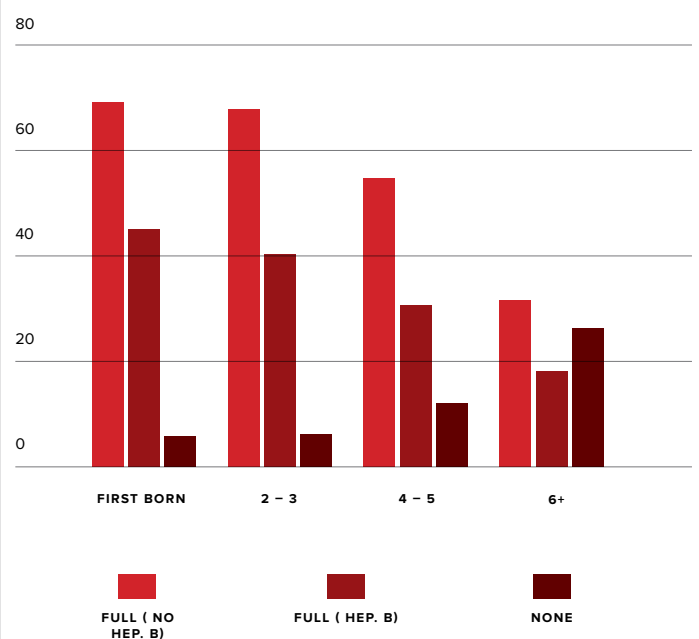
(2010) found that poor accuracy of responses on antenatal care and child curative care were widespread among physicians, nurses and midwives.

USE OF HEALTH SERVICES IS ALSO AFFECTED BY MOTHERS' EDUCATION AND BEHAVIOR. Educated mothers are much more likely to fully immunize their children (Figure 2.18). They are also more likely to know about using ORT to treat diarrhea, use child micronutrients and deworming, and take maternal iron supplements while pregnant. Moreover, there is evidence to suggest that it is not only a lack of knowledge or available services, but also motivation that leads to incomplete usage of health services; immunization rates fall significantly for children born fourth or later (Figure 2.19).

Full immunization rates for children aged 12–23 months by mother's education (percent) (fig. 2.18)



Immunization rates for children based on birth order (percent) (fig. 2.19)



SOURCE DHS 2012.

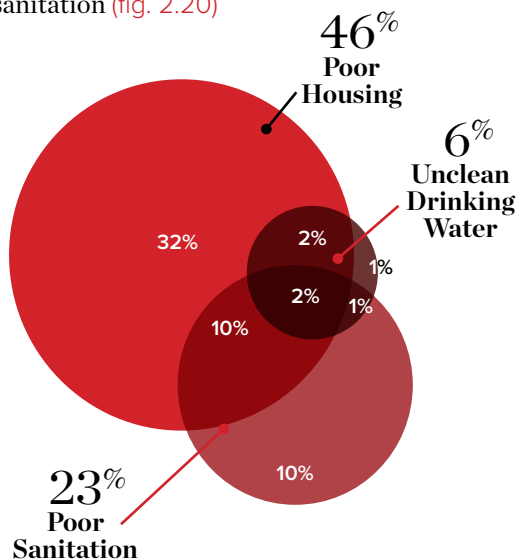
NOTE Complete immunization according to WHO guidelines means one dose of BCG vaccine, three doses each of DPT and polio vaccines, and one dose of measles vaccine. In 1997, Indonesia added four doses of Hepatitis B vaccine.

FURTHERMORE, THE MOST VULNERABLE CHILDREN MISS OUT ON MULTIPLE OPPORTUNITIES ALL AT ONCE. It is important to look not only at how many children do not have access to critical opportunities on each dimension, but also to understand whether it is the same children who are poor across multiple dimensions. For example, if children live in an area without a school or good transportation, building a school alone may not help increase enrolment

rates. Lacking access to both good sanitation and health care increases the risk of illness and lowers the chance of proper treatment. Often children in rural areas and eastern Indonesia are poor on a number of related dimensions (World Bank 2015b). For example, while many urban children who are poor with respect to housing conditions, water and sanitation are deprived on only one of these (Figure 2.20), rural children are generally poor on two or all three (Figure 2.21).²⁸

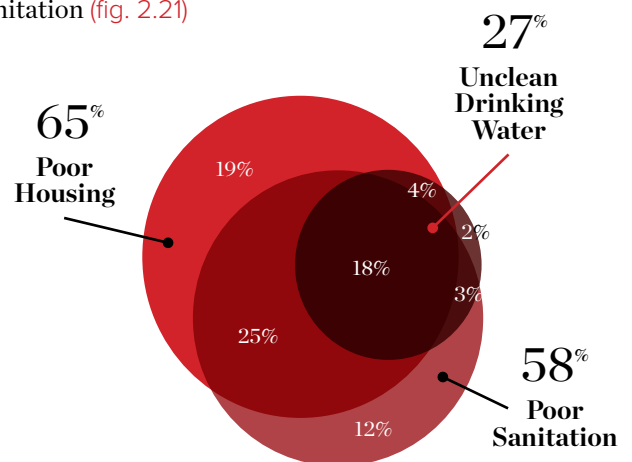
²⁸ These results come from Hadiwidjaja, Paladines and Wai-Poi (2013), implementing a methodology first proposed in Ferreira and Lugo (2012).

Urban poverty for housing, water and sanitation (fig. 2.20)



SOURCE Susenas and Podes, from Hadiwidjaja, Paladines and Wai-Poi (2013).

Rural poverty for housing, water and sanitation (fig. 2.21)



Falling household sizes for the poor used to help reduce inequality

Changes in fertility patterns are also affecting inequality, both today and tomorrow

HOUSEHOLD SIZES FELL FASTER FOR POORER HOUSEHOLDS THAN RICHER HOUSEHOLDS IN THE 1990S. Household sizes and total fertility rates have been falling in Indonesia for decades, as the result of an effective national family planning campaign (Jones and Adioetomo 2014; Hull, forthcoming). This trend continued into the 1990s for all households, with the poorest 10 percent of households shrinking in average size from 5.6 to 4.8 people between 1993 and 2002, and the poorest 50 percent from 4.9 to 4.3 people. At the same time, while richer households were also getting smaller, they were shrinking by less; the richest 50 percent of households fell in average size from 3.8 to 3.6 people, and the richest 10 percent of households stayed constant at 3.3 people (Table 2.1).

THIS MEANT INEQUALITY WAS LOWER THAN IT WOULD OTHERWISE HAVE BEEN. With poorer households having fewer people to spread their income over, their consumption per person rose faster than it would otherwise have done. Figure 2.22 shows the actual Gini, which was 34 points in both 1993 and 2002 (spanning the Asian financial crisis and the recovery). It also shows that the Gini would have been 2.5 points higher if household sizes in 2002 had stayed the same as they were in 1993, instead of seeing significant declines for poorer households.

HOWEVER, WHILE RICHER HOUSEHOLDS HAVE CONTINUED TO SHRINK IN THE 2000S, POORER HOUSEHOLDS HAVE NOT, CONTRIBUTING TO HIGHER INEQUALITY. Between 2002, the average household size of the poorer half of the population stopped falling and has remained broadly stable at 4.3, while that of the richer half of the population has continued to fall, albeit more slowly, from 3.6 to 3.4 (Table 2.2).

Average household size by per capita consumption decile, 1993 and 2002 (Tab. 2.1)

| Decile | 1993 | 2002 | Change(%) |
|--------|------|------|-----------|
| 1 | 5.6 | 4.8 | -13.7 |
| 2 | 5.1 | 4.4 | -13.1 |
| 3 | 4.8 | 4.3 | -10.8 |
| 4 | 4.6 | 4.1 | -10.8 |
| 5 | 4.4 | 3.9 | -11.2 |
| 6 | 4.2 | 3.9 | -8.8 |
| 7 | 4.1 | 3.7 | -9.9 |
| 8 | 3.8 | 3.6 | -7.4 |
| 9 | 3.6 | 3.4 | -6.8 |
| 10 | 3.3 | 3.3 | 1.1 |

SOURCE Susenas

Comparison of actual and counterfactual 2002 Gini if household size in 2002 remained the same as in 1993 (fig. 2.22)

| Year | Actual Gini | 2002 Gini with 1993 Household Size |
|------|-------------|------------------------------------|
| 1993 | 34.48 | 34.48 |
| 2002 | 34 | 36.5 |

SOURCE Susenas and World Bank calculations

NOTE Average household size was estimated for every per capita consumption percentile in 1993 and 2002. A baseline Gini was estimated for 1993 and 2002 based on total household expenditure divided by the relevant percentile average size (rather than actual household size). A counterfactual Gini for 2002 was estimated based on total household expenditure divided by the relevant percentile average size in 1993 (that is, what would have happened if demographics had remained constant). The difference between baseline and counterfactual was then applied to the official 2002 nominal Gini.

This has contributed to an increase in inequality over this period, with the Gini being 1.3 points higher in 2014 than it would have been had the household structures stayed the same as in 2002 (Figure 2.23). What is more, if changes in household sizes across the distribution had not only not reversed but had continued to fall faster for poorer households than for richer ones—as they did between 1993 and 2002—the Gini would have been substantially lower in 2014 by 4 points at 36.5.

Demographic and fertility trends in Indonesia have changed

REDUCED FERTILITY RATES ARE IMPORTANT NOT ONLY FOR INEQUALITY, BUT ALSO HELP TO ACHIEVE OTHER DEVELOPMENT GOALS; HOWEVER, EARLIER DECLINES IN FERTILITY HAVE NOT BEEN SUSTAINED.²⁹ Having more children can mean that poorer households do not meet their desired family sizes and instead increases per person inequality. However, it has other important development consequences. A larger school-age population means greater challenges in achieving the current 9-year and discussed 12-year compulsory education. However, Indonesia's Total Fertility Rate (TFR), considerably lower than Malaysia, India, Bangladesh and Vietnam in 1985, is now higher than these neighbors. It is clear that the declines in fertility in the latter half of the last century have not continued into the current one, and may even have begun increasing.³⁰

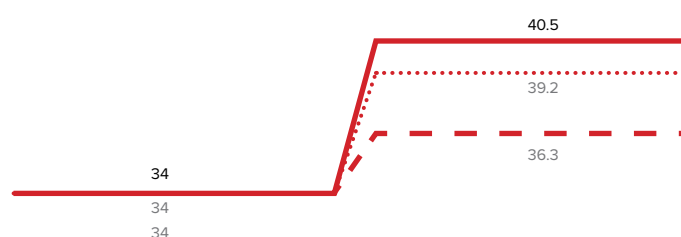
ONE REASON IS THAT MARRIAGE HAS BEEN HAPPENING AT AN EARLIER AGE, ESPECIALLY FOR THE POOR, WHICH INFLUENCES FERTILITY. Increased schooling, especially for girls, and greater urbanization—as seen in Indonesia—are usually associated with later marriage and lower fertility. However, this has not been the case in Indonesia; since 2005, there has been a trend towards earlier marriage (Hull, forthcoming). The reasons for this are not well understood, but many think it is due to increased religiosity among the young (Jones and Adioetomo 2014). This phenomenon has been most pronounced for poorer women; 16.7 percent of the poorest quintile and 13.7 percent of the second-poorest quintile are already mothers or pregnant by ages 15–19 years, compared with 6.6 and 2.6 percent for the second-highest and highest

Average household size by per capita consumption decile, 2002 and 2014 (Tab. 2.2)

| Decile | 1993 | 2002 | Change(%) |
|--------|------|------|-----------|
| 1 | 4.8 | 4.8 | –0.3% |
| 2 | 4.4 | 4.4 | –0.8% |
| 3 | 4.3 | 4.3 | 0.0% |
| 4 | 4.1 | 4.1 | –1.4% |
| 5 | 3.9 | 3.9 | –1.0% |
| 6 | 3.9 | 3.8 | –2.6% |
| 7 | 3.7 | 3.6 | –2.1% |
| 8 | 3.6 | 3.4 | –4.3% |
| 9 | 3.4 | 3.3 | –2.1% |
| 10 | 3.3 | 3.0 | –8.6% |

SOURCE Susenas

Comparison of actual and counterfactual 2014 Gini if household size in 2014 remained the same as in 2002, and if size continued to decline at the same rate as 1993–2002 (fig. 2.23)



| 2002 | 2014 |
|-------------|--|
| ACTUAL GINI | 2014 GINI WITH 2002 HOUSEHOLD SIZE |
| | 2014 GINI WITH CONTINUED DECLINE IN HOUSEHOLD SIZE |

SOURCE Susenas and World Bank calculations.

NOTE Average household size was estimated for every per capita consumption percentile in 1993 and 2002. A baseline Gini was estimated for 1993 and 2002 based on total household expenditure divided by the relevant percentile average size (rather than actual household size). A counterfactual Gini for 2002 was estimated based on total household expenditure divided by the relevant percentile average size in 1993 (that is, what would have happened if demographics had remained constant). The difference between baseline and counterfactual was then applied to the official 2002 nominal Gini.

²⁹ This section summarizes material in Jones and Adioetomo (2014).

³⁰ See Hull (forthcoming) for a careful discussion of the problems with data.

quintiles, respectively. This only exacerbates the other disadvantages faced by the poor.³¹

ANOTHER KEY REASON IS THAT THE EFFECTIVENESS OF FAMILY PLANNING IN INDONESIA HAS BEEN REDUCED OVER THE PAST DECADE, PARTICULARLY FOR THE POOR. The contraceptive prevalence rate is roughly the same now as it was a decade ago: 60 percent by any method in 2002, 57 percent by modern methods; 62 percent by any method in 2012, 58 percent by modern methods (Jones and Adioetomo 2014; IDHS). The unmet need for contraception is not particularly high compared with other countries, but remains a major reproductive health issue and has shown few signs of falling in recent years, being 13 percent in 2002 and 11 percent in 2012 (Jones and Adioetomo 2014). Moreover, this reflects unequal access to proper family planning. Those in the richest quintile use long-term methods of contraception (IUDs, female sterilization and implants) at double the rate (30 percent) of the poorest quintile (15 percent), although “it is hard to imagine that the poor really want to rely on short-term methods to a much greater extent than the wealthy” (Jones and Adioetomo 2014, 10).

DECENTRALIZATION, A LACK OF POLITICAL SUPPORT AT THE LOCAL LEVEL, AND REGULATORY DEFICIENCIES HAVE WEAKENED FAMILY PLANNING. Jones and Adioetomo (2014) identify three factors limiting contraceptive use in Indonesia. First, the National Family Planning Agency (BKKBN), previously a strong, centrally-run agency, has struggled to maintain its effectiveness in a decentralized Indonesia, where significant responsibilities for implementation and monitoring have been devolved to the districts. Moreover, the division of roles between the BKKBN and the Ministry of Health continues to be unclear at the grassroots level. Second, a lack of political commitment to family planning by local governments has emerged after decentralization, as demonstrated in insufficient budgetary support for family planning. Finally, the 2009 Law on Family Planning (Law No. 52/2009) has not been supported adequately by implementing regulations. See **Box 2.6** for further issues facing family planning.

³¹ High rates of teenage marriage are a concern not only because of higher fertility. They are also associated with issues of human rights (whether the girl had a choice of husband), illegality with respect to age of marriage (16 years old in Indonesia), and reproductive health (earlier childbearing and too short birth spacing are related to worse maternal and child health outcomes, contributing to an unfair start in life for many children (see next section)).

BOX 2.6

Strategic and emerging issues for family planning in Indonesia

There remain several strategic and emerging issues facing family planning. Jones and Adioetomo also highlight key strategic issues for revitalized family planning in Indonesia:

1

Financing and method mix

About 73 percent of family planning users are served by the private sector. However, private sector suppliers emphasize short-term methods, which disadvantages those who would prefer to terminate rather than delay childbearing, especially the poor who struggle to afford the cost of contraceptive resupplying.

2

Improvements of equity in access

Inequities in access and quality of family planning services exist between provinces and districts, and between the general population and marginalized groups. Because a number of groups are costly to reach for various reasons, the private sector is unlikely to address these access and quality issues; the public sector will need to adopt this role.

3

Local planning & budgeting support

Family planning receives a very small share of local government budgets (between 0.04 and 0.2 percent), due in part to the non-

involvement of local family planning officials in the budgeting process, and there being 27 other areas required by law to be funded, and a lack of integrated planning with local health bureaus (*Dinas Kesehatan*) and the Ministry of Women's Empowerment and Child Protection. Moreover, the majority of districts do not provide the 30 percent of contraceptives and supplies as required under the minimum service standards, meaning the central BKKBN office has to instead. However, funding is not provided for delivery costs, and fees are then charged by local providers to users (66 percent of the users of public family planning pay a fee for services). Finally, access to special funds set aside for national strategic priorities (*Dana Alokasi Khusus*, or DAK) are restricted to infrastructure, ruling out an alternative source of funding at the local level.

4

BKKBN human resource capacity

Various assessments of family planning program revitalization needs have identified the lack of capacity of BKKBN staff at the local level,³² in particular with respect to basic planning, program implementation, and monitoring and supervision; advocacy on the importance of family planning to executives and legislators at the district level; and communication with other sectors.

5

Family planning services

Private sector services are mainly provided by midwives (*bidan*). Of the 135,000 registered midwives, only 40,000 provide family planning services, which is too small relative to the scale of family planning demand. Moreover, relatively few are trained in longer-term methods (only 44 percent in IUDs and 37 percent

in implants), which are the methods most needed by poorer households looking to limit family size.

6

Demand creation issues

The past success of the family planning program relied heavily on the work of family planning field officials (*Petugas Lapangan Keluarga Berencana*, or PLKB), whose task was to encourage couples to understand the benefits of smaller families and to use contraception. After decentralization, the PLKB come under local governments and numbers have declined significantly. The promotion of family planning is now often neglected at the local level.

7

Contraceptive supply chain management issues

Managing the contraceptives logistics and delivery is another source of problems (Brandt and Benarto 2013). Local supply levels are based on targeted new users rather than data-based underlying demand; data are also poor in the reporting system. As a result, many clinics supplied by the BKKBN are often out of stock of certain contraceptives. Moreover, the centralized warehouse approach used by the BKKBN lengthens the supply chain, compared with the Ministry of Health's direct delivery of drugs and medicine to provinces and districts. Nor is there funding for delivery of stocks from district to village level. In addition, temperatures at central and local storage facilities are far higher than the 25 degrees Celsius maximum recommended, which may reduce the potency of contraceptive stocks.

8

Family planning under the new JKN

Family planning services are included under the new National Health Insurance (*Jaminan Kesehatan Nasional*, or JKN), although the 2013 Presidential Decree covering JKN contains conflicting articles about the inclusion of family planning. Three main issues arise for family planning under JKN. First, JKN is a social insurance system based on the concept of risk-pooling through revenue collection from members. Thus revenues for service providers are fixed (capitation). However, the focus of family planning is to recruit increasing numbers of users from those who have unmet needs for contraception, meaning the more family planning services are delivered, the less profitable it is. There is already some evidence that some health centers are reluctant to provide such services. Second, new regulations require the BKKBN to cover contraception for all users, compared with the current situation in which most users pay out of pocket. There is a need to distinguish between those who can afford to pay the premiums and those who are entitled to new services. Finally, midwives who work out of clinics, while registered and accredited, cannot be contracted directly by BPJS (the JKN implementing agency) under current regulations.

³² For example, Lewis and Haripurnomo (2009), Thomas and Adioetomo (2010) and Febriani (2012)

2.2.4

An unfair start in life continues with differences in skills development and education

AFTER A HEALTHY START, PEOPLE NEED TO ACQUIRE THE EDUCATION AND SKILLS THEY NEED TO GET A GOOD JOB LATER. The key

to getting a good job later in life is going to (and staying in) school and developing key skills while there. When not all children can go to school, or when they do not get the education and skills they need at school, they have a much lower chance of getting a good job as an adult compared with those children who do receive such education.

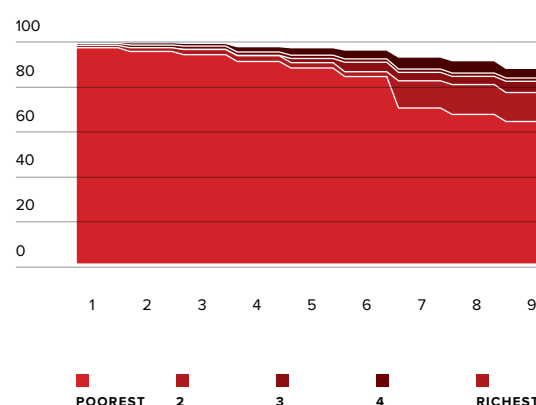
THE FIRST STEP IS MAKING SURE THAT MORE CHILDREN MAKE THE TRANSITION BETWEEN SCHOOL LEVELS. By far the greatest

rate of school dropout occurs in the transition between school levels, rather than during each level. This is the case for all children, but especially for the poor. For example, enrolment rates in year six of primary school are almost 100 percent for children from the richest quintile, but also near 90 percent for the poorest quintile (Figure 2.24). During the transition to the first year of junior high school (seventh year of school), enrolment rates drop to 94 percent for the richest quintile, a fall of 5 percentage points. However, they drop far more dramatically for the poorest quintile, by 17 percentage points to 73 percent. A similar pattern is observed between years nine and ten during the transition from junior to senior secondary school (Figure 2.25); enrolment rates for children from the richest quintile fall from 89 to 76 percent, but for those from the poorest quintile fall from 59 to 33 percent, or three times as fast.

SOMETIMES THERE ARE NOT ENOUGH SCHOOLS AT THE NEXT LEVEL, BUT GENERALLY SCHOOLS ARE ACCESSIBLE AND HAVE ROOM FOR MORE STUDENTS. Access to

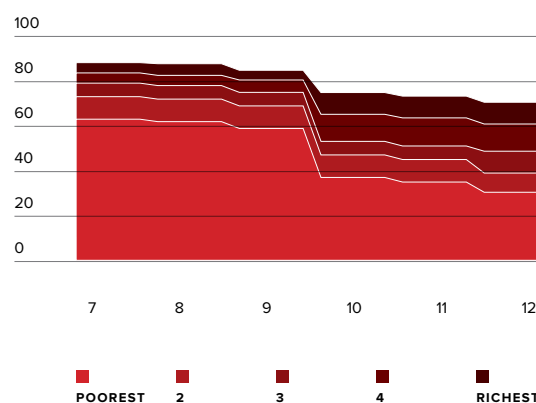
public senior secondary or vocational schools is an issue in some sub-districts, especially in Papua and Maluku, but also in East Nusa Tenggara (less than 70 percent access), North Sulawesi, North Maluku, South Kalimantan, and West, Central and East Java (all less than 80 percent access).³³ However, junior and secondary schools are generally available.

Years of completed education, 16-18 year olds (percent) (fig. 2.24)



SOURCE Susenas 2012.

Years of completed education, 19-21 year olds (percent) (fig. 2.25)



SOURCE Susenas 2012.

Enrollment rates drop dramatically between school levels

Moreover, when they are available, they are not too full to take on additional students. According to Susenas, nearly half of all junior and senior secondary schools have less than 180 students, with average class sizes below 25.³⁴

SOME CHILDREN DO NOT RE-ENROLL BECAUSE COSTS RISE SHARPLY BETWEEN LEVELS, AND FEW POOR CHILDREN RECEIVE SCHOLARSHIPS, EVEN WHEN THEY ARE ELIGIBLE.

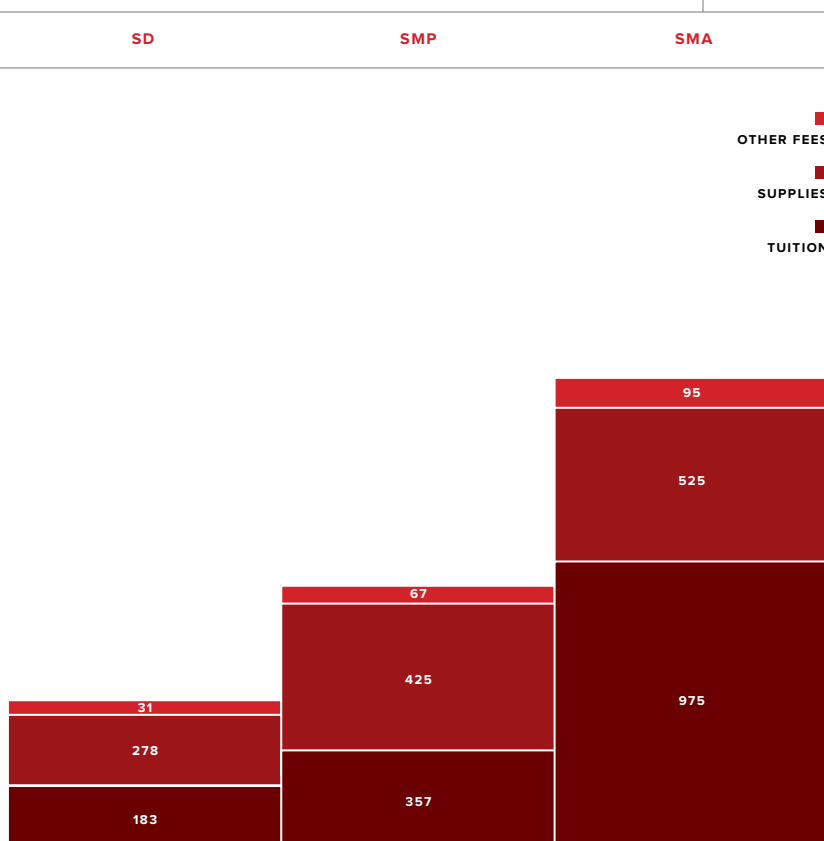
An important driver of dropping out is the significant increase in schooling costs when making the transition between school levels. Costs increase from around IDR 500,000 per year on average for primary school to over IDR 800,000 at junior secondary level, and to IDR 1.6 million at senior secondary level (Figure 2.26). This can make schooling unaffordable for poorer households. Put another way, the annual costs of junior secondary school are 25 percent of the per capita poverty line, those of senior secondary school rise to 50 percent of the poverty line. At the same time, relatively few of the poor and vulnerable are currently receiving scholarships (Figure 2.27) despite expanded coverage and improved targeting, and scholarship benefit levels are insufficient to meet all schooling costs (World Bank 2012a and 2012c).

³³ Analysis of Podes Village Census data.

³⁴ Susenas education module 2012.

Annual schooling costs by school level (IDR thousand) (fig. 2.26)

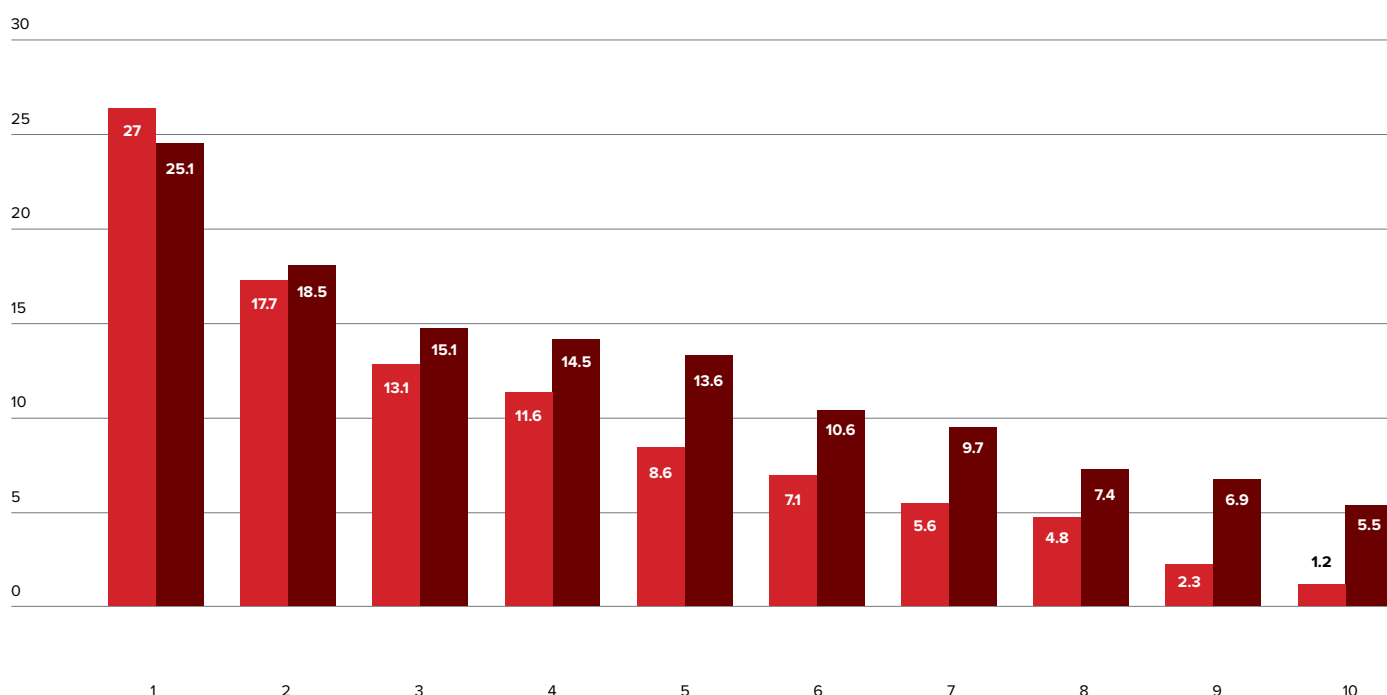
SOURCE
Susenas
2014 and
World Bank
calculations
from World
Bank
(2015e).



Percentage of households with school-aged children receiving a scholarship by household per capita expenditure deciles (percent) (fig. 2.27)

URBAN
RURAL

SOURCE Susenas 2014 and
World Bank calculations from
World Bank (2015e).



OTHERS DROP OUT BECAUSE THEY CAN HELP BOOST HOUSEHOLD INCOME BY WORKING. While data on the level of child wages below the age of 15 years old are poor, the survey data on those aged 15 to 18 years old indicate that the monthly income that can be earned is nearly three times higher than the monthly poverty line, making contributing to household income attractive for poor children (Figure 2.28).

HOWEVER, DESPITE CONTINUED DISPARITIES, INDONESIA HAS DONE WELL AT CLOSING THE EDUCATION ENROLMENT GAP BETWEEN THE URBAN AND RURAL, RICH AND POOR, AND MALE AND FEMALE. Historically, richer, urban, male children born to more educated parents were more likely to be enrolled than poorer, rural, female children born to less educated parents. However, the gender, urban-rural, rich-poor, educated-less-educated parental gaps have been closing. For example, the junior high school (SMP) enrolment gap between children whose parents have no education and

tertiary education, or are in the poorest quintile and richest quintile, has halved in the past decade (Figure 2.29 and Figure 2.30).

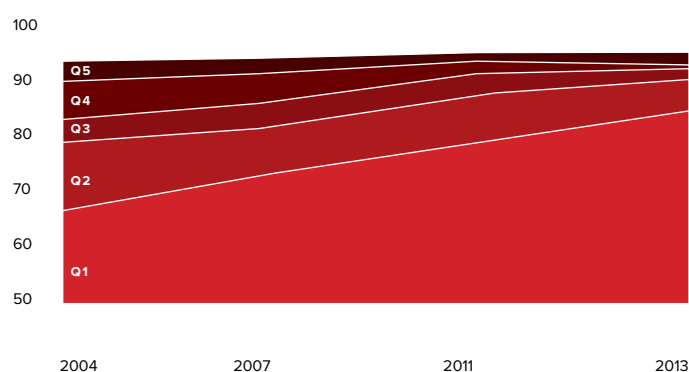
NONETHELESS, GREATER YEARS OF EDUCATION ARE NOT TRANSLATING INTO HIGHER INCOMES. There has been a long-term trend towards great mobility in education: children born in the 1960s and 1970s to parents with no education are considerably more likely to have received more education than their parents compared with those born in the 1950s. For example, of children whose parents did not complete primary school, compared with those born in the 1950s, those born in the 1960s and 1970s are less likely to have no education themselves (11 and 37 percent less likely, respectively), and more likely to achieve a higher final attainment than their parents (Figure 2.31 and World Bank 2015b). However, as adults, their chance of moving up the income distribution as adults has been little more than their older, less educated colleagues (Figure 2.32).

Median monthly incomes of children aged 15-18 years old (rupiah) (fig. 2.28)

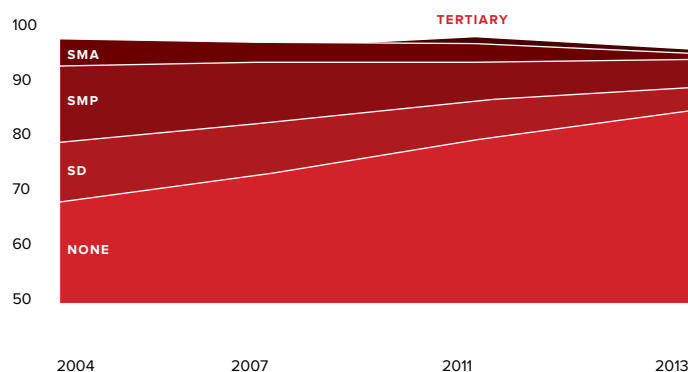
SOURCE Sakernas 2013



Enrolment of 13-15 year olds by parents' consumption quintile (fig. 2.29)



Enrolment of 13-15 year olds by parents' education (fig. 2.30)



SOURCE Susenas.

NOTE Highest of both parents' education; parents' per capita household consumption quintile.

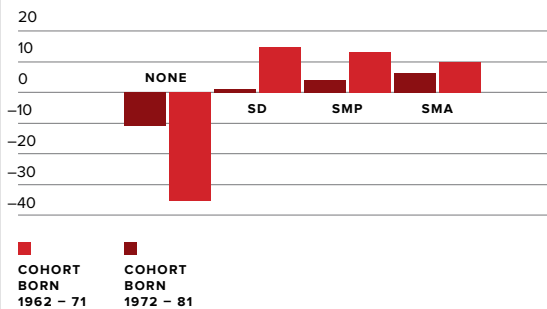
ONE REASON IS THAT NOT ALL CHILDREN RECEIVE THE SAME BENEFITS FROM SCHOOLING DUE TO NOT ENJOYING A HEALTHY AND SMART START PREVIOUSLY.

Disadvantages at an early age limit educational benefits from schooling later on. We have already seen that children whose parents have lower education and income are more likely to be stunted (Figure 2.7 previously and World Bank 2015b). They are also less likely to be enrolled in early childhood development (ECD) programs, as are those in eastern Indonesia (Figure 2.33). As a consequence of these and other factors, they more likely to be in the lowest cognitive quintile (and less likely to be in the highest quintile (Figure 2.34).

LIMITED ACCESS TO ECD CENTERS PLAYS A ROLE, AS DOES PARENTAL BACKGROUND. Only in urban areas and in Java are ECD centers either in the village (around 90 percent of the time) or under

10km from the village (Figure 2.35). Only around half of rural villages have an ECD center, and it is an average of 20km to the nearest one otherwise. Only 10 percent of villages in Papua and Maluku have an ECD center, and for the rest it is an extremely prohibitive average of 50km to the nearest one, virtually ensuring non-enrolment and attendance. Even when ECD centers are accessible, not all children enroll. For example, a typical 4-year-old child in an urban area has a 30 percent chance of being enrolled, while a typical 4-year-old in a rural area only has a 21 percent chance. However, for an urban child with a highly educated mother, this probability increases from 30 to 36 percent, while for a rural child with a poorly educated mother, this probability decreases from 21 to only 9 percent (Hasan *et al.* 2013). Similarly, a typical child from the richest 20 percent has a 40 percent chance of being enrolled, compared with a 16 percent chance for a child from the poorest 20 percent.

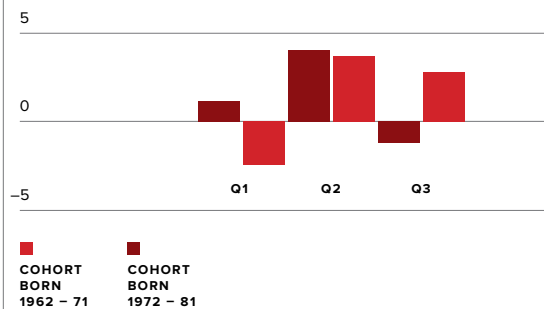
Educational attainment probability of children born in the 1960s and 1970s with parents who did not complete primary, relative to the 1950s cohort (percent) (fig. 2.31)



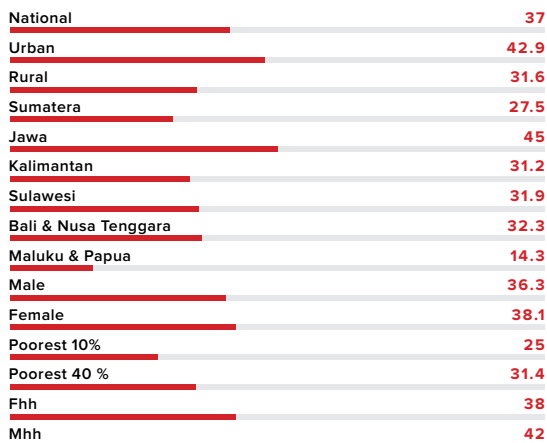
SOURCE Susenas.

NOTE: Highest of both parents' education; parents' per capita household consumption quintile.

Adult income quintile probability of children born in the 1960s and 1970s with parents who did not complete primary, relative to the 1950s cohort (percent) (fig. 2.32)

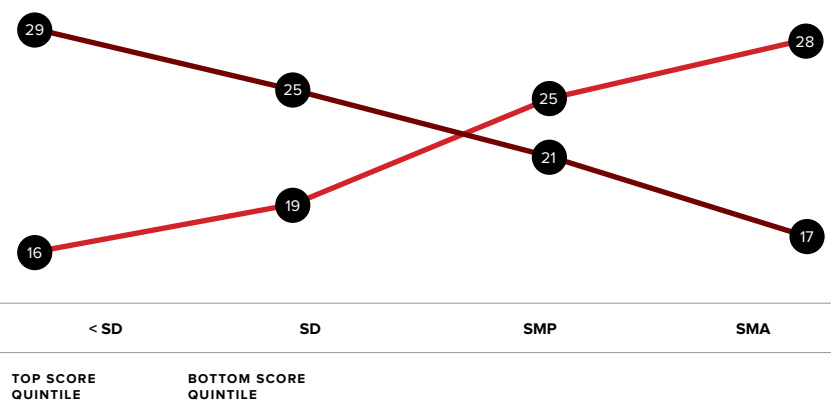


ECD enrolment rates for 5-6 year olds by region, gender and income (percent) (fig. 2.33)



SOURCE Susenas.

Probability of 7-14 year old children being in the top or bottom quintile of cognitive scores by parents' education (percent) (fig. 2.34)



SOURCE IFLS and World Bank calculations..

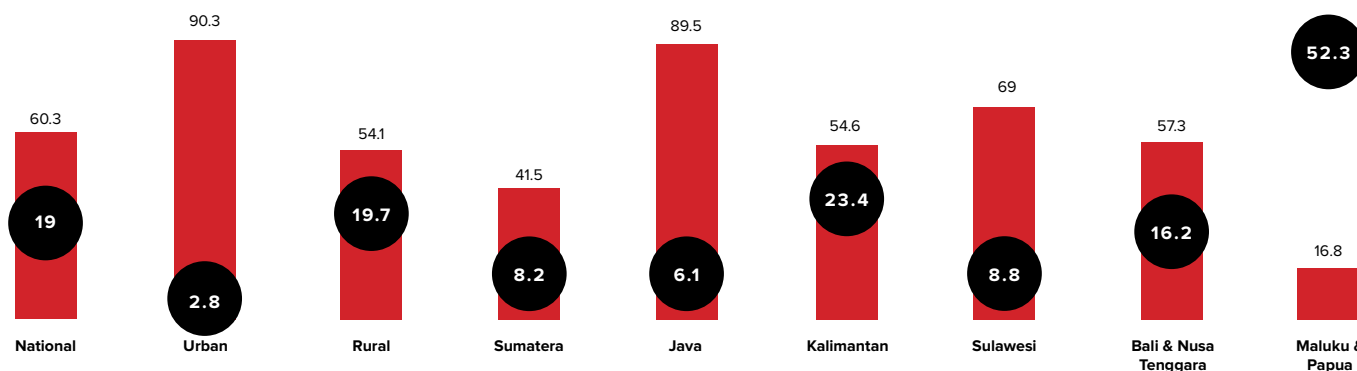
A KEY REASON WHY MORE EDUCATION DOES NOT TRANSLATE TO HIGHER INCOMES IS BECAUSE OF DIFFERENCES IN THE QUALITY OF THAT EDUCATION. Poor children may be more likely to attend school than before, but the quality of their skill development is hampered by the quality of their education. This negatively affects the learning outcomes of poorer students and those in remote regions. For example, Grade

3 children in Java read 26 words faster per minute than those in Nusa Tenggara, Maluku or Papua, and 10-12 words faster than elsewhere (Table 2.3). Similarly, children from the middle of the income distribution read 6-12 words faster than poorer children and richer children 18 words faster. These advantages are in addition to an 11-word-faster reading ability for those who attended ECD.

ECD availability in village (percent) and distance to nearest center if not in village (km) by region (fig. 2.35)

SOURCE Podes 2011 Infrastructure Survey.

● AVERAGE DISTANCE TO ECD FACILITIES, IF NOT IN VILLAGE
■ % VILLAGE WITH ECD FACILITIES



Oral reading fluency advantages based on ECD participation, location and wealth (words per minute faster than reference) (Tab. 2.3)

SOURCE USAID (2014)

Advantages to location: words per minute faster than children from Maluku, Nusa Tenggara and Papua

Advantages to wealth: words per minute faster than children from the poorest wealth quartile

Advantages to ECD: words per minute faster than children who did not attend preschool

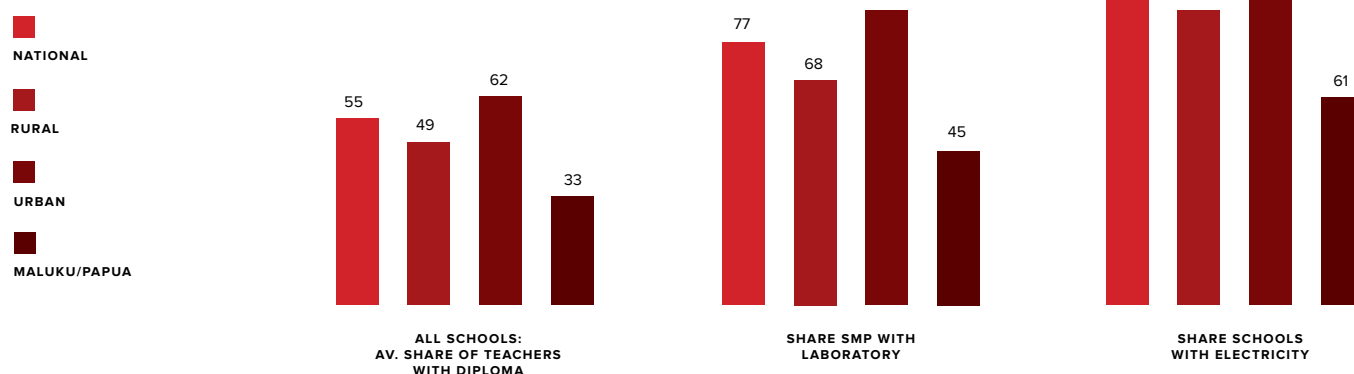
12.2 Kalimantan-Sulawesi
15.5 Sumatra
26.5 Java-Bali

5.8 Lower-middle
11.8 Upper-middle
18.0 Highest

11.5 Attended

Quality of schooling facilities and teachers (percent) (fig. 2.36)

SOURCE Podes 2011 Infrastructure Survey

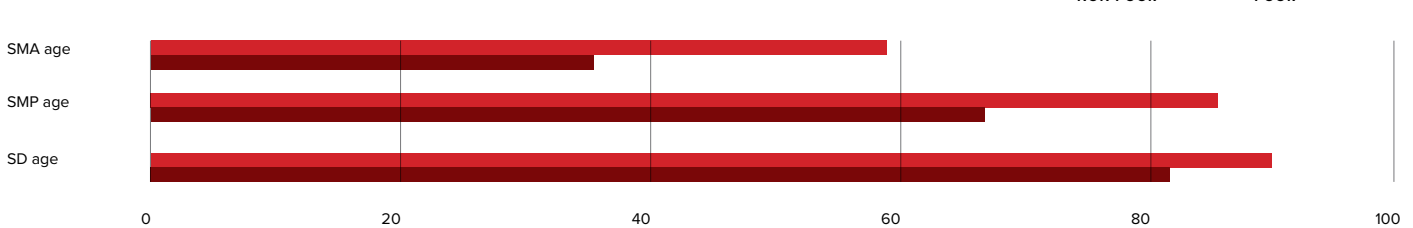


ONE CONSTRAINT ON CHILDREN'S ACHIEVEMENT IS THE QUALITY OF BOTH FACILITIES AND TEACHERS; ANOTHER IS THAT POORER CHILDREN ARE ALSO LESS LIKELY TO STUDY. A constraint on the quality of education that many Indonesian children face is the quality of education facilities and teachers. This is even more problematic for rural children and especially those in eastern Indonesia (Figure 2.36). Moreover, 11 percent of junior secondary students in Papua and Maluku say their teacher is often or always late or absent, compared with just 1 percent nationally.³⁵ At the same time, access to quality education is not enough to develop the right skills for all children. Poor children are not only less likely to have a school nearby with good teachers, they are also less likely to study (Figure 2.37 and Figure 2.38).

AS A CONSEQUENCE OF UNEQUAL ACCESS TO QUALITY EDUCATION FOR MANY CHILDREN, NEARLY THREE-QUARTERS OF INDONESIAN CHILDREN LACK EVEN BASIC SKILLS IN MATHEMATICS AND SCIENCE. In the OECD international educational test scores (Programme for International Student Assessment, or PISA), 15-year-old children need to score 420 or more in order to be considered as having basic skills in mathematics and science. With 74 percent of Indonesian children scoring below 420, it has the fifth-worst share of 15-year-old children without basic skills of the 83 countries included in the data (Figure 2.39, OECD 2015).

³⁵ Susenas education module, 2012.

Children who reported reading a text book in the past week (percent) (fig. 2.37)



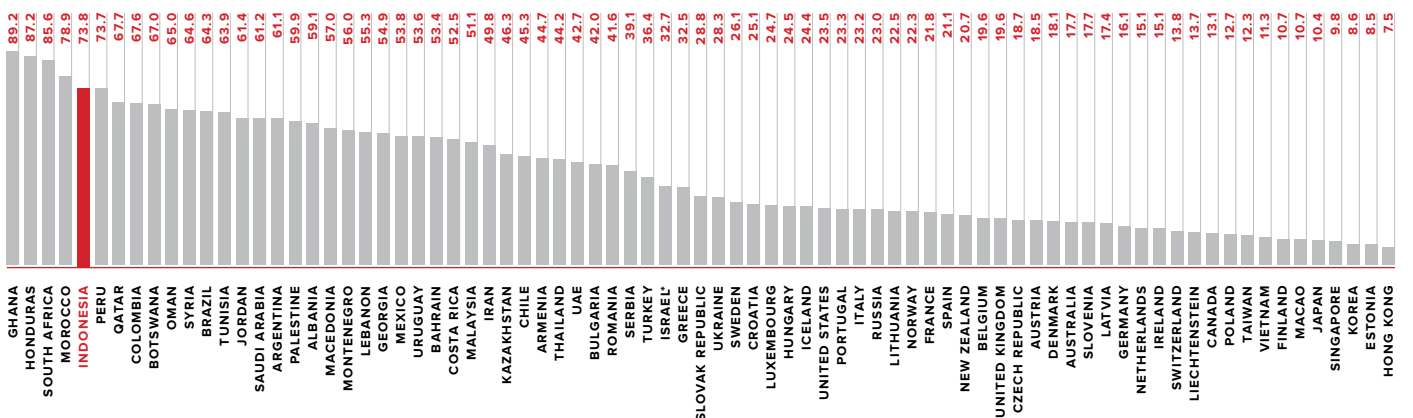
Children who reported reading a science book in the past week (percent) (fig. 2.38)



SOURCE Susenas education module 2012.

Percentage of 15-year olds with international PISA mathematics and science scores below Level 2 (basic skills, 420 points) (fig. 2.39)

SOURCE
OECD 2015



2.3

WHY A WIDENING GAP BETWEEN SKILLED AND UNSKILLED WAGES IS INCREASING INEQUALITY

2.3.1

Increasing demand for and shortage of skilled workers is driving their wages higher, which benefits those children who got the right start in life

IN THE MODERN, DYNAMIC, GLOBAL ECONOMY, TECHNOLOGICAL ADVANCES, ESPECIALLY IN INFORMATION TECHNOLOGY, MEAN THAT SKILLS ARE BECOMING INCREASINGLY IMPORTANT.

Technological progress has brought significant benefits in recent decades, with cheaper transportation and cheaper goods, greater access to markets for those in remote areas, and improved communication and knowledge sharing. The new technologies underpinning these advances are demanding increasingly more skill to use and improve. As a consequence, demand for skilled workers in many sectors has increased in most countries around the world. And these skilled workers tend to be those children who

completed school and benefitted from a high quality education in the first place, highlighting the consequences of unequal opportunity from birth.

IN INDONESIA, EMPLOYERS ARE INCREASINGLY DEMANDING MORE SKILLED WORKERS, BUT ARE STRUGGLING TO FIND THEM.

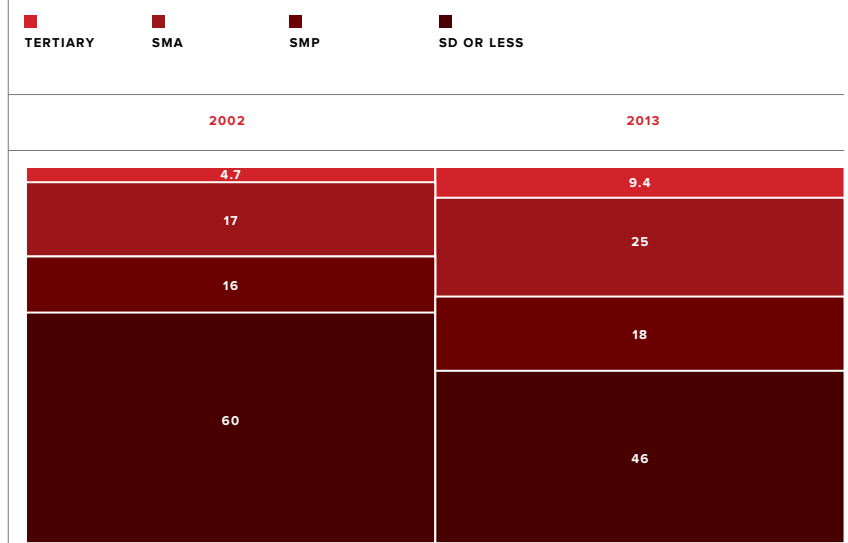
Employers in Indonesia are also looking for workers with higher skill levels. The proportion of jobs requiring senior high school or tertiary education has increased over the past decade from 22 percent in 2002 to 35 percent in 2013 (Figure 2.40). However, despite increasing educational attainment, half of all workers have no more than a primary level of education. Only 6.3 percent have a university, or 4-year diploma,

degree (Figure 2.41). Moreover, education levels are not the same as skills. A survey in 2011 found that employers ranked basic skill as the most important, followed by thinking and behavioral skills (World Bank 2011). However, 35 to 40 percent of those surveyed identified a “skill gap in staff” in thinking and behavior, and around 13 percent thought even basic skills were lacking (Figure 2.42).

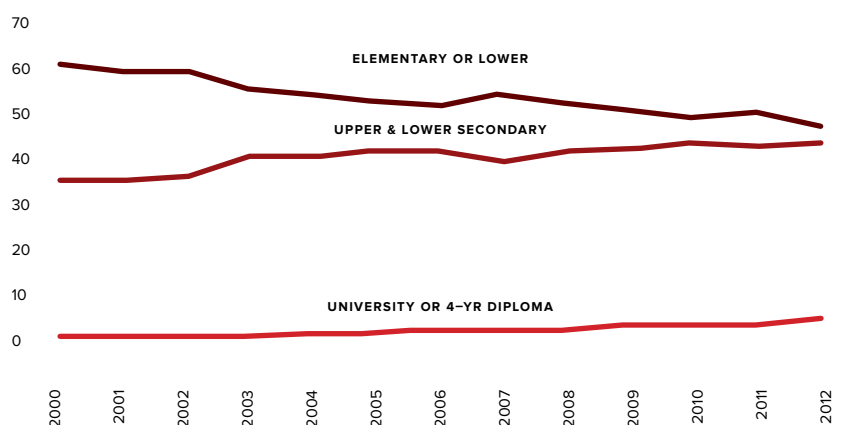
MOREOVER, WORKERS FROM POORER BACKGROUND HAVE LIMITED ABILITY TO FIND GOOD JOBS, WHICH TYPICALLY RELIES ON USING SOCIAL CONNECTIONS. There are many ways that young workers and prospective employers can find each other: advertisements, job fairs, university career services, and customized recruitment strategies by firms. Most Indonesians, and youth in particular, however, rely on personal connections with family and friends to find a job (Figures 2.43 and Figure 2.44). This means that young workers from richer households with good connections tend to get better jobs. This, however, leaves young workers from poorer households with fewer social connections at a disadvantage.

AT THE SAME TIME, WITH LIMITED ACCESS TO “SECOND-CHANCE” SKILLS TRAINING OPPORTUNITIES, LESS SKILLED WORKERS FIND IT DIFFICULT TO IMPROVE THEIR SKILLS TO FIND BETTER JOBS. Much of the Indonesian workforce leaves school without basic skills because of incomplete and poor quality education. There are limited opportunities for these workers to develop such skills later in life. Less than 1 percent of youths aged 19 to 24 years old have attended training courses in engineering, IT or languages, in part because of limited supply (Figure 2.45). In addition, significantly fewer Indonesian firms offer training opportunities than elsewhere in East Asia or throughout the world (Figure 2.46). Large firms are much more likely to do so than smaller ones, but the proportion is still less than half. Exporting firms and foreign firms are also more likely than non-exporting and domestic firms to provide formal training, but the rates are still low. Moreover, since employees at large, exporting, foreign-owned firms are more likely to be already skilled, the training that is available probably does little to reduce the skilled wage gap.

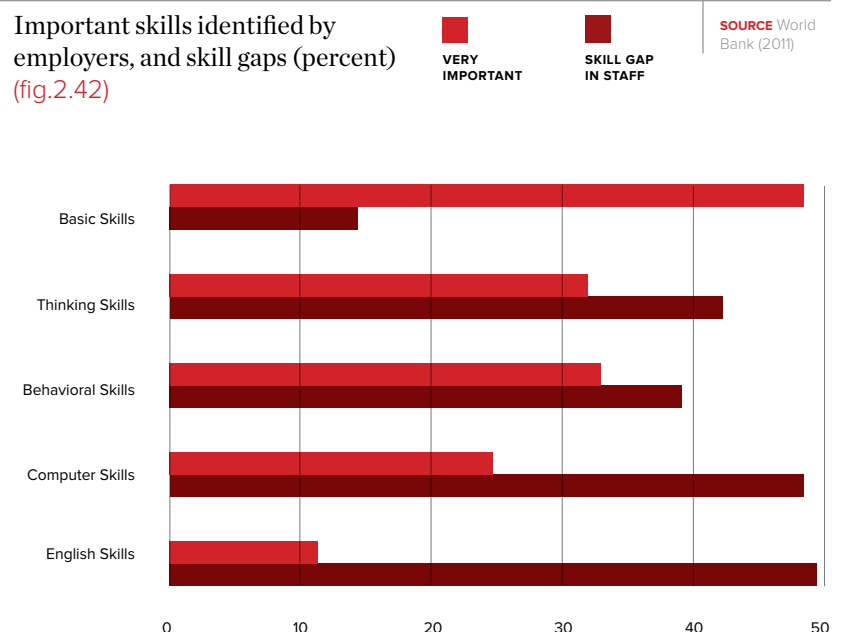
Employment by education level, 2002-13 (percent) (fig. 2.40)



Education decomposition of labor force (fig. 2.41)

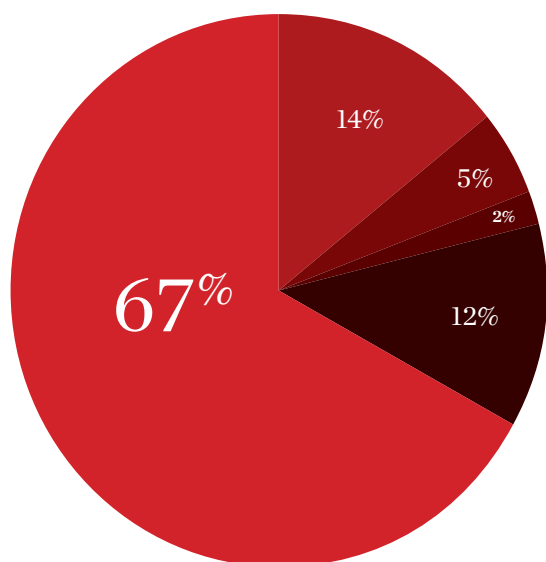


Important skills identified by employers, and skill gaps (percent) (fig. 2.42)

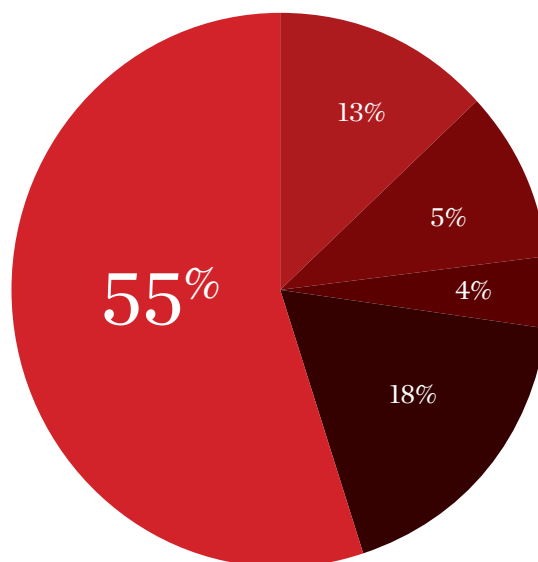


SOURCE World Bank (2011)

Method for finding job, youth aged 15-24 years old (percent) (fig. 2.43)



Method for finding job, all workers aged 25 years and older (percent) (fig. 2.44)



FRIENDS AND RELATIVES

CONTACTED BY COMPANY

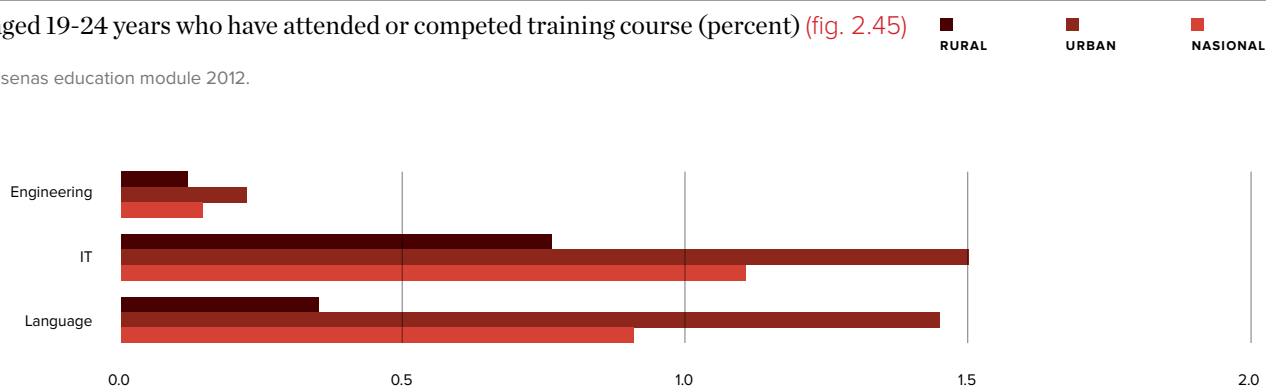
JOB FAIRS

CONTACTED COMPANY

ADVERTISEMENT

SOURCE IFLS and World Bank calculations.

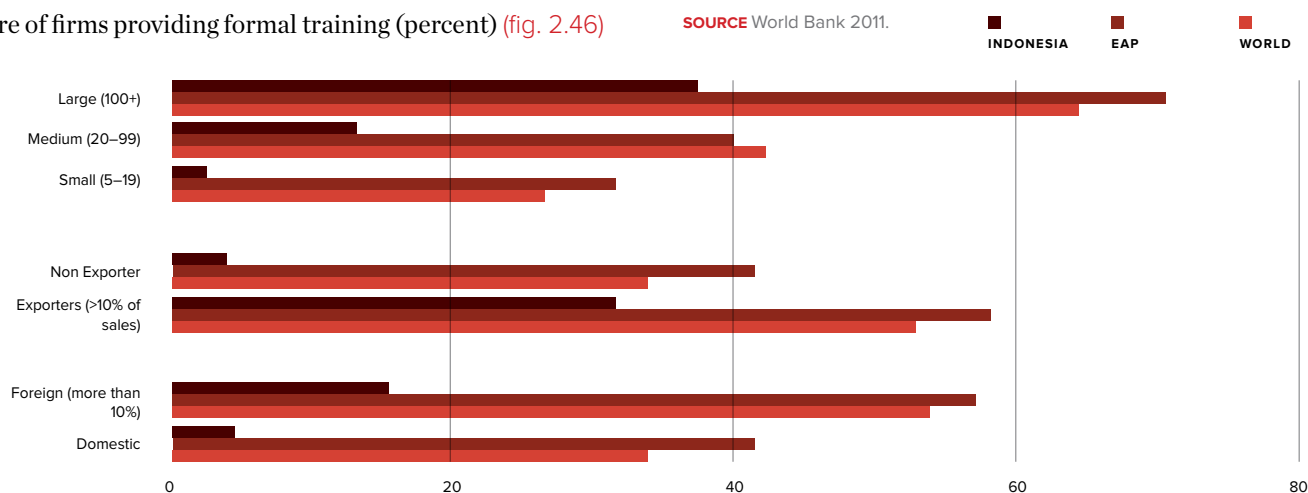
Youths aged 19-24 years who have attended or completed training course (percent) (fig. 2.45)



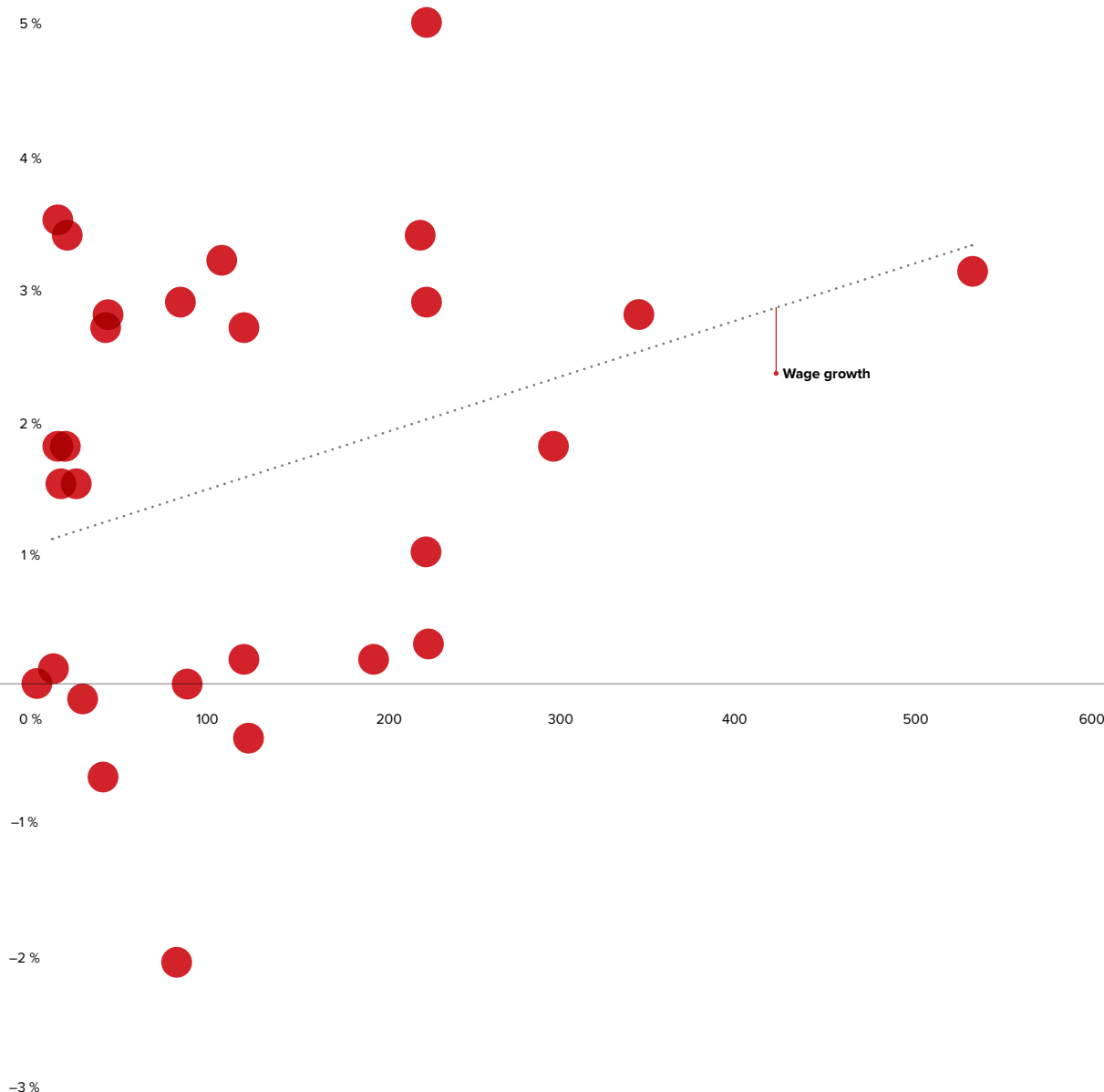
SOURCE Susenas education module 2012.

Share of firms providing formal training (percent) (fig. 2.46)

SOURCE World Bank 2011.



Annualized wage growth (2001-14) versus sectoral productivity (2012 annual value added per worker, IDR million) (fig. 2.47)



SOURCE Sakernas, National Accounts, World Bank calculations.

AS A CONSEQUENCE, WAGES FOR SKILLED WORKERS—THOSE WHO ARE MOST LIKELY TO HAVE BENEFITTED FROM A HEALTHY START AND GOOD EDUCATION—HAVE BEEN INCREASING FASTER THAN THOSE FOR UNSKILLED WORKERS. There is an increasing wage gap between skilled and unskilled workers. Skills, rather than education, are hard to identify in workforce surveys. However, on the whole, wages in higher productivity sectors that demand more skill, such as financial services,

telecommunications and some manufacturing sectors, have risen faster than in those in lower productivity sectors. On average, every extra IDR 200 million of annual labor productivity enjoyed by a sector corresponded to 1 percentage point higher real wage growth each year between 2001 and 2014 (Figure 2.47).³⁶ In this labor market, workers from richer households, who are more likely to be better educated and more skilled, are benefitting from higher wages.

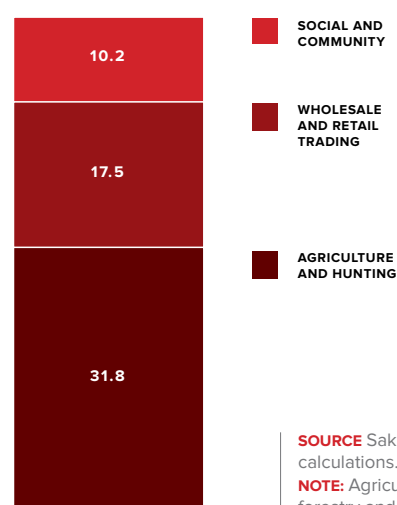
³⁶ Labor productivity is measured here as the value of GDP output in the sector divided by the number of workers. Worker productivity ranges from around IDR 20 million of GDP in very low productivity sectors, such as agriculture, to IDR 100-200 million in higher productivity sectors in manufacturing and financial services, to over IDR 500 million in non-oil and gas mining.

2.3.2

At the same time, most workers are trapped in low-paying jobs

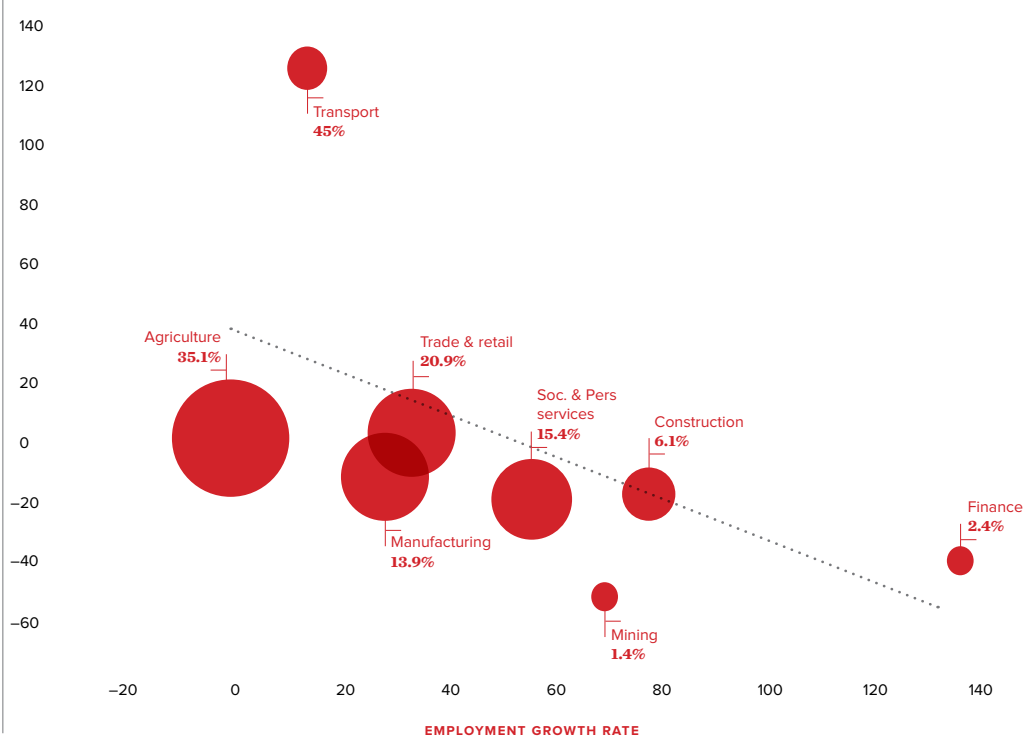
MOST EXISTING AND NEW JOBS ARE IN LOW-PRODUCTIVITY SECTORS. Most existing jobs are in low-productivity sectors. In fact, in 2014, three of the lowest productivity sectors accounted for 60 percent of all jobs (Figure 2.48): agriculture and hunting (32 percent of jobs, average value-added per worker IDR 21 million per year), wholesale and retail trade (18 percent of jobs, average value-added IDR 19 million per year) and community, social and personal services (10 percent of jobs, average value-added IDR 5 million per year). Moreover, most of the 20 million new jobs created between 2001 and 2012 have been concentrated in low-productivity, non-skill-intensive sectors (Figure 2.49). Out of total employment growth, 30 percent occurred in community, social and personal services and 28 percent in wholesale, trade and retail, while manufacturing contributed only 16 percent of total growth (3.3 million jobs).

Share of total employment, 2014 (percent) (fig.2.48)



Employment and labor productivity growth by sector, 2001-12 (percent) (fig.2.49)

Employment growth and labor productivity growth and negatively correlated



AS A CONSEQUENCE, MANY LOW-SKILL WORKERS FROM POORER HOUSEHOLDS ARE TRAPPED IN INFORMAL OR LOW-PRODUCTIVITY WORK.

A large informal sector still employs more than 50 percent of total workers (70 percent in rural areas), and remains one of the most serious challenges for the Indonesian labor market. Although the share of “good jobs” in total employment (defined here simply as the share of formal dependent employees) rose from 27.7 to 36.4 percent between August 2001 and August 2012 (Figure 2.50), a large share of the employed pool is still highly vulnerable, with nearly 18 million unpaid family workers and some 11.5 million casual workers (16 percent and 10 percent of the total, respectively). Many of these workers are concentrated in the low-skill, low-productivity sectors with high informality and low wages, such as agriculture, construction, transportation, and wholesale and services (Figure 2.51). In addition, a decrease in the number of casual workers in agriculture has been offset by the rise of casual workers in non-agriculture sectors, and although

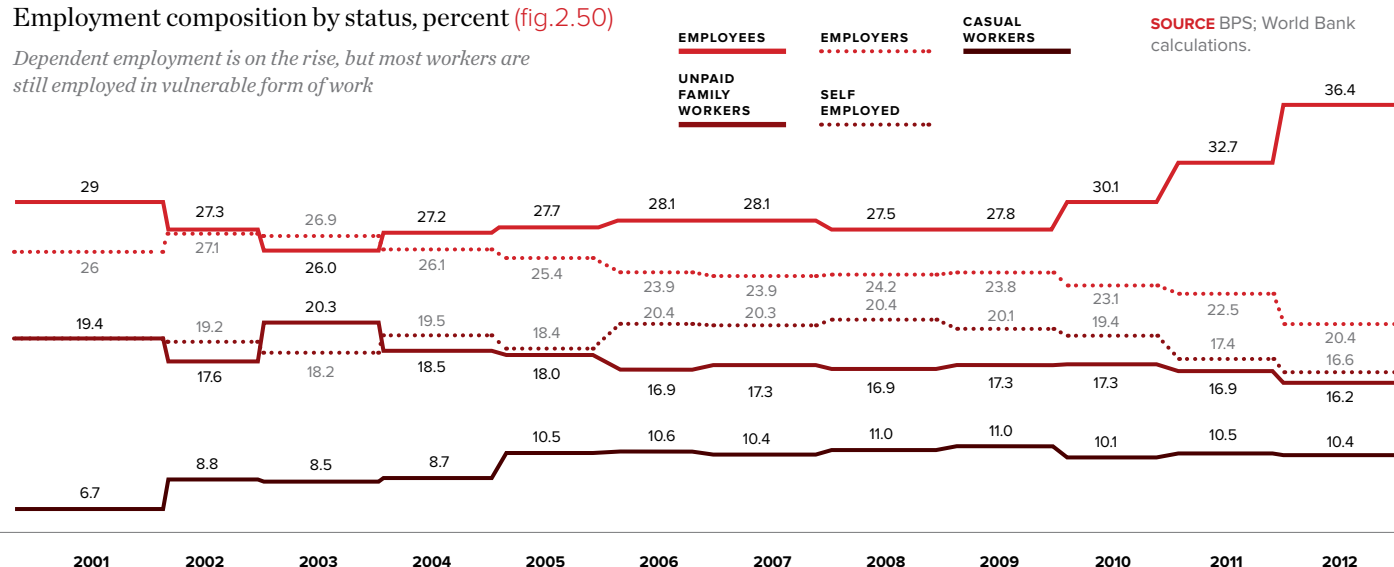
the number of employers with permanent workers is increasing, those with temporary workers still represent 82 percent of total employers. Finally, workers on their own account (or self-employed in a strict sense), who are more likely to be vulnerable and less productive, although declining, still add up to some 18.5 million (16.6 percent of total employment).

A NUMBER OF FACTORS RESTRICT THE CREATION OF MORE PRODUCTIVE AND BETTER PAID JOBS.

In addition to the low productivity of most workers on the labor supply side, which has already been discussed, there are two main constraints to the generation of better, more productive jobs in Indonesia. The first is a range of barriers to competitiveness and productivity, including underinvestment in infrastructure; a complicated and long process to establish new businesses; a lack of access to finance for productive firms; and the need for higher productivity in the agricultural sector; and a revitalized manufacturing sector (see World Bank

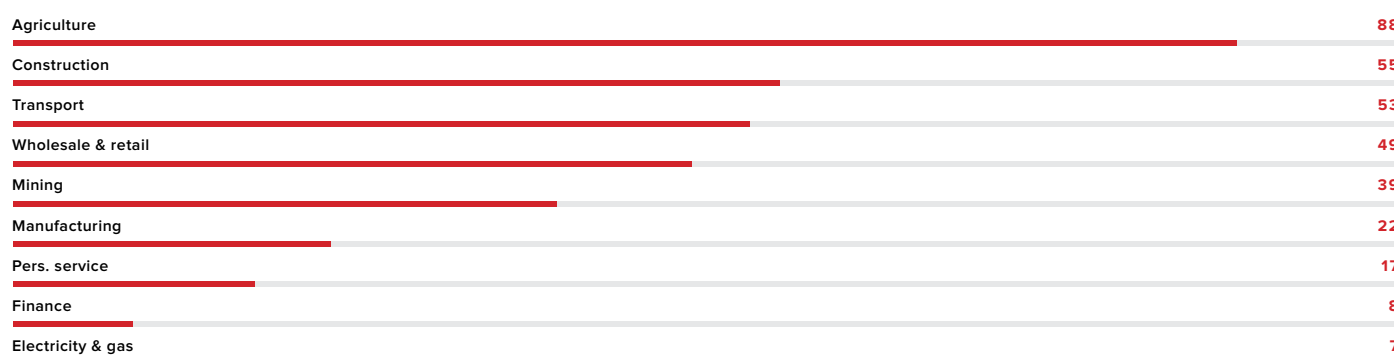
Employment composition by status, percent (fig.2.50)

Dependent employment is on the rise, but most workers are still employed in vulnerable form of work



% of informal workers by sector, 2012 (fig.2.51) *Low-productivity sectors tend to have higher levels of informality*

SOURCE
BPS



2014c for an extended discussion). The second is a rigid labor market with regulations that deter the creation of better jobs and prevent workers from switching from lower productivity firms and sectors into higher productivity ones.

UNDERINVESTMENT IN INFRASTRUCTURE IS A PARTICULAR PROBLEM FOR FIRM AND WORKER PRODUCTIVITY AND COMPETITIVENESS IN GENERAL IN INDONESIA.

Investment in infrastructure in Indonesia collapsed during the Asian financial crisis and, unlike its peers, has not fully recovered since. Annual total infrastructure investment declined from an average 7 percent in 1995-97 to around 3-4 percent of GDP in recent years, compared with over 7 percent in Thailand and Vietnam, and 10 percent in China over the past decade. Despite rising government spending in recent years, Indonesia's core infrastructure stock, such as road networks, ports, electricity, telecommunication facilities, has failed to keep pace with economic growth. It is estimated that Indonesia has lost more than 1 percentage point of additional GDP growth due to under-investment in infrastructure, chiefly transportation (World Bank 2014c). Problems with transportation are among the worst business constraints for manufacturing firms and prohibitive transport costs undermine their competitiveness. Raw material producers find themselves unable to tap growing opportunities linked to final consumer demand. It is cheaper to import oranges from China than to source them from Kalimantan.

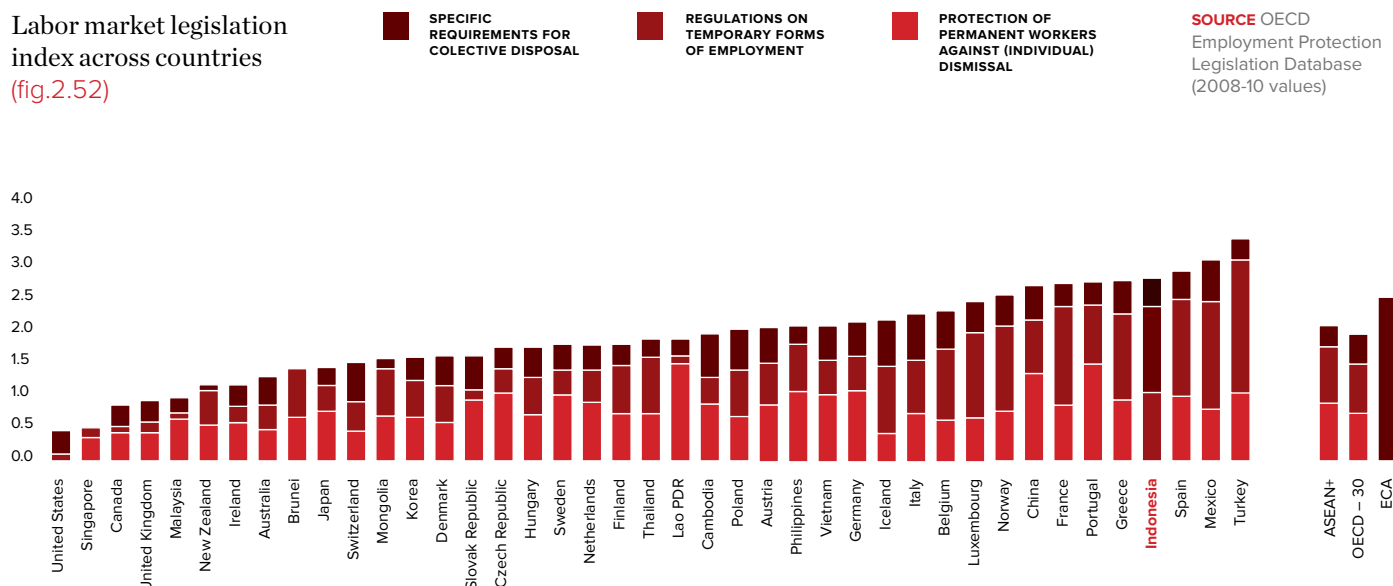
ANOTHER MAJOR ISSUE THAT CONTRIBUTES TO THE POOR INVESTMENT CLIMATE IS THE (LACK OF) EASE OF DOING BUSINESS IN INDONESIA.

Obtaining business licenses is very complicated, expensive and time-consuming. Indonesia ranks 114th out of 189 countries in the Ease of Doing Business index (Table 2.4; World Bank 2014e), worse than Malaysia (18th), Thailand (26th), Vietnam (78th), China (90th) and the Philippines (95th). For example, obtaining the licenses necessary to start a new business in manufacturing takes 794 days by law, although actual implementation can be slower still. Within the energy sector, the growth of which has been identified by government as a key policy priority, investors report that obtaining the various permits and licenses needed to establish a power plant can take over 4 years. And it takes 101 days to get an electricity connection, compared with just 35 in Thailand.

INDONESIA'S LABOR MARKET REGULATIONS ARE AMONG THE MOST RIGID IN THE REGION.

The 2003 Labor Law (Law No. 13/2003) significantly expanded workers' rights, but made it more costly to dismiss them, with a minimum severance pay of at least 100 weeks of wages. As a consequence, firms are less likely to employ workers formally, especially young educated ones. This also makes Indonesia's labor market regulations among the most rigid in the region (Figure 2.52). Most companies respond by not using formal contracts or using short-term contracts. Those that do sign formal contracts face higher labor costs, as they need to deposit an accrual for severance pay in a secured account.

Labor market legislation index across countries (fig.2.52)



CONSEQUENTLY, HIRING FORMAL WORKERS IS DISCOURAGED WHILE MOST WORKERS REMAIN NONETHELESS UNPROTECTED.

The legislation protects only a small number of workers. Most workers receive no severance

payment at all (66 percent), while those who do receive payments usually receive less than they are entitled to (27 percent); only 7 percent of fired workers receive the full payment (World Bank 2010c).

Ease of doing business in East Asia Pacific (Tab. 2.4)

SOURCE World Bank (2014e)

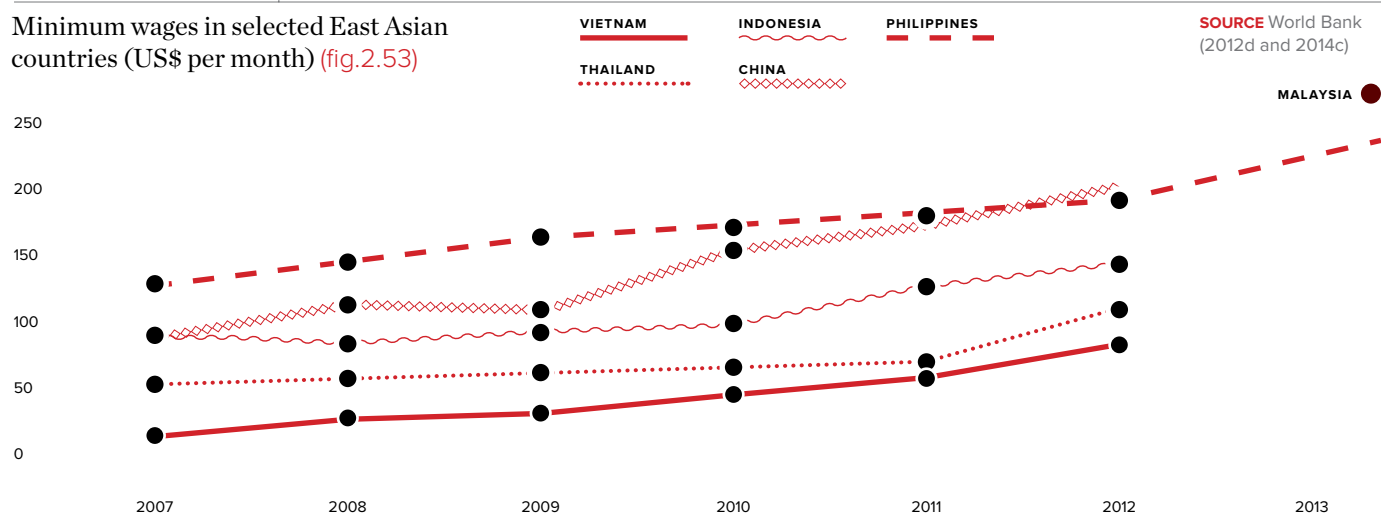
| Economy | REGIONAL RANKING | | | | | | | | | | |
|-----------------------|------------------|---------------------|----------------------|---------------------|----------------------|----------------|-------------------------------|--------------|------------------------|---------------------|----------------------|
| | World Rank | Starting a Business | Construction Permits | Getting Electricity | Registering Property | Getting Credit | Protecting Minority Investors | Paying Taxes | Trading Across Borders | Enforcing Contracts | Resolving Insolvency |
| Singapore | 1 | 1 | 2 | 2 | 2 | 2 | 2 | 2 | 1 | 1 | 2 |
| Hong Kong SAR, China | 3 | 2 | 1 | 4 | 14 | 3 | 1 | 1 | 2 | 2 | 3 |
| Malaysia | 18 | 3 | 8 | 9 | 10 | 3 | 3 | 5 | 3 | 5 | 4 |
| Taiwan, China | 19 | 4 | 5 | 1 | 7 | 8 | 6 | 6 | 4 | 14 | 1 |
| Thailand | 26 | 9 | 3 | 3 | 3 | 17 | 5 | 10 | 5 | 4 | 5 |
| Samoa | 67 | 5 | 12 | 7 | 8 | 21 | 8 | 14 | 12 | 13 | 16 |
| Tonga | 69 | 7 | 6 | 11 | 22 | 5 | 20 | 11 | 11 | 8 | 17 |
| Mongolia | 72 | 6 | 16 | 24 | 4 | 9 | 4 | 12 | 25 | 3 | 11 |
| Vanuatu | 76 | 17 | 17 | 18 | 13 | 5 | 17 | 7 | 20 | 12 | 13 |
| Vietnam | 78 | 14 | 7 | 22 | 5 | 5 | 15 | 25 | 10 | 7 | 14 |
| Fiji | 81 | 21 | 15 | 15 | 9 | 11 | 13 | 15 | 21 | 10 | 12 |
| Solomon Islands | 87 | 10 | 9 | 13 | 20 | 11 | 9 | 9 | 14 | 19 | 18 |
| China * | 90 | 15 | 24 | 20 | 6 | 11 | 16 | 19 | 16 | 6 | 7 |
| Philippines | 95 | 22 | 20 | 6 | 16 | 19 | 18 | 20 | 8 | 16 | 6 |
| Brunei Darussalam | 101 | 23 | 11 | 12 | 21 | 17 | 13 | 4 | 6 | 18 | 10 |
| Palau | 113 | 12 | 14 | 17 | 1 | 11 | 23 | 23 | 18 | 17 | 21 |
| Indonesia * | 114 | 20 | 23 | 16 | 17 | 11 | 7 | 24 | 7 | 21 | 8 |
| Papua New Guinea | 133 | 16 | 22 | 8 | 12 | 24 | 11 | 16 | 23 | 23 | 19 |
| Kiribati | 134 | 13 | 13 | 25 | 18 | 22 | 18 | 3 | 13 | 11 | 23 |
| Cambodia | 135 | 24 | 25 | 23 | 15 | 1 | 9 | 13 | 22 | 22 | 9 |
| Marshall Islands | 139 | 8 | 4 | 14 | 23 | 11 | 23 | 21 | 9 | 9 | 22 |
| Micronesia, Fed. Sts. | 145 | 18 | 10 | 10 | 23 | 9 | 25 | 17 | 19 | 20 | 15 |
| Lao PDR | 148 | 19 | 18 | 21 | 11 | 20 | 21 | 22 | 24 | 15 | 23 |
| Timor-Leste | 172 | 11 | 19 | 5 | 23 | 22 | 12 | 8 | 15 | 25 | 23 |
| Myanmar | 177 | 25 | 21 | 19 | 19 | 25 | 21 | 18 | 17 | 24 | 20 |

THE MINIMUM WAGE SETTING PROCESS HAS ALSO BEEN PROBLEMATIC, DISCOURAGES FORMAL JOB CREATION AND FAILS TO BENEFIT MOST WORKERS.

After a decade of moderate increases in the minimum wage, the rate of increase has surged since 2010. In 2013, 25 provinces increased their minimum wage by an average of 30 percent and Jakarta increased it by 44 percent, taking it even further above Thailand and Vietnam, but also likely above China and the Philippines, making it the second-highest in the region after Malaysia. This despite the fact that Indonesia has one of the lowest levels of labor productivity (Figure 2.53 and World Bank 2014c). As a consequence, there is considerable cost uncertainty over time for labor-intensive

employers in manufacturing and services. At the same time, the legislation applies to very few workers (World Bank 2014c), since many workers are self-employed (61 percent in 2011), informal (54 percent), or do not have a contract (over 80 percent) even if they are formal, while government capacity to enforce compliance is low. As we go to print, the Government has enacted Government Regulation No. 78/2015, which introduces a new formula for annually adjusting minimum wages linked to inflation and growth in GDP. While this is progress, it still leaves scope for uncertainty in allowing further discretionary adjustments by provincial governors, and the effectiveness of its implementation remains to be seen.

Minimum wages in selected East Asian countries (US\$ per month) (fig.2.53)



2.3.3

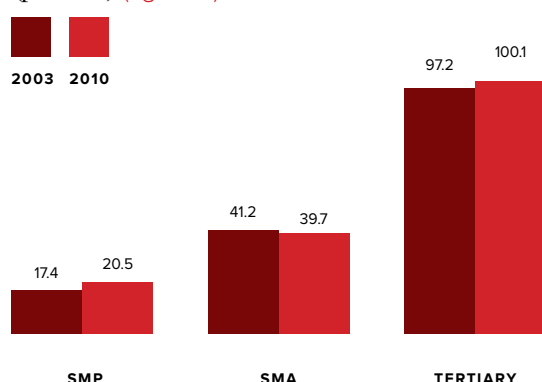
The widening wage gap between few skilled workers and the majority of unskilled workers is one of the main drivers of increasing inequality in the past decade

WORKERS FROM RICHER HOUSEHOLDS, WHO ARE MORE LIKELY TO BE MORE HIGHLY SKILLED AND BETTER EDUCATED, ARE BENEFITTING FROM INCREASINGLY HIGHER WAGE PREMIUMS.

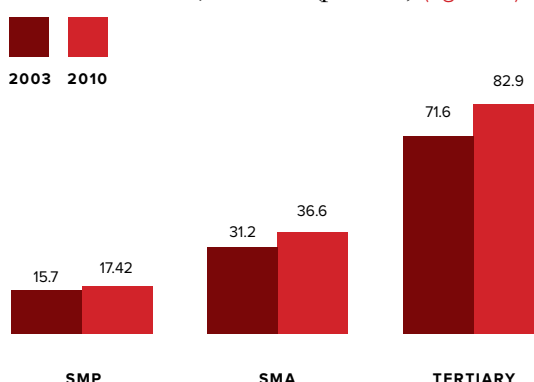
Workers with more education have always received a higher wage than those with less education (education is used here as a proxy for skill; returns to skill are likely to be even higher since there is considerable skill variation within each education level). However, the wage and consumption premiums for the educated have

been increasing (Figure 2.54 and Figure 2.55). At the same time, workers trapped in low-productivity, informal and vulnerable forms of work have less protection against risk and shocks, are not able to access to worker protection benefits, and earn lower incomes. As of August 2012, casual workers and self-employed average earnings amount to 48 percent and 65 percent of employees' average wage, respectively, compared with 45 percent and 75 percent as of 2001, which could explain part of the overall rise in inequality.

Worker wage premium over those with primary education or less, 2003-10 (percent) (fig.2.54)



Household per capita consumption premium over those with head of household primary education or less, 2003-10 (percent) (fig.2.55)



SOURCE Sakernas, Susenas and World Bank calculations.

Worker wage premium represents how much higher wages workers at each level of education receive compared with workers with primary or less education, controlling for experience, gender, work status, location and other factors. Household consumption premium represents the same thing for per capita consumption and head of household's education.

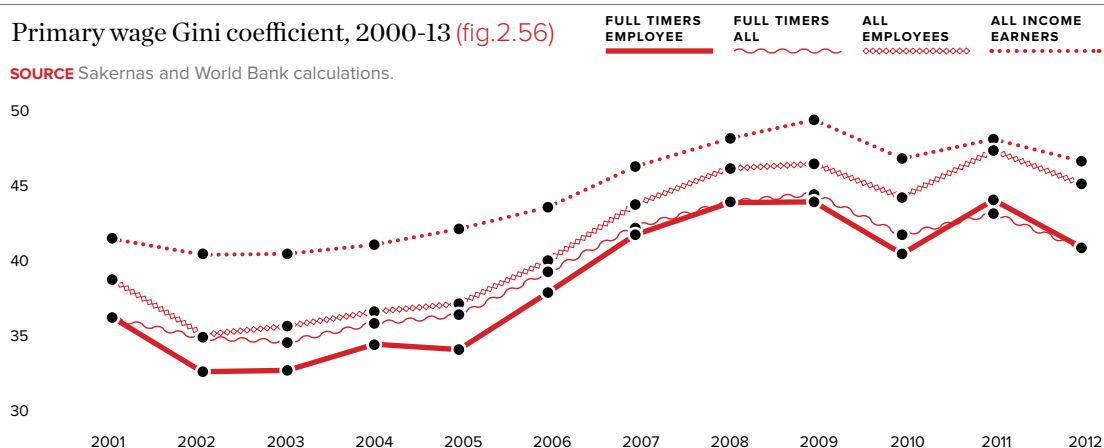
THE INCREASING SKILLED WAGE GAP IS REFLECTED IN HIGHER WAGE INEQUALITY AND IS ONE KEY REASON WHY INEQUALITY IS INCREASING.⁴⁰

The primary wage Gini coefficient increased by around 5 points over the 2000s, contributing to higher inequality (Figure 2.56). In fact, by one measure, around 28 percent of the increase in consumption inequality in the 2000s can be explained by increasing

returns to education, which is one indicator of the skills that a worker has (Table 2.5). However, the flattening out of the wage Gini trend in the past 5 years, compared with a still rising consumption Gini, suggests that either a factor outside of wage inequality is still playing an important role, or that recent consumption data have been affected by methodological changes at a time when the wage data methodology has remained unchanged (Box 1.1).

Primary wage Gini coefficient, 2000-13 (fig.2.56)

SOURCE Sakernas and World Bank calculations.



Change in consumption Gini 2003-10 decomposed (percentage of change explained) (Tab. 2.5)

| KEY CHANGES LEADING TO HIGHER INEQUALITY | | KEY CHANGES LEADING TO LOWER INEQUALITY | |
|---|-----------------------------------|--|-----------------------------------|
| Change in consumption Gini 2003-10 decomposed | Percent of total change explained | Change in consumption Gini 2003-10 decomposed | Percent of total change explained |
| Increasing returns to education | 28 | Increased endowments (e.g., urban migration, higher education, more formal work) | -28 |
| Changing returns to sector of work | 12 | Decreasing urban-rural gap | -23 |
| | | Decreasing provincial gaps | -16 |
| | | Decreasing work type gaps | -8 |

⁴⁰ Gender wage gaps also play a role, but they have been falling.

WHY FINANCIAL AND PHYSICAL ASSETS ARE HELPING THE RICH PULL AWAY FROM THE REST

2.4

In addition, a small number of Indonesians are benefitting from high returns from financial and physical assets today, which in turn drives higher incomes tomorrow

INTERNATIONALLY, INCOME FROM CAPITAL IS BECOMING MORE IMPORTANT AND INCOME FROM LABOR LESS IMPORTANT; THIS IS ALSO THE CASE IN INDONESIA.

The income share of labor has been falling in a majority of countries, while that of capital has been becoming more important (Figure 2.57). This has also been happening in the Indonesian manufacturing (Figure 2.58) and is likely to be occurring the broader economy as well.

THE RETURNS TO SOME TYPES OF SAVINGS AND INVESTMENTS HAVE BEEN VERY HIGH.

Since 2003, the Indonesian stock market has increased nearly 900 percent (Figure 2.59), while high-end Jakarta apartments have doubled in value over the past 6 years (Figure 2.60). This is despite the fact that the rich were the hit hardest segment during the Asian financial crisis and the slowest to recover.

Labor share of income, 10-year change (percentage points) (fig.2.57)

10

SOURCE Karabarbounis and Neiman (2014).

5

CHN

GER

ITA

FRA

CAN

JPN

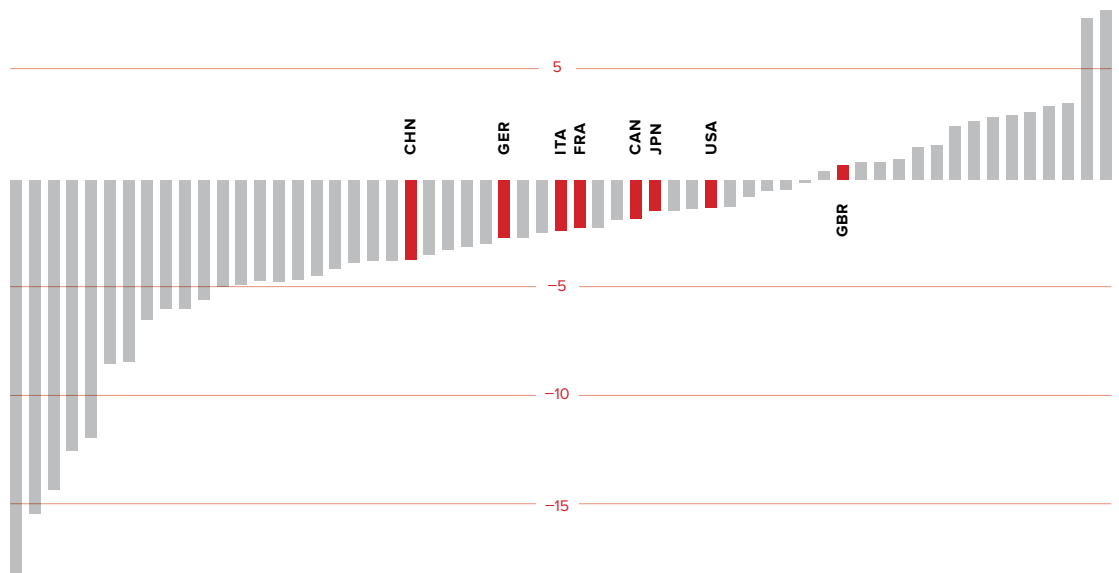
USA

GBR

-5

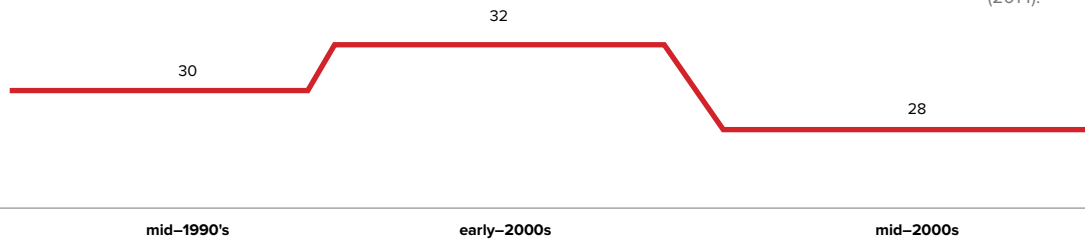
-10

-15



Labor share of Indonesian
manufacturing income (percent)
(fig.2.58)

SOURCE
OECD 2012,
reported
in Zhuang,
et al.Rhee
(2014).



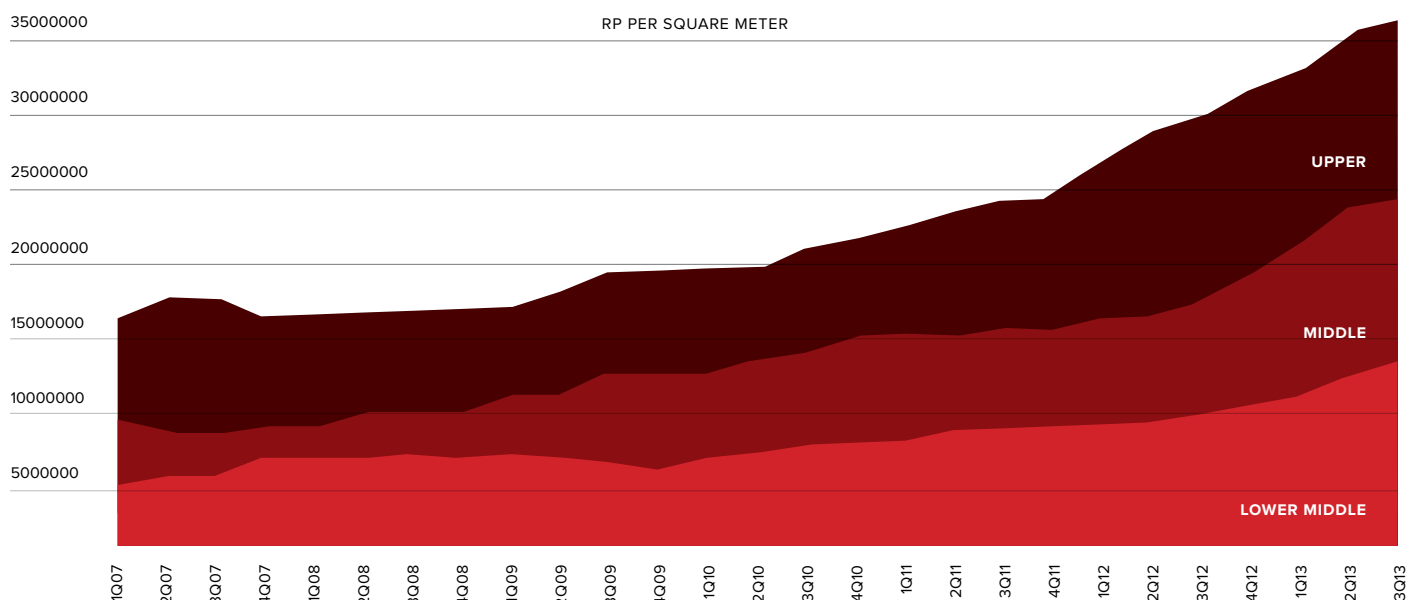
Jakarta Composite Index, 1997-2014 (fig.2.59)

SOURCE JCI.



Jakarta residential condominium market (fig.2.60)

SOURCE Jones Lang LaSalle 2013.



HOWEVER, ONLY THE RICHEST INDONESIANS OWN THESE ASSETS. At most, only 4.5 million Indonesians have direct or indirect investments in stocks and securities. About 439,000 Indonesians have securities accounts, 170,000 Indonesians are invested in mutual funds, and 3.6 million Indonesians have formal pensions that may include securities investments.⁴¹ Furthermore, only 1 percent of Indonesians have a mortgage, suggesting that very few are benefitting from the current housing boom (World Bank forthcoming (c)).

⁴¹ However, public pensions are not based on individually invested accounts, but rather are ‘pay-as-you-go’, which means that public pensions do not have an exposure to the stock market.

⁴² Ministry of Finance, Realisasi APBN, Rincian Penerimaan Perpajakan. Nonetheless, a significant portion of the labor income tax base is not subject to withholding, for example independent professionals such as lawyers, doctors, accountants, and so forth, which significantly reduces overall labor income tax compliance.

MOREOVER, TAXES RAISED FROM CAPITAL INCOME ARE MUCH LOWER THAN FOR LABOR INCOME, ALTHOUGH COMPLIANCE IS PROBLEMATIC FOR BOTH. Some income from capital benefits from a lower withholding tax than labor income. For example, dividend withholding tax is only 10 percent (and earned interest withholding is only 20 percent), lower than all but one labor income tax rate and considerably lower than the 30 percent top marginal tax rate most dividend earners would otherwise be paying. At the same time, the significant capital gains that have been made from the housing boom and the

stock market are theoretically subject to personal income tax, but are not subject to withholding taxes. With weak monitoring and compliance on personal income taxes, low withholding rates often mean less tax paid. Meanwhile, for many workers, income tax on salaries and wages is withheld by the employer, ensuring a degree of compliance for labor income. As a consequence, around 95 percent of personal income taxes (around 20 percent of total income taxes) are collected through withholding, mostly on salaries, and only the remaining 5 percent from capital income.⁴²

HOUSEHOLDS EARN INCOME NOT ONLY THROUGH JOBS BUT ALSO FROM FINANCIAL AND PHYSICAL ASSETS, WHICH ARE HIGHLY CONCENTRATED AMONG THE RICHEST HOUSEHOLDS. The share of income generated by labor has been falling and the share generated by capital, such as financial and property assets, has been increasing—in Indonesia as elsewhere in the world. In Indonesia, this partly reflects the strong returns to these assets over the past decade. It is largely rich households, however, that have access to these resources. As discussed



in the Executive Summary, the richest 1 percent own half of all the wealth in Indonesia (Figure xiii), which is the second-highest (along with Thailand) after Russia from a set of 38 countries. Moreover, the richest 10 percent of Indonesians own an estimated 77 percent of all wealth, which is equal second-highest (along with Turkey and Hong Kong) after Russia from a set of 46 countries (Figure 2.61). This means that income from financial and physical assets benefits fewer households in Indonesia than almost anywhere else.

FURTHERMORE, ACCUMULATED WEALTH GENERATES EVEN HIGHER INCOMES IN THE FUTURE, DRIVING INEQUALITY HIGHER.

Financial and physical assets are generating higher incomes for only a few wealthy households in Indonesia, and these households are then saving this income as even more wealth. The share of wealth owned by the richest 10 percent in Indonesia increased by 7 percentage points between 2007 and 2014, in the top-10 of 46 countries over that period (Figure 2.62). These increased financial and physical assets today generate even higher incomes tomorrow.

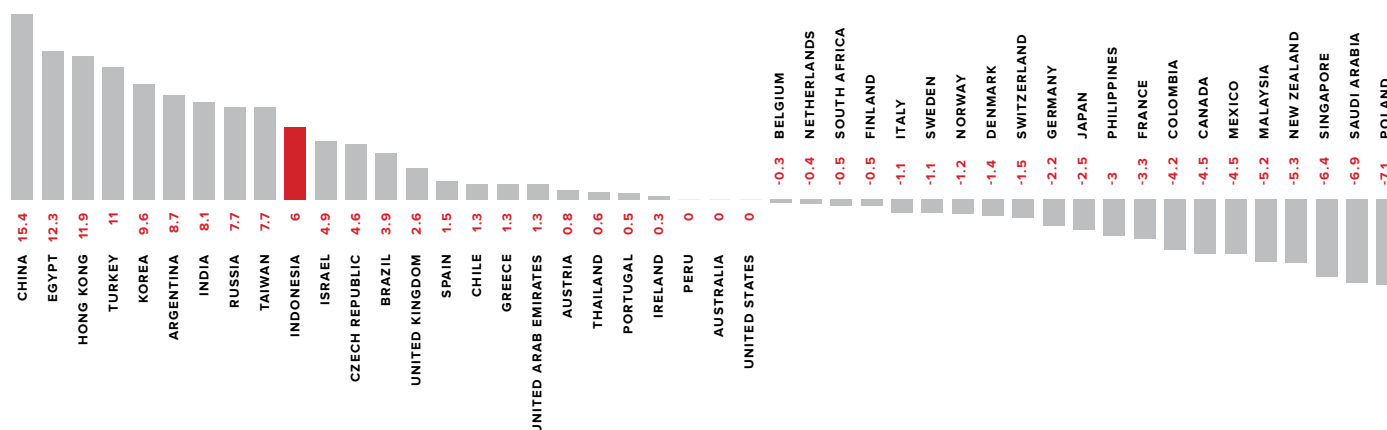
Share of total wealth held by richest 10 percent of households (percent) (fig.2.61)

SOURCE Credit Suisse (2014)

| | |
|----------------------|------|
| RUSSIA | 84.8 |
| TURKEY | 77.7 |
| HONG KONG | 77.5 |
| INDONESIA | 77.2 |
| PHILIPPINES | 76 |
| THAILAND | 75 |
| UNITED STATES | 74.6 |
| INDIA | 74 |
| EGYPT | 73.3 |
| BRAZIL | 73.3 |
| PERU | 73.3 |
| SWITZERLAND | 71.9 |
| ARGENTINA | 71.8 |
| MALAYSIA | 71.8 |
| SOUTH AFRICA | 71.7 |
| CHILE | 68.9 |
| SWEDEN | 68.6 |
| DENMARK | 67.5 |
| ISRAEL | 67.3 |
| CZECH REPUBLIC | 67.3 |
| SAUDI ARABIA | 66.4 |
| NORWAY | 65.8 |
| COLOMBIA | 65.2 |
| MEXICO | 64.4 |
| CHINA | 64 |
| AUSTRIA | 63.8 |
| KOREA | 62.8 |
| POLAND | 62.8 |
| TAIWAN | 62 |
| GERMANY | 61.7 |
| UNITED ARAB EMIRATES | 60.4 |
| SINGAPORE | 59.6 |
| IRELAND | 58.5 |
| PORTUGAL | 58.3 |
| CANADA | 57 |
| NEW ZEALAND | 57 |
| GREECE | 56.1 |
| SPAIN | 55.6 |
| NETHERLANDS | 54.8 |
| FINLAND | 54.5 |
| UNITED KINGDOM | 54.1 |
| FRANCE | 53.1 |
| ITALY | 51.5 |
| AUSTRALIA | 51.1 |
| JAPAN | 48.5 |
| BELGIUM | 47.2 |

Change in share of total wealth held
by richest 10 percent of households
(percentage points) (fig.2.62)

SOURCE Credit Suisse (2014)



HIGH WEALTH CONCENTRATION, EVEN WHEN FAIR, CAN HAVE NEGATIVE CONSEQUENCES FOR INEQUALITY, IN TERMS OF UNDERINVESTMENT IN HUMAN CAPITAL AND ELITE CAPTURE OF POLITICAL AND ECONOMIC INSTITUTIONS.

Even without illegal or unfair accumulation, a high concentration of wealth might be bad for two reasons. First, it transmits unequal opportunities across generations, both in terms of greater financial resources and their earning ability, as well as facilitating greater investment in the human capital of the children in wealthier households. Second, high wealth may facilitate the capture of policies and institutions. For example, the wealthy may use their financial and political influence to make tax rates on capital lower than labor, or subvert the legal process to avoid prosecution for corruption. North, Wallis, and Weingast (2009), for example, describe “limited access orders” in which an elite-level bargain is reached whereby economic rents are divided up as a means to maintain stability and limit violence. To protect rents the elite must restrict access of non-elites to the economic and political playing field. Similarly, Acemoglu and Robinson (2012) describe “extractive” economic and political institutions that function to concentrate the rents from the economy into the hands of a small elite, and raise barriers to entry to economic competitors, thereby eliminating the possibility of “creative destruction” in the economy. Given the high concentration of wealth in Indonesia and its consistently poor

performance on international indices of corruption, such analytical narratives may well be relevant. However, this is an issue requiring far more research.

FINALLY, THE COMMODITIES BOOM MAY HAVE CONTRIBUTED TO RISING INEQUALITY IN THE 2000S, BUT DOES NOT EXPLAIN ALL OF THE INCREASES IN INEQUALITY.

If the commodities boom had been the main driver of increasing inequality in Indonesia then, given its apparent end, concerns that it will continue increasing might be lessened. However, inequality rose only moderately in the 1970s despite another commodities boom, in the capital-intensive oil and gas sector (therefore concentrating the benefits on relatively few). With the recent commodities boom being both less concentrated than oil and gas, as well as occurring in the context of a more decentralized and diffused rent-allocation system, there are reasons to believe that the impact of the 2000s commodities boom on inequality would have been no larger than during the 1970s boom, which saw the Gini only 4 points higher at the height of the boom in 1978 (Hill 2000). While many mineral extractives are capital- rather than labor-intensive sectors, much of the boom in the 2000s was in estate crops, such as palm oil, rubber and cocoa, as well as coal, which are labor-intensive industries. Moreover, inequality had begun to rise in the mid-1990s and again in the early 2000s, well before the second boom started in around 2003 (see Box 2.7 for further discussion).

BOX 2.7

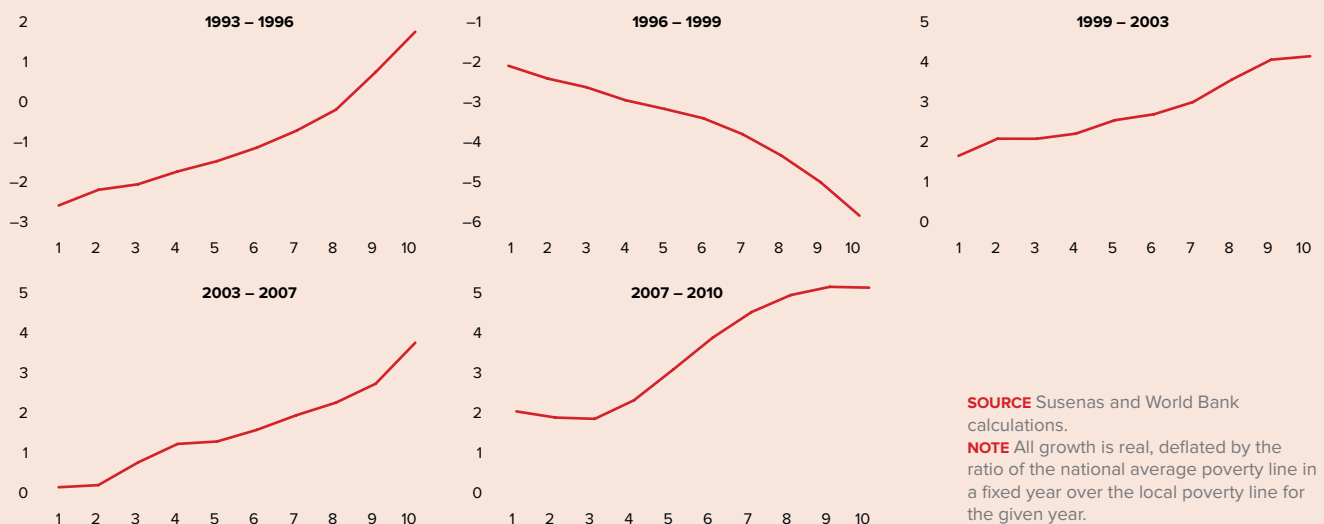
Increasing inequality: not just the commodities boom

The rise in inequality began before the 2000s commodities boom and is likely to continue despite its apparent end.

The Gini coefficient had begun to rise between 1993 and 1996 after a long period of stability. This is reflected in the upward sloping (pro-rich) pattern of growth in household consumption at the national level over this period (Figure 2.63), where the rich enjoyed better growth than the poor or those in the middle, as can also be seen in the

period between 1999 and 2003, during the recovery from the Asian financial crisis but before the beginning of the commodities boom (everyone was hit during the crisis, but the rich more than the poor, which is reflected in the downward-sloping GIC). That is, there was upward pressure on inequality before the commodities boom; to the extent the factors driving it then are still active, inequality is likely to continue increasing.

Growth incidence curve, 1993-2014 (annual real per capita consumption growth by household per capita consumption quintile, percent) (fig.2.63)



However, there are key differences between contexts of the oil and gas boom of the 1970s and the more diverse commodities boom of the 2000s, which need to be considered when thinking about inequality. Hill (2000) identifies a number of factors behind the relatively good record on distribution in the 1970s and 1980s. A number no longer apply in the new Indonesia. First, much of Indonesia's growth under the

New Order was in equality-enhancing sectors. The rice sector performed strongly; the food crops sector tends to be associated more inherently with more even distributions of income and wealth due to the technologies employed, cultivation processes and predominance of smallholders. In addition, growth of export-oriented, labor-intensive manufacturing also tends to promote more equal growth (World Bank 1993). Second, much of the

oil and gas windfalls were channelled back into development projects and employment-generation schemes in rural areas, as well as through a major emphasis on education and literacy. Large investments in infrastructure assisted poor farmers and increased personal mobility and consequently employment opportunities.

2.5

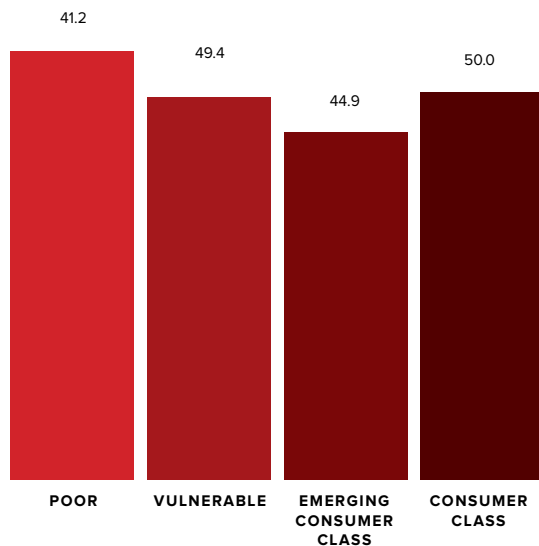
WHY SHOCKS MAKE IT EVEN HARDER FOR MANY TO CATCH UP

Poor and vulnerable households are also affected more by shocks in life, which can prevent them from climbing up the economic ladder

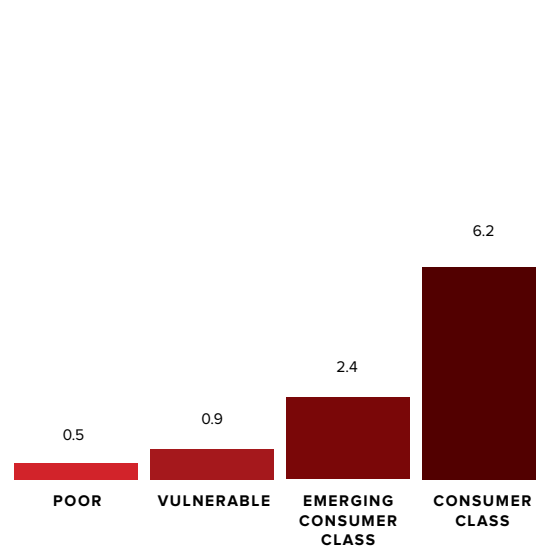
THERE ARE MANY SHOCKS THAT CAN AFFECT HOUSEHOLD RESOURCES AND INCOMES. There are many risks in life, and they can affect everyone, from the individual and household, up to the community, national and even international level. Households can be affected by economic, health, social and political shocks, as well as natural disasters. Moreover, an aging population is more prone to non-communicable diseases (NCDs), meaning the incidence of health shocks is likely to increase (World Bank 2014a). These shocks can reduce household income through a number of channels. They can affect the underlying assets that generate income; a natural disaster might destroy the livestock or equipment used to make a living. They can reduce the income that comes from these assets; a drought might make a harvest meager. They can also reduce how far that income goes in the case of food price shocks. And they can reduce tomorrow's income by depleting today's assets (for example, selling a sewing machine to pay for hospital care) or by preventing accumulating assets for the future (for example, lack of income due to losing a job).

HOWEVER, MANY INDONESIANS LACK THE FORMAL MECHANISMS TO DEAL WITH THESE SHOCKS. Many Indonesians lack health insurance (Figure 2.64) and few have pensions. Civil servants and the wealthy have access to health and employment insurance and pensions, and the Government previously ran a social assistance program that waived health fees for individuals from poor and vulnerable households (Jamkesmas). In 2014, the goal of universal health coverage began to be implemented under the National Social Security Law (SJSN). Around 90 million poor and vulnerable Indonesians have their premiums covered by the Government as part of Jaminan Kesehatan Nasional (JKN, or national health insurance). However, there are tens of millions more Indonesians who are informal workers are not currently covered. With coverage depending upon contributions, expansion in coverage to these households may be years away, despite the fact that every year one in 20 Indonesians faces catastrophic health costs that represent 5 percent of their total consumption and one in 10 face costs equivalent to 10 percent of their total consumption (Bredenkamp, et al. 2011).

Access to health insurance (percent) (fig.2.64)



Access to pensions (percent) (fig.2.65)



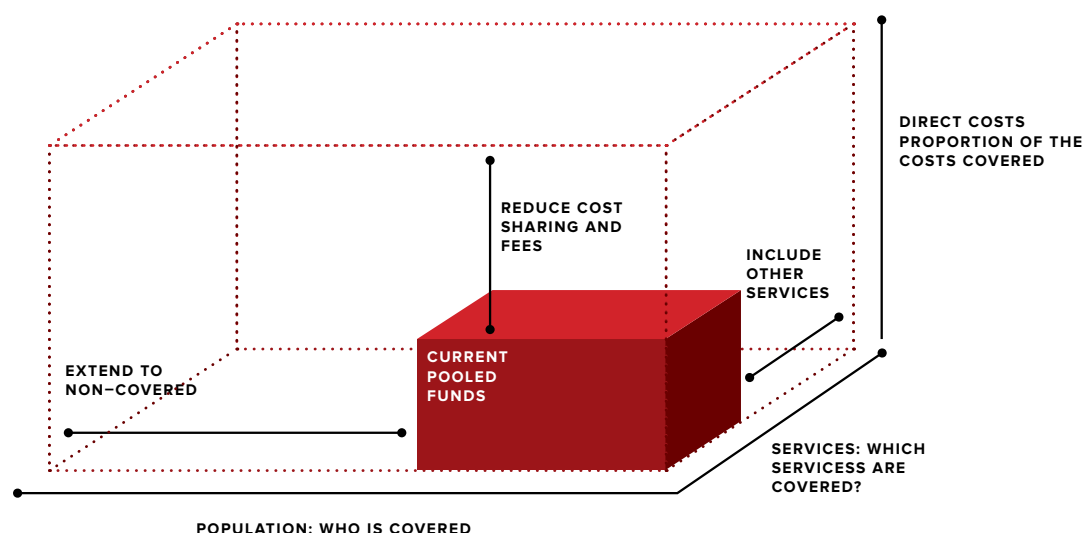
SOURCE: Susenas and World Bank (forthcoming (a)).

NOTE: The poor are under the national poverty line, around PPP US\$1.30; the vulnerable are under 1.5 times the poverty line, around US\$1.90; the emerging consumer class are under 3.5 times the poverty line, around US\$4.50; and the consumer class are above this. See World Bank (forthcoming (a)) for details.

MOREOVER, EVEN WHEN THE POOR AND VULNERABLE ARE TECHNICALLY COVERED BY SOCIAL SECURITY SCHEMES, THEY MAY NOT BE BENEFITTING. Not only are many millions of Indonesians not covered by JKN, but even those who are covered may not be receiving the same level of protection as richer households. Universal health coverage is not just about coverage of the population, but also about adequate health services and user affordability of

those services (Figure 2.66). While it is too early to evaluate JKN, the lessons from Jamkesmas, which has been incorporated into JKN as the non-contributory component for the poor and vulnerable, may be relevant. This is because “on balance, the effect of the program on protecting the poor, both in terms of promoting health care utilization and in terms of reducing the impact of out-of-pocket payments, is not as large as one might expect given the generosity of the benefit

The three dimensions of universal health coverage (fig.2.66)



package” (Bredenkamp, et al. 2011). First, many poorer beneficiaries do not know what services their health insurance entitle them to and are therefore unlikely to make use of it (World Bank 2012a and 2012d). Second, limitations on service availability, especially in poorer areas, mean that they cannot always use their insurance (World Bank 2012a, 2012d and 2014a). As a consequence, poorer and informally employed households may not have the same effective access to nutrition and health-related investments in human capital (while health care utilization rates are higher among Jamkesmas beneficiaries than the uninsured, out-of-pocket health care costs are the same per capita and as a share of total consumption; Harimurti et al. 2013). Universal health coverage is an important policy step in protecting all Indonesians, but its effectiveness will depend upon implementation.

times of shock, they use informal ones. Usually, this means turning to family and friends. However, often this does not provide enough support to fully cope, and can be impossible when a shock hits an entire community, such as a natural disaster. When informal borrowing is not enough, households may resort to steps that reduce their future income, such as selling productive assets or pulling children out of school.⁴³

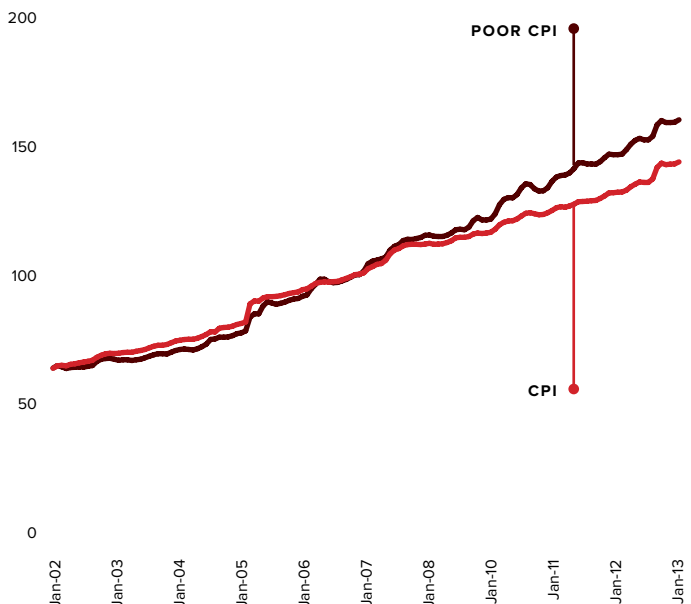
IN ADDITION, PRICES HAVE RISEN FASTER FOR THE POOR AND VULNERABLE THAN FOR OTHER HOUSEHOLDS, MEANING THEIR STANDARD OF LIVING IS FALLING EVEN FURTHER BEHIND. Between October 2007 and December 2013, prices for the average consumer increased by 144 percent (Figure 2.67). However, the price for goods and services used by the poor increased by 161 percent over the same period. This is driven primarily by high food price inflation, which comprises the majority of poor household consumption. Food prices for the poor rose by 175 percent during this period, while non-food prices for the poor rose by only 138 percent (Figure 2.68).

⁴³ For a detailed exploration of the risks households face and the mechanisms they use to cope, see World Bank (2015c) Risk and Informal Risk Management among the Rural Poor in Indonesia.

INSTEAD, PEOPLE OFTEN RELY ON FRIENDS AND FAMILY, WHICH CAN BE INADEQUATE, OR TAKE STEPS THAT INADVERTENTLY REDUCE FUTURE EARNINGS. When people do not have access to formal coping mechanisms in

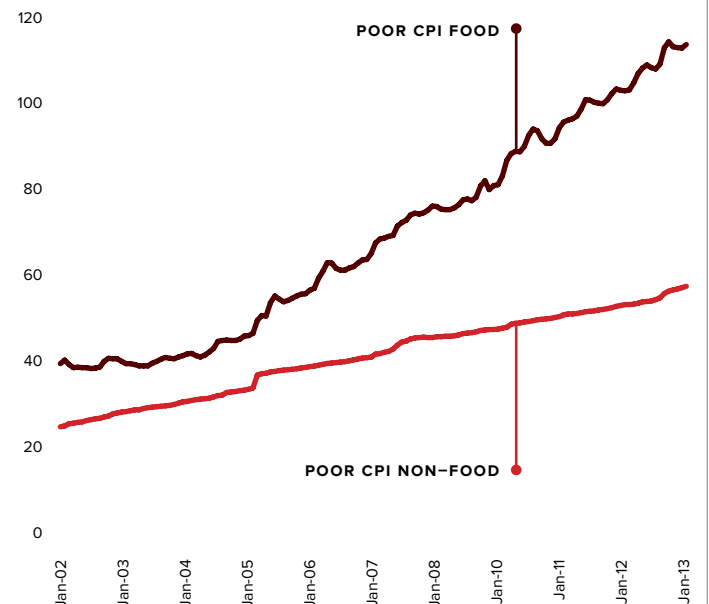
CPI and CPI for the poor, 2002-13 (fig.2.67)

SOURCE World BPS and World Bank.

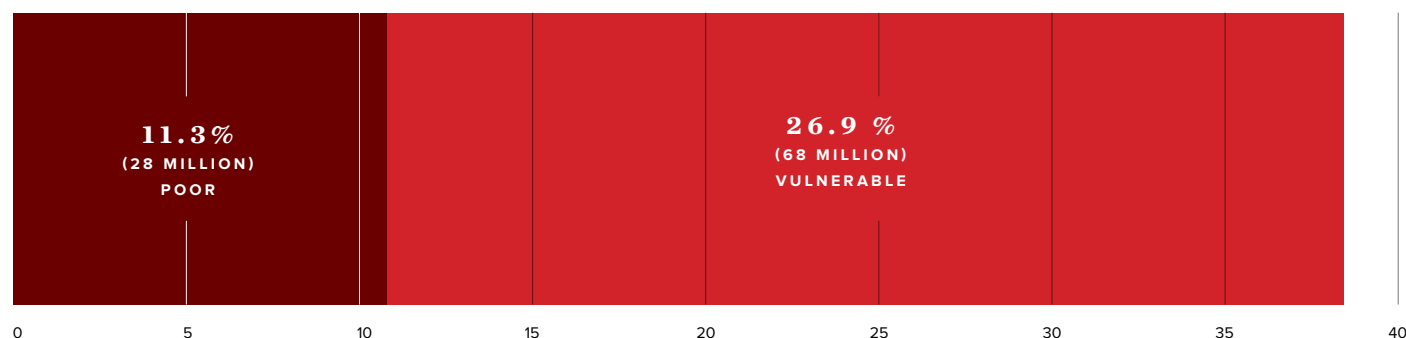


CPI poor (food) and CPI poor (non-food), 2002-13 (fig.2.68)

SOURCE World BPS and World Bank.



Poverty and vulnerability rates in Indonesia, 2014 (percent) (fig. 2.69)



SOURCE Susenas and World Bank calculations.

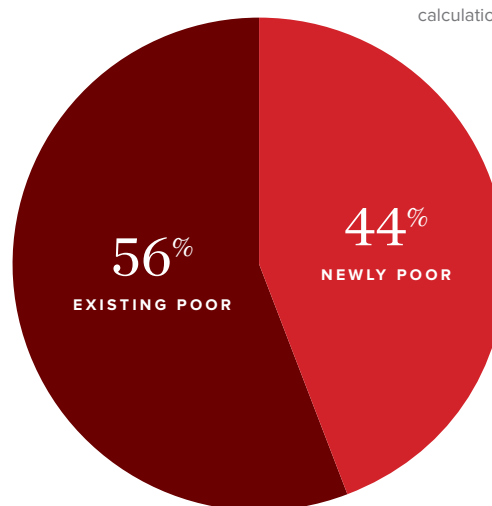
WITH VULNERABILITY HIGH, SMALL SHOCKS CAN EASILY REDUCE INCOMES.

While 28 million Indonesians live below the poverty line, many more—a further 68 million—live on less than 50 percent above it (Figure 2.69). As a consequence, small shocks can easily send the vulnerable into poverty; in fact, around half of the poor each year were not poor the year before (Figure 2.70).

MEANWHILE, RICHER HOUSEHOLDS CAN BETTER WITHSTAND THESE SHOCKS AND TEND TO STAY RICH.

Many Indonesians climb out of poverty and vulnerability, while many more fall into poverty. Of the poorest 20 percent of Indonesian households by income in 1993, two-thirds were in a richer income quintile 14 years later in 2007 (Table 2.6). Thirty-six percent climbed into the second quintile, 19 percent into the third, and a small number into the richest two quintiles. Of the households in the middle three income quintiles (Q2-Q4), many households climbed into a higher income quintile (41, 23 and 21 percent, respectively). At the same time, many fell into a lower income quintile (31, 50 and 52 percent, respectively). It is only the richest 20 percent of households in 1993 that had a better-than-even chance of staying there: all other quintiles had a 26 to 37 percent chance of staying in the same place as 14 years earlier; the richest quintile had a 56 percent chance. A key driver of this outcome is that the rich are better able to protect their assets and income from shocks, both protecting income today, as well as income tomorrow, reinforcing future inequality.

Proportion of poor who were poor the year before (fig. 2.70)

SOURCE
Susenas
panel
2008-10 and
World Bank
calculations.

Household income mobility matrix, 1993-2007 (tab. 2.6)

| | | 2007 INCOME QUINTILE | | | | |
|----------------------|----|----------------------|-----|-----|-----|-----|
| | | Q1 | Q2 | Q3 | Q4 | Q5 |
| 1993 INCOME QUINTILE | Q1 | 37% | 36% | 19% | 6% | 2% |
| | Q2 | 31% | 28% | 19% | 14% | 8% |
| | Q3 | 23% | 27% | 28% | 13% | 10% |
| | Q4 | 12% | 18% | 22% | 26% | 21% |
| | Q5 | 8% | 8% | 11% | 18% | 56% |

SOURCE: Indonesian Family Life Survey and World Bank calculations.





HOW **INEQUALITY** CAN BE ADDRESSED

Inequality in Indonesia depends upon households' human and financial resources, and how much those resources earn. Based on the income-generating asset model used in this report, we can gain an overall understanding of how the drivers explained in the previous section have led to increasing inequality (Table 3.1).

3.1.
Improving local
service delivery
97

3.2.
Promoting better
jobs and skills
107

3.3.
Ensuring protection
from shocks
111

3.4.
The right fiscal
policy
117

3.5.
Implementing
policies that have
broad-based
support while
communicating the
importance of those
that do not
125

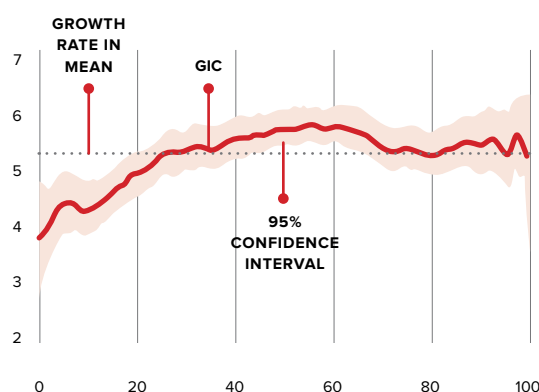
Drivers of inequality, based on the income-generating asset model (tab. 3.1)

| | Human Capital | Physical and Financial Capital |
|---------------------------------------|--|---|
| Household Resources | INEQUALITY REDUCING Access gap between rich and poor has been closing Quality gap remains, reducing impact of closing access gap | INEQUALITY INCREASING Wealth is becoming more concentrated among the richest 10 percent |
| Returns to Household Resources | INEQUALITY INCREASING Gap between skilled and unskilled wages widening | INEQUALITY INCREASING Returns to capital have been significant, accessible by relatively few |
| Impact of Shocks | INEQUALITY INCREASING Rich households are better able to prevent shocks (e.g., preventative health, less manual labor), and have the assets or insurance to cope this shocks if they occur. Poor households may be more prone to shocks, and need to resort to reducing key expenditures (education, health) or pulling children out of school to work. | NEUTRAL Rich households are more affected by financial crises because they own most of the assets (e.g., Asian financial crisis). However, non-rich households may be less able to cope with natural disasters, and more likely to sell productive assets in times of health or unemployment shocks. |

HOWEVER, HIGH AND RISING INEQUALITY IS NOT INEVITABLE; REGIONAL NEIGHBORS HAVE GROWN WITHOUT INCREASING DISPARITY BETWEEN THE RICH AND THE POOR. While inequality has been rising quickly in Indonesia, economic growth in Thailand and Vietnam over a similar period in the 2000s was shared relatively similarly by the rich, poor and those in the middle (Figure 3.1, Figure 3.2, Figure

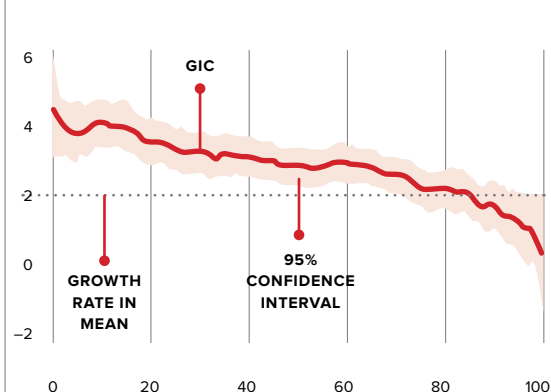
3.3). This indicates that rising inequality is not an unavoidable byproduct of rapid growth. In fact, some countries, such as Brazil, have been able to slow and eventually reverse rising inequality through a planned policy approach (see Box 3.1). Consumption growth of the poorest 40 percent in Brazil during the 2000s was over four times higher than that of the richest 10 percent (Figure 3.4).

Growth incidence curve, Thailand 2000-06 (fig. 3.1)



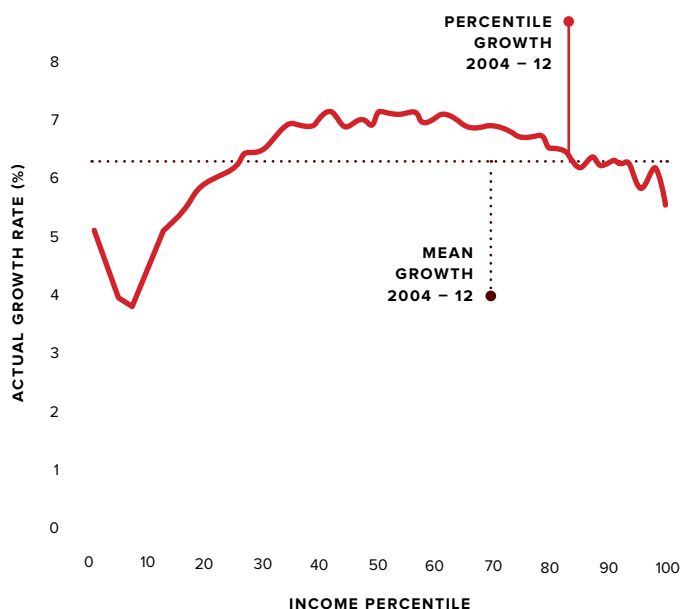
SOURCE: World Bank using household socio-economic survey data.

Growth incidence curve, Thailand 2006-10 (fig. 3.2)



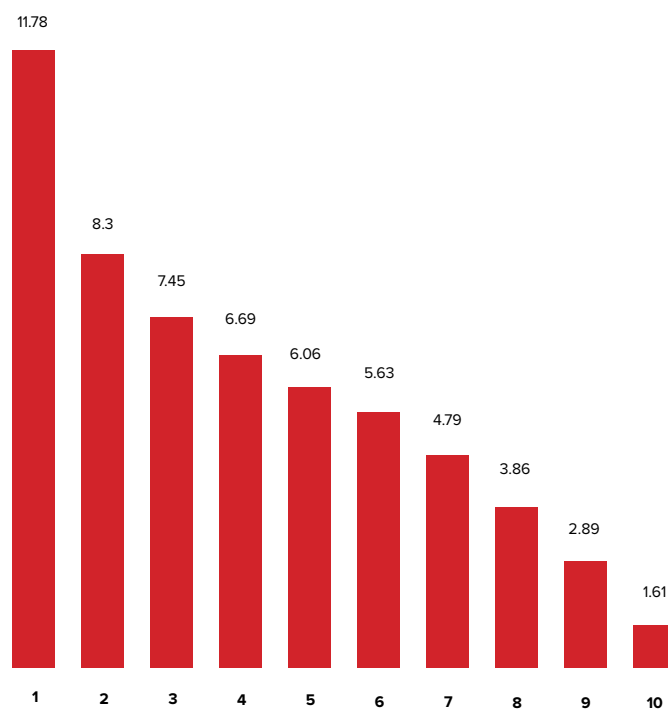
Growth incidence curve, Vietnam 2004-12 (fig.3.3)

SOURCE World Bank calculations using household socio-economic survey data (World Bank 2014g)



Growth incidence curve, Brazil 2001-09 (fig.3.4)

SOURCE World Bank (2012e).



INEQUALITY CAN BE TACKLED THROUGH POLICIES THAT REDUCE THE IMPACT OF FACTORS OUTSIDE AN INDIVIDUAL'S CONTROL FROM AFFECTING THEIR OUTCOMES.

Not all inequality needs to be addressed; the Government should aim to address inequality that arises due to factors outside an individual's control, while leaving inequality that rewards individuals for hard work, risk-taking and innovation. To do this, policymakers have a range of instruments at their disposal. They should use tools that both address the main drivers of rising inequality previously identified and that are feasible (Table 3.2). The remainder of this report focuses on the main policies required to reduce inequality, both now and in the future.

- **Section 3.1:** Improving local service delivery:

A key to a better start for the next generation is improved local service delivery, which can improve health, education and family planning opportunities for all.

- **Section 3.2:** Promoting better jobs and skills:

Today's workers who had an unfair start can still improve their skills. When they do, the Government can help to make sure there are better jobs available through a more conducive

investment climate and a more flexible regulatory approach.

- **Section 3.3:** Ensuring protection from shocks: Government policies can reduce the frequency and severity of shocks, as well as provide the coping mechanisms to ensure that all households have access to adequate protection from shocks when these do occur.

- **Section 3.4:** The right fiscal policy: Spending in the right areas allows a government to create more equal opportunities for the future and better jobs now. How it funds this spending can also affect inequality today, as well as potentially address some unfair aspects of wealth concentration.

- **Section 3.5:** Implementing policies that have broad-based support while communicating the importance of those that do not. Most of the recommended policies in Section 3 have broad-based public support as a means to tackle poverty. The Government should not be afraid to pursue these policies. At the same time, an effective communications strategy will be needed for the small number of policies that do not have much support.

Drivers of inequality, based on the income-generating asset model (tab. 3.2)

| Driver of inequality | Possible tools to address it |
|---|--|
| Gap in opportunities to access health and education | <ul style="list-style-type: none">• The right fiscal policy (spending on services)• Improving local service delivery (health, education, family planning)• Increased investments in infrastructure |
| Gaps in wages and access to skilled jobs | <ul style="list-style-type: none">• The right fiscal policy• Promoting better jobs and skills• Increased investments in infrastructure |
| Shocks | <ul style="list-style-type: none">• Ensuring protection from shocks• Increased investments in infrastructure |
| Gaps in access and return to financial assets | <ul style="list-style-type: none">• The right fiscal policy (taxation reform and enforcement)• Supporting policies (reduce corruption) |

BOX 3.1

How Brazil reduced inequality ⁴⁴

Brazil was effective in reducing inequality in the 2000s, albeit from a very unequal starting point. Between 2001 and 2009, Brazil's income Gini coefficient fell by 5 points, from 58.8 to 53.7.⁴⁵ This was a greater fall than

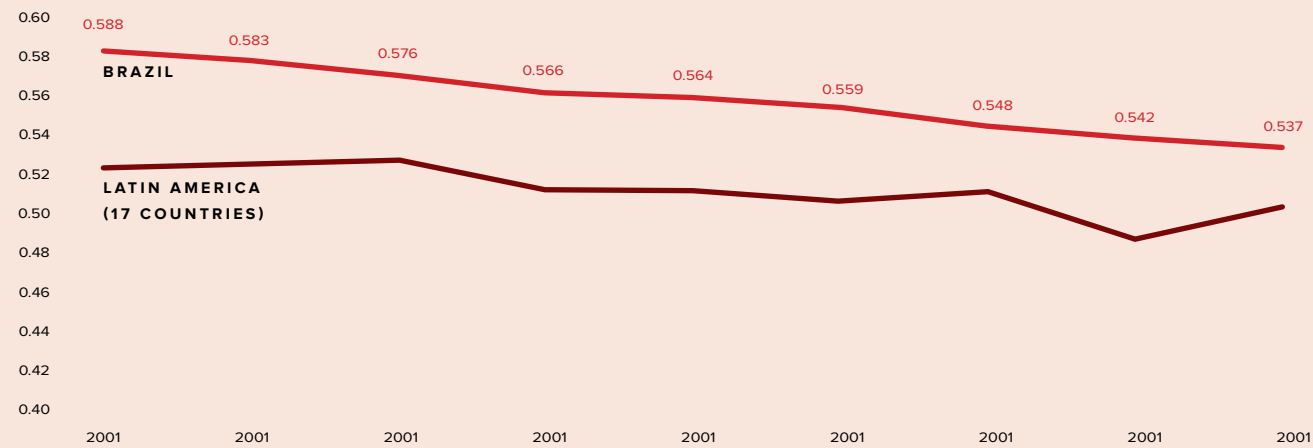
average in the Latin American region, which also saw declining inequality over the 2000s.

With Brazil having many similarities to the Indonesian context, there are

a number of relevant lessons to be learned on how inequality can be reduced. Brazil resembles Indonesia in a number of ways: it has a large, natural resource-based economy that has enjoyed strong growth over the

Gini coefficient in Brazil and Latin America (fig.3.5)

SOURCE World Bank (2012e).



⁴⁴ This summary is based on World Bank (2012e), Inequality in Focus.
⁴⁵ Income Ginis are higher than consumption Ginis because rich households save more income, meaning consumption is more equally distributed than income. The Indonesian income Gini was 6.4 points higher than the consumption Gini, based on the average difference for the three years when both income and consumption Ginis were collected in Indonesia (1984, 1990 and 1993).

2000s; it has a highly decentralized political system; it has already made the transition to become an upper middle-income country as Indonesia is in the process of now doing; and it suffers from high income inequality and inequalities of opportunity. Given this context, the four drivers behind falling inequality in Brazil should be of interest to Indonesia: (i) macroeconomic stability; (ii) an expansion of primary and secondary education; (iii) pro-poor social spending; and (iv) an expansion of social assistance.

Macroeconomic stability and economic growth have benefitted the poor.

Since the poor do not have access to the financial instruments that would protect them from inflation, a stable macroeconomic environment that keeps prices low has benefitted the poor and vulnerable in Brazil. At the same time, strong economic expansion has driven job creation, allowing poorer households to earn better incomes.

Expansion in primary and secondary education has changed the labor force profile. Brazil's inequality in labor income had been driven in large part by inequality in education. Brazil began a concerted policy effort to expand education for poorer households. This expansion was highly successful; in 1993, a child of a father with no formal education would complete four years of schooling, whereas now students complete 9-11 years, regardless of parents' education. As more workers become skilled, they benefit from higher wages. At the same time, this means there are fewer unskilled workers. With economic growth also increasing demand for unskilled workers, unskilled wages increased as well. It has been estimated that the falling wage differences between skilled and unskilled labor represents two-thirds of the fall in inequality.

A move towards more pro-poor social spending, and a significant expansion in social assistance, also contributed

to falling inequality. Nearly half of all government spending is social spending, including cash transfers, health and education. An important role in reducing inequality was played by a large expansion in social assistance spending. Increased contributory and non-contributory government transfers accounted for around 30 percent of the Gini reduction between 2001 and 2009. Most important was the expansion of Bolsa Familia, Brazil's conditional cash transfer program, similar to PKH in Indonesia. Unlike PKH, which covers only about 5 percent of households in Indonesia, Bolsa Familia has grown to cover 25 percent of Brazilian households, and is viewed as the most cost-effective contribution in reaching the poor and reducing inequality. Other programs such as Beneficio de Prestacao Continuada (non-contributory pensions) provide greater benefit levels than Bolsa Familia, but play less of a role in reducing inequality, while generous formal and public sector social security programs have been highly regressive.

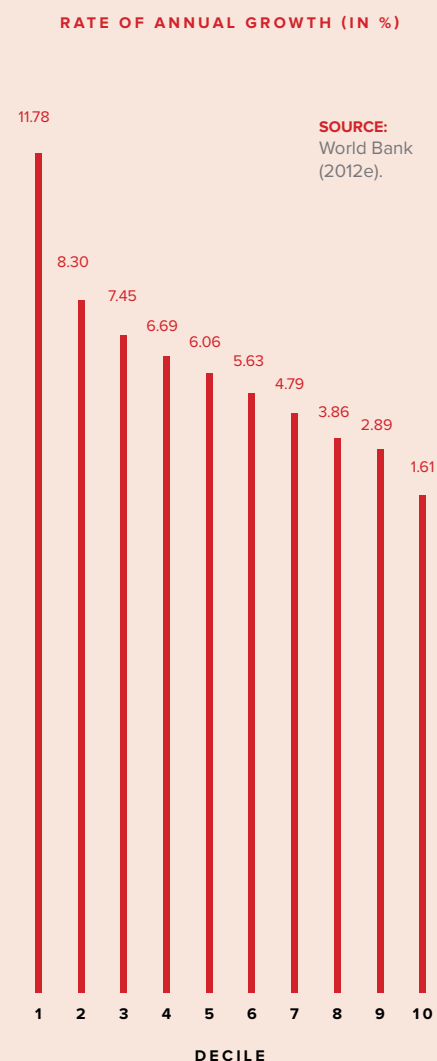
As a consequence of these policies, poorer Brazilians saw the highest increases in income over the period.

Average income growth for the poorer half of the Brazilian population was above the national average, and particularly benefitted the poorest, whose annual average per capita income growth of nearly 12 percent was twice the national average and 10 times that of the richest 10 percent.

The Brazilian case illustrates that significant reductions in inequality are possible. It is clear that Indonesia can go beyond slowing the increase in inequality, and can actually begin to reduce inequality itself, provided that: (i) it becomes a key government priority; (ii) a coherent and explicit strategy is developed; (iii) accountability for overseeing and implementing this strategy is a key responsibility for a senior government minister with a

strong mandate from the President himself; (iv) new major policy proposals in all ministries and agencies are examined for possible effects on inequality; and (v) key policies and programs aiming to reduce inequality are well-designed, funded and implemented.

Growth incidence curve for Brazil, 2001-2009 (fig.3.6)



AVERAGE OF INCOME PER CAPITA GROWTH RATES

5.91%

3.1

IMPROVING LOCAL SERVICE DELIVERY, PARTICULARLY FOR HEALTH, EDUCATION AND FAMILY PLANNING

IMPROVING THE QUALITY OF EDUCATION AND HEALTH-RELATED SERVICES REQUIRES OVERHAULING THE CURRENT SYSTEM FOR DELIVERING SERVICES THROUGH LOCAL GOVERNMENTS.

The delivery of services and infrastructure in a country as vast and dispersed as Indonesia requires the active involvement of local governments and communities. However, more than a decade after decentralization, and despite significant increases in decentralized public spending (about half of total government spending), the quality of services remains persistently low and unevenly distributed across regions. The problem is that most local governments do not have adequate capacity to deliver services, nor are they accountable for results to the central government and their citizens.

KEY POLICY ACTIONS CAN UNDERPIN IMPROVEMENTS IN ALL AREAS OF LOCAL SERVICE DELIVERY.

Local service delivery can be improved by building the capacities of local government to deliver services, moving towards a more performance-based transfer system and providing the tools for citizens to monitor local service delivery. Some priorities for improving local service delivery that cross sectors include: changes in the way central budgeting allocations are made; changes in the incentives local budgeting face; incentives for achieving local delivery standards; and increased demand for public accountability. In particular, we look at how this might be achieved in health, education and family planning.

3.1.1

Ensuring all children receive a fair start in life through quality health care

ENSURING GOOD HEALTH FOR ALL CHILDREN MEANS BETTER EQUIPPED AND STAFFED FACILITIES, ACCESSIBLE BY ALL, AND DEMAND FOR THEIR SERVICES BY THOSE WHO NEED THEM MOST. The three main actions required to make sure all children get

a healthy start are:

- I.** Addressing the financing of health facilities to ensure adequate access and equipment;
- II.** Ensuring a supply of sufficient and competent health workers, with greater distribution to disadvantaged areas; and

A healthy start
for children
is the most
important step

III. Generating greater demand for health services from those who need them most.

INDONESIA'S PUBLIC HEALTH SPENDING—ONE OF THE LOWEST IN THE WORLD—NEEDS TO INCREASE SUBSTANTIALLY, AS IS THE PLAN IN THE 2016 BUDGET, BUT WITH A GREATER EMPHASIS ON PRIMARY HEALTH CARE.⁴⁶ Until recently, Indonesia had the fifth-lowest health spending to GDP ratio out of 188 countries, at 1.2 percent of GDP, and relatively high out-of-pocket health spending as a percentage of total health spending. Most countries that have reduced out-of-pocket health spending below the WHO's recommended target of 15 to 20 percent have done so with levels of public health

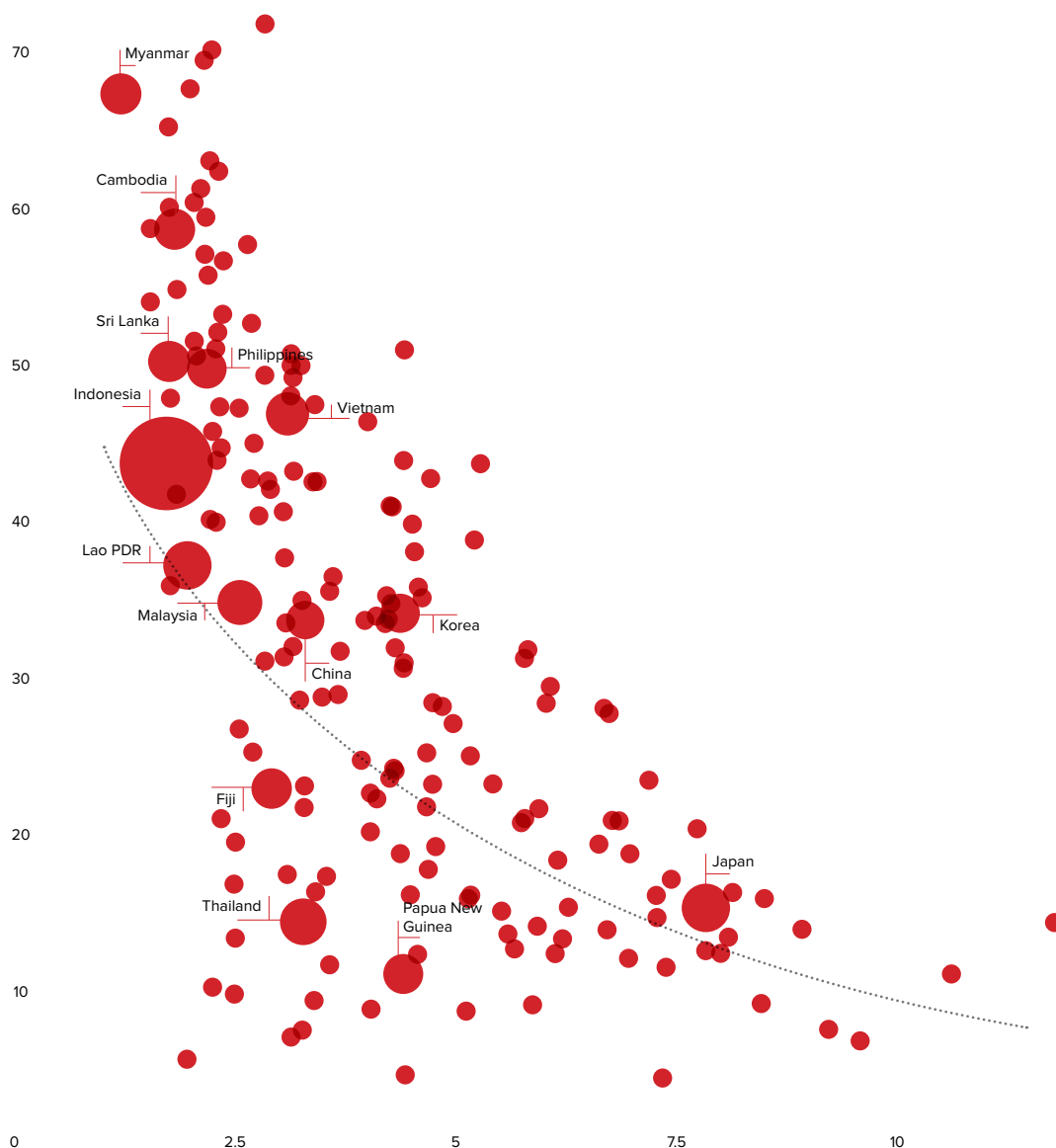
spending at around 5 percent of GDP (Figure 3.7). The high out-of-pocket spending in Indonesia means health shocks impact inequality not only indirectly through reduced access to better health, but directly through households falling into poverty when illness strikes. The administration of President Joko Widodo has increased the health budget in 2016 to 5 percent of total state spending. However, much of this increase is devoted to the national health insurance system (Jaminan Kesehatan Nasional, or JKN). This currently skews spending towards large hospitals in the major cities, which tends to benefit richer households more, whereas greater spending on primary health care would be more pro-poor.

What is needed is not just greater spending, but also better spending

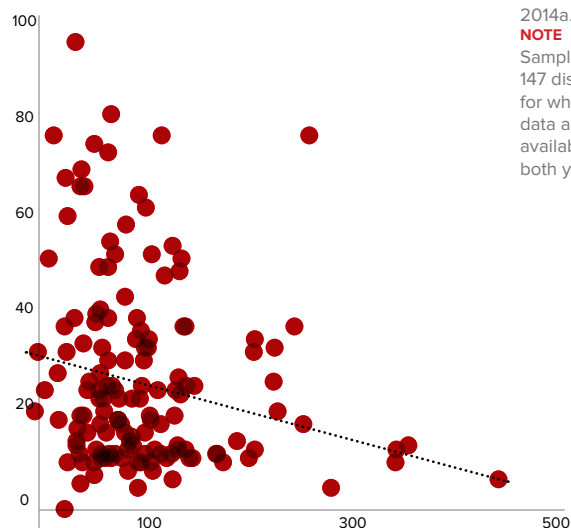
Public health spending (percent of GDP) and out-of-pocket spending (percent of total health spending) internationally (fig.3.7)

SOURCE: World Development Indicators and World Bank (2014a).

⁴⁶ This section contains the key recommendations for improved health financing and delivery from World Bank (2014a).

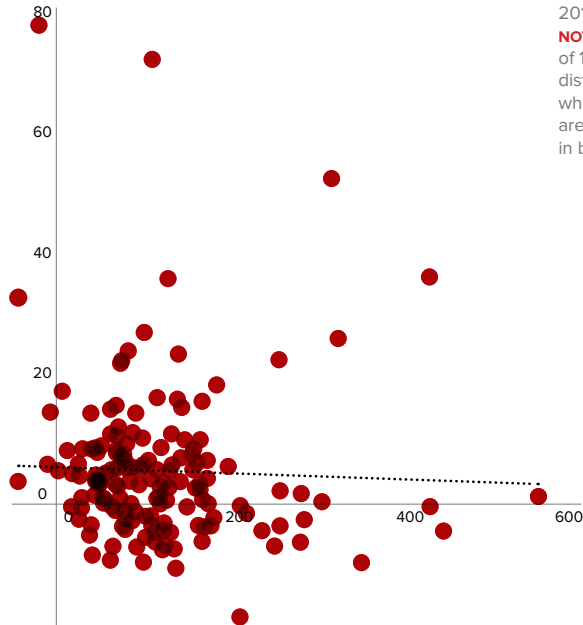


Changes in real health expenditure (percent, 2003-11) and change in immunization coverage (percent, 2003-11) (fig.3.8)



SOURCE Ministry of Finance and BPS, as reported in World Bank 2014a.
NOTE Sample of 147 districts for which data are available in both years.

Changes in real health expenditure (percent, 2003-11) and change in immunization coverage (percent, 2003-11) (fig.3.9)



SOURCE Ministry of Finance and BPS, as reported in World Bank 2014a).
NOTE Sample of 154 districts for which data are available in both years.

PUBLIC HEALTH SPENDING ALSO NEEDS TO IMPROVE BY MAKING LOCAL GOVERNMENTS MORE ACCOUNTABLE AND BETTER ABLE TO DELIVER HEALTH SERVICES ON THE GROUND. Districts have had the main responsibility for delivering health services since 2001, with the rationale that decentralization would improve service quality by more local-level decision-making (particularly for a country as vast and diverse as Indonesia). However, there has been no relationship between the levels and changes in district health spending and some key outcomes (Figure 3.8 and Figure 3.9, World Bank 2014a).

ONE APPROACH IS TO USE TARGETED INVESTMENTS WITH BUILT-IN INCENTIVES. Increased Dana Alokasi Khusus (DAK) multi-year transfers to districts could be linked to measurable gaps in key health services relative to basic standards, such as those related to maternal and child health. Districts' contributions to DAK would be reimbursed provided districts show these services are being provided, as has been piloted successfully in a number of provinces for DAK infrastructure transfers.

DISTRICTS THAT UNDERPERFORM COULD BE SUPPORTED, PROVIDED THAT THE PROBLEM IS A WEAK CAPACITY TO DELIVER. If needed, the central government could consider taking over the service temporarily, as has been

done successfully in countries such as Colombia. Subsequent transfers can also be linked to progress in closing gaps.

ANOTHER APPROACH IS TO DESIGN PROVIDER PAYMENTS IN A MANNER THAT SUPPORTS EFFECTIVE SERVICE DELIVERY. Provider payment systems in the former Jamkesmas program are currently being adapted for use by the Ministry of Health and BPJS. An analysis of potential efficiency gains from the strengthening of these payment systems' focus on primary care and limiting any overuse of high-cost services may include: (i) analysis of the share of insurance payments made to primary, secondary, and tertiary care to possibly inform benchmarking for increasing allocations to primary care; (ii) analysis of the rate of potentially avoidable hospitalizations for primary care-sensitive conditions; and (iii) analysis of drug prices and reimbursement relative to international benchmarks and neighboring countries.

REFORMS WILL NEED TO BE UNDERPINNED BY HIGH QUALITY DATA. The success of the proposed schemes relies heavily on the ability to collect regular and relevant facility-level data (in a sample of facilities representative at the district level, including private facilities) and ensure that data collected reflect national guidelines and norms. This would help to shed light not just on

where the deficiencies lie but also why they exist. Such data collection efforts would be independent and, ideally, separate from routine administrative data monitoring, which is also crucial. If possible, data would also be collected from a sample of beneficiaries to ensure that service provision is occurring as intended and that patients are receiving the care they are entitled to. There are other dimensions of service delivery—including the ability and effort of providers—that capture higher dimensions of provision of care that could also be assessed and improved systematically and regularly. These could include efforts to ensure that the basic equipment in facilities is not just available but also properly calibrated and utilized, and assessments made of whether or not health workers have the necessary skills and motivation to provide high-quality services.

BETTER SOCIALIZATION OF THE RECENTLY INTRODUCED UNIVERSAL HEALTH COVERAGE (UHC) IS NEEDED FOR LOCAL GOVERNMENTS, BENEFICIARIES AND PROVIDERS. In some cases, the issue is likely not one of additional resources but more to do with greater knowledge of, and ongoing preparations for, UHC among local governments, beneficiaries and providers. The Government could ensure that clear supply-side implications are specified based on the JKN benefits package, and that this information is effectively disseminated and fed into operational priorities. This would cover the equipment, training, diagnostic capabilities, and medicines to be provided at different levels of care. It would also specify accountabilities for this provision and finance appropriate referrals as needed. In this regard, BPJS could consider implementing a regular and independent accreditation process for public and private facilities.

Improving the supply, distribution & competence of health workers⁴⁷

A NUMBER OF WAYS HAVE BEEN IDENTIFIED TO ADDRESS PROBLEMS OF ADEQUATE, COMPETENT HEALTH WORKERS EVERYWHERE. The problems of not having enough competent health workers, particularly in disadvantaged areas, has already been discussed. The World Bank (2009) has highlighted nine ways to improve this. Of these, the most important for ensuring the adequate supply of quality health

workers to disadvantaged areas are:

- I.** Provide better information about the dynamics of the health workforce at the national and subnational levels;
- II.** Limit the recruitment of publicly-funded medical doctors in urban areas;
- III.** Modernize health workforce policies using an evidence-based evaluation of past policies; and
- IV.** Strengthen not only the clinical competence of nurses and midwives, but also compensate them for providing clinical services in remote areas.

PROVIDE BETTER INFORMATION ABOUT THE DYNAMICS OF THE HEALTH WORKFORCE AT THE NATIONAL AND SUB-NATIONAL LEVELS.

A total of 5,500 medical doctors, 34,000 nurses and 10,000 midwives graduate each year. At the same time, data on the stock of health workers report small increases per year. It is clear that the current information does not track accurately where the health workers take up jobs; whether this is in the private or public sector, rural or urban areas; who they serve; and whether they maintain their skills after graduation. In addition, better information is needed regarding allied and administrative health workers and this need should be given a high priority in the future research agenda and Human Resource Information System development. Finally, there is very little information on the salaries and incomes of health workers; information that is needed for a better understanding of incentive structures. Improving these data are key to knowing how well-served disadvantaged areas are, how to match these needs with new graduates, and the degree of additional incentives that may be needed,

LIMIT THE RECRUITMENT OF PUBLICLY-FUNDED MEDICAL DOCTORS IN URBAN AREAS. Given the fact that more medical doctors settle in urban areas because of private practice opportunities, it appears logical for the public sector to emphasize the placement of medical doctors in underserved rural areas to increase the efficient use of public money.

MODERNIZE HEALTH WORKFORCE POLICIES BASED ON AN EVIDENCE-BASED EVALUATION OF PAST POLICIES. Allowing dual practice, the impact of decentralization, the contracted doctors' scheme (Pegawai Tidale Tetap, or PTT), which is the practice of contracting doctors on higher remuneration packages in remote areas and so forth, are policies that may

⁴⁷ This section contains the key recommendations for improved a supply of health workers from World Bank (2009).

not have provided the impact foreseen for a variety of reasons. It is worthwhile trying different incentive initiatives to motivate health workers to work in remote areas. Other countries use point systems (Bangladesh) to allocate credits towards a future posting to a more appealing location, or require a period of working in rural and remote areas as part of doctors' national accreditation (Australia). In the United States, where medical education is very expensive, subsidized medical education is provided on condition of service in remote areas. Of course, getting the provider to the remote area, even with a good salary, does not entice them to provide a quality service (unless altruism is sufficiently strong). Introducing competition was suggested by Hammer and Jack (2001). However, this can be introduced only if the market allows it, which is a question for doctors assigned to rural areas.

STRENGTHEN NOT ONLY THE CLINICAL COMPETENCE OF NURSES AND MIDWIVES, BUT ALSO COMPENSATE THEM FOR PROVIDING CLINICAL SERVICES IN REMOTE AREAS. The importance of nurses and midwives for basic care at the community level in rural areas is evident. Studies clearly show that, in those areas, nurses and midwives are taking on many responsibilities beyond their skill level and without legal support. Improving the skills and legalizing the practice will improve the provision of health services in remote and rural areas.

Generating greater demand for health services from those who need them most

INCREASED USE OF SKILLED BIRTH DELIVERY AT PROPER FACILITIES, ANTE- AND POST-NATAL CARE, IMMUNIZATION, MATERNAL AND CHILD MICRONUTRIENT INTAKE, AND EFFECTIVE TREATMENT OF DIARRHEA FOR THE POOR AND VULNERABLE IS NEEDED. These activities should be promoted among this population through education, social

encouragement and pressure, or incentives, including:

- I.** Better socialization of the importance of vital behaviors, as well as teaching poor mothers which services they should be receiving at Posyandus and Puskesmas;
- II.** A reinvigorated and enhanced Posyandu cadre;
- III.** Outreach from Puskesmas officials;
- IV.** Outreach from trusted community leaders (tokoh), who need to be provided the necessary messages to deliver;
- V.** Outreach from NGOs;
- VI.** Explore how community groups and forums can encourage or motivate increased utilization among the poor, e.g., through PNPM-Generasi or PNPM-Rural;
- VII.** Consider incentives through PKH or other social assistance programs;
- VIII.** Most vital behaviors are already required as PKH condition; and
- IX.** The planned expansion of PKH over time will bring these conditionalities to other poor women.

IN PARTICULAR, INCREASED PROFESSIONALIZATION OF POSYANDU CADRES IS NEEDED, THROUGH IMPROVED TRAINING QUALITY, PERFORMANCE-BASED INCENTIVES, AND STRONG SUPERVISION FROM PUSKESMAS. These cadres can visit every community to make sure that pregnant women receive routine prenatal care, encourage mothers to bring children for immunization, ensure that children with fevers are seen immediately for a malaria diagnosis, and other basic steps that reduce the threat of illness, as well as the high costs of late treatment. With respect to stunting and nutrition, Posyandu cadres can play a key role in ensuring effective Behavioral Change Communication (BCC), especially tailored personal counselling focusing on improved caring practices for maternal care and feeding behaviors for infants and young children. As shown in other countries, regular home visits to provide individualized support to caregivers are key. Posyandu training pilots under PNPM-Generasi could be further scaled up.

3.1.2

Ensuring all children receive a fair start in life through quality education

CLOSING THE QUALITY GAP IN EDUCATION IS MORE IMPORTANT FOR REDUCED INEQUALITY THAN CONTINUED IMPROVEMENTS IN ACCESS GAPS.

To ensure that all children get a fair start in life through quality education means: improving access to early childhood development (ECD) for all; increasing transition rates for poorer children between school levels; and closing the quality gaps that persist despite closing access gaps. However, it is improvements in schooling quality that will most reduce inequality. Enrolment gaps between students from rich and poor households have been closing over time, but this is not reflected in the contribution of inequality of opportunity to overall inequality because of a continuing quality gap. Reducing the role of education in inequality will require closing this quality gap.

IMPROVED QUALITY RATHER THAN HIGHER ENROLMENT RATES IS ALSO THE MORE IMPORTANT FACTOR FOR INCREASING ECONOMIC GROWTH.

The OECD (2015) analyzed two different scenarios: bringing all current students to basic skills by 2030 (closing the quality gap) and full participation in secondary school at current quality levels (closing the access gap). For Indonesia, they estimated the benefits in terms of economic growth to be around seven times higher for closing the quality gap compared with closing the access gap. Closing the quality gap: Bringing all current students to basic skills by 2030 (level 2, 420 points) would mean a 62 percent higher GDP in 2095, 0.92 higher long-run growth and 14.5 percent higher discounted future GDP. Closing the access gap: Full participation in secondary school at current quality would mean a 7 percent higher 2095 GDP, 0.13 higher long-run growth and 1.8 percent higher discounted future GDP. Closing both gaps: a 84 percent higher 2095 GDP, 1.16 higher long-run growth and 19 percent higher discounted future GDP.

AS WITH HEALTH SERVICE QUALITY, IMPROVING THE QUALITY OF EDUCATION FOR ALL MEANS IMPROVING LOCAL SERVICE DELIVERY. The three main actions required to make sure all children get a good start are:

- I.** Ensuring that both central and local financing mechanisms give schools the money and resources they need;
- II.** Increasing the competency of teachers everywhere, and ensuring sufficient distribution to disadvantaged areas; and
- III.** Improving accountability to parents through better information on the quality of education.

IMPROVING QUALITY BY ADDRESSING FINANCING FOR DISADVANTAGED AREAS MAKING SURE ALL SCHOOLS HAVE SUFFICIENT FINANCIAL RESOURCES MEANS RETHINKING THE CURRENT BOS FINANCING MECHANISM.

⁴⁸ The main mechanism for school-level funding in Indonesia is through the BOS (Bantuan Operasional Sekolah) program. The objectives of the program are to reduce the public's financial burden of education in the framework of providing nine years of good quality compulsory education and to support school-based management (SBM) reforms. These objectives are designed to raise overall education outcomes through three main channels: increased state funding of schools and reduced burden on households; direct financial support to poor students; and strengthened SBM through the establishment of rules and responsibilities of schools and local communities in managing BOS.

SIGNIFICANT INCREASES IN BOS FUNDING HAVE BEEN ASSOCIATED WITH REDUCED EDUCATION COSTS FOR HOUSEHOLDS AND INCREASED ENROLMENT RATES, PARTICULARLY FOR POORER HOUSEHOLDS, ALTHOUGH NOT COMMENSURATE WITH THE LEVEL OF FUNDING (WORLD BANK 2015G).

The real value of the per-student allocation has more than doubled since the introduction of the program in 2005. In 2014, the BOS program provided funds to the average primary (junior secondary) school of about US\$10,000 (US\$20,000). This seems to have initially reduced the education costs faced by households and increased enrolment rates. Moreover, drops in household education spending directly after the introduction of the BOS program were relatively larger for the poorest 20 percent of households

Improved quality of education for all that will have the greatest impact on both growth and inequality

⁴⁸ The discussion and recommendations for BPS come from World Bank (2014f and 2015g).



in Indonesia. However, the drop in education costs faced by households appears to have been relatively small compared with the size of the per-student grants given to schools. While the analysis is only indicative, it suggests that where overall drops in household per-student spending occurred, these were relatively small, particularly at primary school, when compared with the per-student amount given to schools through BOS. Drops in household spending for the poorest households were equivalent to around 5 percent of the BOS grant at primary school and around 30 percent at the junior secondary level. The limited use of BOS funding to reduce charges faced by households is further supported by the significant increase in discretionary resources that schools appeared to have after the introduction of BOS, often spent on hiring additional teachers instead.

THE WORLD BANK (2014F) RECOMMENDS A NUMBER OF IMPROVEMENTS TO BOS.

A number of recommendations, such as linking BOS funding or directly to education standards and reviewing the eligible items under BOS to provide schools with the flexibility to invest in quality enhancing inputs, are aimed at enhancing the focus on improving education quality. Three in particular are aimed at strengthening the poverty and equity focus of BOS:

- I.** Adjust the value of BOS periodically to account for regional price differences and inflation to ensure that all schools can meet operating standards;
- II.** Use the BOS formula to provide more funding to schools serving poor and vulnerable children; and
- III.** Phase out the use of BOS resources to support the 'out-of-pocket' expenses of poor students in favor of existing targeted programs.

ADJUST THE VALUE OF BOS PERIODICALLY TO ACCOUNT FOR REGIONAL PRICE

DIFFERENCES AND INFLATION TO ENSURE THAT ALL SCHOOLS CAN MEET OPERATING STANDARDS. Indonesia is a large and diverse country and providing the same amount of per-student funding to schools in areas with high costs is unfair. At the minimum, consideration should be given to adjusting the BOS funding formula periodically for geographical cost differences and inflation.

USE BOTH THE BOS FORMULA AND DAK TO PROVIDE MORE FUNDING TO SCHOOLS SERVING POOR AND VULNERABLE CHILDREN.

Schools serving poor and disadvantaged students need additional support to ensure that they are able to provide a quality of schooling similar to schools in wealthier areas of Indonesia. In addition, the targeted and performance-based DAK investments proposed in health could also be adopted for education based on district-level education gaps.

PHASE OUT THE USE OF BOS RESOURCES TO SUPPORT THE 'OUT-OF-POCKET' EXPENSES OF POOR STUDENTS IN FAVOR OF EXISTING TARGETED PROGRAMS. Existing guidelines on BOS allow schools to cover the education costs of poor households. However, large cash transfer programs (e.g., *Kartu Indonesia Pintar*) already exist that are perhaps more effective at supporting these costs. While these programs require strengthening, they should be the principal way of reducing the direct costs of schooling.

AT THE SAME TIME, BOSDA CAN BE USED TO COMPLEMENT BOS IN ORDER TO REACH HIGHER QUALITY STANDARDS, AS WELL AS TO PROVIDE EQUITY AND PERFORMANCE COMPONENTS. Local education funds (*Bantuan Operasional Sekolah Daerah*, or BOSDA) need to be used as a complement to BOS, rather than a substitute. BOS funding is designed to enable schools to meet the national minimum service standards. However, schools should aspire to the higher national education standards, and local governments can use BOSDA to help them reach these higher standards. In addition, BOSDA can include equity and performance components. The equity focus would increase funding to remote and disadvantaged areas, reflecting the higher costs of service delivery. The performance component would provide incentives for schools for improving student performance. Recent reforms in DKI Jakarta suggest a potential approach.

BOX 3.2

Innovations in improving delivery of education services

Recent reforms in DKI Jakarta show how BOSDA can complement BOS to help schools reach higher quality standards, support schools in disadvantaged areas, and encourage higher performance

Recent reforms in DKI Jakarta suggest a potential approach, combining an equity component (rather than equal spending per person, schools in the Thousand Islands sub-district receive more funding because of the higher costs of service provision) and an incentive component (schools in the top quarter with respect to the level and increase in national test scores receive an extra allocation the following year). In addition, BOSDA (known as BOP in Jakarta) funds are being used to help DKI Jakarta reach national education standards. The provincial government conducted a study of the resources required to reach the minimum service standards (MSS) and national education standards (NES), finding that the BOS and BOP funds combined fell short of the NES (Table 3.3), and is now adjusting BOP funding to ensure that schools have sufficient funds to reach the NES.

Costs and funding in DKI Jakarta to reach different education standards (IDR '000) (tab. 3.3)

WORLD Bank (2014f).

| | Estimated per-student needs for different standards (IDR '000s) | | Current per-student allocations (IDR '000s) | | |
|--------------------------|---|-------|---|-------|-------|
| | MSS | NES | BOS | BOP | TOTAL |
| Primary schools | 1,084 | 1,783 | 580 | 720 | 1,300 |
| Junior secondary schools | 1,261 | 2,142 | 710 | 1,320 | 2,030 |

Improvements are needed in teacher competency and ensuring good teachers reach poorer areas

TEACHER COMPETENCIES IN GENERAL IN INDONESIA NEED SIGNIFICANT STRENGTHENING; EVIDENCE FROM INDONESIA AND GLOBALLY SUGGESTS A NUMBER OF OPTIONS FOR BUILDING AN EFFECTIVE TEACHING FORCE IN

INDONESIA. Over half of Indonesia's teachers do not reach the 60 percent level of competency across a range of skills needed for basic competency. In addition, there is significant regional variation in teacher competency as well.

Evidence from Indonesia and globally suggests a number of options for building an effective teaching force in Indonesia, including the following:

- I.** Pre-service and induction: Partly attracted by the increase in teachers' pay, there are now 1 million students in teacher training colleges, one-third of the total university enrollment, and way above current needs. Greater selectivity at entry and exit (through the use of competency tests) and institutional accrediting can help to ensure an adequate supply of competent teachers.
- II.** Recruitment and deployment of competent teachers, particularly in disadvantaged areas: Make the hiring of teachers into schools more transparent and merit-based; and strengthen the program to recruit and deploy competent teachers

to disadvantaged areas by combining financial incentives, bonding schemes and group-based postings.

III. Professional development and support—large payoffs in the short to medium term: Strengthen the role of school principals in identifying needs through annual appraisal; develop and test training modules, and accompanying lesson plans to improve subject knowledge and teaching practices; and deliver support through teacher

working groups supported by district cadre of experts (proven successful for geometry in a World Bank study (forthcoming b)) and ICT.

IV. Teacher accountability: Make use of annual appraisal and competency test to determine career progression; use of new term contracts for public employees (P3K) for new teachers (including existing honorarium teachers); and tying renewal to performance.

3.1.3

Revitalizing family planning to help poor households to have the family sizes they want



HELPING HOUSEHOLDS HAVE SMALLER, HEALTHIER FAMILIES WILL HELP TO REDUCE INEQUALITY BOTH DIRECTLY AND INDIRECTLY. We have already seen that spreading household income across smaller families for poorer households will help to reduce inequality in Indonesia. However, it will also contribute to better maternal and child health outcomes. Improved birth spacing allows the mother's body to recover and deliver more nutrients, helping babies to be born at a healthy weight. It also means that more attention can be devoted to each child, helping prepare them better for entering preschool. Reduced rates of teenage pregnancy can decrease maternal and child mortality rates, as well as the incidence of low birth weight. Healthier children born into poorer families in turn can reduce inequality because they have had a better start in life.

A NUMBER OF POLICY RECOMMENDATIONS HAVE ALREADY BEEN IDENTIFIED TO REVITALIZE FAMILY PLANNING IN INDONESIA. Jones and Adioetomo (2014) identify a number of strategies to revitalize family planning, including: assisting the private sector to better meet the needs of the its users, who make up 73 percent of the population; strengthening contraceptive supply chain management; assisting the National Family Planning Agency (Badan Kependudukan dan Keluarga Berencana Nasional, or BKKBN) to better serve the needs of the poorer sections of the community when the cost of contraceptives is likely to be an obstacle to use; reinvigorating the BKKBN's post-partum, post-abortion and workplace-based family planning programs; facilitating cooperation between the BKKBN, local health agencies and local government at the district level to improve

the effectiveness of family planning programs; following a midwife-focused strategy for ensuring the effective provision of family planning services with high quality of services; mounting a communications program through the BKKBN and supportive local government agencies, workplaces and schools to foster later marriage; and meeting the reproductive health needs of the unmarried through a communication program and provision of services.

OF THESE, THE ONES THAT FOCUS ON SMALLER HOUSEHOLD SIZES AND LATER MARRIAGE AND FERTILITY AMONG THE POOR WILL HAVE THE BIGGEST CONTRIBUTION TO ADDRESSING INEQUALITY. The most important policies for helping poorer households have fewer, healthier children are:

- I.** Demand creation among the poor for particular BKKBN programs;
- II.** A focus by the BKKBN on the family planning needs of poorer households;
- III.** Support for later marriage; and
- IV.** Financing the family planning program.

GREATER DEMAND FOR FAMILY PLANNING AMONG THE POOR CAN BE PURSUED THROUGH REVITALIZED BKKBN COMMUNICATIONS PROGRAMS.⁴⁹

These include the Behavior Communication Change (BCC) and Information Education and Communication (IEC) programs, which would help poorer households to understand the benefits of small family sizes through key messages such as: improved mother and child health; greater financial ability to meet the basic needs of children and invest more in their education; the intergenerational gains in welfare; and reduction in poverty and vulnerability.

MORE EFFORT IS THEN NEEDED TO ADDRESS THE UNMET CONTRACEPTIVE NEEDS OF ECONOMICALLY DISADVANTAGED COUPLES. In addition to communication about the use of contraceptives through a life-cycle approach (spacing and limiting), this includes: making sure that information and services relating to long-acting methods are available (especially for limiting); providing access to contraceptive services that are affordable for poorer households; increasing the number of midwives who are qualified to insert IUDs and implants; and reducing the side-effects and health-related problems

resulting from contraceptive use through more effective counselling and increased availability of trained personnel.

SUPPORTING LATER MARRIAGE WOULD ALSO DISPROPORTIONALLY BENEFIT POORER HOUSEHOLDS. Since early marriage is more likely among poorer households, reducing this trend is important. Four actions include: advocacy to politicians, officials, religious and community leaders on the benefits of delayed marriage, and encouraging local government commitment to counter under-age marriage; enforcing the current legal minimum marriage age of 16 years old for girls; enforcing regulations that keep children in school longer (currently 9 years, with 12 years being considered), facilitated for poorer households through better targeting and take-up of scholarships; and IEC programs to parents and children on the benefits of later marriage.

FINALLY, WITH POORER HOUSEHOLDS LESS ABLE TO ACCESS PRIVATE SECTOR SERVICES, ADEQUATE FUNDING OF PUBLIC FAMILY PLANNING PROGRAMS IS CRITICAL. With family planning budgeting now a local prerogative, a central agreement between the BKKBN and the Ministry of Home Affairs (which oversees local government issues) on family planning financing is needed. Local champions of family planning (Satuan Kerja Perangkat Daerah Keluarga Berencana, or SKPD-KB) need to receive technical assistance and local family planning boards (BKKBD) need to be established in more districts under existing regulations. The use of DAK (special allocation budget for national priorities) for family planning also needs to focus less on infrastructure and more on operational expenses, such as training of midwives and contraceptive supplies.

THE EFFECTIVENESS OF THESE POLICIES WILL DEPEND UPON IMPLEMENTATION. Many of the key recommendations of Jones and Adioetomo have already been incorporated into the 2015-19 Medium-Term Development Plan (RPJM) of the State Development Planning Agency (Bappenas). A focus now is needed on effective implementation to ensure that these recommendations are successful in reducing family sizes for the poorest half of Indonesians.

⁴⁹ Each of the following set of recommendations is from Jones and Adioetomo (2014).

IMPROVING THE SKILLS OF TODAY'S WORKFORCE AND PROVIDING THEM WITH MORE PRODUCTIVE JOBS

The impact of improved public services will be felt in the long term. In the shorter term, more can be done to improve the skills of today's workforce and provide workers with more productive jobs and better protection.

3.2

3.2.1

Creating more jobs

CREATING MORE FORMAL, ENTRY-LEVEL, SEMI-SKILLED JOBS FOR THE MANY WORKERS IN UNPRODUCTIVE JOBS WOULD HELP TO ADDRESS INEQUALITY THROUGH HIGHER LABOR INCOMES FOR THESE WORKERS. Most of today's workforce will not be able to perform highly skilled (and well-paid) jobs even with post-schooling and on-the-job training. However, they should not have to spend their entire working lives in unproductive and poorly paid jobs. If there were more entry-level semi-skilled jobs in the formal sector, the millions of informal and casual workers could become more productive, boosting economic growth, as well as earning higher incomes, and thereby reducing inequality.

THERE ARE FIVE KEYS TO REMOVING EXISTING BARRIERS TO JOB CREATION, MOST CRUCIALLY AMONG THEM BEING UNDERINVESTMENT IN INFRASTRUCTURE AND THE EASE OF DOING BUSINESS. The five key actions include: (i) improving infrastructure, connectivity, logistics, transport efficiency; (ii) reducing time and procedures to start up and run a business; (iii) improving access to finance for productive firms; (iv) revitalizing manufacturing; and (v) modernizing the agriculture sector. Infrastructure, which is perhaps the most critical area, is discussed

under the following fiscal policy section, while access to finance, revitalizing manufacturing and modernizing agriculture are discussed in World Bank (2014c). Summarizing the World Bank (2015d), the following section will focus on reducing the time and complexity of starting a business.

PREVIOUS ATTEMPTS TO IMPROVE BUSINESS LICENSING AND DEVELOP ONE-STOP SERVICES FOR LICENSES HAVE YIELDED FEW RESULTS, BUT THE NEW ADMINISTRATION HAS PUT BUSINESS LICENSING BACK AT THE TOP OF THE REFORM AGENDA. A number of initiatives were undertaken to improve and simplify licensing application processes at the national and sub-national levels during the previous administration, but with limited results (see World Bank 2015d). A key failure has been that lack of progress in creating a single point of contact for investors' license applications and an institutional setting in which inter-agency collaboration and simplification, or streamlining of licensing processes, generally becomes easier and more compelling: a centralized "One-Stop Services" (OSS) at the national level with simplifying application procedures for faster issuance of business licenses. The new administration has

publicly committed itself to improving the business environment and making it easier, cheaper, and faster for firms to comply with regulatory requirements, including a central OSS. The aim is to make it possible for investors to visit only the Investment Coordinating Board (Badan Koordinasi Penanaman Modal, or BKPM) to apply for licenses at the national level, instead of various ministries and agencies as currently. The intended result is quick, simple, transparent and integrated licensing services. The President has also announced that he intends to pressure governors, district heads and city mayors to implement effective sub-national one-stop services, with possible budget transfer consequences for those failing to implement the changes (World Bank 2015d).

INITIAL REFORM MOMENTUM HAS BEEN STRONG. BKPM has begun reforming its services to meet ambitious targets. An initial mapping of business licensing procedures for selected sectors and identified potential areas for reform has been conducted, and its online application has been made mandatory, although limited pilot testing has been done of the system or private sector familiarization with the new processes. To prepare for the launch of the central OSS in 2015, BKPM has worked with the relevant ministries and agencies towards achieving four key milestones: (i) the development and issuance of ministerial decrees on the delegation of authority to BKPM, and the assignment of liaison officers from ministries and agencies to the central OSS; (ii) the development and issuance of ministerial regulations on standard operating procedures for all licensing processes under the central OSS; (iii) the organizational set-up of the central OSS; and (iv) the initial engagement of the private sector in the reform process. As a result, BKPM now provides a single physical location at which investors can apply for many national licenses. However, while this is a significant step forward, many challenges remain before realizing the goal of truly integrated investment licensing.

HOWEVER, THERE ARE TEETHING PROBLEMS WITH THE NEWLY IMPLEMENTED ONLINE APPLICATION SYSTEM. Following the launch of the central OSS, several implementation issues have been identified. Investors complain that the online application system is not reliable and lacks user-friendliness, so most continue to visit the central OSS in person to consult with staff. This raises concerns regarding BKPM's current ICT system and its capacity to support a fully

integrated OSS. In addition, applications for licensing processed by sectoral ministries' and agencies' liaison officers dropped in the weeks following the integration of the central OSS in January. The fact that many investors continue to submit their applications directly to the sectoral ministries and agencies, or have delayed their submissions, suggests limited familiarity with how the central OSS works.

ACHIEVING FULLY INTEGRATED LICENSING WILL REQUIRE A CREDIBLE REFORM PLAN AND ADEQUATE RESOURCES. The current central OSS is not yet a fully integrated service. For example, investors still need to go from desk to desk within BKPM to obtain each license and apply for the next one in the chain, and BKPM still only processes licenses for about 300 business types out of a total of 1,200. The design and implementation of a credible reform plan will require considerable resources and strong coordination across various agencies at both national and sub-national levels. Special taskforces have been assigned to carry out this work and have already identified priority areas where revision of existing regulations governing required licenses will be needed (for example, regarding forestry and land use, and environmental requirements). BKPM plans to pursue regulatory simplification to reduce the number of steps and days required for all licenses, starting with selected priority sectors, including the electricity, labor-intensive manufacturing, agriculture, and maritime sectors. The second phase of central OSS implementation will include further sectors at the national level, and sub-national OSS piloting will begin this year.

BKPM WILL NEED ADDITIONAL HUMAN RESOURCES AND A REFORMED ORGANIZATIONAL SET-UP, AND FOLLOWING THROUGH ON HIGH LEVEL COMMITMENTS AND MANAGING IMPLEMENTATION RISKS WILL BE IMPORTANT. New business processes will require significant organizational changes. With some staff from ministries and agencies having so far only been temporarily assigned to work for the central OSS in BKPM, the organizational set-up of BKPM, and the issue of human resources for business licensing, requires careful attention if longer-term sustainability is to be achieved. Moreover, the targets are ambitious and the systematic and sustained implementation of new regulatory processes, across not just BKPM but all ministries and agencies, will be challenging. Implementation difficulties and delays could quickly come under the spotlight, and the

Government will need to carefully manage the risks associated with the reform plan. Much now depends on the extent to which high-level support at all relevant ministries and agencies is achieved,

sustained and translated through the reform implementation strategy into new and improved processes.

3.2.2

Improving protection for low-income and vulnerable workers⁵⁰

STRONG LABOR REGULATIONS ON PAPER DELIVER LITTLE PROTECTION TO WORKERS IN REALITY DUE TO LOW COMPLIANCE, RESULTING IN A LOSE-LOSE SCENARIO. With full receipt of severance pay at only 7 percent (Figure 3.10) and a high rate of non-compliance with the minimum wage, even for richer formal employees (Figure 3.11), the current regulations deter job creation and switching but fail to protect most workers.

RECENT CHANGES IN THE MINIMUM WAGE SETTING PROCESS MAKE IT SIMPLER AND MORE CERTAIN, BUT THE MECHANISM REMAINS TO BE TESTED. The Government recently enacted Government Regulation No. 78/2015, which introduces a new formula for annually adjusting minimum wages linked to inflation and growth in GDP. While this is progress, and helps to simplify the calculation and render the mechanism more predictable, it still leaves scope for uncertainty in allowing further discretionary adjustments by provincial governors. The new process remains untested but could still generate conflicts of interest, and leads to a “lose-lose” scenario not conducive to the creation

of more and better jobs. In general, bi-partite negotiations are too polarized around minimum wages and do not discuss productivity or training, collective bargaining agreements are not common, and real wages for the poor are stagnant.

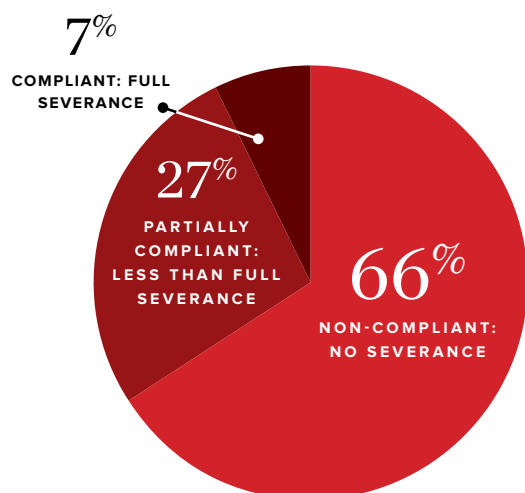
THE NEW MINIMUM WAGE SETTING PROCESS NOTWITHSTANDING, ACHIEVING A COMPLETE SET OF REFORMS ACROSS ALL STRATEGIC LABOR REGULATION DIMENSIONS WILL POLITICALLY REQUIRE A “GRAND BARGAIN” BETWEEN EMPLOYERS, LABOR UNIONS, AND THE GOVERNMENT.

Individual reforms are unlikely to gain political traction due to the sensitive and perceived zero-sum nature of labor-market regulations. Thus, effective reform can only be carried out with a regulatory overhaul that is perceived as beneficial to all parties. Broad and evidence-based social dialogue should be initiated, which would set up a “grand bargain” for labor regulation and workers’ protection, to move from the largely lose-lose current situation to a win-win, where protection and regulation are improved for all workers, not just a small subset of formal workers.

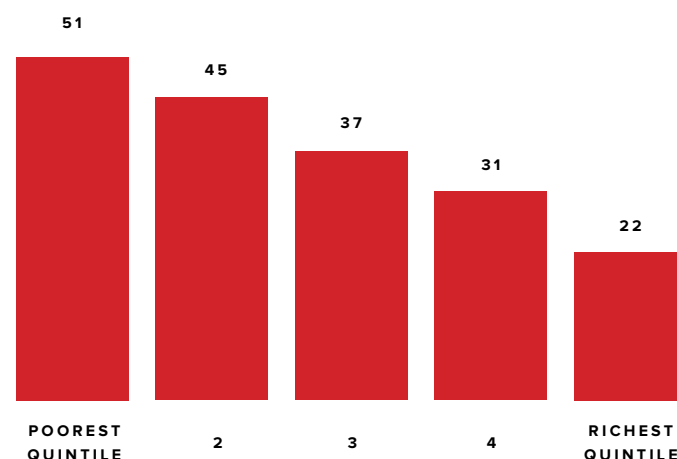
⁵⁰ World Bank (2014c) provides a detailed discussion (of which this section is a summary) on Indonesia’s rigid labor laws, which impose high costs to firms and impede formal employment and productivity growth (p115-118).

Receipt of severance pay, as reported by workers (percent) (fig. 3.10)

SOURCE
Sakernas



Employees receiving less than minimum wage by consumption quintile (percent) (fig. 3.11)



SOURCE Sakernas.

NOTE: Predicted per capita consumption quintile.

3.2.3

Reforming the skills training system to enable workers to access jobs

IN ORDER TO GAIN ACCESS TO PRODUCTIVE JOBS, THE POOR AND VULNERABLE NEED TO BE ABLE TO UPGRADE THEIR SKILLS.

In Indonesia's current skills training system, the pillars of an effective skills development system exist: competency standards, competency-based training, certification, accreditation, and labor-market information. However, the system does not function well because the elements are not implemented properly. In addition, as mentioned in the previous chapter, private sector involvement in training programs is low, with the majority of programs being government-run. Thus, comprehensive, gradual reform can build on existing elements to improve the implementation of the skills training system.

THE SKILLS TRAINING SYSTEM SHOULD BECOME MORE DEMAND-DRIVEN, WITH A STRONGER ROLE FOR THE PRIVATE SECTOR.

As employers are best placed to identify their skills needs, and will benefit most from a training system that caters specifically to those needs, they should be the main drivers of the development of competency standards. Employers should also utilize their facilities and expertise to play a more active role in training provision and professional certification.

THE GOVERNMENT SHOULD PLAY A STRONG ROLE IN QUALITY ASSURANCE AND SETTING INCENTIVES FOR THE PRIVATE SECTOR.

While employers need to play a stronger role in the system, the role of the Government is also crucial in acting as a regulator and facilitator and, in the initial stages, a funder of the reforms

in particular training activities. The main role of the Government should be to ensure that all the elements necessary for an efficient market in training provision are in place. The two main elements of such a market are: (i) availability of information (e.g., quality assurance system); and (ii) the setting of the right incentives (e.g., through financing of skills training).

AN INCREASE IN PRIVATE SECTOR SPENDING CAN ALLOW PUBLIC RESOURCES TO BE SPENT ON VULNERABLE GROUPS.

There is a need to increase the contribution of firms to the overall cost of training, as firms benefit from skilled and productive employees. If this occurs, public resources could be used strategically to subsidize and incentivize training for vulnerable groups, such as the poor, women, youth, and people living with disabilities.

OTHER REFORM ELEMENTS CAN ALSO BE TAILORED TO FOCUS MORE ATTENTION ON VULNERABLE GROUPS.

The training system should be made accessible in all provinces in Indonesia and for all segments of the population. A larger and more comprehensive system can allow for a better targeting of public resources to those most in needs and ensure that locally relevant economic activities are supported by the training system. Specific training programs can also be developed that cater to specific employee needs, for example, for people living with disabilities. Both the regional expansion of the training system and the inclusion of vulnerable groups can contribute greatly to decreasing inequality.

3.3

ENSURING ALL HOUSEHOLDS HAVE EFFECTIVE PROTECTION FROM SHOCKS

PROTECTING HOUSEHOLDS FROM SHOCKS REQUIRES ACTION ON MANY FRONTS.

Households face shocks from multiple sources. Many of the policies required to address these have been covered in detail elsewhere.⁵¹ Besides ensuring adequate health services, particularly in poorer areas (as discussed in Section 3.1.1), we

focus here on those policies that are likely to have the greatest impact on reducing inequality through protecting the poor and vulnerable:

- I.** Addressing high and volatile rice prices;
- II.** Strengthening social protection; and
- III.** Building a permanent crisis monitoring and response system.

3.3.1

Addressing high and volatile rice prices

THERE ARE A NUMBER OF POLICY AREAS IN WHICH THE GOVERNMENT CAN PROMOTE STABILITY TO PREVENT SHOCKS FROM OCCURRING.⁵²

One important area that affects the poor is food prices, especially for rice.⁵³ The poor and vulnerable are most affected by food price increases, given that food accounts for 65 percent of all poor household consumption (World Bank forthcoming (a)). They are particularly vulnerable to high rice prices, which are held artificially high in Indonesia. Poor households spend 25 percent of their income on rice alone, and while some poor households do produce their own rice, they are usually still net consumers, meaning that higher rice prices hurt rather than

help them. Slowing rice production and import restrictions mean that domestic rice prices are higher than international prices, adversely affecting the poor; when rice prices soared in 2005-06, the poverty rate increased by 2 percentage points.

DOMESTIC RICE PRODUCTION HAS SLOWED IN RECENT DECADES FOR A NUMBER OF REASONS, INCLUDING SLOW MECHANIZATION, COUPLED WITH POOR INFRASTRUCTURE AND CONNECTIVITY.

Total rice production growth in Indonesia has slowed from between 4.3 and 5.4 percent per year in the 1960s to the 1980s to less than 2.5

⁵¹ World Bank 2014c (coping with natural disasters; see also Jha and Stanton-Geddes 2012) and World Bank (2014a), Indonesia Economic Quarterly, December 2014 (Building an effective social insurance system).

⁵² A continued focus on sound macro-fiscal management is key for continued economic growth: sustainable fiscal and external sector balances; the need to avoid boom-and-bust cycles; and an enhanced policy certainty and credibility to support investment. It is also needed to help to protect the poor. Without access to financial instruments to manage price risk, inflation acts as a tax on the poor. For greater discussion, see World Bank (2014c).

⁵³ For an extended discussion on rice prices in Indonesia, their impact on the poor and vulnerable (including rice farmers), how government policies are currently exacerbating this, and what could help, see World Bank (2015d) of which this section is a summary.

percent in the 1990s and 2000s.⁵⁴ Productivity has been hampered by a number of factors, including low productivity (smaller farms with less mechanization), poor infrastructure and connectivity, low levels of technology and information (such as the adoption of innovative high-yielding and high-variety seeds), low agricultural research and extension spending, and land administration bottlenecks (limiting the process of land titling that is commonly needed for loan collateral). Poor infrastructure (irrigation, water resources, road access to markets) and high logistics costs also weigh on Indonesia's rice market.

INCREASED PUBLIC SPENDING ON AGRICULTURE HAS FAILED TO SPUR PRODUCTION. Public spending on agriculture, including rice, has increased significantly, but allocations have not been effective in supporting domestic productivity growth. The ratio of public agricultural spending to GDP in agriculture increased from 9 percent in 1970-80 to 35 percent in 2009 and the agriculture share of the budget doubled from 3 percent in 2001 to 6 percent by 2008. But this increase did not result in a corresponding rise in agricultural production, which increased by an average of 3 percent between 2001 and 2009 (Armas, et al. 2010). The weak apparent impact of spending on productivity can be attributed to the poor allocation of spending; agriculture subsidies on private inputs such as fertilizer increased by four times between 2001 and 2009, while public spending for irrigation remained flat. Research on Indonesia has shown that spending on public goods such as irrigation has a positive and significant impact on GDP per capita growth in agriculture, while public spending for fertilizer subsidies has a negative impact (Armas, et al. 2010).

AT THE SAME TIME, PRICE STABILIZATION POLICIES ARE INEFFECTIVE AND MAY EVEN CONTRIBUTE TO THE PROBLEM. While agricultural productivity and connectivity are the long-term drivers of rice prices, the Government uses various mechanisms to stabilize prices in the short term, including market operations (*Operasi Pasar*, or OP) and rice imports, both controlled by the Government's Logistics Agency (*Badan Urusan Logistik*, or Bulog). OP is the main price-stabilization mechanism, while Bulog effectively has a rules-based import monopoly. However, neither mechanisms appear to have significantly stabilized prices. Together, OP, rice imports, and

Raskin (a major social subsidized rice social assistance program) directly affect only a small share of total rice production. The small amount of OP released, at less than 1 percent of total rice production, likely explains why this mechanism has had no significant impact on reducing prices (Kusumaningrum, et al. 2015). Perversely, although the OP, Raskin and import volumes are relatively low, they may contribute to rice price volatility when forecasted stocks are low, as in for example February 2015; traders may restrict their sales, waiting for price-stability mechanisms to be deployed. Problematic information regarding production, consumption and stocks, can combine with government operations to create uncertainties about true rice availability, distorting the market and creating space for short-term speculation.

EFFECTIVE RICE SECURITY REQUIRES BOTH BETTER INFORMATION, AND ADDRESSING THE CONSTRAINTS TO PRODUCTIVITY GROWTH. Rice is Indonesia's staple food, and the international market for rice is very thin (only 6 to 7 percent of total global rice production is traded across international borders).⁵⁵ In this context, concerns over achieving secure rice supply, in Indonesia as elsewhere, are valid. However, recent experience shows that the current price policy mix and implementation has had limited effectiveness in achieving the stated government objective of protecting the poor and farmers. Policies that have the effect of keeping rice prices high also increase poverty and distort the domestic rice market, including by encouraging illegal imports, and generating wider inflationary pressures. While market operations can play a role in smoothing price volatility, interventions should be timely, appropriately sized and well-targeted. This will require an effective early warning system and reliable real-time information about prices, stocks and flows of rice. Over the longer term, achieving a sustained improvement in Indonesia's rice security will require increasing productivity through long-term, structural improvements in the agriculture sector.

⁵⁴ However, poor quality data on both rice production and consumption adversely affect proper analysis and informed policy decisions. See World Bank (2015d).⁵⁵ World Bank 2012g, "Using Trade Policy to Overcome Food Insecurity," in Food Prices, Nutrition, and the Millennium Development Goals, available online, p.119.

3.3.2

Strengthening social protection

GREATER SOCIAL PROTECTION WILL REQUIRE A STRONG SOCIAL SECURITY SYSTEM. Social security not only promotes social and economic transformation, but it can also help to reduce poverty, vulnerability and inequality through helping prevent elderly poverty for workers who have to exit the workforce and protecting against employment shocks for active workers. It will also establish universal access to health care, helping all households prevent or cope with health shocks, including government subsidies for poor and vulnerable households.

THIS MEANS THE UPCOMING EXPANSION OF SOCIAL INSURANCE NEEDS TO BE DESIGNED AND IMPLEMENTED EFFECTIVELY AND SUSTAINABLY.⁵⁷ Universal social insurance

(SJSN) is legally mandated by law for health (by 2014) and employment (by 2015) under the SJSN Law.⁵⁸ To be effective and sustainable, the system will require appropriate benefit levels, sound fiscal risk management, sound institutional development and management, and non-contributory coverage of the poor and vulnerable, while at the same time collecting contributions from those who can afford to pay. Since most of the poor and vulnerable are in the non-salaried work force, it is important to extend the SJSN programs to these groups. For the health program, it is the "missing middle" that is of concern, since the poor are paid for by the Government. Also of concern are the poor whose premiums are not covered due to mis-targeting. For the employment programs, the Government may have to fully or partially subsidize the contributions to the four programs for those who cannot afford to pay. This is permitted but not required by the SJSN Law. There is also the issue of providing income security to non-salaried workers when (or if) they retire. The SJSN pension program only covers salaried workers; how will others be covered? This could be through social assistance or minimum income types of programs, through social pensions on a universal or means-tested basis, or in other ways. Nonetheless, SJSN is a key building block for a more equal society by providing important protection against financial shocks and assuring income following exit from the labor force, as well as health, work accident

and death insurance. These matter not just for the poor, but also for the economically secure consumer class, who can be more vulnerable to financial shocks than often assumed, and particularly to health shocks.

STRONG LEADERSHIP IS REQUIRED FOR IMPLEMENTATION DUE TO THE LARGE NUMBER OF STAKEHOLDERS WITH DIVERGING INTERESTS, THE SIGNIFICANT IMPACT OF THESE PROGRAMS TO THE SOCIAL STRUCTURE OF THE COUNTRY, AND THE SIGNIFICANT POTENTIAL IMPACT ON THE STATE BUDGET, THE LABOR MARKET AND THE MACRO ECONOMY. The nationwide SJSN programs will differ in both design and coverage from the existing programs and will include a newly defined benefit pension program.

FOR THOSE UNABLE TO COPE WITH SHOCKS THEMSELVES OR ACCESS CONTRIBUTORY SOCIAL INSURANCE, STRONGER SOCIAL ASSISTANCE IS NEEDED. Social assistance, in the form of non-contributory government programs that help to protect the poor from shocks, invest in their human capital, and promote them out of poverty is, alongside social insurance, the other essential component of a comprehensive social protection framework.

SAFETY NETS HAVE AN IMMEDIATE IMPACT ON REDUCING POVERTY AND INEQUALITY. Safety nets enable households to make better investments in their future to help the next generation escape from poverty and vulnerability. Safety nets also protect people from falling into poverty, and reduce their need to rely on bad coping behaviors.⁵⁸

INDONESIA HAS BEEN BUILDING AND EXPANDING A SOCIAL ASSISTANCE FRAMEWORK SINCE THE ASIAN FINANCIAL CRISIS, BUT IT IS NOT YET FULLY EFFECTIVE AT PROTECTING HOUSEHOLDS FROM SHOCKS. Key programs include Raskin (subsidized rice for the poor), Jamkesmas (now rolled into JKN, where the Government pays premiums on behalf of the poor and vulnerable),

⁵⁷ This section summarizes the social insurance discussion on Indonesia: Avoiding the Trap (World Bank 2014c).

⁵⁸ Under the 2004 National Social Security Law (Law No. 40/2004, the SJSN Law, (Sistem Jaminan Sosial Nasional) and the 2011 Social Security Administrators Law (Law No. 24/2011, BPJS Law, Badan Penyelenggara Jaminan Sosial).

⁵⁸ See Indonesia: Avoiding the Trap (World Bank 2014c) for more details.



Indonesia Pintar (scholarships for the poor) and PKH (a conditional cash transfer). However, there are a number of problems with many of the programs (World Bank 2012a, 2012b). Benefits are often too little, do not reach the right people, or are not received at the right time. Some vulnerable groups are not covered, and some risks are not protected against. Other programs have been shown to work, but are too small. Further reforms are needed to strengthen safety nets (see World Bank 2012a, 2012b and 2014c). In addition to allocating more budget for a comprehensive and integrated social assistance system appropriate for a middle-income country, those that are most important for addressing risk and shocks include:

- I.** Improved targeting to better reach the target population;
- II.** Reform of Raskin for better food security; and
- III.** Piloting of public works programs to provide employment options in times of job loss or underemployment.

IMPROVED TARGETING UNDERPINS THE EFFECTIVENESS OF SOCIAL ASSISTANCE

FOR THE POOR. Targeting outcomes have been improved since the Unified Database—a registry of about 40 percent of the population that has been identified as poor and vulnerable—has been used for social assistance beneficiary identification. Further improvements, however, are required. These include updating the Unified Database to capture newly poor and vulnerable households, and shifting to a dynamic updating process that relies on on-demand applications.

REFORM THOSE PROGRAMS, SUCH AS RASKIN, THAT ARE COSTLY AND PROVIDE INEFFECTIVE PROTECTION. Raskin has positive potential: the consistent provision of a basic food package could protect poor households from food-price volatility, calorie scarcity, and malnutrition. However, in its operation Raskin fails to achieve most of these fundamental social assistance goals. Dilution of benefits, missing rice, and hidden financing burdens all reduce the transfer values provided to target households. If serious reform remains out of reach, Raskin should be encouraged to focus on implementing agency strengths such as price stabilization.

PILOT A PUBLIC WORKS PROGRAM, TO ADDRESS THE EMPLOYMENT RISKS THAT ARE NOT YET COVERED BY CURRENT PROGRAMS. A short-term public works program, Padat Karya, was used in response to the Asian financial crisis. However, recent reviews of the program (e.g., World Bank 2010c) suggest that it largely failed to protect the most vulnerable workers due to critical flaws in program design,

such as fragmentation under various agencies, too high a wage that displaced workers and caused social tension, and non-labor intensive works, reducing the benefits available to workers. **Box 3.2** discusses how a new public works program might be developed in Indonesia. A number of international case studies exist that provide useful lessons learned, including cases from South Africa, India, Morocco and Ethiopia.

BOX 3.3

A public works program for Indonesia

Public works programs typically have three primary objectives:

1. Mitigation of covariate shocks (unexpected and seasonal). An example: the World Bank alone helped at least 24 countries to mobilize public works programs in response to the food, finance, and fuel crises of 2007-09. Pre-existing safety nets and administrative capacity have been proven to enable a timely response to sudden covariate shocks in many countries. This enabled India to promptly expand its program when the country was hit by a massive drought in 1987 (Rao et al. 1988).

2. Mitigation of idiosyncratic shocks (in response to a temporary or structural job crisis). In India, the MGNREGS guarantees a certain number of days of employment for anyone needing a job (self-selection). This acts as an insurance program. Beneficiaries are disproportionately poor even though the program does not specifically target the poor (i.e., poverty is not a requirement for participation).

3. Bridge to permanent employment. In Bangladesh, the Rural Maintenance program requires participating women to attend income-generation and skills training. In addition, they must agree to save Tk 10 of the Tk 51 they are paid each day to participate. The purpose of the program is to create new microentrepreneurs who have the requisite skills and seed capital to take up self-employment in the informal sector (Hashemi and Rosenberg 2006).

Recommendations for Indonesia (World Bank 2010c)

1. Increasing the frequency and improving the comprehensiveness of labor data can help to detect shocks in time and accurately pinpoint affected workers. Protecting workers from shocks requires collecting up-to-date information for early detection and pinpointing which regions and households are most affected. The Central Statistics Agency (BPS) can increase the timeliness of data while, at the same time reducing costs, by adopting a quarterly or continuous survey approach that can provide labor data on a quarterly or monthly

basis. There is also a need to expand survey questions to better monitor the extent of vulnerability among workers. These data can feed into a permanent monitoring system that can detect future shocks, including wage and employment shocks.

2. One of the pillars of a national shock response system should be a public works program. The framework should govern when, where and how employment generating projects will be delivered in anticipation of a range of potential shocks. This could include the identification of triggers that will launch public works projects or increase allocations for existing labor intensive programs. For example, the National Community Empowerment Program (Program Nasional Pemberdayaan Masyarakat Mandiri, or PNPM-Mandiri) can channel funds to support labor-intensive, locally-identified development projects in rural areas where this has been shown to reduce unemployment rates. Additional projects or channels must also be identified to provide temporary assistance to workers when needed in urban areas. At the same time, the response system can maintain a standing list of ongoing and planned

infrastructure projects that can quickly absorb workers during shocks in both urban and rural areas.

3. A successful public works program in Indonesia can include a skills building component to help poor workers transition into gainful employment. New skills training programs can help to strengthen the skills of poor workers who often have not had access to formal education or public training facilities. A new comprehensive training program can form the second component of a national strategy to equip workers with job relevant skills. The program can support vulnerable and disadvantaged workers, especially targeting young, poor and informal

workers who would benefit the most from a second chance. The Ministry of Manpower should take the lead in strategic planning and monitoring the performance of the implementing agencies. Supporting private-public partnerships will help to build links with prospective employers and ensure that training providers survey local employers to ascertain the needs of the local labor market.

4. In the medium term, commission a technical team to develop a strategic plan for the creation of a permanent public works program. Include: objectives, design features, delivery mechanisms, institutional arrangements and a step-by-step roadmap.

5. Appoint one single, central institution to be responsible for overall strategic leadership and monitoring of the public works program. Other program features could include: systematic use of geographic targeting to determine program locations; wages set below market level for unskilled works so that workers will self-select themselves into the program; female participation encouraged by modifying program design elements; and labor-intensive projects selected that have been identified by communities or infrastructure programs that have already been identified by development strategy/plans to ensure that the works created are useful and productive.

3.3.3

Crisis monitoring and response: developing a permanent and comprehensive system

EVEN WHEN THE RIGHT TOOLS HAVE BEEN AVAILABLE, INDONESIA HAS NOT ALWAYS KNOWN WHEN, WHERE AND HOW TO RESPOND WHEN CRISES STRIKE. In the past, when Indonesia has been exposed to economic and price shocks, such as the 2005/06 food and fuel price shock, the 2008/09 global financial crisis, and the 2010 global food price shock, government responses were hampered, as a formalized monitoring and response was not in place. This meant that the Government did not know whether the effects of the crises were being transmitted, through what channels, to where and to whom. As a consequence, formulating the right response was difficult. Moreover, even if the appropriate response had been known, the fiscal and operational protocols to enable such as response to be quick and effective were absent.

DEVELOPING A CRISIS MONITORING AND RESPONSE SYSTEM (CMRS) IS ESSENTIAL FOR DETECTING THE EFFECTS OF A CRISIS AND RESPONDING APPROPRIATELY.⁵⁹ Even with the right social protection tools in place, a CMRS is needed to make them work in times of crisis. Such a system will allow the Government to know whether a potential shock is occurring, who is being affected, and where and how, and how it should respond. Such a system has three components: a permanent and relatively real-time monitoring system at both the national and household levels; a pre-agreed protocol for when, where and which response will be initiated; and pre-agreed institutional arrangements on planning, coordination, funding and disbursement, and monitoring and evaluation.

⁵⁹ For example, see World Bank (2010a and 2010b) for a detailed discussion of the effect of the global financial crisis on Indonesia and the limitations of its response.

3.4

ALIGNING GOVERNMENT TAXES AND SPENDING TO BETTER ADDRESS INEQUALITY

3.4.1

Fiscal policy as a tool to address inequality, now as well as in the future

ADDRESSING INEQUALITIES OF OPPORTUNITY AND BETTER JOBS IN THE LONG RUN WILL REQUIRE ADDITIONAL GOVERNMENT SPENDING.

Many of the policies required to address inequality discussed already require significant government expenditures: increased health spending and continued funding of education, greater investment in infrastructure, increased social assistance coverage and benefits, and social security for all. Aligning government budgets behind these priorities is one key role that fiscal policy can play in addressing long-term inequalities due to factors outside of an individual's control.

HOWEVER, FISCAL POLICY CAN ALSO BE USED TO ADDRESS INEQUALITY IN THE SHORT TERM.

Many of the policy actions discussed will only have an impact on inequality in the long term, such as increased child health and nutrition, better quality of education and skills development, higher labor productivity and an environment that favors job creation. However, how overall fiscal policy is designed can impact inequality almost immediately through a number of channels. The income that a household receives from wages and salaries, income from capital and private transfers—its market income—can be reduced through taxes, excises and social security contributions, increased directly through social security payments and social assistance benefits, or increased indirectly through the consumption

of subsidized goods and services such as fuel and food, health and education. The net effect of these different channels means that final incomes (after all taxes are paid and all spending enjoyed) can be more or less equal to market incomes.

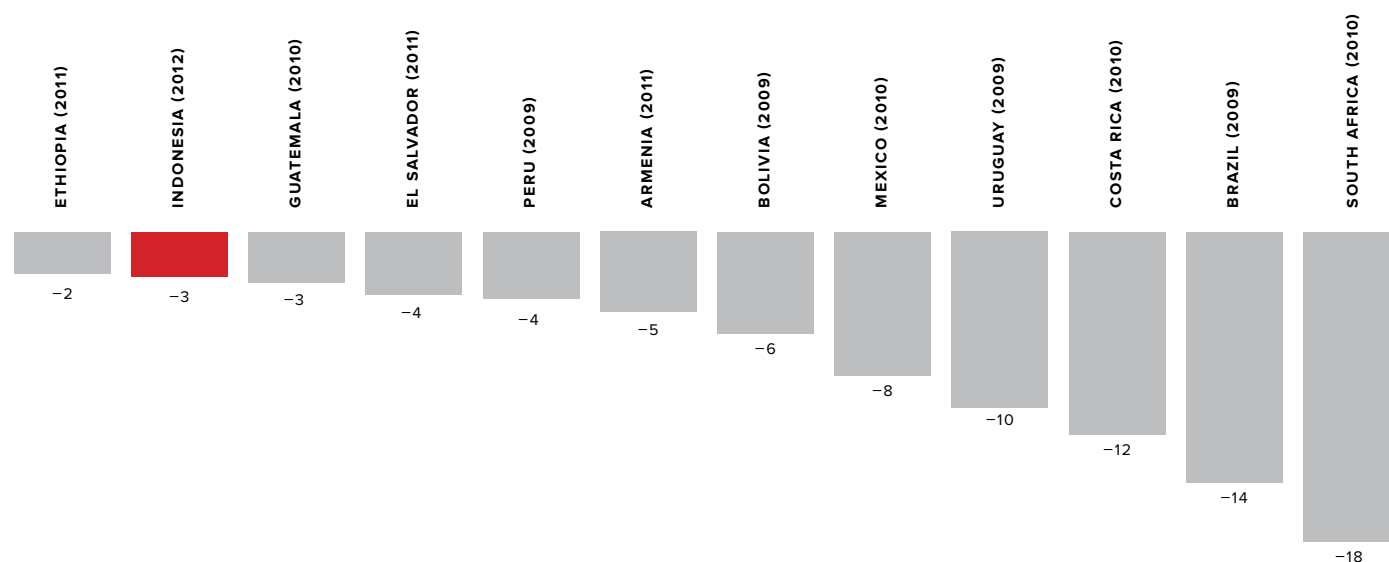
CURRENTLY, FISCAL POLICY IN INDONESIA NEITHER SIGNIFICANTLY INCREASES NOR DECREASES INEQUALITY TODAY.

Recent research (Jellema *et al.* 2015; Ministry of Finance and World Bank 2015) looks at what impact different government taxes and spending have on inequality. It finds that the net changes to household income from taxes and transfers leave the Gini coefficient almost unchanged; including in-kind health and education spending, it only drops a modest 1 point.

HOWEVER, FISCAL POLICY HAS BEEN USED IN OTHER COUNTRIES TO SIGNIFICANTLY REDISTRIBUTE WEALTH AND REDUCE INEQUALITY.

In Latin America, where inequality is the highest in the world, many governments have taken conscious steps, along with other policy actions, to use fiscal policy in a more equalizing manner. **Figure 3.12** shows how much selected countries reduce inequality (as measured by the Gini) through different fiscal policies. While each country reduces inequality in a different way, all of them reduce it significantly more than Indonesian fiscal policy does.

Reduction in the Gini coefficient through fiscal policy, selected countries (points) (fig. 3.12)



SOURCE Armenia (Younger and Khachatryan 2014); Bolivia (Paz et al. 2014); Brazil (Higgins and Pereira 2014); Ethiopia (Woldehanna et al. 2014); Mexico (Scott 2014); Peru (Jaramillo 2014); Uruguay (Bucheli et al. 2014); Lustig (2014) based on Costa Rica (Sauma et al. 2014), El Salvador (Bencke de Sanfeliu et al. 2014), and Guatemala (Cabrera et al. 2014); South Africa (Inchauste et al. 2014); and Jellema, et al. (2015) for Indonesia based on Susenas 2012.

3.4.2

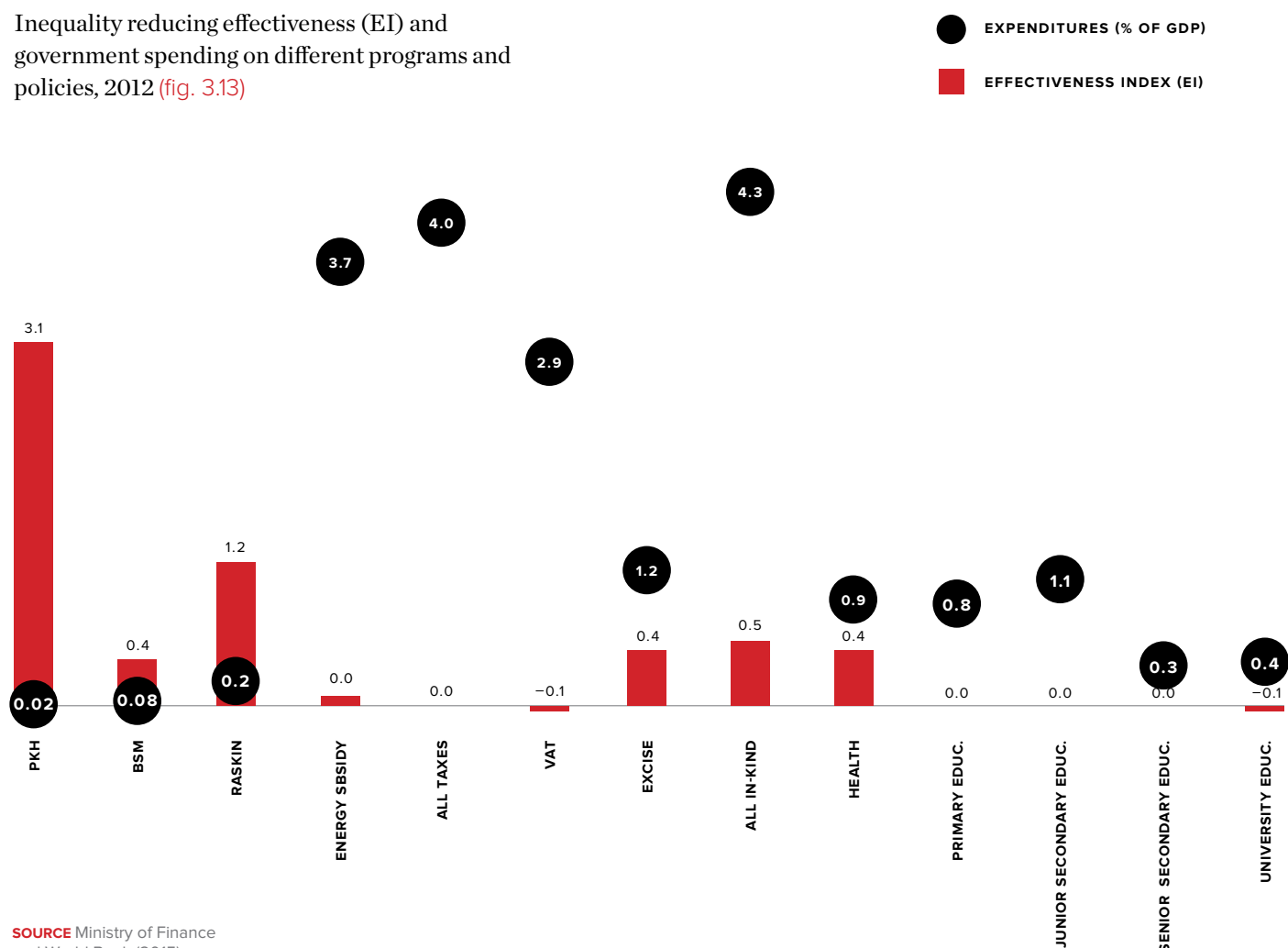
Spending choices are likely to have the greatest influence on current inequality

INDONESIA HAS HISTORICALLY SPENT MOST ON THOSE PROGRAMS AND POLICIES THAT LEAST REDUCE INEQUALITY IN THE SHORT TERM, AND LITTLE ON THOSE THAT HAVE THE GREATEST IMPACT. Figure 3.13 compares how much the Government spends in different areas, such as health, social assistance, subsidies and education. This is indicated by the bubble for each area. For example, in 2012 Indonesia spent 3.7 percent of GDP on energy subsidies, the largest share of central government spending outside of transfers to local governments. The figure also shows how much immediate inequality was reduced by each type of spending, relative to its size; this is the Effectiveness Index (EI), which is marked by the blue bar. The EI is a measure of the inequality reducing cost-effectiveness of each spending. A larger bar means that the Gini was

reduced by more for the given percent of GDP spent on it than an area with a lower bar. What this figure indicates is that the programs that reduce inequality the most per rupiah (PKH is by far the most effective, followed other social assistance programs such as Raskin and BSM [now called *Indonesia Pintar*], as well as health) receive the least spending; social assistance in particular, which is the most effective and reducing inequality, receives the least spending overall. At the same time, the areas receiving the most spending (subsidies, 3.7 percent of GDP, and education, 2.6 percent of GDP) have no significant effect on inequality.⁶⁰ Furthermore, even the spending that does the most to reduce inequality now, such as on education, health and social assistance, is not as pro-poor as it is in other countries (Jellema, et al. 2015).

⁶⁰ Richer households consume far more fuel and so benefit far more from energy subsidies in absolute terms, but they also have much higher market incomes, so the value of the subsidy as a percentage of their income (which is how taxes and spending affect the Gini) is broadly similar to that of poorer households that use less but earn less. For education, while richer children are more likely to be enrolled in higher levels of education, which are considerably more expensive, poorer households have more children in total, so they consume more schooling through quantity, largely offsetting at each level until tertiary (where the poor have near-zero enrolment).

Inequality reducing effectiveness (EI) and government spending on different programs and policies, 2012 (fig. 3.13)



SOURCE Ministry of Finance and World Bank (2015).

MOREOVER, SPENDING THAT REDUCES INEQUALITY NOW ALSO REDUCES INEQUALITY IN THE FUTURE. Not only do the living standards of poorer households increase today from spending on social assistance (higher incomes), health and education (reduced out-of-pocket expenditures), the same spending

can help their children to get a fairer start in life and therefore earn a better income tomorrow. Social assistance helps mothers and children to receive health and education services; health and education spending helps to make sure the quality of those services is providing equal opportunities for these children to succeed later in life.

3.4.3

Closing the large infrastructure gap can reduce inequality in Indonesia by strengthening growth, stimulating job, improving access to public services, and lowering food prices

INDONESIA'S INVESTMENT IN INFRASTRUCTURE HAS FALLEN BEHIND.

Despite rising government spending in recent years, Indonesia's core infrastructure stock, such as road networks, ports, electricity,

telecommunication facilities, has not kept pace with economic growth. In real terms, the infrastructure stock grew by only 3 percent annually in 2001-11, against 5.3 percent for GDP growth. Slow growth in the infrastructure

capital stock, in a context of high economic and vehicle fleet growth, contributes to serious major gaps, congestion problems and poor logistics performance, seriously undermining productivity growth, competitiveness and poverty reduction efforts. Greater investments—and the right investments—in infrastructure can help to reduce inequality in a number of ways.⁶¹

CLOSING INDONESIA'S INFRASTRUCTURE GAP WILL HELP TO SUSTAIN ECONOMIC GROWTH. Sustained growth is necessary for reducing inequality. It has been estimated, however, that Indonesia has lost more than 1 percentage point of additional GDP growth due to under-investment in infrastructure, chiefly transportation. Closing the infrastructure gap would support growth through several channels. As the investments are being made, the spending effect would support short-term growth and jobs. As the investments translate into infrastructure stock, private investment is crowded-in and the productive capacity, productivity and long-term growth are supported.⁶² This increased growth can lead to higher household incomes and consumption, and greater fiscal resources for government spending on programs that help to level the playing field for everyone.

INVESTMENTS IN INFRASTRUCTURE WILL HELP TO CREATE MORE AND BETTER WORK OPPORTUNITIES FOR LOWER-SKILLED WORKERS. It will also support the type of job creation that is needed to tackle inequality. Firm surveys show that problems with transportation are among the main business constraints for manufacturing firms, which are critical for generating job opportunities for lower-income and lower-skilled workers. Reducing these constraints will improve productivity and competitiveness in this sector. Better roads and ports will also give

farmers better access to markets, which in turn will improve their productivity and ability to create better work opportunities for agricultural workers.

INFRASTRUCTURE CAN HELP TO ADDRESS INEQUALITIES OF OPPORTUNITY BY IMPROVING ACCESS TO GOVERNMENT SERVICES. One-quarter of urban populations and more than half of rural dwellers have poor access to transport (World Bank 2014c). This directly affects poorer and remote households that rely on road infrastructure to access family planning services, maternal and child health services, and schools. There is a need to increase spending on roads to ensure access to these services. At the same time, attention must be paid and budget allocated to road maintenance, which is typically a lower priority than the construction of new roads. It is estimated that adequate subnational road maintenance will require doubling the current level of spending (World Bank 2012f).

INFRASTRUCTURE CAN ALSO HELP REDUCE FOOD PRICES, WHICH MAKES A MAJOR DIFFERENCE IN THE LIVES OF POORER HOUSEHOLDS. Infrastructure investments—particularly in roads and ports—will also bring local raw material producers closer to domestic markets. It is currently cheaper to import oranges from China than to source them from Kalimantan (World Bank 2014c). Increased connectivity for remote areas and reduced logistics costs in general will also help to reduce the high and volatile rice price and other food prices that disproportionately affect the poor.

THE WORLD BANK (2014C) INCLUDES AN ENTIRE CHAPTER FOCUSED ON THE NEED TO IMPROVE INFRASTRUCTURE IN INDONESIA AND HOW THIS CAN BE DONE; Box 3.3 summarizes these recommendations.

⁶¹ The analysis in Section 3.5 on which type of government spending reduces inequality the most excludes the inequality-reducing impacts of infrastructure spending, which is analytically difficult to isolate. A joint World Bank-Fiscal Policy Office effort, however, is underway to include infrastructure spending in updated fiscal incidence analysis work. See Ministry of Finance and World Bank (2015).

⁶² Theoretically, augmenting the stock of public capital through investment in infrastructure directly raises the productivity of other factors (e.g., labor, land) and stimulates economic output. As shown by Barro (1990), it can increase the long-term growth trajectory of an economy under certain conditions, for example the presence of economies of scale. There are indirect effects as well. The availability of high-quality infrastructure may reduce the need for own-provision of certain inputs such as roads, water or electricity (Agenor and Moreno-Dodson 2006) and support the formation of human capital (Galaini et al. 2005).

BOX 3.4

Improving infrastructure in Indonesia

The previous Susilo Bambang Yudhoyono administration planned to close the infrastructure gap through the Medium-Term Development Plan (Rencana Pembangunan Jangka Menengah Nasional, or RPJMN) and the Master Plan for the Acceleration and Expansion of Indonesia Economic Development (Master Plan Percepatandan Perluasan Pembangunan Ekonomi Indonesia, or MP3EI). A number of policies and initiatives were introduced, including significant budget increases for capital spending and a strengthened institutional and regulatory framework for public-private partnerships (PPP). However, overall progress on infrastructure output and services on the ground was slow, due to a range of implementation and coordination

challenges. The 2015 and 2016 budgets under the new Joko Widodo administration included large increases in investment for infrastructure, funded by the savings of the 2015 fuel subsidy reform. However, disbursement of this spending has remained slow.

Making progress in closing the gap will need three main actions:

A. Mobilize funding for infrastructure development. In recent years, the central government has spent much less on infrastructure (less than 1 percent of GDP) than it has on fuel subsidies (about 2.6 percent of GDP). It will be important to continue and maintain recent policy decisions to eliminate or reduce subsidies. Also, increasing revenue collection could further increase the fiscal space for higher infrastructure spending. The Government has space

to seek additional infrastructure financing, thanks to the low debt level (the debt-to-GDP ratio stood at 24 percent of GDP in 2014), which can be supplemented by subnational governments' investments and private sector financing.

B. Continue coordination and engagement with ASEAN regional partners. These countries have committed to implementing the ASEAN Economic Community (AEC) Blueprint by the end of 2015. To realize this goal, member states will set up trade facilitation by establishing "single window" facilities to enhance customs data exchange, increase the use of ICT for border agencies and increase transparency in border clearance processes. There is also an ASEAN Connectivity Master Plan that will accelerate the implementation of

cooperation initiatives and investment projects to better connect member states through three types of connectivity: physical, institutional, and people-to-people.

C. Clarify land acquisitions regulations and guidelines. There is a lack of clarity in the regulations that govern land acquisition and the compensation to landowners. This is one of the main reasons behind delays in infrastructure projects, particularly for toll roads. It is also perhaps a key factor behind the reluctance of the private sector to invest in this sector on a large scale. A revised Land Acquisition Law signed under Presidential Decree No. 30/2015, however, is expected to improve the clarity and transparency of the land acquisition process, and strengthen public confidence in the Government's efforts to advance the infrastructure agenda.

3.4.4

However, fiscal policy needs to remain sustainable

WHILE FISCAL POLICY CAN BE USED TO ADDRESS INEQUALITY NOW, IT MUST BE DONE IN A SUSTAINABLE FASHION. Many

Latin American countries have significantly reduced inequality through fiscal policies. Progressive taxing and spending that primarily benefits the poor and vulnerable are important tools for tackling inequality. However, they must be used in sustainable ways. When too much is spent on redistribution and other social spending relative to revenues, the fiscal framework can become unsustainable. In Brazil, for example, cash transfers now represent 4 percent of GDP. In addition, when social transfers are too large, this can create a disincentive to work. For instance, cash transfers are now worth 70 percent of market income to the poorest decile in Argentina (Lustig and Pessino 2014).

INDONESIA CAN AND SHOULD SPEND MORE ON SOCIAL SPENDING, BUT IT SHOULD MAKE SURE THAT EXPANSIONS IN SPENDING ARE NOT BASED ON UNREALISTIC

INCREASES IN REVENUES. The 2015 national budget (APBN) includes significant increases in spending, notably on infrastructure, health and social assistance. As this report has argued, these are needed increases in vital areas for both increasing economic growth and reducing inequality. However, while some of the new spending in these areas comes from reallocating fuel subsidy spending, some is funded through significant increases in budgeted revenues. If these ambitious revenue targets are not met and spending budgets are, Indonesia risks exceeding the legal limit of the central fiscal deficit of 2.5 percent of GDP.⁶³

SIGNIFICANT REFORMS WILL BE REQUIRED TO INCREASE REVENUES. If a "business-as-usual" scenario is assumed, with no significant reforms on revenue policy or administration, baseline revenue for 2015-19 is projected to stay level at between 13.3 and 13.5 percent of GDP. Without being constrained by the fiscal rule, the fiscal deficit would reach 4.6 percent of GDP

⁶³ Historically, however, Indonesia's actual spending has been around 8 percent lower than budgeted, reducing the risk of a ballooning deficit, especially since infrastructure disbursements have been particularly lower than planned.

in 2015, rising to 6.0 percent of GDP by 2019. Additional fiscal space is needed—from 2.1 percent in 2015 rising to 3.5 percent of GDP by 2019—to stay within the fiscal deficit rule of 2.5 percent for the central government. Without creating

additional fiscal space, the Government will have to dramatically cut back on the planned increases for spending on development priorities. Box 3.4 discusses what mix of policies might achieve this.

BOX 3.5

Achieving fiscal sustainability: priority actions

Additional fiscal space will have to come from a massive effort to mobilize revenue—in particular non-oil and gas tax and non-tax revenue by improving tax administration and compliance and optimizing tax policy. Relative to its regional and emerging market peers, Indonesia has one of the lowest ratios of revenue-to-GDP (15.2 percent in 2014) and tax-to-GDP (11.3 percent in 2014). This is not due to lower tax potential; by one estimate, Indonesia is collecting less than 50 percent of its total potential tax revenue (Fenochietto and Pessino 2013). With continued moderation in oil and other commodity prices, revenue-to-GDP may fall to as low as 13.5 percent in 2015 and stay in that range in the medium term under a “business-as-usual” scenario due to significantly lower revenues from oil, gas and other commodities. Consequently, and as emphasized by

the Government, a sustained major effort to mobilize revenues is critical. Revenue policy reforms to broaden the tax base, simplify tax structures, rationalize tax types, and selectively revise certain rates to be in line with international levels, could help to raise revenues, as well as reduce economic distortions and lower administration costs.

In addition, improving tax and non-tax revenue administration and compliance through a more strategic, risk-based approach to compliance management, and additional efforts to increase voluntary compliance, will also be critical. A comprehensive package of revenue policy (including the optimization of tobacco and vehicle excise taxes) and administration (including improvement of non-oil and gas income tax, VAT and mining non-tax revenue compliance) could

potentially raise additional revenues of 1 percent of GDP in 2016, rising to over 4 percent of GDP by 2019.⁶⁴ Second, growth in average central personnel spending could be tempered to grow in line with inflation (CPI) rather than at 5 to 8 percent above inflation, as has been the case in recent years. Personnel spending grew from 2.4 percent of GDP in 2014 to 2.7 percent in the 2015 revised budget. Maintaining central personnel spending flat in real terms would free up 0.5 percent of GDP per year by 2019. Taken together, these measures have the potential to expand the available fiscal space by 1.1 percent of GDP in 2015, rising to 4.7 percent of GDP by 2019. This would result in a declining fiscal deficit over the medium term, eventually meeting the fiscal rule of 2.5 percent of GDP in 2018.

3.4.5

The revenue mix used to achieve fiscal sustainability can also influence inequality today

TAXES ARE PRIMARILY ABOUT REVENUE COLLECTION, BUT THEY CAN ALSO INFLUENCE INEQUALITY DIRECTLY. The role that taxes play in a fiscal policy framework designed to address inequality is largely to fund equality-promoting spending. Even in countries with particularly progressive income taxes, such

as Brazil, Mexico and Uruguay, their impact on inequality is less than that of targeted cash transfers or (considerably so) health and education spending (see Jellema, et al. 2015). Nonetheless, different taxes are collected from households to different degrees and this should be at least considered when the Government thinks about tax policy.

⁶⁴ In line with the IMF estimates of a medium-term target for tax-to-GDP of between 13.4 and 16.4 percent of GDP. IMF, 2011a, “Revenue Mobilization in Developing Countries”, IMF Policy Paper. IMF, 2011b, “IMF Country Report: Indonesia”, No. 11/30.

THE GOODS AND SERVICES THAT ARE VAT EXEMPT AFFECT BOTH REVENUE AND INEQUALITY. The incidence of Indonesia's VAT—which households pay VAT and how much—is neutral across the consumption distribution. The poorest 10 percent pay around 3.5 percent of their market income in VAT, which is about the same for the richest 10 percent and everyone in between, although tobacco excises are slightly regressive (Jellema, et al. 2015).⁶⁵ This is in contrast to some other countries, where the poor pay far more in indirect taxes such as VAT and excises as a percentage of their market income than other households.⁶⁶ From Figure 3.14 it is clear that there are two categories of countries: those with neutral or even progressive indirect tax incidences, but for whom revenues from indirect taxes are lower; and those with much higher revenues from indirect taxes (as a share of GDP), but where the poor are paying a much greater share of their market incomes (as high as 30 percent in Brazil). This difference is largely due to the number of exemptions on basic foods and staples in the first set of countries.

INCREASING REVENUE IN INDONESIA THROUGH INDIRECT TAXES CAN AVOID A SIGNIFICANT IMPACT ON INEQUALITY TO THE EXTENT THAT IT FOCUSES ON GOODS AND SERVICES THAT ARE NOT HEAVILY CONSUMED BY THE POOR. These might include: extending taxes on luxury goods and high-end property (recently mooted in Indonesia),⁶⁷ as well as increasing compliance with existing taxes; and closing the compliance gap by addressing transfer pricing would increase revenue to its potential 0.5 percent of GDP from its actual 0.2 percent of GDP while reducing inequality, as the incidence is on higher income households.⁶⁸ It also means removing VAT exemptions for those goods and services that are not equity-enhancing. This could mean domestic electricity consumption at thresholds above that level normally used by the poor (e.g., in households with more than 450W or 900W installed capacity), piped water (used by relatively few poor) and agricultural, plantation, forestry, farm and animal husbandry products (most poor and vulnerable are agricultural laborers rather than farming their own land).

⁶⁵ Although richer households pay more in absolute terms because their market incomes are higher.

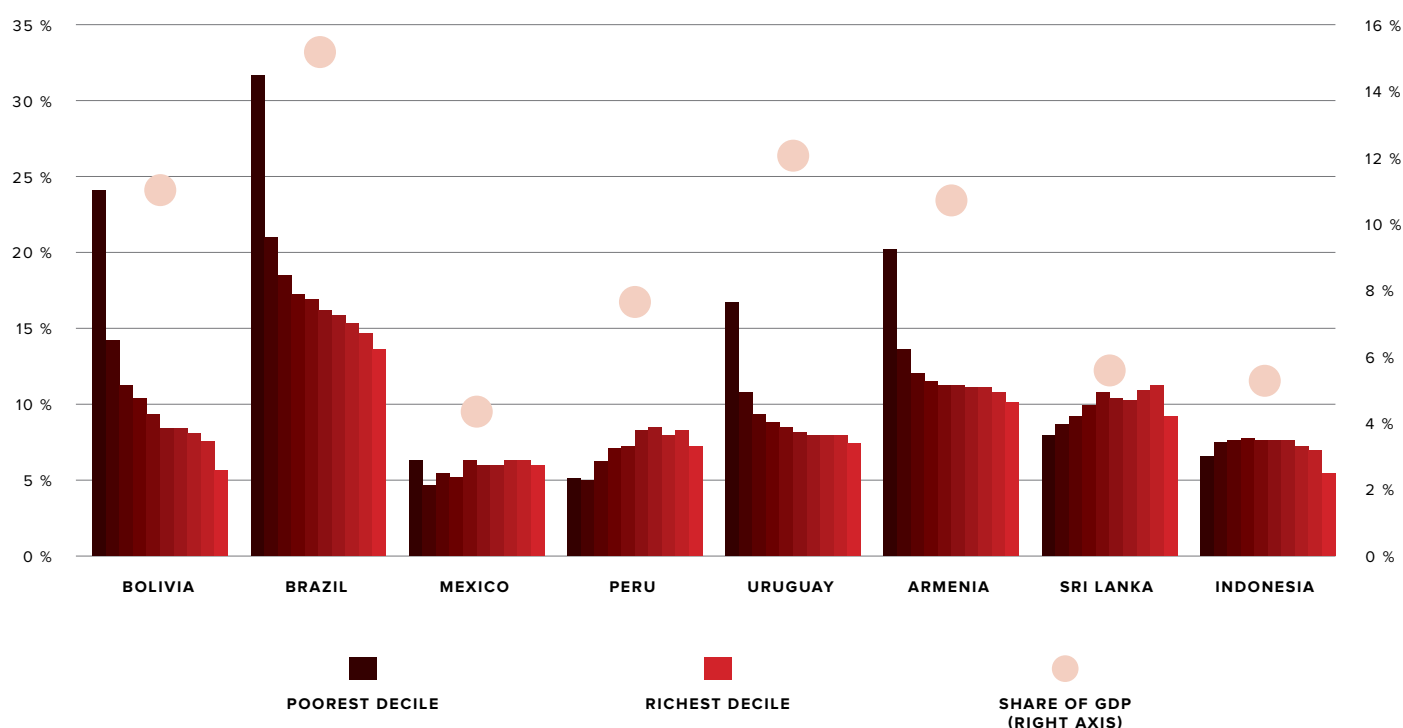
⁶⁶ This comparison includes not only VAT but other indirect taxes such as excises. Indonesia's data in this figure include the impact of the tobacco excise, which has a higher incidence on the poor and middle than the rich, see Jellema, et al. (2015).

⁶⁷ Although there is debate over whether it would be effective. For example, see <http://thejakartaglobe.beritasatu.com/business/indonesia-risks-killing-golden-goose-5-super-luxury-tax>.

⁶⁸ World Bank estimates.

Incidence of indirect taxes in selected countries
(percent of market income) (fig. 3.14)

SOURCE: For Latin America see: Lustig and Pessino 2014; Paz et al. 2014; Higgins and Pereira 2014; Scott 2014; Jaramillo 2014; Bucheli, et al. 2014; Lustig et al. 2013. For Armenia and Sri Lanka, results are preliminary by Arunatilake, et al. (2014) and Younger and Khachatryan (2014).



INCREASED CORPORATE INCOME AND RESOURCE-SHARING COMPLIANCE WOULD BOTH INCREASE STATE REVENUES AND REDUCE INEQUALITY.

In addition, Indonesia currently receives mining royalties (classified as non-tax revenue, or NTR), which is set as a fixed share of sales revenue. As commodity prices increase, royalties as a share of profits decrease, meaning wealthier shareholders benefit most in boom times. Revenue could be increased from the extractive sectors (and inequality potentially reduced) by both improving mining NTR compliance, as well as by making the mining royalty regime more progressive (for example, linking the royalty rate to prices), so the state collects more when profits are increasing.

FINALLY, AN ESTATE TAX WOULD BE VERY DIFFICULT TO IMPLEMENT BUT MAY HELP ADDRESS THE HIGH CONCENTRATION OF WEALTH, RAISE ADDITIONAL REVENUE

FOR KEY DEVELOPMENT PRIORITIES AND REDUCE INCOME INEQUALITY TOMORROW.

The concentration of wealth in the richest 10 percent of households (and most likely concentrated in a much smaller number of Indonesians than that) is one of the highest in the dataset. This indirectly increases future inequality by conferring significant advantages in life on the children of rich households through better education, health and social connections. It also directly increases future inequality by allowing the children of wealthy parents to enjoy income from their inherited wealth, which concentrates wealth further (and may decrease incentives for working). An estate tax on inheritance could be used to address this intergenerational reinforcement of inequality, although this would likely receive little public support in Indonesia currently (Table 3.4) and compliance can be difficult to enforce, even in developed countries with high tax administrative capacity.



3.5

MOST OF THE RECOMMENDED POLICIES HAVE BROAD-BASED PUBLIC SUPPORT FOR TACKLING INEQUALITY

MOST INDONESIANS THINK SOMETHING NEEDS TO BE DONE ABOUT INEQUALITY; WHAT SORT OF POLICIES WILL THEY SUPPORT? Using survey data on Indonesian's perceptions of inequality collected by LSI, the World Bank (2015a) examined how Indonesians think the rich get rich, the poor become poor; what they think about inequality; and what they think should be done about it.

MANY INDONESIANS THINK THAT WEALTH IS OBTAINED THROUGH HARD WORK, BUT THEY ALSO THINK THAT LUCK AND FAMILY BACKGROUND PLAY A BIG PART. Some attribute wealth to corruption. Around 45 percent of those surveyed think that talent and hard work are the most important factors in becoming rich. Around the same number believe external factors such as luck, family background and education and connections are more important. The other 10 percent think that corruption is the main driver.

AT THE SAME TIME, WHILE MANY BELIEVE THAT HARD WORK CAN PULL PEOPLE OUT OF POVERTY, CIRCUMSTANCES OUT OF PEOPLE'S CONTROL (BAD LUCK AND A POOR FAMILY BACKGROUND) ARE OFTEN RESPONSIBLE FOR POVERTY. Around 50 percent believe that it is easy for people to improve their economic status through hard work,

while around another 40 percent think that while this is difficult it is still achievable.

THESE BELIEFS ABOUT SOURCES OF WEALTH AND POVERTY ARE REFLECTED IN THE POLICIES MOST POPULAR FOR ADDRESSING INEQUALITY. People were asked to choose 3 out of 15 policy options as the most important for reducing inequality. The results are presented in [Table 3.4](#).

THE POLICIES VIEWED AS MOST IMPORTANT FOR REDUCING INEQUALITY FALL INTO THREE LARGE GROUPS: PROVIDING OPPORTUNITIES FOR HARD WORK, PROVIDING PROTECTION FROM SHOCKS AND CIRCUMSTANCE, AND ERADICATING CORRUPTION. The policies that are most often chosen as top priorities are social protection programs, job creation, eradicating corruption, free education, credit for SMEs, and free health care ([Table 3.4](#)). Job creation, credit for SMEs, and free education are all ways to provide opportunities for people to work hard and earn a higher income. Social protection programs and free health are ways to protect people from bad luck and a poor background. Finally, the high prioritization of eradicating corruption shows the perceived importance of preventing ill-gotten gains.

Providing opportunities for hard work, protecting people from shocks, and eradicating corruption are seen as top priorities for reducing inequality. (tab. 3.4)

| Question “What are the three most important policies for reducing inequality?” | |
|---|-----------------|
| Policy | Top 3 priority? |
| Social protection programs (Raskin, BLT, BSM, health insurance, etc) | 49% |
| Creating more jobs | 48% |
| Eradicating corruption | 37% |
| Free education for all | 30% |
| SME credit | 27% |
| Free health care for all | 17% |
| Increasing the minimum wage | 17% |
| Infrastructure improvements (roads, power, etc) | 14% |
| More subsidies (e.g., for agriculture, fuel, etc) | 14% |
| Improving schools | 10% |
| Grants to village level (e.g., PNPM) | 7% |
| Loans for the poor (not business loans) | 7% |
| Increasing the tax on the rich | 2% |
| Unemployment insurance | 2% |
| Equitable asset ownership (e.g., for land, forests, mines, etc) | 2% |

THESE PREFERENCES ARE LARGELY CONSTANT ACROSS ALL EDUCATION AND INCOME GROUPS. Social protection, more jobs and eradicating corruption are the top three for all subsets by income and education. While wealthier and more educated respondents prefer jobs to social protection and poorer and less educated respondents prefer social protection to jobs, both policies are chosen in the top three by at least 40 percent of all groups.

POLICIES THAT ARE UNLIKELY TO SIGNIFICANTLY REDUCE INEQUALITY RECEIVE LITTLE SUPPORT, MEANING THERE IS LITTLE PRESSURE TO ENACT THEM.

Fortunately, policies that are unlikely to reduce inequality receive relatively little support. Subsidies (including agricultural and fuel subsidies), which are wasteful of resources and do not tend to benefit the poor and vulnerable, are chosen in the top three by only 17 percent of people surveyed. While most Indonesians want cheaper fuel, they think there are more important priorities for government spending. Minimum wages, which are harmful for productive job creation if set too high, are chosen

by only 14 percent. A vocal minority advocate for higher minimum wages, but this policy does not receive broad support.

HOWEVER, SOME POLICIES THAT ARE KEY GOVERNMENT PRIORITIES OR THAT WOULD BE MOST EFFECTIVE IN REDUCING INEQUALITY ARE NOT POPULAR EITHER.

Two major government initiatives, investment in infrastructure and village-level transfers, also receive little support; 14 percent choose the first in the top three and only 7 percent choose the second. The lack of support for infrastructure in particular is worrying, as it is key to boosting growth and creating jobs. Government communications on infrastructure spending need to be stronger and clearer. With the strong support for jobs and lack of support for growth,⁷¹ linking infrastructure to job creation rather than economic growth may be more effective. Furthermore, increasing taxes on the rich receives only 2 percent of support, meaning any efforts to broaden the personal income tax base will need to be presented as compliance with existing laws (“people paying their fair share”) rather than tax increases.

⁷¹ The survey results find that 61 percent of respondents said they would prefer “lower income growth and lower inequality” over “higher income growth and higher inequality.”



OUR CONCLUSION

Addressing inequality takes time; it is urgent to begin now

ADDRESSING INEQUALITY IS LARGELY A LONG-TERM ISSUE. Inequality generally changes slowly over time, so a rapid reduction in the short term is unlikely. Some key policies for addressing inequality, such as more equal opportunities in health and education for today's children combined with better jobs tomorrow, will take a generation to bear fruit.

IT IS URGENT TO TAKE STEPS NOW. Remedial action takes time to have an effect, which means beginning now. Beginning now can also capitalize on both the political will that currently exists to tackle inequality, as well as the current popular support for taking action. Moreover, there is danger in delay. With many wealthier Indonesians opting out of public health, education and other services, there is the danger that they will neither be a strong driver for better public service delivery, nor supportive of increased and fairer public spending on these services funded through taxes.

In some areas, more needs to be known; the future research agenda should also be a priority

IN SOME AREAS, PARTICULARLY THE POLITICAL ECONOMY OF INDONESIA'S INSTITUTIONS AND THE NATURE OF CORRUPTION, NOT ENOUGH IS KNOWN ABOUT THE NATURE OF THE PROBLEM AND THE BEST ACTIONS TO TAKE. Not enough is known about the nature of corruption in Indonesia and how it drives inequality. Public

perceptions suggest that it is widespread, and high profile cases provide vivid examples of how the rules of game are being biased in favor of insiders or circumvented altogether without legal consequences. Both forms of corruption seem highly likely to be linked to inequality through lower growth, high wealth concentration and policymaking that exacerbates inequality (for example, rigid labor markets that prevent productive job creation or switching, or import restrictions that drive food prices higher). However, a political economy analysis is needed to identify the underlying causes. Which aspects of the political, economic and legal institutions in Indonesia provide the incentives for such rent-seeking to take place? When is it due to a lack of appropriate checks and balances, and when is it due to a lack of enforcement of these checks (whether through discretion on investigation and prosecution of potential corruption or the outright subversion of the legal process through judicial capture)?

IN OTHER AREAS, SUCH AS INFRASTRUCTURE, A CAREFUL ANALYSIS IS REQUIRED TO MAP LOCAL NEEDS TO INVESTMENT. The future research agenda also needs to look into how infrastructure can best be improved at the local level. For example, in different locations, different types of infrastructure might be needed to help improve access to services and markets or to generate jobs. The solution to access constraints might be bridges in one place, rural roads in another, and a port in yet another again. A detailed infrastructure needs analysis could be done using Indonesia's rich local-level data, including sub-district and village level poverty maps, and district, sub-district and village level facility data.

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