Chapter 1
Introduction

Abstract Dualism is closely linked with inequality. Any process of development entails forces of dispersion (centrifugal) and forces of concentration or agglomeration (centripetal). The tendency for activities to concentrate is driven by the external economies that exceeds the negative externalities (higher prices, congestion, etc.) caused by the concentration. On the other hand, external economies can help mitigate the inequality between MSMEs and large businesses by offering benefits to MSMEs if they work through clusters for collective action.

Keywords Agglomeration · External economies · Spatial distribution · Policy interplay · Institution

Defined as the state of being dual or consisting of two parts, dualism is reflected in the co-existence of two systems, i.e., large modern sectors (core regions) and small traditional sectors (periphery regions). It occurs everywhere, developed and developing countries alike. It only differs in characteristics and degree. Among several indicators of economic dualism, the most widely applied is the productivity gap or the relative labor productivity. The productivity gap between regions within a country indicates regional dualism, and the productivity gap between small and large businesses denotes business dualism.

The sources of productivity gap between regions are found to be not mutually exclusive. They range from industry mix, capital intensity, investment in information and communication technology (ICT), and the extent of product market regulation and labor market flexibility (OECD, 2018). Location-specific factors including local institutions matter too. Acemoglu and Dell (2010) argued that the availability of local public goods and the security of property rights in developing countries significantly explain the variation of relative productivity between regions within a country. Although dualism between large and small firms, income and wage differentials are sometime used as an alternative measure, productivity gap remains the most important indicator. The relative productivity difference between large and small firms fluctuates considerably across countries. Typically, the productivity of small firms is in the range of 20–60% of that of larger firms, although the number varies between sectors.

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Dualism has a close link with inequality. By using the ratio of labor productivity in agriculture to that in the rest of the economy as a measure of economic dualism, Bourguignon and Morrisson (1998) showed that, given a set of control variables, the relative labor productivity plays a major role in explaining the differences in income distribution across developing countries. For Indonesia, the average relative labor productivity during the last decade has been around 0.36 compared to 0.38 during the 1990s decade.

But dualism goes beyond economics. In countries where interregional inequality is high and productivity gap between small and large businesses is wide, the concept of social dualism is highly significant. Incorporating it into economic dualism and inequality, however, increases the complexity of the analysis. Yet, it is imperative in our case and is precisely the approach we take in the book. By using the case of Indonesia, the focus of the analysis is on the inequality between regions and the challenges surrounding the efforts to improve the country's micro small and medium enterprises (MSMEs). The main intention is to understand the key factors and forces behind the country's interregional inequality, and the reasons behind difficulties to boost MSME competitiveness. Note, however, that while the conceptual analysis presented in the book can be applied to MSMEs in general, in Indonesia and other countries alike, the survey results reported in Chap. 4 are based almost entirely on micro and small enterprises (MSEs) in various regions throughout Indonesia.

The relevance of social dualism for Indonesia was first shown by a Dutch economist cum lawyer, J. H Boeke, in his landmark study on the causes of the dualistic characteristics in underdeveloped countries (Boeke, 1953). In the context of our book, one of the implications of Boeke's study is the need to take into account the characteristics of dualistic society if we intend to have a better understanding about the persistence of interregional inequality and the reasons why a good majority of MSMEs had difficulties to improve their performance. For that purpose, the role of institution and social capital cannot be ignored. Insofar the prevailing institution and social capital are shaped by the characteristics of the society, the interactions between policies and those two may hold the key to the problem. Making policies effective or be responded positively by the MSMEs requires a good comprehension about such interactions.

The starting point of the analysis is the recognition that any process of development entails forces of dispersion (centrifugal) and forces of concentration or agglomeration (centripetal). The interplay of those two forces determines the spatial configuration of activities. Interregional inequality occurs when the agglomeration forces are stronger than the dispersion forces. The inequality effect of it reflects the dualism of all sorts. The tendency for activities to concentrate is driven by the external economies that exceeds the negative externalities caused by the concentration (higher prices and costs, congestion, etc.). On the other hand, the same external economies can help mitigate the inequality between MSMEs and large businesses by offering benefits to the MSMEs if they work through clusters or operate in close proximity to each other.

It has been long recognized that spatial concentration of activities can be the socio-economic engines for competitiveness and growth (Azis, 2020a, 2020b; Krugman, 1991a; Porter, 1998). When activities concentrate in few regions within a country, national efficiency improves, but the gap between those regions and the rest of the country tends to widen, that is, the interregional inequality increases. The resulting equilibrium is therefore sub-optimal. When firms and other activities agglomerate in few localities or areas within a region, either organically or lured by government-provided incentives (e.g., industrial zone), both the region's growth and the inequality between localities tend to increase, which is another sub-optimal equilibrium. The source of the sub-optimality is obviously the arising inequality or divergence between the core and the periphery. Arguably, the precise conjecture linking spatial concentration and inequality is conditional to where the concentration occurs. Rising dualism and inequality emerge when increased agglomeration occurs in the developed regions/areas which typically are in a better position to attract new activities at the first place.

Insofar dualism and inequality are multidimensional, they can occur on various levels; e.g., between rich and poor households, between rural and urban, between small and large businesses, and between traditional and modern sectors. If, for some reasons, activities concentrate in the less-developed areas, or, in the case of business activities small businesses operate in a cluster to benefit from agglomeration economies, the outcome could be more optimal. Consider dualism and inequality between large firms and MSMEs. By definition, MSMEs are very different than large businesses not only in size but also in terms of legal structures, management style, financing arrangements, technology, and market size and niches. MSMEs also have limited networks for expansion (e.g., lobbying capacity, business contact, communication), and their location tends to scatter. These characteristics prevent them from enjoying the benefits of input sharing, labor market pooling, and knowledge spillovers (sources of agglomeration economies). By operating in a cluster, they will have the opportunity to reap those benefits. Thus, there is a great deal of similarity between the concepts associated with forces leading towards spatial concentration applied to regions and those applied to business sectors of different sizes. While the earlier results in a stronger growth with more intense dualism, the latter has the potential to foster growth and reduce dualism, if the agglomeration-related external economies can be enjoyed by MSMEs operating in clusters.

From this perspective, the general direction of the policy should be to mitigate the effects of agglomeration forces leading towards concentration of activities in developed areas, and exploit the same forces by encouraging small businesses to operate in a close proximity to enable them enjoy the external economies. If serious efforts to foster inclusive growth are to be made, these two are among the important tasks of social planners. The question is, how? The book addresses this question by focusing on the role of interactions between policies and institution, of which social capital is an important part.

The analysis in Chap. 3 delves into the nature of interactions between policy and institution. The approach taken is to link the concept of agglomeration leading towards dualism and inequality with the mechanisms of how the combined policies and institution including social capital affects the outcome. The working hypothesis is: observed dualism and inequality are not only the results of development policy but also the consequence of agglomeration forces and the interplay of policies and

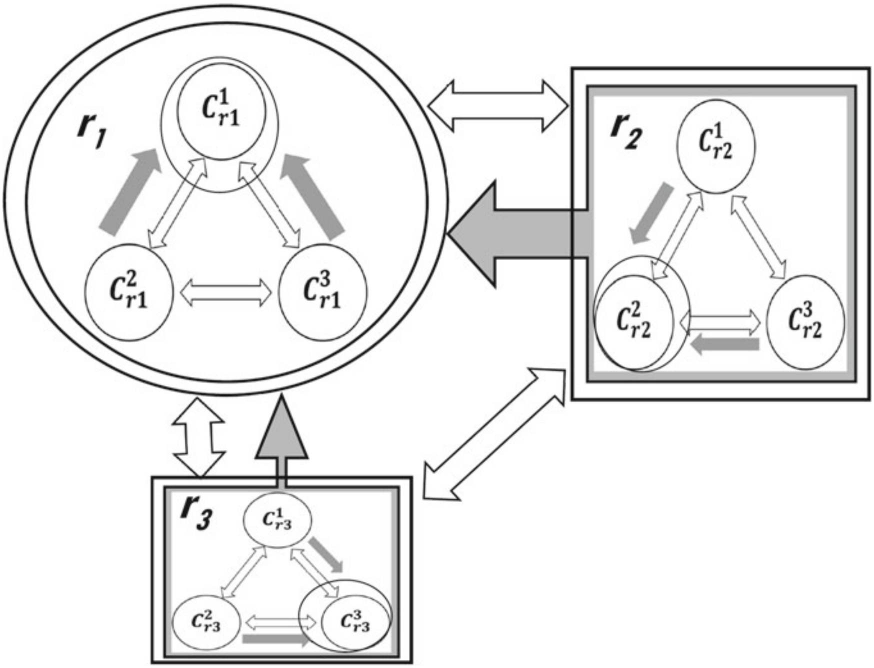

Fig. 1.1 Development with agglomeration and intersectoral-interregional interactions

institution. Policy alone is likely to fail if social capital based on the prevailing institution is ignored. Attempts to verify this hypothesis are made in Chap. 4, in which alternative scenarios of redirecting spending towards different regions are compared, and the results of MSE survey are discussed. Since institution and social capital are at the center of the hypothesis, the discussion about their role and mechanisms of interactions with policies takes up most part of Chaps. 3 and 4.

Putting all together, Fig. 1.1 depicts the line of reasoning behind the analysis throughout the book. It epitomizes a typical development process involving agglomeration forces and interactions between regions. Within each of the three regions, r_1-circle, r_2-square, and r_3-square, there are three sectors each is represented by the small circles; for example, $\boldsymbol{C^1_{r1}}$ denotes sector 1 in region r_1-circle, $\boldsymbol{C^3_{r3}}$ denotes sectors 3 in region r_3-square, etc. The clear arrows pointing towards two directions indicate the interactions, both between sectors and between regions, and the grey arrows pointing towards one direction represent the forces of agglomeration. r1-circle is assumed to be the developed (core) region—hence the circle has the largest area–and region r_2-square and r_3-square are less developed regions, of which r_3-square is the least developed one (smaller size of the square).

The three activities in each region are interacting via both, the intraregional multipliers (measurable by the intersectoral input–output relations) and the interregional multipliers (measurable by the interregional input–output relations). Based on those two multipliers, all three regions will grow, and this is depicted by expanded r_1-circle, r_2-square, and r_3-square. But there is another source of regional growth, i.e., external economies driven by agglomeration or concentration of activities in $\boldsymbol{C}^{1}_{r1}$, $\boldsymbol{C}^{2}_{r2}$ and $\boldsymbol{C}^{3}_{r3}$ (to which the one-direction arrows point towards). This is depicted in the Figure by the expanding circles $\boldsymbol{C}^{1}_{r1}$, $\boldsymbol{C}^{2}_{r2}$ and $\boldsymbol{C}^{3}_{r3}$. Obviously, the precise extent of expansion depends on how much external economies can be reaped by the sector, which could be influenced by the type and effectiveness of policy measures designed to exploit those external economies.

Nonetheless, three things happen: first, all regions grow, albeit at different rates, implying that the national economy grows; second, the distribution between regions is altered, implying a change in interregional inequality; and third, the spatial distribution of activities in each region is altered, implying that the intraregional inequality is changed as well. What is the outcome of it? A growing national economy is a forgone conclusion, but the resulting inequality–between and within regions–is uncertain.

This is where our proposition becomes relevant, i.e., to mitigate the effects of agglomeration forces that lead to concentration, and exploit those forces by encouraging small businesses to operate in close proximity in order to enjoy the external economies. Failure to do the first results in growing interregional inequality, failure to do the second widens the gap between small and large activities. To avoid those failures, the book argues that one needs to delve into the dynamics of interactions between policies and institution. In the first case, the role of regional and interregional structure that reflects the existing institutional arrangements ought to be considered in designing policies to reduce the gap between core (r_1) and periphery (r_3). In the second case, the direction of policy should be to encourage small businesses to cooperate and act collectively through clusters, and provide measures that are compatible with the prevailing social capital.

All the discussions and analysis up to Chap. 4 demonstrate how the model framework is used to explain the role of agglomeration forces and the interactions between policies and institution-cum-social capital in shaping dualism and inequality. On the role of social capital, the use of a model framework and the survey reflects our attempt to generalize the results by using data and people perceptions as a piece of evidence. Yet, the actual relationship between policy making, institution, and outcome is more complex than what is conceptualized, and to some extent such a relationship is unforeseeable. In reality, how do the institutional arrangements and social capital actually work in affecting small businesses operations? Do cases on the ground corroborate what has been conceptualized and concluded in the analysis? To answer these questions, a number of case-based evidence is discussed in Chap. 5. In particular, the presented narratives involve real people doing small business in different regions throughout Indonesia. They obviously operate within the prevailing institutional arrangement. The discussions show how they cope with challenges and possible disputes by using the prevailing social capital, and how the role of local customs and customary laws affect their business operations.

The book is structured as follows. The first part of Chap. 2 discusses the historical ‘source’ of dualism in Indonesia, with a particular emphasis on the relevance of Boeke’s concept of ‘dualism,’ and the second part presents the evidence of inequality in a dualistic system in Indonesia despite the fact that various policies to address inequality have been implemented. The methodologies and the main concepts to explain why such inequality happened are discussed in Chap. 3. Insofar they describe the sources of agglomeration, and conceptualize the interactions between policies and social capital through collective actions, they are subsequently used to develop the questionnaire for the survey on MSEs, the results of which are discussed in Chap. 4. The first part of that chapter discusses how the intra and inter regional economic structure as part of the prevailing institution influences the effectiveness of policy to reduce interregional inequality. The second part, which is the bulk of the chapter, is devoted to the analysis of MSE survey on the interplay between policies and social capital in affecting the type of MSE cluster. Overall, Chap. 4 exposes the importance of mitigating the inequality caused by the agglomeration forces and exploiting the elements of those forces through MSME clusters. To complement the analysis on the effect of interactions among policies, institution, and social capital on MSME performance, Chap. 5 presents some examples of evidence from cases throughout different regions in Indonesia. Chapter 6 summarizes the overall finding.

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