INDONESIA’S RISING DIVIDE

EXECUTIVE SUMMARY

AKU Indonesia

Akhiri Ketimpangan Untuk

THE WORLD BANK

Australian Aid

INDONESIA’S RISING DIVIDE
Indonesia's Rising Divide
is a product of the staff
of the World Bank. The
findings, interpretations,
and conclusions expressed
herein do not necessarily
reflect the views of the
Board of Executive
Directors of the World
Bank or the Government
they represent.

The World Bank does not
guarantee the accuracy of
the data included in this
work. The boundaries,
colors, denominations, and
other information shown
on any map in this work do
not imply any judgment on
the part of the World Bank
concerning the legal status
of any territory or the
endorsement or acceptance
of such boundaries.

For any questions
regarding this report,
please contact

Vivi Alatas
(valatas@worldbank.org)
and Matthew Wai-Poi
(mwaipo@worldbank.org).
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

November 2015, World Bank
Acknowledgements

*INDONESIA’S RISING DIVIDE WAS PREPARED BY THE WORLD BANK’S POVERTY GLOBAL PRACTICE TEAM IN THE JAKARTA OFFICE.* The team, led by Vivi Alatas (Lead Economist, GPVDR), provides technical and policy advice based on sound empirical research and analysis to the Government of Indonesia to support their efforts to reduce poverty, vulnerability and inequality.

Financial support for this report was provided by the Australian Department of Foreign Affairs and Trade through the trust fund for the Partnership for Knowledge-based Poverty Reduction. The trust fund is under the strategic oversight of Bambang Widianto, Executive Secretary of the National Team for the Acceleration of Poverty Reduction (*Tim Nasional Percepatan Penanggulangan Kemiskinan*, or TNP2K) and Rahma Iryanti of the National Development Planning Agency (*Badan Perencanaan Pembangunan Nasional*, or Bappenas).

This report was prepared by a core team led by Matthew Wai-Poi (Senior Economist, GPVDR) based on a series of background papers and presentations. The paper on the Distributional Impact of Fiscal Policy in Indonesia was written by Rythia Afkar (Consultant, GPVDR), Jon Jellema (Consultant, GPVDR) and Matthew Wai-Poi; on the Inequality of Opportunity by Grace Hadiwidjaja (Consultant, GPVDR), Ray Hervandi (Consultant, GPVDR), Matthew Wai-Poi and Laura Wijaya (Consultant, GPVDR); and on the Public Perceptions of Inequality by Taufik Indrakesuma (Consultant, GPVDR) with the guidance of Edgar Janz (Senior Knowledge Management Specialist, GPVDR) and Matthew Wai-Poi. Background presentations were developed on Top Incomes in Indonesia by Michaelino Mervisiano (Consultant, GPVDR), Imam Setiawan (Consultant, GPVDR), Matthew Wai-Poi, Monica Wihardja (Consultant, GPVDR) and Dody Suria Wijaya (Consultant, GPVDR); on Indonesia’s Middle Class by Ririn Purnamasari (Economist, GPVDR), Ikuko Uochi (Consultant, GPVDR) and Matthew Wai-Poi; and on the Inequality of Outcomes by Amri
Excellent comments were received from Peer Reviewers Luis-Felipe Lopez-Calvo (Lead Economist, GPVDR), Caterina Laderchi (Senior Economist, GPVDR), and Hal Hill (H.W. Arndt Professor of Southeast Asian Economies, Australian National University), as well as from Emma Allen (ILC), Chantelle Boudreaux (Consultant, GHNDR), Melissa Chew (Consultant, GHNDR), David Gottlieb (Department of Foreign Affairs and Trade, Australian Embassy), Pandu Harimurti (Health Specialist, GHNDR), Ahyo Ihsan (Economist, GMFDR), Yue Man Lee (Economist, GMFDR), Norman Loazya (Lead Economist, DECMG), Neil McCulloch (Director, Economic Policy Program, Oxford Policy Management), Puti Marzoeki (Senior Health Specialist, GHNDR), Iene Muliati (Social Protection Specialist, GHNDR), Arvind Nair (Lead Economist, GSPDR), Eko Setyo Pambudi (Research Analyst, GHNDR), Samer al-Samarrai (Senior Economist, GEDDR), Ali Winoto Subandoro (Health Specialist, GHNDR), Ajay Tandon (Senior Economist, GEDDR), and Wei Aun Yap (Consultant, GHNDR), as well as unnamed DFAT staff. The report has benefited greatly from these comments.

The report was edited by Peter Milne and Edgar Janz, with support from Taufik Indrakesuma.

This report was produced under the overall guidance of Shubham Chaudhuri (Practice Manager, GMFDR), Ana Revenga (Senior Director, GPVDR), Carlos Silva-Jauregui (Lead Economist, GPVDR) and Salman Zaidi (Practice Manager, GPVDR). Strategic guidance and key comments were provided by Rodrigo Chaves (Country Director, EACIF), Ndiame Diop (Lead Economist, GMFDR) and Cristobal Ridao-Cano (Program Leader, EACIF).

The report draws from joint work on fiscal incidence with a team from the Fiscal Policy Office, led by Luky Alfirman (Head of Macroeconomic Policy Center, PKEM-BKF) and including Arti Dyah Woroutami (Head of Welfare and Labor Sub-division of PKEM-BKF) and Ahmad Fikri Aulia (Executive of Welfare and Labor Sub-division of PKEM-BKF). The fiscal incidence work adopts the Commitment to Equity approach. Launched in 2008, the Commitment to Equity (CfEQ) project is an initiative of the Center for Inter-American Policy and Research (CIPR) and the Department of Economics, Tulane University, the Center for Global Development, and the Inter-American Dialogue. Developed by Nora Lustig and her team at Tulane University, the Commitment to Equity diagnostic tool relies on a comprehensive fiscal incidence analysis designed to assess how taxation and public expenditures affect income inequality, poverty, and different socioeconomic groups. For more details, see www.commitmenttoequity.org.

The report also draws on joint work on top incomes in Indonesia, conducted in collaboration with Luky Alfirman of the Fiscal Policy Office and Bank Indonesia. The Bank Indonesia team includes N.A. Anggini Sari (Deputy Director, Division Head, Credit Information Regulation, Licensing, and Development Division) and Sani Eka Duta (Assistant Director, Credit Information Division). The perceptions data used in this report and the perceptions background paper were kindly provided by the Indonesian Survey Institute (Lembaga Survei Indonesia, or LSI).
## TABLE of CONTENTS

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>OVERVIEW</td>
<td>01</td>
</tr>
<tr>
<td>EXECUTIVE SUMMARY</td>
<td>05</td>
</tr>
<tr>
<td>01 THE TREND IN INEQUALITY IN INDONESIA</td>
<td>07</td>
</tr>
<tr>
<td>02 WHY INEQUALITY IS RISING</td>
<td>09</td>
</tr>
<tr>
<td>03 WHY INEQUALITY MATTERS</td>
<td>11</td>
</tr>
<tr>
<td>04 REDUCING INEQUALITY</td>
<td>21</td>
</tr>
<tr>
<td>05 OUR CONCLUSION</td>
<td>33</td>
</tr>
</tbody>
</table>
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 benefitted 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 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.
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.

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.

EXECUTIVE SUMMARY

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, Indonesia’s Rising Divide. All of the material here is discussed in significantly more detail in the main report, which also includes sources and references for all data, figures and claims in the Executive Summary. The main report, in turn, draws on a series of technical background papers that are individually referenced in this Executive Summary.
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 2). Even this elevated level, however, is likely to be underestimated because household surveys tend to fail to capture the richest households. 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 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 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 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, 2015a)

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 Not Quite Middle: Who is the middle class, how big is it and how are they different?” (World Bank, 2015b).
CHAPTER 1  TRENDS IN INEQUALITY IN INDONESIA

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

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

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 3)

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.


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

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 (2015b) for more details.

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

Gini coefficient in East Asia 1990s & 2000s

Population share by class 2002–2014
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

---

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, 2015b).
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.
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 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.

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

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. 5)

1. **Assets**
   - Different households have different quantities and qualities of assets
     - Human resources
     - Financial resources
   - Shocks directly reduce income generating assets; e.g., natural disaster, illness

2. **Income**
   - Households receive incomes from what each resource generates
     - Human resources generate labour income
     - Financial resources generate interest and rents

3. **Consumption**
   - Households spend income on consumption (determining inequality today), but the more family members the farther the income is spread
     - Shocks increase the cost of living; e.g., food price shocks

4. **Investment**
   - Income not spent is invested, in better financial and human resources for their children (determining inequality tomorrow through more assets)

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 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. 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 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 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

Stunting by country (percent)

<table>
<thead>
<tr>
<th>Country</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Thailand</td>
<td>16</td>
</tr>
<tr>
<td>Malaysia</td>
<td>17.5</td>
</tr>
<tr>
<td>Vietnam</td>
<td>23.3</td>
</tr>
<tr>
<td>Philippines</td>
<td>33.3</td>
</tr>
<tr>
<td>Myanmar</td>
<td>35.3</td>
</tr>
<tr>
<td>Indonesia</td>
<td>39.1</td>
</tr>
<tr>
<td>Cambodia</td>
<td>41.0</td>
</tr>
</tbody>
</table>

There is a strong link between stunting and worse outcomes later in life. Stunting is much higher in Indonesia than most neighboring countries. (fig.6)

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.7)

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

SOURCE
WHO Child Nutrition Indicators.

SOURCE
susenas

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, 2015c).
Poorer families tend to be larger, which means that resources are spread thin. 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.8)  
Enrolment of 13-15 year olds by parents’ per capita consumption quintile

...but increasing enrolment rates mask differences in the quality of education across schools and regions... (fig.9)  
Quality of schooling facilities and teachers (percent)

SOURCE  
susesas 2012
Podes 2011  
Infrastructure Survey

- National
- Rural
- Urban
- Maluku/Papua

SOURCE: INDONESIA’S RISING DIVIDE
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 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 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 10, OECD 2015).

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

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

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

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 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 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.
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 1.0 percentage point of higher real wage growth each year between 2001 and 2014. 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.

RISING 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.

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

Employment by education level, 2002-13 (percent)

<table>
<thead>
<tr>
<th>Year</th>
<th>Primary or Less</th>
<th>Junior Secondary</th>
<th>Senior Secondary</th>
<th>Tertiary</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002</td>
<td>47.78</td>
<td>17.55</td>
<td>6.74</td>
<td>32.93</td>
</tr>
<tr>
<td>2013</td>
<td>46.94</td>
<td>18.46</td>
<td>25.11</td>
<td>18.6</td>
</tr>
</tbody>
</table>

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

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

<table>
<thead>
<tr>
<th>Skill</th>
<th>Very Important</th>
<th>Skill Gap in Staff</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basic Skills</td>
<td>50.92</td>
<td>20.66</td>
</tr>
<tr>
<td>Thinking Skills</td>
<td>46.41</td>
<td>22.78</td>
</tr>
<tr>
<td>Behavioral Skills</td>
<td>45.13</td>
<td>23.27</td>
</tr>
<tr>
<td>Computer Skills</td>
<td>44.64</td>
<td>23.74</td>
</tr>
<tr>
<td>English Skills</td>
<td>45.64</td>
<td>22.74</td>
</tr>
</tbody>
</table>

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
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.
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 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

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

<table>
<thead>
<tr>
<th>Country</th>
<th>Share of total wealth held by richest 1 percent of households (percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Russia</td>
<td>66.2</td>
</tr>
<tr>
<td>Thailand</td>
<td>50.5</td>
</tr>
<tr>
<td>Indonesia</td>
<td>50.3</td>
</tr>
<tr>
<td>India</td>
<td>49.0</td>
</tr>
<tr>
<td>Brazil</td>
<td>45.7</td>
</tr>
<tr>
<td>Chile</td>
<td>41.1</td>
</tr>
<tr>
<td>South Africa</td>
<td>40.1</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>38.6</td>
</tr>
<tr>
<td>United States</td>
<td>38.4</td>
</tr>
<tr>
<td>Israel</td>
<td>38.3</td>
</tr>
<tr>
<td>China</td>
<td>37.2</td>
</tr>
<tr>
<td>Korea</td>
<td>35.9</td>
</tr>
<tr>
<td>Mexico</td>
<td>33.7</td>
</tr>
<tr>
<td>Poland</td>
<td>33.0</td>
</tr>
<tr>
<td>Colombia</td>
<td>32.8</td>
</tr>
<tr>
<td>Taiwan</td>
<td>32.7</td>
</tr>
<tr>
<td>Switzerland</td>
<td>30.9</td>
</tr>
<tr>
<td>Romania</td>
<td>30.8</td>
</tr>
<tr>
<td>Sweden</td>
<td>30.8</td>
</tr>
<tr>
<td>Austria</td>
<td>29.3</td>
</tr>
<tr>
<td>Denmark</td>
<td>29.3</td>
</tr>
<tr>
<td>Norway</td>
<td>28.9</td>
</tr>
<tr>
<td>Singapore</td>
<td>28.6</td>
</tr>
<tr>
<td>Germany</td>
<td>28.1</td>
</tr>
<tr>
<td>Ireland</td>
<td>27.3</td>
</tr>
<tr>
<td>Portugal</td>
<td>27.1</td>
</tr>
<tr>
<td>Spain</td>
<td>27.0</td>
</tr>
<tr>
<td>Portugal</td>
<td>26.7</td>
</tr>
<tr>
<td>Greece</td>
<td>26.7</td>
</tr>
<tr>
<td>Canada</td>
<td>24.4</td>
</tr>
<tr>
<td>New Zealand</td>
<td>23.9</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>23.3</td>
</tr>
<tr>
<td>Netherlands</td>
<td>22.7</td>
</tr>
<tr>
<td>Finland</td>
<td>22.0</td>
</tr>
<tr>
<td>Italy</td>
<td>21.7</td>
</tr>
<tr>
<td>France</td>
<td>21.4</td>
</tr>
<tr>
<td>Australia</td>
<td>21.1</td>
</tr>
<tr>
<td>Japan</td>
<td>17.9</td>
</tr>
<tr>
<td>Belgium</td>
<td>17.3</td>
</tr>
</tbody>
</table>

High wealth concentration and its consequences

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.

Why inequality is rising

Chapter 3

Indonesia’s rising divide
THE 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
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 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 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.14)

*Access to health insurance (percent)*

<table>
<thead>
<tr>
<th>Category</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>POOR</td>
<td>55.3</td>
</tr>
<tr>
<td>VULNERABLE</td>
<td>49.4</td>
</tr>
<tr>
<td>EMERGING CONSUMER CLASS</td>
<td>44.9</td>
</tr>
<tr>
<td>CONSUMER CLASS</td>
<td>50.0</td>
</tr>
</tbody>
</table>

### 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.15)

*Poverty and vulnerability rates in Indonesia, 2014 (percent)*

<table>
<thead>
<tr>
<th>Category</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>POOR</td>
<td>11.3% (28 million)</td>
</tr>
<tr>
<td>VULNERABLE</td>
<td>26.9% (68 million)</td>
</tr>
</tbody>
</table>

**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 (2015a) for details.
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 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 have 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 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. 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.

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 Gini’s are higher than consumption Gini’s 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.17)

Rate of Annual Growth (in %)

Aver age of Income per Capita Growth Rates

5.91%
In addition to adequate funding, the most important policy action underpinning a better start in life for all is improved local service delivery.

01 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.

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 benefited 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.

*Box 1 (End.)*

---

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

**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 underserviced 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
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,
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:

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
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 CRIPES 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
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
Transportation problems are a major constraint. The planned reallocation of fuel subsidy savings and productivity. This will have multiple benefits._access to services; a quarter of Indonesia's urban 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.

- **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 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.

---

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.