

# Beyond the Neoclassical Approach: Addressing Income Inequality in Indonesia Through Institutional Economics

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## ABSTRACT

Indonesia is a developing country that still has many economic development problems. Income inequality is one such problem. In the Cold War era, many countries, including Indonesia, began to adopt the neoclassical economic system used by the West to stem the influence of Soviet communism. Unfortunately, much literature states that the neoclassical school of economics creates a wide curtain between the rich and the poor. Income inequality is a problem that can lead to social unrest, and it was proven that in 1997/1998, there was a multidimensional crisis caused by this widening inequality. The ability of neoclassical economics to answer Indonesia's economic challenges is starting to be doubted. This is due to quite complex problems in the structure of Indonesian society, which still adheres closely to local culture, norms, and customs in carrying out its economic activities. Adopting a new institutional economic system is deemed more appropriate to address the challenges of income inequality in Indonesia than the neoclassical economic system. The new institutional economic system is able to explain that differences in culture, societal structure, and norms will shape different economic behavior, so the role of institutions and externalities is needed to support this form of economic behavior. In this article, we will explain the condition of income inequality in Indonesia, the use of neoclassical schools of thought in developing countries such as Indonesia, and the role of new institutional economics in explaining the problem of income inequality in Indonesia.

**Keywords:** Income inequality, Culture, Economic crisis, Externalities, Collectivism

## 1. Introduction

In general, all countries in the world have the same goal to increase the economic growth. The usual way to detect the increment of economic growth can be measured in the Gross Domestic Product (GDP).<sup>1</sup> Many countries, including Indonesia, adopted the neoclassical school of thought to increase economic growth. After the Second World War, a lot of Western countries gained strong economic growth, especially the United States, which has become a winning country. They spread their influence to tackle the eastern bloc of the Soviet Union with a framework that could boost economic growth in many developing countries such as Indonesia.

This framework is called neoclassical economics. The economics used and taught in many countries emerged from Paul Samuelson's book "Economics, an Introductory Analysis" (1948). The central assumption in neoclassical economics concerns the importance of market efficiency and minimal government intervention. It does not mention that there is market failure,<sup>2</sup> which will cause inequality.

Indonesia faces several challenges in the development of its economy. One issue that consistently emerges is income inequality, which causes the non-optimal distribution of resources and economic instability and may

<sup>1</sup> OECD defines Gross domestic product (GDP) as the standard measure of the value added created through producing goods and services in a country during a certain period.

<sup>2</sup> A situation in a free market where the market has become inefficient in distributing goods and services.

even lead to an economic crisis ([Bordo & Meissner, 2012](#); [Kumhof & Rancière, 2011](#)). While some inequality is inevitable in a market-based economic system because of differences in talent, effort, and luck, excessive inequality could erode social cohesion, lead to political polarization, and ultimately lower economic growth ([Berg & Ostry, 2011](#); [Rodrik 1999](#)). Income inequality happens when a few people owe a large portion of consumption and income. In Indonesia, the gap was wider from 1980 to 1996, right before the crisis happened. The higher gap between the poor and the rich people led to an economic crisis, which became a social crisis during 1997/1998.

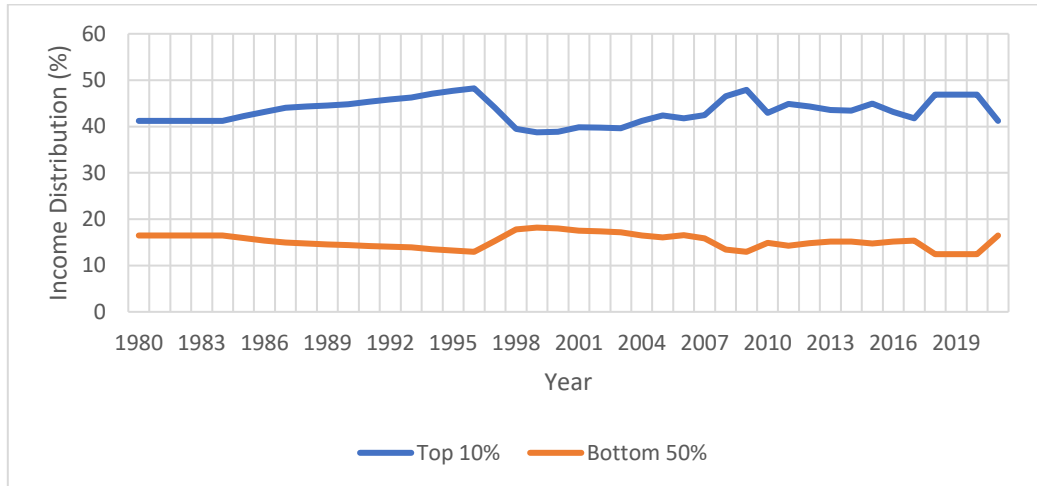


Figure 1. The Income Distribution (%) during 1980-2021 in Indonesia  
Source: World Inequality Database (2022)

Economic stresses are leading to social and political problems, resulting in President Suharto's resignation in 1998. The most impacted are the people from the high-income class, while the poor people are helped by the government by various programs and safety net. After the crisis, inequality will slightly increase again till 2021. From Graph 1 above, we can see that the top 10% of the people acquire 40-50% of the income distribution while the bottom 50% of the people acquire less than 20% during 1980-2021. The World Inequality Report in 2022 indicated that Indonesia's level of inequality has been rising. In 2021, the top 10% earn €PPP56,100 while the bottom 50% earn only €PPP2,900. It means that people in the top 10% earn, on average, 19 times more than people from the bottom 50%. Graphs 2 and 3 below show that the Gini Ratio is still high despite the increase in Gross Domestic Product, which means the increment of GDP could not solve the disparity problem. The trickle-down effect does not happen in the economy. The rich remain in high wealth, while the poor become worse off

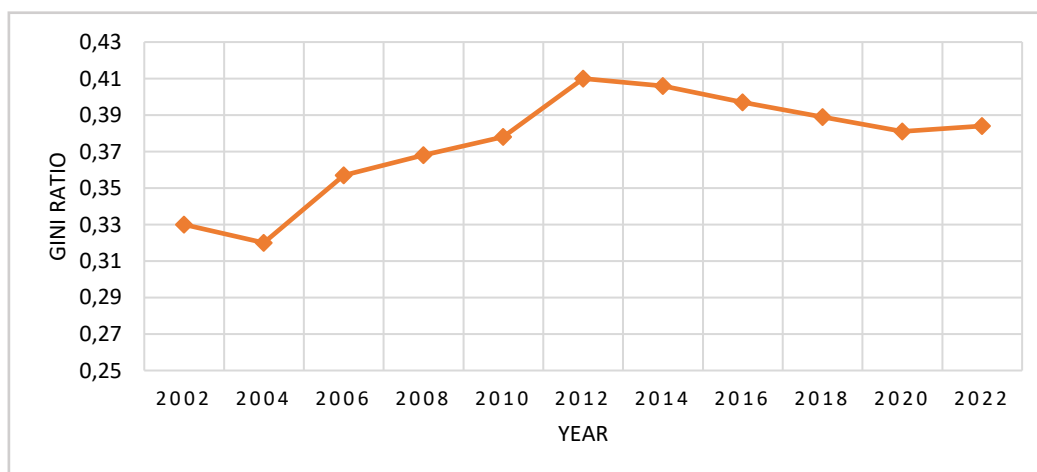


Figure 2. Gini Ratio in Indonesia from the last 2 decades (2002 – 2022)  
Source: BPS-Statistic of Indonesia

Pape et al. ([2023](#)) explained that numerous factors cause income inequality in Indonesia. Inequality can stem from two sources: (i) differences in preferences, abilities, and effort and (ii) differences in access to opportunities (“unfair” inequality). After a period of balanced economic expansion, the introduction of

economic liberalism in response to the 1997 financial crisis has given rise to an economy where those at the top are able to claim far the most significant portion of growth.

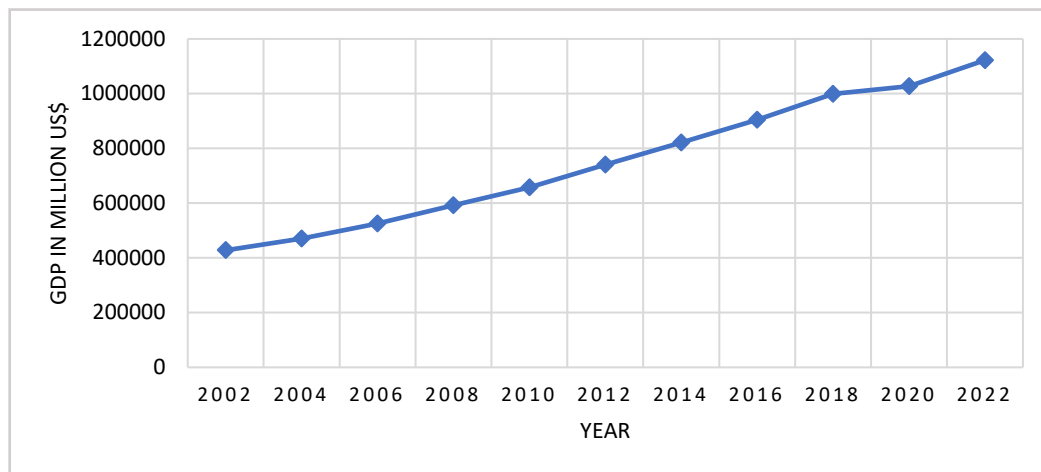


Figure 3. Constant=2015 GDP in Indonesia from last 2 decades (2002-2022)  
Source: BPS-Statistic of Indonesia

Consequently, this has led to a rise in their political dominance, as those at the top have harnessed the power that wealth affords to manipulate regulations in their favour, to the detriment of the majority. The “unfair” inequality, such as barriers to education and the high gap between males and females in the workforce, contributed to this distortion. Gender inequality, a longstanding form of disparity, is widespread in Indonesia and serves as both a driving force and a result of economic inequality. Chancel et al. (2022), through their report, show that the female labour income share in Indonesia is only equal to 25%. The Central Agency of Statistics (BPS) in 2023 reported that elementary school graduates still dominate the productivity of labour by 39.76%. This unequal access lowers competitiveness, thus receiving lower wages.

## 2. Litelatur Review

### 2.1. Adaptation of Neoclassical Economics in Developing Countries: Challenges and Criticisms

Numerous economists think that neoclassical economics might be well-suited to developed countries but needs adjustment if we want to adapt to developing countries. This fact is caused by totally different aspects between developing countries and developed countries. The implementation of neoclassicism in developed countries such as the United States is inseparable from the many criticisms raised, which are inequality, environmental devastation, and the insufficient explanation of the social and cultural factors in shaping economic decisions and outcomes. The focus orientation should be on equal justice and income distribution with deep consideration in solving the problems of poverty, education, property rights, and the workforce.

Paul Omerod (1995) also said in his book “The Death of Economics” that neoclassical economics is not relevant anymore due to the emergence of several problems. He thinks that government interventions need to be made for the income distribution among the people. One of the assumptions in neoclassicism is that the market player has the same perfect information and zero transaction cost,<sup>3</sup> which is not likely to happen in the real world. In fact, many people, mainly from lower-income groups, have less information rather than the high-income group. They do not know information such as market conditions or financial markets better than the top ones. Eventually, the poorest will be disadvantaged by the market activities, which result in uneven distribution of benefits. The uneven information leads to the existence of transaction costs.

Gunnar Myrdal (1972), from his magnum opus in “Asian Drama: An Inquiry into the Poverty of Nations,” also said that economics theory, which is taught and implemented in various developing countries using neoclassical economics, is more suitable for high-income countries. He thinks that this economic theory is unable to answer the economic problem in developing countries. Several reasons why neoclassicism is less suitable for developing countries is the rational assumption of the differences in social norms and culture. The limited access to information due to poverty, inequality, and barriers to gaining education happened more often

<sup>3</sup> Transaction cost is any cost that is incurred from any transaction.

in developing countries than in high-income countries. Thus, developing countries like Indonesia do not gain rational information. In contrast, neoclassical assumptions state that individuals act rationally to maximize their utility.

## 2.2. *The Role of New Institutional Economics to Examine Income Inequality in Indonesia*

Various sides concerned about the failure of the neoclassical strand mainly emerged the income inequality problem in Indonesia; therefore, it needs another alternative to provide a better idea for developing countries like Indonesia. One of the alternatives is New Institutional Economics. Names like Marx, Veblen, Weber, Coase, Williamson, and North come to the surface to develop this strand of economics. In general, new institutional economics views economics as a unity with other social sciences, like psychology, sociology, politics, anthropology, history, and law. New institutional economics is more flexible than neoclassic economics because it emphasizes "rules" or economic policies, not the dominance of free market roles. Where the institutional framework determines the types of skills and knowledge that are considered to have maximum results (North, 2003). Williamson (2000) has introduced the evolution of the new institutional economics theory through four levels of "social analysis." the first level is considered the lowest level is social theory, the second level is economics of property rights, the third level is transaction cost economics, and the fourth level as the highest level is resource efficiency and incentive structure originating from neoclassical economics or agency theory. Therefore, it is essential to gain insight into the relationship between social capital and rural welfare (Ali, 2006). The new institutional economics deepen their focus on non-market institutional, like recognizing that different cultures and societies have distinct institutions and norms that shape economic behaviors, emphasizing the role of institutions and the externalities.

## 3. Method

This research adopts a descriptive analysis methodology, which focuses on systematically examining and interpreting phenomena as they occur in their natural state. The primary objective of this approach is to provide a detailed and accurate representation of the characteristics, relationships, and patterns inherent in the subject under investigation, without engaging in variable manipulation or hypothesis testing.

Descriptive analysis encompasses the collection, organization, and interpretation of qualitative or quantitative data in a structured manner. This method is particularly valuable for exploring emerging topics, establishing foundational insights, and offering a comprehensive understanding of specific issues.

Through the application of this approach, the study seeks to generate an objective portrayal of the observed phenomena, contributing to a deeper understanding of the research context while establishing a solid foundation for subsequent investigations.

## 4. Result

### 4.1. *Indonesian Culture into the Economic Preference*

Indonesia still holds a significant portion of its culture in the economic behavior of its people. Indonesian culture places a strong emphasis on collectivism and social harmony. It can influence economic behaviors by promoting cooperation and social cohesion within communities and among business partners. Trust and relationships are crucial in economic transactions. The moral and cultural aspects will influence preferences, while the technical and cultural aspects will affect beliefs (Casson, 1991). Although these two aspects are distinguished, they are interrelated. The technical and cultural aspect consists of habits that motivate individuals to create an environment that supports efficiency, such as hard work, time management, etc. Conversely, the moral and cultural aspect involves group habits that encourage people to treat others well, like honesty and integrity. It helps different individuals coordinate their decisions better, resulting in lower transaction costs.

In addition to reducing transaction costs, the impact of the moral aspect on efficiency also compensates for lost property rights. It is related to the possibility of having important jobs that may need to offer more material rewards. Indonesia has many important job positions for society and culture but receives only a small amount of incentive, such as Abdi Dalem<sup>4</sup>. They choose to become Abdi Dalem not because of the wage but because

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<sup>4</sup> Abdi Dalem is also a 'cultural servant.' A servant of culture is a person who can and is able to provide a role model for the wider community. Abdi Dalem must be able to be an example of life in society, act based on integrity, and

of the moral culture. Things like this can never be considered in the neoclassical school of thought. They think that individuals work according to economic incentives only, but in fact, many factors, such as social and cultural, affect a lot of economic decisions. The new institutional economics can be involved in regulating job sectors and career opportunities. It includes policies that reduce income inequality between various types of jobs. Minimum wage regulations, working hour rules, and worker rights protection are examples of regulations that can help ensure that workers in various fields have fair access to income.

#### 4.2. *Individualism vs Collectivism*

In Indonesia, social interaction is rooted in the idea of working together as a group and cooperating. Several key concepts in Indonesian society are based on this fundamental principle, and one of them is known as "Gotong royong," which can be translated as "mutual assistance." Gotong Royong is considered a personal responsibility towards the community, involving sharing responsibilities among community members. This type of interaction can lead to the development of enduring friendships and the building of trust. Communities that embrace Gotong Royong share their duties and help prevent conflicts among their members. It represents a sense of social unity within smaller community circles. Gotong Royong can be observed in various social activities, such as "Kerja Bakti," which involves collaborative efforts to clean up the neighborhood. This collectivist dimension of culture outweighed the individualism in neoclassic thought. This spirit could prevent social conflict between rich and poor people even if it is managed adequately through the government; it would have potentially reduced gap income disparities among people.

Culture also affects the role of institutions. Graef (1994) found that in societies that value collectivism, traditions, and informal ways of doing things are essential. These societies often lack strong institutions that can check the power of a few individuals, as is common in individualistic countries. In places with strong institutions and transparent governance, contracts are better enforced. In collectivistic countries, where institutions and transparent decision-making are less common, power tends to be concentrated in a small group. This concentration of power, combined with infrequent leadership changes, can result in wealth being concentrated among a select few. That is why new institutional economics takes a role by providing solid laws and rules of the game between institutions. So, it can be transparent and transform good governance.

#### 4.3. *Environmental Externalities and Their Impact on Income Inequality*

There are numerous cases in Indonesia where pollution from the firm affected the environment surrounding the firm location and brought negative externalities into the environment and to society, such as pollution. The research from Salim (2018) found that the public health of the population living in coastal areas in Cilegon tends to experience acute respiratory infections (ARI) due to air pollution from many medium to heavy industries. Many industries choose areas with affordable land prices to construct their facilities. Unfortunately, many low-income communities reside in these areas. This results in many low-income residents in the vicinity of the factories experiencing the direct impact of the negative externalities generated by these factories, such as health issues and reduced property value for residents. It exacerbates income inequality, placing a more significant burden on those with fewer resources. While Neoclassic argued that externalities are a market failure. They typically advocate for government intervention to address negative externalities. They often propose implementing taxes, regulations, or tradable permits to internalize the external costs and increase market efficiency. If the tax burden is lower than the profit the company earned, it will continue its expansion. New institutional economics see it differently. The Coase Theorem suggests that in the absence of transaction costs and with clearly defined property rights, private bargaining between affected parties can lead to efficient solutions to externalities. Well-defined property rights are essential for understanding who bears the costs or enjoys the benefits of externalities. Institutions establish and enforce property rights, affecting how externalities are managed. However, applying the Coase Theorem in the real world can be challenging for several reasons. One of the critical challenges is the presence of transaction costs, which can make negotiations and agreements difficult. Additionally, property rights are not always clear, and parties may need more information or resources for efficient bargaining.

### Conclusion

The new institutional economics strand is suitable for a multicultural country like Indonesia, which is one of the most geographically and culturally diverse countries in the world. Indonesia has over 17,000 islands, over

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understand etiquette. Therefore, the servants of the Yogyakarta Palace always show a smile that is bright, friendly, and high-mannered.

200 ethnic groups, and over 700 local dialects and spoken languages. Bahasa Indonesia is one national language, and Indonesian people follow more than seven legal religions. Therefore, it indeed impacts people's behavior, way of life, formal and informal law, and policy making. Furthermore, it needs a different approach to the economics strand, which includes all aspects.

The income inequality problem in Indonesia still exists even when the national output increases yearly. Income disparities are a big issue that can transform into multidimensional problems and social unrest, like what happened in 1998. Implementing neoclassical economics creates a vast income gap between the poor and the rich. The relationship between culture, institutions, transaction cost, and externalities in the economy cannot be explained by neoclassic thought because of its central assumption that the market is always allocated effectively. The preference for a job for morality and integrity rather than a higher wage contradicts the neoclassical assumptions. The differences in the ideology of collectivism also play a role in inequality.

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