

## Growth, equity, and poverty reduction in an East Asian giant

Indonesia presents an illuminating example of the long-term interactions of the three basic themes of this report on equity and development:

- The importance of market-driven processes in determining the distribution of opportunities and incomes.
- The role of political processes, and the engagement of the poor in these processes, in determining the policy framework for market and asset accumulation.
- The overriding dominance of institutions in determining the long-run conditions of governance for markets and politics to operate.

These complex interactions require long periods of developmental evolution to observe and identify.

Indonesia has substantial variance across all three of these themes. There is enough independence in the variance for each factor to sort out, if only roughly, what is driving what. In chapter 6, the political dimension of the economic performance of the Suharto regime was discussed. Here, we discuss the connections with policy choices.

Because Indonesia has been so important to the development profession, it has been studied for a long time. The Dutch exploited the Netherlands East Indies from the seventeenth century to early in the twentieth century. Then, under political pressure at home, the Dutch experimented with an “Ethical Policy” for the colony, and the poor benefited significantly. During the Great Depression, World War II, and the fight for Independence, the Indonesian economy deteriorated rapidly, and the poor suffered disproportionately. Java was the original home of the “dual economy” analyzed by Boeke (1946) and formalized by Lewis (1954). After declaring independence in 1945, President Sukarno eventually put

“politics in command” in 1959 and produced a ruinous inflation that brought much of the population to near starvation in the mid-1960s. It was with just cause that Gunnar Myrdal pronounced in *Asian Drama*, 1967, that “no economist holds out any hope for Indonesia.”

Indonesia’s rapid, pro-poor growth for the 30 years after the fall of Sukarno astonished the development profession and, along with other countries in East and Southeast Asia, Indonesia became the object of intense analysis.<sup>1</sup> In Indonesia, the weak starting conditions significantly influenced how the economic planners approached the task of linking growth to the poor. They designed a three-tiered strategy for pro-poor growth, which connected sound macroeconomic policy to market activities that were facilitated by progressively lower transaction costs. Those policies were linked to household decisions about labor supply, agricultural production, and investment in the nontradable economy.

The extent to which the poor benefited from growth depended on the array of assets they controlled: their labor, human capital, social capital, and other forms of capital, including access to credit.<sup>2</sup> Appropriate government policies also influence those dimensions, especially in health and education. The “road to pro-poor growth” started from desperately poor economic conditions, weak institutions, and a decade of political instability. It seemed that everything needed to be done at once. The key was to focus on restarting and then sustaining rapid economic growth, empowering poor households to enter the market economy, and reducing the costs and risks of doing so by investments to lower transaction costs.

The strategy worked for three decades: between 1967 and 1996, income per capita increased by 5 percent a year. The incomes of the bottom quintile of the income distribution, all individuals below the national

poverty line until the 1990s and all still subsisting on less than \$2 a day, grew at the same rate (or possibly slightly faster). The distribution of household expenditures had been remarkably stable, with the overall Gini coefficient staying within a narrow range between 0.31 and 0.36.<sup>3</sup> Rural inequality had actually declined significantly since the 1970s, when access to land allowed substantial benefits to be reaped from the green revolution. By the mid-1980s, the labor market had become the primary determinant of income in rural areas.

But when the Asian financial crisis hit in 1997 and President Suharto was forced to resign in the face of widespread rioting in 1998, the country was entirely unprepared in political or institutional terms to cope with the rapid changes needed in corporate and public governance. The crisis sharply lowered inequality, as urban real estate and financial markets collapsed. But the dramatic reduction in GDP—over 13 percent in 1998 alone—caused poverty rates to triple. Only after 2002 did poverty rates return to the previous lows observed in 1996. By 2004 they still had not returned to the trend rate of decline disrupted in 1998.

Explaining these trends in per capita incomes and their distribution requires an understanding of how markets, politics, and institutions jointly shaped the rapid, pro-poor growth strategy, its subsequent collapse, and current efforts to revive it. Any such explanation is bound to be controversial, and there is no formal model behind the story about to be told.<sup>4</sup> But the story is plausible and anchored in the historical record.

The story begins with two concerns of the emerging Suharto government in the late 1960s. The first was the misery and discontent of the rural masses, who had supported Sukarno’s communist leanings and populist rhetoric. After a decade of active discrimination against their livelihoods,



rural households were near starvation and thus an obvious source of opposition unless the new government could incorporate them in its development plans. Second, the hyperinflation of the mid-1960s, the total disintegration of the market economy, and the political chaos meant the entire population was ready for a more stable life. A strategy that promised stability and rural recovery would win wide support (as it would throughout densely settled East and Southeast Asia).

This is the message that Suharto delivered to his technocrats. This economic team had engaged Suharto and other senior military officials in economic training exercises at the Military College. The technocrats were handed the macroeconomic portfolio and told to deliver on what became known in Indonesia as the development trilogy—growth, equity, and stability. To many in the political and military arena, stability meant repressive measures to stifle dissent, but to the technocrats it meant restraining inflation (which they did in spectacular fashion in just three years) and stabilizing the rice economy, which was still a quarter of GDP and providing half the average Indonesian's daily calories. The institutions built to provide this stability, in both macro terms and in the food economy, became essential to the Suharto regime's success.<sup>5</sup>

Thirty years of rapid economic growth, with equally rapid rates of poverty reduction, was politically popular (the elasticity of reduction of the headcount poverty index with respect to growth in per capita incomes was about 1.3 during the Suharto era). Every five years, the polling results for parliament were gleaned for signs of disappointment with the development program. Despite the heavy hand of Golkar, the president's party, real information was flowing from villages up to the center through these elections.

Almost despite the intentions of the Suharto regime, political institutions were taking root (people expected to vote) and these institutions provided feedback to the policy approach of the government. There were other feedback mechanisms as well, and the ones that threatened stability were taken very seriously. After the 1974 riots in Jakarta in reaction to the visibly widening income distribution, especially in urban areas, the government responded brutally

by putting down the riots and imprisoning the student leaders. Then it mounted a serious effort to make the economy more equitable. The result, also stimulated by the world food crisis in 1973–4, was a major shift in priorities toward rural development and a specific push toward increasing domestic rice production. Behind this push were the objectives of stabilization and equity. To lose control of the rice economy was to lose control of what mattered to Indonesian society.

The restructuring of Indonesia's development approach after 1974, especially the preemptive devaluation of the rupiah in 1978, signaled the government's determination to include the poor in the development process. The stability of the Gini coefficient seen from the late 1960s to 2004 should not be taken as the result of market-driven forces in the face of given technology, but as a conscious government effort, led from the macroeconomic arena by the technocrats, to stimulate pro-poor growth.<sup>6</sup> This effort succeeded in spectacular fashion until the mid-1990s, when cronyism and the growing influence of Suharto's children on economic decision making caused the approach to unravel.

Part of the problem of post-Suharto governments has been their need to distance themselves from this record of repression and cronyism, despite three decades of pro-poor growth. This tension brought the failure of political and institutional development during the Suharto era to the fore. Questions about causality remain, particularly whether rapid, pro-poor growth can be implemented by authoritarian regimes. Indonesia's record, along with that of most of East and Southeast Asia, indicates that they can. But is such growth sustainable? And which is more important for managing long-run, pro-poor growth: good economics or good institutions?

In Indonesia, there was no "chicken or egg" problem. Something had to be done at once in view of widespread destitution and political chaos, and the sequencing was clear. Rapid, pro-poor economic growth was imposed by an authoritarian regime concerned about its survival. But this same regime also imposed on itself commitment mechanisms to make the growth process market friendly to rural households and to Chinese capitalists—that is, both ends of the economic system. Inflation was brought under control by a law requiring the

national budget be balanced quarter by quarter—a law Suharto basically imposed on himself, but then touted to all constituents as a rule the government had to live under. To build confidence among the Chinese business community, the government opened the capital account in 1970 when it unified the exchange rate. The flow of foreign exchange to and from Singapore and Hong Kong was a sensitive barometer of the investment climate.

Thus the two constraints on the presidency, which Suharto felt personally and used as motivation for his bureaucracy and government (not the same thing in Indonesia), were the need for rural areas to participate in growth, and the need to keep the investment climate highly favorable for Suharto's business partners. The response to both constraints was an economic package—low inflation, food price stability, an open economy, and massive investments in rural infrastructure—that generated rapid pro-poor growth. But another part of the investment climate, a part only for those favored business partners, involved special licenses, trade protection, and lucrative access to domestic markets. This part unraveled the "open economy" part of the growth package.

The Suharto legacy, despite the deep commitment to pro-poor growth, did not build the groundwork for a political and institutional framework that would ultimately support it. A deep tension developed between the institutional framework to keep the open economy functioning efficiently and the political controls to keep the cronies' businesses profitable. Without political feedback about these very same political controls, the regime was blindsided by the ferocity of the opposition to its management of the Asian financial crisis. The depth of the crisis, both economic and political, reflected the vacuum of institutions in place to cope with an alternative political system.

The climb out of the chaos of 1998 mirrors that from the 1965 era, but this time without order imposed from above. The eagerness and skill with which the Indonesian population has participated in the democratic process suggests that social and political order will now be far more sustainable. The challenge now is to translate the same democratic process into rapid and sustainable pro-poor economic growth.

