



Munich Personal RePEc Archive

## **Why is growth less inclusive in Indonesia?**

Dartanto, Teguh

Institute for Economic and Social Research (LPEM), Faculty of  
Economics and Business, University of Indonesia

2013

Online at <https://mpra.ub.uni-muenchen.de/65136/>  
MPRA Paper No. 65136, posted 20 Jun 2015 05:51 UTC

Draft of ADB Economics Working Paper Series

## Why Is Growth Less Inclusive in Indonesia?

Teguh Dartanto

No. \_\_\_\_ 2014

Teguh Dartanto is a Head of Poverty and Social Protection Research Group at the Institute for Economic and Social Research (LPEM), and a Director of Undergraduate Program in Economics, Faculty of Economics and Business, University of Indonesia.

Author would like to thank for Theresia Kinanti Dewi, Usman, Widi Larasari, Almira Salsabila and Sulistiadi Dono Iskandar for extensive research assistance and valuable comments on the completing of report.

Email: [teguh@lpem-feui.org](mailto:teguh@lpem-feui.org) or  
[teguh.dartanto@ui.ac.id](mailto:teguh.dartanto@ui.ac.id)

## CONTENTS

<b>ABSTRACT</b>	<b>v</b>
<b>I. INTRODUCTION</b>	<b>1</b>
<b>II. POVERTY, INEQUALITY AND HUMAN DEVELOPMENT</b>	<b>2</b>
<b>A. Poverty, Growth, and Inequality</b>	<b>2</b>
<b>B. Human Development Index</b>	<b>6</b>
<b>C. Poverty, Growth, Inequality and Human Development         Index in Provincial Level in Indonesia</b>	<b>8</b>
<b>III. ECONOMIC GROWTH AND ITS PATTERN</b>	<b>9</b>
<b>A. Growth Patterns</b>	<b>9</b>
<b>B. Employment Rate Policies</b>	<b>11</b>
<b>C. Elasticity of Poverty, Inequality and Employment to         Economic Growth</b>	<b>12</b>
<b>D. Growth, Poverty and Inequality at Provincial Level in Indonesia</b>	<b>14</b>
<b>IV. MACROECONOMIC POLICIES AND POVERTY REDUCTION</b>	<b>16</b>
<b>A. Fiscal Policy</b>	<b>16</b>
<b>B. Monetary Policy</b>	<b>18</b>
<b>V. ADJUSTMENT POLICIES AND POVERTY REDUCTION</b>	<b>21</b>
<b>A. Financial Liberalization</b>	<b>22</b>
<b>B. Trade Liberalization</b>	<b>23</b>
<b>VI. SOCIAL POLICIES AND POVERTY REDUCTION: A NEW         DIRECTION FOR POVERTY REDUCTION STRATEGIES</b>	<b>25</b>
<b>VII. CONCLUDING REMARKS</b>	<b>27</b>
<b>REFERENCES</b>	<b>28</b>

## **ABSTRACT**

The speed of poverty reduction in Indonesia has begun to slow down with inequality continuing to rise significantly. Examining the macroeconomic dataset for last three decades, this study found that inclusive growth is observed only during 1980s in which one percent of economic growth could reduce the poverty rate by 0.72 percentage point and the Gini index by 0.0021 point. Nevertheless, during the 1990s and 2000s, the growth is less inclusive as indicated by shrinking the elasticity of poverty to growth and the positive elasticity of inequality to growth. The elasticity of employment to growth has also continuously declined from 1.12 (1985) to 0.21 (2012). There are two possible reasons for less inclusive growth in Indonesia: first, the Indonesian economy is moving into more services-oriented economy and capital-intensive sectors such as mining, financial and telecommunications that create less job opportunities particularly for unskilled labor. It deprives the poor to benefit from a rising economy. Second, the productivity of industrial sector and service sector is more than seven-fold and three-fold of the agriculture's productivity, respectively. Consequently, the employees working at service and industry sectors are benefit much more than those working in agriculture sector. However, Indonesia has already two essential elements of the necessary condition for inclusive growth that are the stable macroeconomic condition and sound economic fundamentals. The government should now focus on the sufficient condition for inclusive growth that strengthens micro level policies such as financial inclusion, improving access to education, health insurance and other social policies.

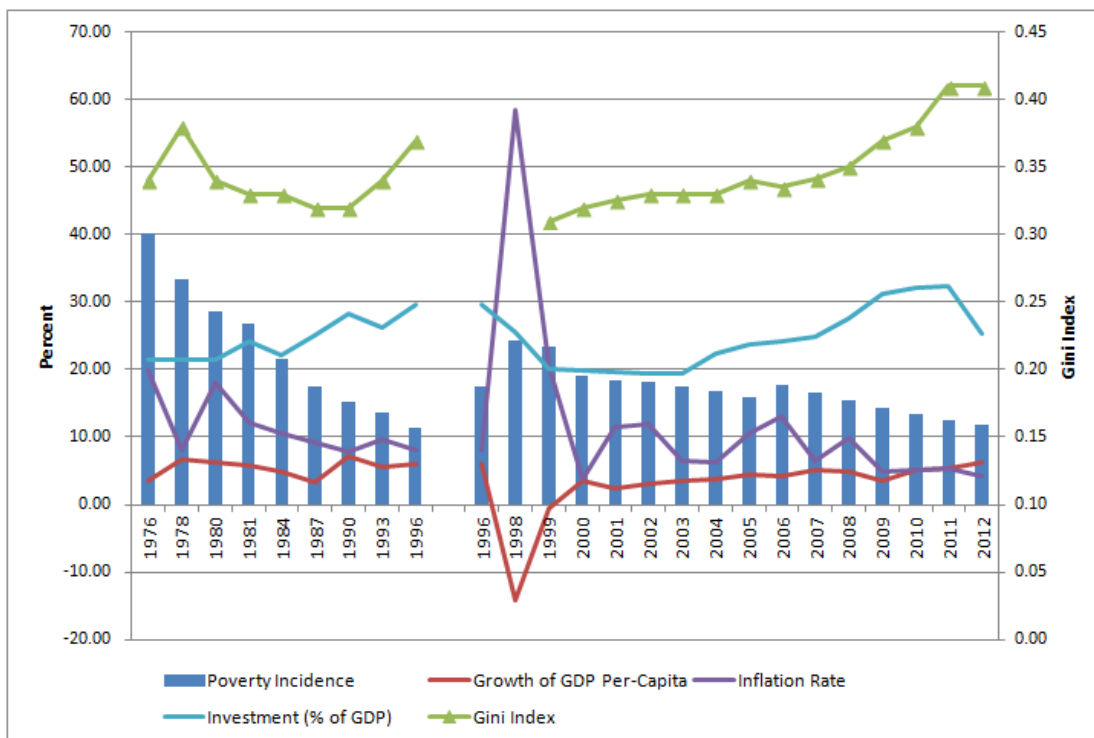
**Keywords: Inclusive Growth, Poverty, Inequality**

**JEL Classification: I32, I38, O40, O43**

## I. INTRODUCTION

Indonesia recorded a good experience in combating poverty during 1976-2012. Sustained economic growth and macroeconomic stability in Indonesia have been the primary driving factors in poverty reduction. In the past three decades, socio-economic conditions in Indonesia have been improving rapidly. During this period, per-capita GDP of Indonesia increased three-fold. The World Bank reported that the per-capita GDP (PPP, 2005 US\$) of Indonesia had jumped from \$1,323 (1983) to \$4,271 (2012).<sup>1</sup> From 1980 to 2012, the transformation of Indonesian economy as the relative shares of three sectors in GDP has been clearly observed. The share of agriculture output in GDP has declined continuously since 1980, while the share of industrial sector as well as service sector has increased significantly. The average share of industrial output in GDP has increased almost 9% during the 30-year period. This substantial increase in income and the transformation of Indonesian economy have been accompanied by improvements in social indicators such as the massive decrease in the absolute poverty incidence from 28.6% (1980) to 11.7% (2012) in headcount ratios (measured by national poverty line)

**Figure 1: Poverty, Growth, Inequality and Other Macroeconomic Indicators**



Source: World Development Indicators and Central Statistical Agency (BPS)

However, the rate of poverty reduction has started to slow down with inequality continuing to rise significantly. The Gini coefficient measured by the expenditure (consumption) substantially increased roughly from 0.33 in 2002 to 0.41 in 2012. De Silva and Sumarto (2013) confirmed that during 2006-2012, the growth rate of household income per capita was 26.5 percent. The growth rate varied from 9 percent for the poorest quintile to 29 percent for the richest. Changes in the sectoral composition of growth away

<sup>1</sup> <http://data.worldbank.org/indicator/NY.GDP.PCAP.PP.KD>.

from agriculture and toward industry and services, driven in part by increased global integration and rural-urban migration are thought to be the root causes of rising inequality (De Silva and Sumarto, 2013). Thus, the economic growth in Indonesia was particularly beneficial for those located at the top of the distribution.

Palanivel (2013) observed that possible sources of rising inequality in Asia are uneven growth across sectors and locations; uneven demand of skilled and unskilled labor; capital intensive sectors driven growth; high food and fuel prices; and uneven asset and infrastructure distribution. Increasing inequality will polarize society and lead to social tensions and undermine the growth process itself. Banerjee and Duflo (2005) and World Bank (2005) have indentified that growing inequality reduces the growth elasticity of poverty reduction and generates a detrimental influence on the growth prospects of an economy.

Rising inequalities can be a catalyst of collective behavior such as an expansion of social protests that was seen lately in Indonesia which slows down economic growth. Even when social protests or social tensions do not urge social conflict, rising inequality can increase resistance and undermine a government's ability to introduce very important reforms needed for economic growth (Coudouel, Dani and Paternostro, 2006). Therefore, now Indonesia should accelerate the rate of poverty reduction and curb rising inequalities by making growth and policies more inclusive that allows the poor to benefit equitable from economic growth. Economic growth that does not only create new economic opportunities, but also one that ensures equal access to the opportunities created for all segments of society, particularly for the poor (Ali and Son, 2007). Inclusive growth implies participation of poor and vulnerable population in the growth process in an equitable manner and the benefits of growth are shared equitably between poor and non-poor.

This paper aims to examine the correlation between poverty, growth and inequality; evaluate the extent to which the recent economic growth in Indonesia has been inclusive; analyze macroeconomic factors that determine inclusiveness of growth process; and attempt to underscore policy measures that can make growth more inclusive in Indonesia. This study utilized on elaborating statistical data/facts to meet the objectives of this study. Thus, this paper can provide understandable evidence and policy recommendations to policy makers how to make growth/development more inclusive in Indonesia.

The structure of the paper is as follows. The next section provides a brief overview of the trends poverty, inequality and human capital that include some stylized facts of education and health. The third section discusses the economic growth and its growth patterns and the transformation of Indonesian economy. The fourth section deals with macroeconomic policies including both fiscal and monetary policies and poverty reduction in Indonesia. The fifth section overviews some adjustment policies including financial and trade liberalization. The sixth section discusses new challenges and directions of poverty alleviation in Indonesia. The last section deals with key findings and conclusion.

## **II. POVERTY, INEQUALITY AND HUMAN DEVELOPMENT**

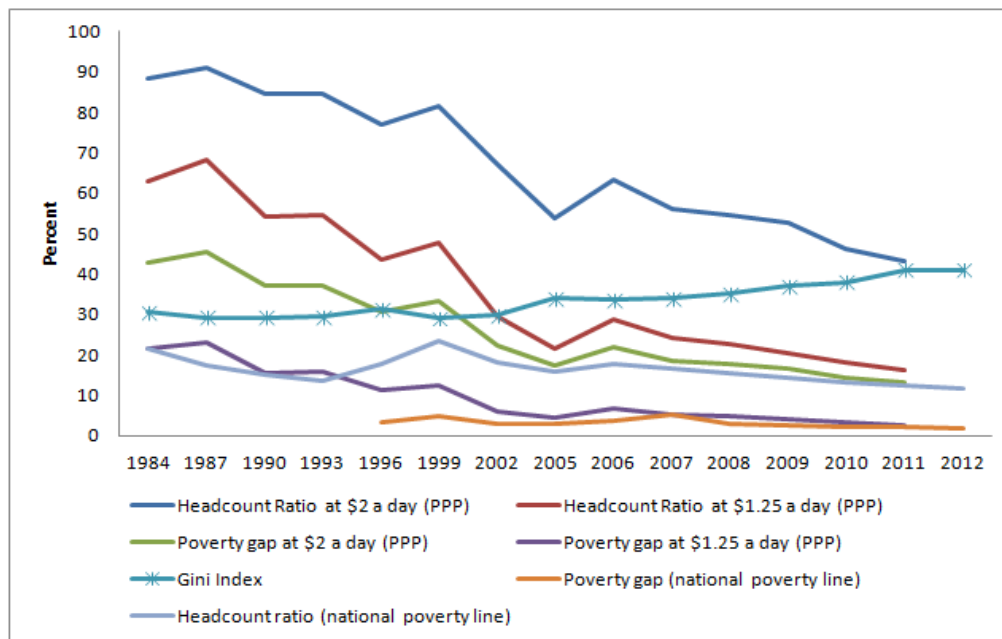
### **A. Poverty, Growth and Inequality**

The Indonesia's experience in tackling poverty over the last 30 years, despite some impediments such as the Asian financial crisis in 1997-1998, has been perceived to be a remarkable success story in Asia. Improvements in democracy, rapid political and institutional reforms, combination of proper economic policy packages and the creation of fair economic institution have generated the substantial and sustained growth and the

transformation of Indonesian economy. These have contributed large improvements in social welfare as well as a massive decrease in the poverty incidence.

The headcount index as measured with the national poverty line declined from 21.6% (1984) to 11.7% (2012).<sup>2</sup> Other poverty measures show that the headcount ratio of US\$ 2 per day had decreased more than half from 88.4% (1984) to 43.3% (2011), while the headcount ratio of US\$ 1.25 per day (PPP) had decreased from 62.84% (1984) to 16.2% (2011) (Table 1). In 1998, the government revised the method of calculating the poverty line by improving the quality of non-food items. As a result the poverty line increased and the population below the poverty line also increased. The poverty incidence in 1996 was 11.30% under the old method of calculating poverty line and 17.47% under the new method of calculating poverty line. The poverty gap index (PGI henceforth) has also declined significantly from 3.15% (1996) to 1.9% (2012) (the national poverty line). The decrease of the poverty gap index is very large when US\$ 1.25 per day (PPP) and US\$ 2 per day (PPP) are applied; for instance, the PGI decreased from 21.36% (1984) to 2.68% (2011) (US\$ 1.25 per day). The lower value of PGI indicates that poverty reduction programs should lift poor people easily out of poverty since they are clustered around the poverty line.

**Figure 2: Trend in Poverty and Inequality during 1984-2012**



Source: Author's Compilation

Poverty figures, however, fluctuated overtime and increased sharply from 17.47% in 1996 to 23.43% in 1999 when the economic crisis hit. The economic growth decreased drastically exacerbated by domestic political turbulence and multidimensional socio-economic crisis. This indicates that households who are clustered around the poverty line are at risk to fall into poverty in the event of the economic fluctuation and small

<sup>2</sup> The poverty line in Indonesia is measured by basic need approach (expenditure) rather than income approach. The poverty line consists of food and non-food poverty line. The food poverty line is calculated based on the minimum nutritional requirement of 2,100 Calories/capita/day (National Congress of nutritionists, 1978) resulted from 52 commodities. The non-food poverty line is calculated based on the consumption of essential non-foods including 51 commodities in urban area and 47 commodities in rural area. In 2012, the average monthly money metric of the national poverty line was IDR 240,441 (US\$21) in rural areas and IDR 277,382 (US\$24) in urban areas.

shocks. Dartanto and Otsubo (2013) observed that the Asian economic crisis in 1997-1998 caused almost 18.5% of non-poor household to fall into poverty. The economic crisis followed by massive contraction in both the industrial sector and service sector hit urban households. The poverty rate in urban area, where most activities are located, jumped significantly around 4.5% compared to the pre-crisis level.

The economic recovery and macroeconomic stability from 2000 to 2005 have led to a significant decreased in poverty incidence during this period. By 2003, the poverty incidence remained almost the same during the pre-economic crisis level. In 2006, poverty incidence had increased as a consequent of the adjustment on fuel subsidies in 2005. The poverty rate increased from 15.97% in 2005 to 17.75% in 2006. However, poverty was not much affected by the adjustment of fuel prices in 2008, because households and firms have had already experienced a very high increase in 2005 and the role of the compensation policies, and the stabilization price policies of commodities price as a safety net for the poor was relatively well function.

**Table 1: Trend in Poverty in Indonesia**

Description	Unit	1984	1990	1996	1999	2005	2010	2011	2012
<i>Poverty Indicators</i>									
Headcount Ratio (National Poverty Line)	%	21.60	15.10	17.47	23.40	16.00	13.30	12.49	11.70
Urban Headcount Ratio (National Poverty Line)	%	22.94	16.61	13.39	18.60	13.02	9.87	9.23	8.60
Rural Headcount Ratio (National Poverty Line)	%	21.15	14.31	19.78	27.66	19.41	16.56	15.72	14.70
Poverty Gap at National Poverty Line	%	-	-	3.15	4.76	2.90	2.20	2.10	1.90
Headcount Ratio at \$2 a day (PPP)	%	88.40	84.59	77.01	81.55	53.80	46.12	43.30	-
Headcount Ratio at \$1.25 a day (PPP)	%	62.84	54.27	43.38	47.70	21.44	18.06	16.20	-
Poverty Gap at \$2 a day (PPP)	%	42.83	36.97	30.67	33.26	17.28	14.29	13.00	-
Poverty Gap at \$1.25 a day (PPP)	%	21.36	15.62	11.44	12.52	4.56	3.30	2.68	-
<i>Number of Poor</i>									
National	Million	35.0	27.2	34.3	48.0	35.1	31.0	30.0	28.6
Urban	Million	9.9	9.5	9.7	14.2	11.5	11.1	11.0	10.5
Rural	Million	25.1	17.7	24.6	33.8	23.6	19.9	19.0	18.1
Ratio of Rural Poverty to Total Poverty	%	71.8	65.2	71.7	70.4	67.1	64.2	63.3	63.3

Source: World Development Indicators and Central Statistical Agency (BPS)

Indonesian poverty profile is still rural and agriculture phenomenon. By 2012, almost two-thirds of the poor (18.10 million) live in rural areas who depend mostly on agriculture as their main source of income and majority of them are self-employed. From 1996 to 2012, the poverty incidence has decreased by 5.08 percentage point (in rural areas) and 4.79 percentage point (in urban areas). This is equivalent to 6.5 million reductions in poor population in the rural areas. Nevertheless, there are significant changes in the headcount index of urban areas, but in the absolute term, the number of poor people living in urban area increased by almost 700,000.



The increase of urban poor and the decrease of rural poor might be due to change in the village category from rural village to urban village and the massive urbanization wherein the proportion of urban population jumped from 36.84% in 1996 to 51.45% in 2012. Smallholder and landless rural poor households migrate to urban area to seek better job opportunities. Moreover, the Central Statistic Agency (BPS) classified between the urban village and the rural village based on the composite score of population density, proportion labor working at agriculture sectors, the availability of urban facilities such as school, fresh market, hospital, electricity and asphalt road. The rapid socio-economic development and the transformation of Indonesian economy during the last three decades have significantly transformed the rural village into the urban village.

The trend of poverty incidence in Indonesia appears to decline significantly, but the reduction rate has begun to slow down recently. The main reason might be the changing nature of poverty. When the poverty incidence was larger enough, a large number of households used to live just below the poverty line and hence only a slight increase in income was needed to push those households out of poverty. However, as the poverty incidence approaches a single digit figure and is around 10 percent, further reductions in poverty becomes more difficult. Now the nature of poverty has changed, with many households living far below the poverty line and others being clustered just above the poverty with the risk of falling back to poverty. Dartanto and Nurkholis (2013) observed the household welfare mobility in and out of poverty during 2005-2007 and found around 11% of rural non-poor households in 2005 subsequently fell into poverty in 2007, compared with only 1% of urban non-poor households. They also confirmed that an increase of 25% in the poverty line causes an increase of more than 100% in the poverty rate.

**Table 3: Trend in Inequality in Indonesia**

Description	Unit	1984	1990	1996	1999	2005	2010	2011	2012
Gini Index		0.305	0.292	0.313	0.290	0.340	0.380	0.410	0.410
Income share held by lowest 10%	%	3.74	4.17	4.00	4.25	3.67	3.36	3.22	-
Income share held by lowest 20%	%	8.68	9.39	9.01	9.58	8.34	7.63	7.27	-
Income share held by highest 20%	%	39.46	38.90	40.71	38.88	42.76	43.65	45.98	-
Income share held by highest 10%	%	24.91	24.68	26.57	25.08	28.51	28.18	30.63	-
Ratio between the highest 10% and the lowest 10%		6.66	5.92	6.64	5.90	7.77	8.39	9.52	-
Ratio between the highest 20% and the lowest 20%		4.55	4.14	4.52	4.06	5.13	5.72	6.32	-

Source: World Development Indicators and Central Statistical Agency (BPS)

As experienced other countries in Southeast Asia, the remarkable success in poverty reduction has been associated with increasing in income inequality. Indonesia follows the same pattern that substantial decrease in poverty came along with increasing in Gini index particularly during the last decade. Inequality in Indonesia has been increasing during the recent six year period from 2006 to 2012 (Figure 2 and Table 2). During the period prior to the Asian economic crisis (1990-1996) the Gini index increased from 0.292 to 0.313, and then inequality slightly dropped from 0.313 (1996) to 0.289 (1999) due to the Asian economic crisis that had hit high income households resulted to closer the income gap (Dartanto and Otsubo, 2013). Economic recovery after the crisis has initiated a growing inequality in Indonesia since the welfare of rich grows higher than that of the poor. From 2005 to 2006, one outcome of fuel price adjustment and some other social policies in 2005 is the decline of Gini index from 0.340 to 0.335. Later, beginning in 2006, an increasing inequality trend has been exhibited by the movements in the Gini index.

Other measure of inequality is the ratio between the income share of lowest 10% and the income share held by the highest 10%. Table 2 shows that the income share ratio

is continuously increasing that means wider income gap between the richest and the poorest. In 1999, the richest has six times more income than the poorest, while in 2011 the richest has ten times more income than the poorest. During the period prior to the Asian economic crisis (1984-1996), the income ratio between the richest and the poorest remained stable from 5.9 to 6.64. Nevertheless during the post crisis period (1999-2011) within ten years, the income ratio of the richest and the poorest is almost double. The wider income gap can be a catalyst of social jealousy that can be a wick of social and political chaos.

## **B. Human Development Index**

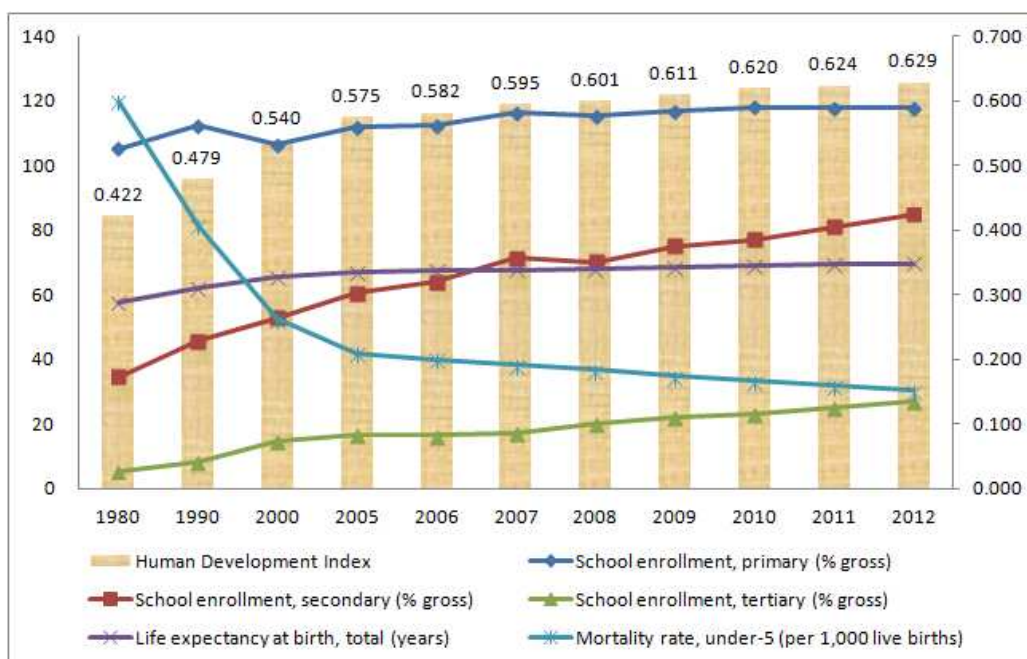
In the past three decades, except for the periods of crises, socio-economic conditions in Indonesia have been improving rapidly. This substantial increase in income has been accompanied by improvements in social indicators such as a massive decrease in the poverty incidence, a significant increase in the gross enrollment rate for secondary education from 41.04% (1986) to 84.85% (2012) and a significant decrease in the infant mortality rate from 64.7 (1985) to 24.8 (2011). Substantial improvements on economic welfare and education and health indicators have significantly contributed to the increase in Human Development Index (HDI henceforth) from 0.422 to 0.629.

In contrast to the slowing down poverty reduction rate, the development of HDI is progressively getting faster. From 1980 to 1990 the improvement of HDI was only 0.057 point, while in the next decade, there was 0.061 point improvement. In the period of 2000-2010, HDI has substantially increased by 0.8 point. Unfortunately, after 2010, HDI progression rate has begun to slow down since there was only 0.002 point increase per year compared to 0.008 point increase per year in the period of 2000-2010. Recent government policies such as fostering economic growth policies and widening access on education and health services through scholarship and health insurance distribution particularly for the poor are expected to improve HDI.

Figure 4 and Table 3 show that school enrollment for secondary and tertiary has significantly improved during the last three decades. The gross enrollment for secondary education has jumped almost 2.5 times from 34.6 (1980) to 84.85 (2012), while the school enrollment for tertiary level has reached five-fold from 5.41 (1980) to 26.88 (2012). An increase in years of schooling directly increases the stock of human capital as well as the stock of skilled labor that is a necessary condition for achieving a long run sustainable economic growth. On the other hand, individuals having a higher educational attainment will have broader opportunities to get jobs with high salary that can enable them to get out of poverty. Thus, the role of education in alleviating poverty is through two channels: 1) boosting economic growth and 2) providing opportunities for a vertical mobilization.

In terms of health outcome, even though maternal mortality rate has decreased significantly from 600 in 1990 to 220 in 2010, this figure is still quite high. The maternal mortality rate is highly correlated to the infant mortality rate as well as the children mortality rate since the existence of mother in early phases of baby's life is very important especially for breast feeding. Declining of infant (children) mortality rate will support directly to the declining of fertility rate as well as the population growth rate. Dartanto (2013a) observed that the infant mortality rate is an important factor influencing the high fertility rate in Southeast and South Asian countries. The high elasticity of infant mortality rate implies that parents cover their risk from losing children by producing more children. Thus, any effort for reducing the infant mortality rate will be followed by the reducing of fertility rate which in the end will reduce the population growth. Moreover, Grant (1992) concluded that in order to lower the population growth rate, child survival action has to be combined with family planning program.

**Figure 3: Trend of Human Development Index during 1980-2012**



Source: Author's Compilation from World Development Indicators

**Table 3: Trend in Human Development Index**

Indicators	Unit	1985	1995	2005	2011	2012
Total population	Millions	162.5	178.6	224.5	243.8	246.9
Population growth rate	%	2.06	1.57	1.43	1.29	1.25
Population Density	Persons per sq. km.	89.68	107.15	123.92	134.58	na
<i>Gross enrolment ratio</i>						
Primary	% of relevant age group	118.74*	109.12*	112.15*	118*	118*
Secondary	% of relevant age group	33.59 (1984) 41.04 (1986)	46.92	60.64	81.00	84.85
Adult literacy rate	%	81.52 (1990)	na	90.38 (2004) 91.98 (2006)	92.58 (2009)	na
Life expectancy at birth	Years	59.99	63.98	67.07	69.32	69.75
Child mortality rate	Per 1,000 children (under-5)	100.3	65.3	42	31.8	30.40
Infant mortality rate	Per 1000 live births	64.7	44.9	31.4	24.8	na
Maternal mortality rate	Per 100,000 live births	600 (1990)	420	270	220 (2010)	na
UNDP- Human Development Index	Index	0.422 (1980)	0.479 (1990) 0.540 (2000)	0.575	0.624	0.629

Source: Author's Compilation from World Development Indicators

Note: The gross enrolment ratio (GER) is the total enrollment of population regardless of age, GER can exceed 100 percent. In table 3, the gross enrollment of primary education that showing a number exceeding 100 percent is due to the inclusion of over-aged and under-aged students. This is because early or late school entrance and grade repetition.

### **C. Poverty, Growth, Inequality and Human Development Index in Provincial Level in Indonesia**

In a diverse society like Indonesia where a great deal of regional disparities exists, the poverty profile at national level should be complemented with the poverty profile at the regional level. Table 4 shows the variation of poverty headcount ratio for each province in Indonesia. Even though, the national poverty rate is 11.96% in 2012, some of provinces located at eastern part of Indonesia such as Maluku, Papua and West Papua have the poverty incidence twice (triple) than the national average. Provinces like DKI Jakarta, Bali, North Sulawesi and Bangka Belitung have less than half of the national poverty rate. According to this diversity, the poverty alleviation program should be tailor-made for each province.

About 57 per cent of poor in Indonesia live in Java, the most populous Island. One-fourth of population in Java, with most being concentrated in East Java, West Java, and Central Java, can be categorized as the poor. The poverty in Java is relatively intense in landless household; particularly those whose income depends solely on agriculture sector (LPEM FEUI, PSE KP UGM, PSP-IPB, 2004). East Java, for example, has around 3 million working poor. More than 60 per cent of the poorest households as opposed to less than 10 per cent of the richest households make their living from agriculture. By contrast, more than 75 per cent of the richest households work in the services sectors, along with only 25 per cent of the poorest households (ILO, 2011). Some of the landless were able to escape from poverty if they are able to find other jobs from non-farm activities. The poverty in Sumatera is mostly concentrated in Lampung, Aceh, Bengkulu and South Sumatera. The highest poverty rate in Kalimantan and Sulawesi is in Central and West Kalimantan, and in Southeast Sulawesi.

The provinces that experienced social riots such as Maluku, Central Sulawesi and Southeast Sulawesi have a high poverty rate. The social riot had caused damage to both physical infrastructures and economic activities. Study in Maluku by Rahayu and Febriany (2007) concluded that things like conflicts, natural disasters, monetary crisis, and the reduction of subsidies can make the household reduce or lose their income. The community members in high conflict area are also very vulnerable to various disturbances that can make them fall into poverty or trapped in poverty. Moreover, the high poverty rate in Papua and West Papua are mostly influenced by isolation and infrastructure problems. Reducing infrastructure barriers will reduce the poverty incidence in Papua. Rahayu and Febriany (2007) showed that improvement of infrastructure, openness of stratification, good social capital, as well as functioning local democracy have helped improve the prosperity of communities.

Regional disparities have a role not only in the poverty rate but also in inequality. Provinces could be categorized into three main clusters: 1) high poverty rate and high inequality, 2) low poverty rate and high inequality, 3) both poverty and inequality in medium rate. Papua, West Papua and West Nusa Tenggara are three provinces located in the first cluster-high poverty and high inequality. These three provinces are categorized as the poorest regions in Indonesia. The development process is not inclusive since the rich enjoys the most benefit of development. On the other hand, provinces such as DKI Jakarta and Bali have a low poverty rate but a high inequality. The development process is not inclusive as well since rich are getting richer faster than the poor. Thus, while the poverty rate in both provinces is continuously decreasing, inequality continues to rise significantly in both provinces.

**Table 4: Trend in Poverty, Growth, Inequality, Unemployment and Human Development Index at Provincial Level 2007-2012**

Province	Poverty		Growth		Gini		Unemployment		HDI	
	2007	2012	2007	2012	2007	2012	2007	2011	2007	2012
1. Aceh	26.65	18.58	-2.36	5.20	0.27	0.32	10.27	8.27	70.35	72.51
2. North Sumatera	13.90	10.41	6.90	6.22	0.31	0.33	10.63	7.18	72.78	75.13
3. West Sumatera	11.90	8.00	6.34	6.35	0.31	0.36	11.02	7.14	72.23	74.70
4. Riau	11.20	8.05	3.41	3.55	0.32	0.40	10.39	7.17	74.63	76.90
5. Jambi	10.27	8.28	7.01	8.21	0.30	0.35	6.74	3.85	73.68	76.20
6. South Sumatera	19.15	13.48	6.82	7.44	0.31	0.34	10.40	6.07	71.46	73.78
7. Bengkulu	22.13	17.51	5.84	6.01	0.32	0.40	5.12	3.41	71.40	73.99
8. Lampung	22.19	15.65	4.54	5.72	0.26	0.29	8.29	5.24	71.62	73.78
9. Bangka Belitung Island	9.54	5.37	6.46	6.61	0.34	0.35	7.36	3.25	71.57	73.93
10. Riau Island	10.30	6.83	5.94	6.48	0.39	0.36	8.86	7.04	69.78	72.45
11. DKI Jakarta	4.61	3.70	6.44	6.53	0.34	0.42	13.27	10.83	76.59	78.33
12. West Java	13.55	9.89	6.48	6.21	0.34	0.41	14.51	9.84	70.71	73.11
13. Central Java	20.43	14.98	6.04	6.15	0.37	0.39	8.10	6.07	69.29	71.49
14. DI. Yogyakarta	18.99	15.88	5.59	6.34	0.33	0.38	6.08	5.47	70.92	73.36
15. East Java	19.98	13.08	4.31	5.32	0.37	0.43	7.45	4.18	74.15	76.75
16. Banten	9.07	5.71	6.11	7.27	0.34	0.36	16.11	13.50	69.78	72.83
17. Bali	6.63	3.95	5.92	6.65	0.33	0.43	4.89	2.86	70.53	73.49
18. West Nusa Tenggara	24.99	18.02	4.91	-1.12	0.33	0.35	6.93	4.34	63.71	66.89
19. East Nusa Tenggara	27.51	20.41	5.15	5.42	0.35	0.36	4.09	2.70	65.36	68.28
20. West Kalimantan	12.91	7.96	6.02	5.83	0.31	0.38	7.55	5.35	67.53	70.31
21. Central Kalimantan	9.38	6.19	6.06	6.69	0.30	0.33	3.98	2.67	73.49	75.46
22. South Kalimantan	7.01	5.01	6.01	5.73	0.34	0.38	7.08	4.99	68.01	71.08
23. East Kalimantan	11.04	6.38	1.84	3.98	0.33	0.36	5.02	3.66	73.77	76.71
24. North Sulawesi	11.42	7.64	6.47	7.86	0.32	0.43	7.31	5.62	74.68	76.95
25. Central Sulawesi	22.42	14.94	7.51	7.71	0.39	0.44	12.83	10.21	68.83	71.31
26. South Sulawesi	14.11	9.82	7.99	9.27	0.32	0.40	13.04	9.19	69.34	72.14
27. South East Sulawesi	21.33	13.06	6.34	8.37	0.37	0.41	7.26	4.61	69.62	72.70
28. Gorontalo	27.35	17.22	7.43	10.32	0.31	0.31	7.01	4.27	67.72	70.73
28. West Sulawesi	19.03	13.01	7.96	10.41	0.35	0.40	12.01	6.69	68.32	71.05
30. Maluku	31.14	20.76	5.62	7.81	0.33	0.38	14.37	7.72	69.96	72.42
31. North Maluku	11.97	8.06	6.01	6.67	0.33	0.34	8.34	5.62	67.82	69.98
32. Papua	40.78	30.66	4.34	1.08	0.41	0.44	5.52	3.72	63.41	65.86
33. West Papua	39.31	27.04	6.95	15.84	0.30	0.43	10.18	8.28	67.28	70.22
<b>All Province</b>	<b>16.58</b>	<b>11.66</b>	<b>5.67</b>	<b>6.30</b>	<b>0.36</b>	<b>0.41</b>	<b>9.75</b>	<b>6.56</b>	<b>70.59</b>	<b>73.29</b>

Source: Central Statistic Agency (BPS)

### III. ECONOMIC GROWTH AND ITS PATTERN

#### A. Growth Patterns

Indonesia is one of the largest economy in the world that has US\$ 427 billion of GDP in 2012 (constant 2005 price) that is equivalent to US\$ 1,731.6 per capita. Indonesia

experienced the highest economic growth in the pre-crisis period with an annual economic growth of 5.54%. In 1998, during the crisis, the economy contracted by 13.7% and inflation rate rose to 78%, driven by the increasing food prices. Since the economy recovered relatively quickly from the crisis, by 2000, economic growth was already 3.5% and it was continuously growing. Average economic growth during post-crisis period was around 5.5-6.5% per year. As the economy quickly recovered from the crisis, poverty began to decline again. The stable economic growth and improving macroeconomic conditions were the main source of sustainable reduction in poverty in the post crisis era. Nonetheless, poverty reduction rates never returned to those seen in the pre-crisis period. It may due to an argument that the main drivers of growth in the post crisis period are capital-intensive sectors such as mining and telecommunications, which employ fewer people and thus, depriving the poor to benefit from a rising economy (Suryahadi et al., 2012).

**Table 5: Trends in GDP Growth Rates: 1985 - 2012**

Indicators	Unit	1985	1995	2005	2011	2012
GDP ( <i>constant 2005 USD</i> )	Million \$	106,367.60	219,164.86	285,868.61	402,398.28	427,468.43
GDP per capita ( <i>constant 2005 USD</i> )	US \$	654.74	1,129.06	1,273.47	1,650.52	1,731.59
GDP per capita in PPP ( <i>constant 2005 international \$</i> )	US \$	1,615.05	2,785.08	3,141.29	4,071.37	4,271.36
<i>Sectoral composition of GDP</i>						
Agriculture, <i>value added</i>	% of GDP	23.21	17.14	13.13	14.72	14.44
Industry, <i>value added</i>	% of GDP	35.85	41.80	46.54	47.15	46.95
Service etc, <i>value added</i>	% of GDP	40.94	41.06	40.33	38.13	38.60
GDP growth rate	%	3.48	8.40	5.69	6.50	6.23
Per capita GDP growth rate	%	1.38	6.81	4.19	5.38	4.91
<i>Sectoral Growth of GDP</i>						
Agriculture, <i>yearly growth</i>	%	4.25	4.38	2.72	2.95	3.97
Industry, <i>yearly growth</i>	%	11.19	10.88	4.60	6.22	5.22
Service etc, <i>yearly growth</i>	%	4.45	8.02	7.87	8.58	7.72
Gross Domestic Savings Rate	Gross domestic savings (% of GDP)	29.71	30.59	29.23	34.38	33.79
Gross Domestic Investment Rate ( <i>Gross capital formation</i> )	% of GDP	27.96	31.93	25.08	32.94	35.34

Source: World Development Indicators and Central Statistical Agency (BPS)

Table 5 illustrates transformation of Indonesian economy as relative shares of three sectors in GDP from 1985-2005. The share of agriculture output in GDP has persistently declined since 1980. On average, it decreased from 23.21% in 1985, to 17.14% in 1995, and continued to decline to 14.44% in 2012. Table 5 also shows an observable trend of industrialization in Indonesian economy. Average share of industry output in the GDP has increased by almost 25% in twenty five years. It increased from 35.85% in 1985 to 46.95% in 2012. Contrary to agriculture and industry sectors that showed continuously downward and upward trends, the share of service sectors in GDP remained stable during this period. The change in the share of service sectors in GDP has only changed by 2.81 percentage points in 26 years.

Looking at the sectoral growth rate, the service sector has the highest growth rate recently. However, with the double digit growth rate during 1980s and 1990s (before the crisis), the industrial sectors was the belle of the Indonesian economy. The agriculture sector has the lowest economic growth compared to the other two sectors. According to this fact, it is evident that the Indonesian economy is moving into more services-oriented economy. By looking at the GDP by expenditures, we can observe that there are significant changes in the share of consumption of both private and government as well as in the share of investment – reflected by gross fixed capital formation – in three decades. The share of investment rises from 27.96% (1985) to 35.34% (2012) (Table 5). A large share of investment in GDP will help to promote a sustainable economic growth.

## B. Employment Rate Policies

The transformation of Indonesian economy will change the share of sectoral employment. The sectoral employment trends are less mimic to the trends in output share described before. Akin to the share of agricultural output in the GDP, share of employment in agricultural sector also fell steadily from 53.83% (in the period of 1985-1994) to 40.20% in the current period of 2005-2011 (Table 6). Yet, the rate of decline in the share of agricultural employment is faster than in the agriculture output. Moreover, the share of employment in the industrial sector grows from 12.82% in the past period, to 18.02% during crisis, and continued to increase to almost 19.09% in the current period. On the other hand, the average share of service sector in total employment increased continuously since 1980, from 32.68% (1985-1994) to 40.64% (2005-2011). In three decades (1985-2011), the share of employment in agriculture sector fell by 13.6%; whereas in the industry sector and the service sector, they have increased almost by 6.2% and 8.0% respectively.

**Table 6: Employment-Growth Linkages**

Description	1985-94	1995-04	2005-11
<i>Sectoral Employment Share (% of total employment, average during the period)</i>			
Agriculture	53.83	44.05	40.20
Industry	12.82	18.02	19.09
Service	32.68	37.93	40.64
<i>Sectoral Value Added Growth (the average during the period)</i>			
Agriculture	3.33	2.45	3.37
Industry	8.59	3.38	4.49
Service	7.62	3.11	7.95
<i>Sectoral Labor Productivity (the ratio between sectoral GDP and total employment (in IDR million))</i>			
Agriculture	4.15	5.53	7.02
Industry	35.90	40.19	52.33
Service	14.24	16.78	22.51
<i>Unemployment Rate (Unemployment, total (% of total labor force, average during the period)</i>	2.66*	7.07**	8.66

Source: World Development Indicators and Central Statistical Agency (BPS)

Table 6 shows the sectoral growth rate and also the sectoral productivity as measured by the ratio between sectoral GDP over the total sectoral employment. The growth rate in agriculture sector that many poor people depend on is the lowest, while the growth rate of industrial sector is the highest. The combination of low growth rate and high

employment share in agriculture is the reason why the productivity in the agriculture sector is quietly low compared to other sectors. The productivity of industrial sector and service sector is more than seven-fold and three-fold of agriculture's productivity respectively. If each factor production is paid based on their productivity, then the average salary of agriculture sector will always be lower than that of industrial (service) sector. These facts support the hypothesis that the rich is getting richer faster than the poor. Most of rich income group is mostly working at either in industrial or service sectors, while the poverty is still rural and agricultural phenomenon.

Recent data also shows that the farmer exchange value as measured by the ratio between the value received by farmer and the value paid by farmer is continuously decreasing that means the welfare of farmer getting worst recently. The farmer exchange value was IDR 30,393 per day (the real value) in 2008 but it is constantly decreasing IDR 27,002 per day. During 5 years, the welfare of farmer decreases by approximately 10% or equals to 2% per year. At the same time, there is a provincial minimum wage policy for industry and service sectors that is adjusted every year following the inflation and some additional factors. This minimum wage policy can keep real wage rate either constant or even larger than the previous year. This will be one of the sources of growing inequality in Indonesia and also slow reduction of poverty in rural area. Margherita and Mello (2009) suggests that minimum wage legislation is hurting, instead of protecting vulnerable workers. Therefore, its use as social-protection and income-redistribution instruments is called into question. Moreover, they also observed that Indonesian minimum wage is very high, even in comparison with OECD countries, at about 65% of the median wage in 2004, which suggests that its dis-employment effect might be potentially strong.

### **C. Elasticity of Poverty, Inequality and Employment to Economic Growth**

This section discusses the elasticity of poverty, inequality and employment to growth. The elasticity will provide information for us about the pattern of the effectiveness of economic growth to reduce poverty, create job opportunity and also reduce (increase) inequality. Table 7 shows the elasticity of poverty, inequality and employment to growth for each decade. The elasticity of poverty to growth (national poverty line) has declined sharply during three decades. In the mid of 1980s, the elasticity of poverty to growth was around -0.74 in which one percent of economic growth can reduce the poverty headcount ratio by 0.74 percentage point. When the poverty rate approached the level of around 11%-12% as the condition prior to the Asian economic crisis in 1995, the elasticity of poverty to growth has diminished by around one-six from 0.74 to 0.12. The declining of elasticity is because the nature of poverty has changed with many households living quietly far below the poverty line and others living just above the poverty line. Consequently, a considerable increase income are needed to lift those households out of poverty, while at the same time, a little shock can easily send out those households living just above the poverty line falling into poverty condition.

In the period of post crisis in 2005, the elasticity of poverty to growth again increased to 0.52. The characteristic of poverty during 1996-2005 are mostly dominated by transient poverty, therefore, the macroeconomic stabilization after the crisis could enable those who were falling into poverty during the crisis move out of poverty. Similar to the condition in 1995, the elasticity of growth to poverty has begun to slow down from 0.52 in (2005) to 0.16 (2011). Hence, currently to reduce the poverty rate by 1 percentage point needs around six percent per year growth. When the poverty rate approaches to single digit, the elasticity of poverty to growth will be more rigid, since at this level the characteristic of poverty is dominated by chronic poverty. Therefore, economic growth should be complemented with some social policies to tackle with the chronic poverty. When the international poverty line of US\$ 1.25 per day and US\$ 2 per day is applied, the



elasticity of poverty to growth is not slightly different compared to the elasticity measured with the national poverty.

**Table 7: Elasticity of Poverty, Inequality and Employment to Economic Growth**

Indicators	1985	1995	2005	2011	2012
Rate of Per capita Income Growth ( <i>GNI per capita growth (annual %)</i> )	1.89	6.49	4.2	5.12	4.88
Rate of Change in Incidence of Poverty ( <i>national poverty line</i> )	-1.4	-0.8	-2.2	-0.8	-0.8
Rate of Change in Incidence of Poverty ( <i>\$2 per day (PPP)</i> )	-0.64	-2.52	-4.39	-0.95	na
Rate of Change in Incidence of Poverty ( <i>\$1.25 per day (PPP)</i> )	-1.43	-3.67	-2.62	-0.48	na
Rate of Change in Gini Index	-0.004	0.0067	0.0142	0.015	0.000
Rate of Change in Employment	2.11	1.58	1.44	1.35	1.04
Poverty Elasticity of Growth ( <i>national poverty line</i> )	-0.74	-0.12	-0.52	-0.16	-0.16
Poverty Elasticity of Growth ( <i>\$ 2 per day (PPP)</i> )	-0.34	-0.39	-1.05	-0.19	na
Poverty Elasticity of Growth ( <i>\$ 1.25 per day (PPP)</i> )	-0.76	-0.57	-0.62	-0.09	na
Gini Elasticity of Growth	-0.0021	0.0010	0.0034	0.0029	0.0000
Employment Elasticity of Growth	1.12	0.24	0.34	0.26	0.21

Source: Author's Calculation based on data from World Development Indicators and Central Statistical Agency (BPS)  
na: not available

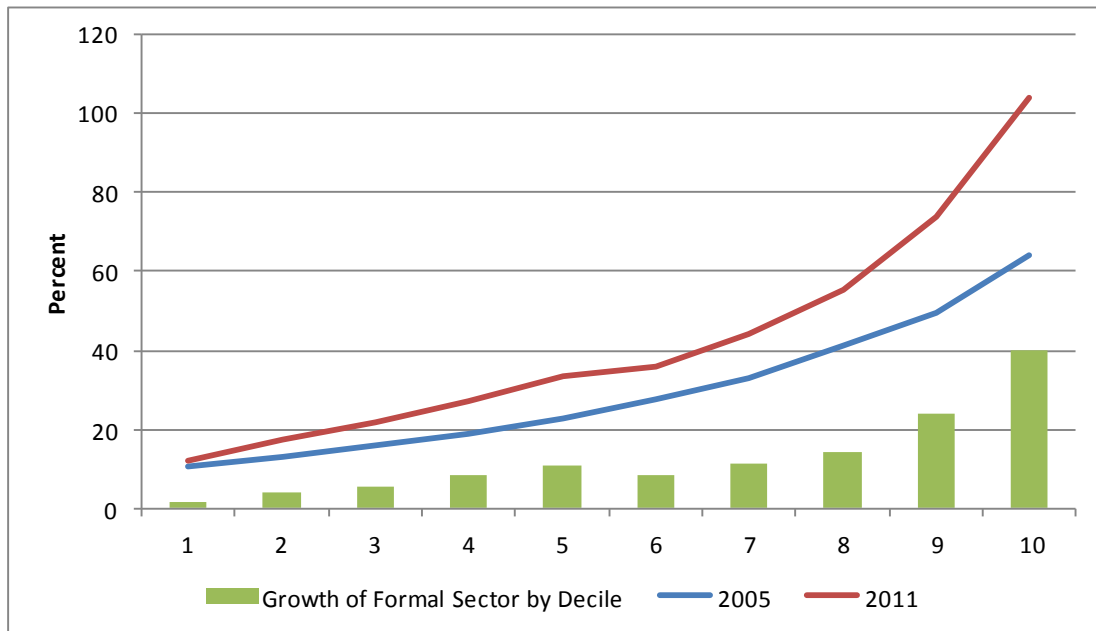
The elasticity of inequality to growth has a different pattern for each decade. During 1980s, economic growth was not only good for the poverty reduction but also good for improving inequality in Indonesia since economic growth can alleviate poverty and also decrease inequality. One percent of economic growth could reduce the poverty rate by 0.72-percentage point and also the Gini index by 0.0021 point. Economic growth during 1980s could be categorized as the inclusive growth since the poor is getting more benefits from the growth than the rich. However, the inclusive growth did not happen during 1990s and 2000s.

The elasticity of employments to growth has also continuously declined from 1.12 (1985) to 0.21 (2012). The condition of 1980s appears to be the increasing return to scale of job creation since one percent of growth could create more than one percent of job opportunities. The recent condition shows that employment is not sensitive to the economic growth. This is because the economic growth is mainly contributed by capital intensive of manufacturing industries and non-tradable sectors.

Figure 4 shows the change of the proportion of formal worker for each income quintile. The economic growth during 2005-2011 has increased the proportion of formal worker by almost 13%. Formal employment provides more stable income and also more benefits to employee that will enable households hired as formal employee to move out of poverty. Dartanto and Nurkholis (2013) confirmed that those working in formal sectors increase their probability of being non-poor by 4.6% in Java-Bali, 6.8% outside Java-Bali and 5.8% nationally. The benefits of increasing job opportunities in formal sectors created during 2005-2011 are mostly enjoyed by the highest quintile. The formal sector needs

skilled workers and higher education level that the lowest quintile households could not fulfill the requirement. This evidence can explain why inequality increases since 2006.

**Figure 4: Growth of Formal Worker by Decile during 2005-2011**



Source: Author's Calculation based on Susenas 2005 and 2011

#### D. Growth, Poverty and Inequality at Provincial Level in Indonesia

Table 8 shows the elasticity of poverty, inequality and unemployment to growth at provincial level from 2007 to 2012. It appeared that the economic growth has reduced the poverty in all provinces, while it also generated higher Gini index. Although West Papua experienced the highest percentage of average growth (16.68%), this growth could only reduce the poverty rate by 3.07 percentage points, the unemployment by 0.48 percentage point and increased the Human Development Index by 0.59 point. On the contrary, it increased the Gini index by 0.03 point.

On the other hand, the least average growth experienced by Aceh Province has reduced poverty incidence by 1.61 percentage point and unemployment rate by 0.50 percentage points. The greatest elasticity of poverty to growth is observed in Aceh and Papua. The elasticity was about -0.86 in which one percentage of economic growth can reduce the poverty incidence by 0.86 percentage point. This might not be surprising since the tsunami's recovery process and rebuilding Aceh has created a lot of jobs and business opportunities that can alleviate poverty. At the same time, the benefits from the recovery process were not equally distributed among society; consequently the highest elasticity of inequality to growth was also in Aceh. In the term of the ability of economic growth to reduce unemployment, the highest elasticity was found in Maluku, Aceh, West Java and Riau. In the case of Maluku, one percent of economic growth can reduce unemployment rate by 0.28 percent.

Figures in Table 8 shows that Indonesia is very diverse society in which the poverty reduction policies should be tailor-made considering the regional characteristics. The eastern parts of Indonesia are still struggling on connectivity and infrastructure bottlenecks while provinces in Java are dominated by the small and landless farmers. An economic transformation from agriculture based economy into industrial and service based economy

may significantly reduce poverty in Java while it may not affect the poverty reduction in the eastern part of Indonesia.

**Table 8: Elasticity of Poverty, Gini and Unemployment to Growth at Provincial Level**

Province	Percentage Change during 2007-2012					Elasticity of [...] to Growth			
	Poverty	Average Growth	Gini	Unemployment	HDI	Poverty	Gini	Unemployment	HDI
1. Aceh	-1.61	1.88	0.01	-0.50	0.43	-0.86	0.006	-0.27	0.23
2. North Sumatera	-0.87	6.27	0.01	-0.86	0.47	-0.14	0.001	-0.14	0.07
3. West Sumatera	-0.98	6.01	0.01	-0.97	0.49	-0.16	0.002	-0.16	0.08
4. Riau	-0.79	4.14	0.02	-0.81	0.45	-0.19	0.005	-0.19	0.11
5. Jambi	-0.50	6.54	0.01	-0.72	0.50	-0.08	0.002	-0.11	0.08
6. South Sumatera	-1.42	7.28	0.01	-1.08	0.46	-0.19	0.001	-0.15	0.06
7. Bengkulu	-1.16	5.53	0.02	-0.43	0.52	-0.21	0.004	-0.08	0.09
8. Lampung	-1.64	5.18	0.01	-0.76	0.43	-0.32	0.001	-0.15	0.08
9. Bangka Belitung Island	-1.04	6.17	0.00	-1.03	0.47	-0.17	0.000	-0.17	0.08
10. Riau Island	-0.87	5.89	-0.01	-0.46	0.53	-0.15	-0.001	-0.08	0.09
11. DKI Jakarta	-0.23	6.24	0.02	-0.61	0.35	-0.04	0.003	-0.10	0.06
12. West Java	-0.92	5.96	0.02	-1.17	0.48	-0.15	0.003	-0.20	0.08
13. Central Java	-1.36	5.86	0.01	-0.51	0.44	-0.23	0.001	-0.09	0.08
14. DI. Yogyakarta	-0.78	5.76	0.01	-0.15	0.49	-0.14	0.002	-0.03	0.08
15. East Java	-1.73	4.86	0.02	-0.82	0.52	-0.36	0.003	-0.17	0.11
16. Banten	-0.84	6.37	0.01	-0.65	0.61	-0.13	0.001	-0.10	0.10
17. Bali	-0.67	6.03	0.02	-0.51	0.59	-0.11	0.004	-0.08	0.10
18. West Nusa Tenggara	-1.74	3.66	0.01	-0.65	0.64	-0.48	0.002	-0.18	0.17
19. East Nusa Tenggara	-1.78	5.10	0.00	-0.35	0.58	-0.35	0.000	-0.07	0.11
20. West Kalimantan	-1.24	5.59	0.02	-0.55	0.56	-0.22	0.003	-0.10	0.10
21. Central Kalimantan	-0.80	6.29	0.01	-0.33	0.39	-0.13	0.001	-0.05	0.06
22. South Kalimantan	-0.50	5.87	0.01	-0.52	0.61	-0.09	0.002	-0.09	0.10
23. East Kalimantan	-1.17	3.70	0.01	-0.34	0.59	-0.32	0.002	-0.09	0.16
24. North Sulawesi	-0.95	7.93	0.03	-0.42	0.45	-0.12	0.003	-0.05	0.06
25. Central Sulawesi	-1.87	7.64	0.01	-0.66	0.50	-0.24	0.002	-0.09	0.06
26. South Sulawesi	-1.07	8.44	0.02	-0.96	0.56	-0.13	0.002	-0.11	0.07
27. South East Sulawesi	-2.07	7.42	0.01	-0.66	0.62	-0.28	0.001	-0.09	0.08
28. Gorontalo	-2.53	8.96	0.00	-0.69	0.60	-0.28	0.000	-0.08	0.07
28. West Sulawesi	-1.51	8.40	0.01	-1.33	0.55	-0.18	0.001	-0.16	0.07
30. Maluku	-2.60	5.94	0.01	-1.66	0.49	-0.44	0.002	-0.28	0.08
31. North Maluku	-0.98	6.52	0.00	-0.68	0.43	-0.15	0.000	-0.10	0.07
32. Papua	-2.53	2.96	0.01	-0.45	0.49	-0.86	0.002	-0.15	0.17
33. West Papua	-3.07	16.68	0.03	-0.48	0.59	-0.18	0.002	-0.03	0.04
<b>All Province</b>	<b>-1.23</b>	<b>5.83</b>	<b>0.01</b>	<b>-0.80</b>	<b>0.54</b>	<b>-0.21</b>	<b>0.002</b>	<b>-0.14</b>	<b>0.09</b>

Note: \* is the change from 2007 to 2011

Source: Author's Calculation based on The Central Statistic Agency (BPS)

## IV. MACROECONOMIC POLICIES AND POVERTY REDUCTION

At the macroeconomic level, the fiscal, monetary, investment and trade policies have moved to the right direction. Though, the social expenditures and product subsidies are still maintained at a minimum level (even increase) similar to the pre-crisis level, the main drawback is a huge allocation on fuel subsidies, a low allocation on infrastructure development and no serious concern on developing agriculture sectors. In the term of monetary policy, Bank of Indonesia has enacted the regulation to support the development of small-medium enterprise sector that might benefit to support the poverty reduction and curb inequalities. Nevertheless, loan distributions provided by commercial banks are biased to service sectors and the western part of Indonesia. Both fiscal and monetary authority is likely well coordinated in mitigating internal and external turbulence. Moreover, to some extent, Indonesia has been liberated financial and trade sectors. All policies have supported the significant decrease of poverty during the last three decades. However, when the poverty rate is approaching a single digit, macroeconomic policies may not directly affect the poverty reduction, the government should focus more on micro policies such as education, social health insurance and financial inclusion etc.

### A. Fiscal Policy

There are significant changes in budget allocation starting from 2001 due to changing from the centralized system to more the decentralized system. The share of transfer to local governments is gradually increasing up to 30.9% but the share of development expenditure is sharply decreasing to 7% in 2009 due to budget reallocation. Provinces and local governments now manage 36% of total public expenditures and carry out more than 50% of public investment. In addition, Government of Indonesia (GOI) pays much attention to education and health sectors represented by an increase in budget allocation to both sectors. Education and health consumed 9.78% of budget in 2005 and by 2012 those consumed almost 11.78% of budget. Education spending reached 2.76% of GDP in 2011 and total public health spending was still below 1% of GDP. In general, the expenditure on health, education, social safety net, and product subsidies (fertilizer, fuel, electricity, etc.) are still maintained at a minimum level as same as the pre-crisis level.

Generally speaking, the taxation system is moving in the right direction. The Indonesian value added tax (VAT henceforth) conforms in its design to the best practice in very many respects (Marks, 2003). For example, VAT on capital goods expenditures is creditable against VAT obligations. Indonesia also exempts a wider range of goods and services which are especially consumed by the low income group. The role of indirect taxes, which previously were dominant, has decreased and direct taxes now dominate so that the distortion in economy can be minimized. During 1996-2009, the average proportion of income tax to total revenue (33.38%) exceeded the proportion of VAT (20.73%). During 2010-2012, the average proportion of income tax to total revenue has become 36.5% that exceeded the proportion of VAT (23.6%).

One of the current issues on the revenue redistribution policy is an income tax reform which was enacted by the new income tax law No.36/2008 junct. to Law, No.7/1983. In many respects, the Indonesian income tax, known as *Pajak Penghasilan (PPH)*, is progressive and applied to both individual and enterprises. The law No.38/2008, however, maintains the progressiveness of personal income taxes but introduces a flat rate of corporate income tax rate. This law cut maximum tax rates from 30 per cent (2008) to 25% (2010) and offers more incentives to listed companies. Moreover, this current reform appears in favor of the development of small medium enterprises (SMEs). A 50% discount of the normal rate is granted to SMEs with the turnover up to IDR 50 billion that is imposed on taxable income of a gross income of IDR 4.8 billion.

**Table 9: Revenue and Expenditure (% of GDP) (1985 – 2012)**

Indicators	1985	1995	2005	2011	2012
Total revenue					
Tax revenue (% of GDP)	15.64 (1991)	14.02	12.50	11.77	12.33
Income tax ( <i>Taxes on income, profits and capital gains (% of revenue)</i> )	59.20 (1991)	52.23	48.83	35.64	37.84
VAT: <i>Taxes on goods and services (% of revenue), include general sales and turnover or value added taxes, selective excises on goods, selective taxes on services, taxes on the use of goods or property, taxes on extraction and production of minerals, and profits of fiscal monopolies.</i>	26.81 (1991)	31.64	14.99	29.34	32.83
Trade tax <i>Taxes on international trade (% of revenue)</i>	5.17 (1991)	4.53	3.14	4.47	4.20 <sup>1</sup>
Non-tax revenue ( <i>Grants and other revenue (% of revenue) - Grants and other revenue include grants from other foreign governments, international organizations, and other government units; interest; dividends; rent; requited, non-repayable receipts for public purposes (such as fines, administrative fees, and entrepreneurial income from government ownership of property); and voluntary, unrequited, non-repayable receipts other than grants.</i> )	5.98 (1991)	10.24	28.57	27.77	23.03 <sup>1</sup>
Current expenditure ( <i>Gross national expenditure (% of GDP)</i> )	98.25	101.33	95.85	98.59	98.56
Government expenditure (% of GDP)	11.23	7.83	8.11	8.97	8.93
Revenue surplus/deficit <i>Cash surplus/deficit (% of GDP) - Cash surplus or deficit is revenue (including grants) minus expense, minus net acquisition of nonfinancial assets. In the 1986 GFS manual nonfinancial assets were included under revenue and expenditure in gross terms.</i>	0.68 (1991)	1.72	-0.13	-1.14	na
Development expenditure ( <i>Research and development expenditure (% of GDP)</i> )	na	0.068 (2000)	0.048 (2001)	0.083 (2009)	na
Total government expenditure (in \$ billion constant 2005 price)	69.13	125.82	179.13	237.85	252.2
Budget deficit (% of GDP)	1.24	1.32	0.52	1.13	1.77
Domestic borrowing ( <i>% of Deficit</i> )	1.85	18.89	192.36	113.59	102.23
Foreign financing ( <i>External debt stocks (% of GNI)</i> )	44.35	63.40	52.15	25.96	na

<sup>1</sup> the realization of government budget in the semester I-2012

na = not available

Source: World Development Indicators and Ministry of Finance-Republic of Indonesia

However, the main drawback of budget allocation is a huge allocation on fuel subsidies, low allocation on infrastructure development and less concern on developing agriculture sectors as indicated there is no allocation for fertilizer subsidies recently (Table 10). Subsidies consume 27.63% of budget and fuel subsidies itself took 72.62% of subsidies in 2010. Indonesia has been subsidizing fuel since the 1970s when the world experienced its first oil price shock. The government fixed the price at a very low level until 2005, with the budget bearing the cost of the difference between domestic and world oil prices. When the world oil price started to rise substantially in 2004, fuel subsidies became the main expenditure item in the budget, consuming more than 20% of total expenditures,

in both 2004 and 2005. Confronted with these financial problem, GOI doubled fuel prices in 2005. When oil prices reached a record high in mid-2008, Indonesia faced the same challenge as in 2005. In May 2008, the government increased fuel prices by another 30%. Lately, GOI has also increased fuel prices in 2013.

Son (2008) observed that Indonesia spent 5 per cent of gross domestic product on energy subsidies. The massive fuel subsidies reduce fiscal space which means the government has fewer sources to promote economic growth through investment in infrastructure or human capital (Agustina et al., 2008). This would also cause a worsening in the income distribution because, in 2008, the richest income group received fuel subsidies approximately IDR 111,533/month/capita while the lowest income group received fuel subsidies approximately IDR 10,787/month/capita. In terms of government expenditure, the share of subsidies to total government expenditure significantly increases by almost 17%. Subsidies currently account to almost 57% of government expenditure (Dartanto, 2013b).

**Table 10: Public Spending on Education and Health (1985 – 2011)**

Indicators	1985-94		1995-04		2005-11	
	% of GDP	% of Govt Expenditure	% of GDP	% of Govt Expenditure	% of GDP	% of Govt Expenditure
Education ( <i>Total public spending on education – average</i> )	0.91 <sup>1</sup> (1989)	na	2.03 <sup>2</sup>	13.97 <sup>3</sup>	3.10	16.57
Health ( <i>Total health expenditure – average</i> )	na	na	2.16	4.53	2.88	5.82
Agriculture related ( <i>fertilizer subsidies</i> )	0.39	1.96	0.03	0.11	na	na
Infrastructure	7.10	37.27	2.80	18.78	1.80	11.83
Fuel Subsidies	na	na	3.04	20.95	2.34	16.51
Anti-poverty programs ( <i>social assistance</i> )	na	na	na	na	1.13	6.47

na = not available

Source: World Development Indicators and Ministry of Finance-Republic of Indonesia

Large fuel subsidy reduces the fiscal room, which may be used to promote economic growth and create job opportunities. As a result of the high proportion of subsidies, infrastructure is one of another account that has experienced significant decrease from 1985-1994 to 2005-2012. In 1985 infrastructure consumed more than 37.27% of GDP, while in 2005-2012 it only consumed around 11% of GDP. Whereas as we discuss before, the nature of poverty in eastern part of Indonesia such as Kalimantan, Sulawesi, Maluku, and Papua are mostly influenced by infrastructure problems both caused by the isolation or being damaged by social riots. Reallocating fuel subsidies into infrastructure projects will have double effects in the economy: promoting long run sustainable economic growth while reducing inequality issue.

## **B. Monetary Policy**

Indonesia as one of the country that being hit by the financial crises in 1998 era has been struggling deeply to recover from the impact of the crisis. To strengthen and create more resilience banking and financial sectors, the regulation related to these sectors has been changed significantly. Under the law no. 3/2004, Bank of Indonesia now can have full concentration to maintain the stability of the national currency and the price level. Bank of

Indonesia has also been given independence in conducting its monetary policy, while coordinating with the government in setting the inflation target (Goeltom, 2008).

Table 11 illustrates some indicators of Indonesian monetary sector. It is shown that monetary base has significantly decreases after the crises from 48.59% of total GDP (1995) to around 40% of total GDP in 2012. This condition is due to the tight monetary policy conducted by the central bank to control the high level of inflation. Table 11 also shows continuous and significant decrease both for deposit and lending interest rate that will induce more investment from the country. While deposit interest rate and lending interest rate in 1985 were 18% and 21.49% respectively, Bank of Indonesia successfully cut both the interest rates to 5.95% and 11.80%. A low lending rate will increase the opportunity of potential business getting credit from commercial banks.

**Table 11: Growth in Money and Inflation (1985 – 2012)**

Indicators		1985	1995	2005	2011	2012
Money Supply ( <i>M2 - % of GDP</i> )		24.16	48.59	43.25	38.78	40.09
Inflation ( <i>Consumer Prices – annual %</i> )		4.73	9.43	10.45	5.36	4.28
Interest rate of borrowing / lending	Deposit interest rate (%)	18	16.72	8.07	6.93	5.95
	Lending interest rate (%)	21.49 (1986)	18.85	12.4	14.05	11.80
	Real interest rate (%)	21.61 (1986)	8.34	-0.25	3.99	6.96
Investments						
<i>Gross Fixed Capital Formation, % of GDP</i>		22.72	28.43	23.64	31.93	33.14
<i>Private (Gross Fixed Capital Formation, private, % of GDP)</i>		na	na	na	na	na
Savings						
<i>Gross Domestic Savings (% of GDP)</i>		29.71	30.59	29.23	34.18	33.79
<i>Gross Savings (% of GDP)</i>		24.59	28.14	26.04	32.01	31.33
Credit						
<i>Domestic credit to private sector (% of GDP)</i>		19.70	53.52	26.43	31.74	34.90
Credit for the poor		na	na	na	na	na

na = not available

Source: World Development Indicators

**Table 12: Outstanding of Loans of Commercial Banks by Economic Sector (IDR Trillion)**

Economic Sector	2002	2005	2008	2011	2012
Agriculture, Livestock, Forestry & Fishery	2.50	8.37	8.02	8.19	8.78
Mining and Quarrying	0.16	0.62	0.63	1.49	1.63
Manufacturing Industry	8.55	27.15	23.13	19.65	19.91
Electricity, Gas and Water Supply	75.82	0.31	1.53	2.75	2.79
Construction	0.95	6.28	7.00	5.93	5.86
Trade, Hotel, and Restaurant	7.12	33.85	33.66	31.98	33.49
Transport and Communication	1.13	4.57	6.86	5.91	5.89
Financial, Ownership & Business Services	3.28	16.35	17.16	10.89	11.38
Services	0.50	2.49	2.01	13.22	10.28

Source: Bank of Indonesia

Table 12 confirms a change in the sectoral composition of Indonesian economy from agriculture to industry and services sector. By 2012, the top three sectors in term of loans provided by commercial banks are trade, hotel and restaurant, manufacture, and financial services. Commercial banks allocated almost 64.7% of total outstanding loans to these three sectors. Despite significant growth in loans for agriculture sector, services sector surprisingly has surpassed the agriculture sector in 2011, implying that service sector has become more promising than agricultural sector in the last two decades. Unbalanced sectoral credit allocation may contribute to the rising inequality in Indonesia.

From Table 13, it is obviously shown that there is imbalance between the distributions of outstanding loan among region in Indonesia. From the last decade, the banking sector put most of their financial resource into three provinces, DKI Jakarta, East Java and West Java. The total credit allocated into three provinces contributed more than 50% from the national credit. At the extreme case, the credit allocated in DKI Jakarta is more than 150 folds of credit allocated in Maluku. Unbalanced credit allocation might contribute a rising inequality both between region and also within region. The government should adapt policy for the banking sector to allocate their proportion of credit to the rural area such as in the eastern part of Indonesia.

After the era of crisis in 1998, Bank of Indonesia as the monetary authority in Indonesia has recorded several achievement such as a fully control on inflation and price stability. Bank of Indonesia has also implemented some regulations which are concordance with poverty alleviation program. In 2012 considering that small medium enterprise has played an important role in the Indonesian economy, Bank of Indonesia has issued Bank Indonesia Regulation (PBI) no. 14/22/2012 in which commercial banks has to allocate 20% of total loans to the small medium enterprise sector. This regulation is expected to boost the size of SME in Indonesia that will result in more jobs and less inequality.

Despite all the achievement above, all data shows that there is a huge imbalance in loans given by commercial bank in Indonesia, both in the terms of sectoral and regional disparities. In the past decade, the agricultural sector which contribute greatly employment have less attention, while service, trade-hotel-restaurant and manufacture sectors have been spoiled by the abundant financial resource from banking sector. Access to credit is a necessary condition for agricultural business to invest and generate productivity as well as value added growth. On the other hand, eastern part of Indonesia which has a high poverty rate also being ignored compare to the western part of Indonesia especially in Java Island.



Improving access to financial services in the eastern part of Indonesia will provide a greater opportunity of business sectors to expand their business. The business expansion will boost economic growth as well as employment creation.

**Table 13: Outstanding of Loans of Commercial Banks by Provinces (IDR Billion)**

Province	2002	2005	2008	2011	2012	2002	2005	2008	2011	2012
	Value in IDR Billion					Share to Total National (%)				
Nanggroe Aceh Darussalam	1,948	4,431	10,358	21,162	23,695	0.72	0.77	0.97	1.13	1.02
North Sumatera	11,863	30,235	54,835	89,838	111,006	4.37	5.25	5.12	4.79	4.77
West Sumatera	4,214	8,167	15,532	29,030	33,765	1.55	1.42	1.45	1.55	1.45
Riau	8,475	12,837	25,048	46,013	55,201	3.12	2.23	2.34	2.45	2.37
Jambi	2,588	4,872	9,719	19,360	23,762	0.95	0.85	0.91	1.03	1.02
South Sumatera	5,353	9,969	19,849	44,256	56,045	1.97	1.73	1.85	2.36	2.41
Bangka Belitung	618	1,422	2,839	6,512	7,780	0.23	0.25	0.27	0.35	0.33
Bengkulu	689	1,810	4,934	9,745	12,346	0.25	0.31	0.46	0.52	0.53
Lampung	3,953	9,445	18,704	34,895	40,456	1.46	1.64	1.75	1.86	1.74
Banten	10,078	23,573	44,258	96,783	132,373	3.71	4.10	4.13	5.16	5.69
DKI Jakarta	94,649	192,759	352,811	543,749	665,289	34.86	33.50	32.95	28.96	28.59
West Java	34,062	74,325	136,454	242,687	300,201	12.55	12.92	12.74	12.93	12.90
Central Java	24,353	48,434	84,789	142,910	174,777	8.97	8.42	7.92	7.61	7.51
D.I. Yogyakarta	2,482	6,183	10,415	16,693	20,250	0.91	1.07	0.97	0.89	0.87
East Java	31,835	66,487	118,067	202,915	254,712	11.73	11.55	11.03	10.81	10.94
Bali	6,090	10,945	19,444	38,093	50,256	2.24	1.90	1.82	2.03	2.16
West Nusa Tenggara Barat	1,583	3,554	7,056	13,808	17,055	0.58	0.62	0.66	0.74	0.73
East Nusa Tenggara	1,214	2,616	5,527	10,972	13,351	0.45	0.45	0.52	0.58	0.57
West Kalimantan	2,769	6,051	12,044	25,773	33,745	1.02	1.05	1.12	1.37	1.45
Central Kalimantan	1,649	3,258	6,710	19,414	22,011	0.61	0.57	0.63	1.03	0.95
South Kalimantan	2,605	6,373	13,352	25,347	31,183	0.96	1.11	1.25	1.35	1.34
East Kalimantan	3,874	11,129	21,428	48,085	62,433	1.43	1.93	2.00	2.56	2.68
North Sulawesi	1,968	4,371	10,131	18,706	21,668	0.72	0.76	0.95	1.00	0.93
Gorontalo	408	1,011	2,091	5,110	6,372	0.15	0.18	0.20	0.27	0.27
Central Sulawesi	1,381	3,302	6,766	13,806	17,485	0.51	0.57	0.63	0.74	0.75
South Sulawesi	8,168	16,256	30,846	56,288	68,858	3.01	2.82	2.88	3.00	2.96
Southeast Sulawesi	803	1,654	4,125	9,275	11,853	0.30	0.29	0.39	0.49	0.51
North Maluku	191	604	1,499	3,550	4,301	0.07	0.10	0.14	0.19	0.18
Maluku	356	915	2,475	5,753	6,533	0.13	0.16	0.23	0.31	0.28
Papua	1,289	2,904	5,249	11,691	15,287	0.47	0.50	0.49	0.62	0.66
West Papua	-	-	2,166	4,468	6,141	-	-	0.20	0.24	0.26
West Sulawesi	-	691	1,954	3,470	4,317	-	0.12	0.18	0.18	0.19
Riau Island	-	4,884	9,300	17,198	22,818	-	0.85	0.87	0.92	0.98
<b>Total</b>	<b>271,508</b>	<b>575,467</b>	<b>1,070,775</b>	<b>1,877,355</b>	<b>2,327,325</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>

Source: Bank of Indonesia

## V. ADJUSTMENT POLICIES AND POVERTY REDUCTION

A stabilization policy is a macroeconomic strategy enacted by government and central bank to keep economic growth stable, along with price levels and unemployment. While keeping sound economic fundamentals, appropriate policy responses were keys to supporting Indonesia's economic resilience especially during the crisis and global uncertainty. Bank of Indonesia and GOI engaged in policy coordination to reinforce economic fundamentals while mitigating impact from external turbulence. On Bank of Indonesia's part, the measure, timely application of a monetary and macro-prudential policy mix, proved successful in safeguarding macroeconomic and financial market stability. This policy mix was implemented through interest rate and exchange rate policy

responses as well as macro-prudential policies for management of capital inflows and banking liquidity.

**Table 14: Balance of Payment Indonesia 2002-2011**

Indicator	Year					
	2002	2005	2006	2008	2009	2011
Internal						
GDP growth (% yoy)	4.38	5.68	5.48	6.01	4.63	6.46
Inflation (% yoy)	5.9	17.11	6.60	11.06	2.78	3.79
External						
Export (Million US \$)	59,16	86,99	103,5	139,60	119,64	200,78
Import (Million US \$)	35,65	69,46	73,86	116,69	88,71	166,01
Current Account (Million US \$)	23,51	17,53	29,64	256,29	208,36	366,79
Reserves (Million US \$)	30,754.34	32,774.19	40,697	49,164	60,369	103,380

Source: Bank of Indonesia

Table 14 shows the status of internal and external balance of Indonesia during 2002-2011 as described by economic growth and rate of inflation. GDP growth shows increase continuously, with the exception of 2009 due to global crisis. In 2011, economic growth reached 6.5%, the highest economic growth during the past ten years, while inflation was a mild 3.79%. The inflation rate generally shows decreasing trend from 2002-2011, with the exception of year 2005 when GOI increase the price of subsidized fuel. On the external side, Indonesia's balance of payments (shown by current account) charted a respectable surplus that expanded the international reserves position and contributed to appreciation in the rupiah exchange rate from 2002 - 2011.

From the Government side, fiscal policy sought to deliver an enlarged stimulus while safeguarding fiscal sustainability. At the sectoral level, the Government worked hard to boost the quality of economic growth through improvements to the investment climate, accelerated construction of infrastructure, stronger competitiveness in industry and exports and greater national food resilience, including measures to stabilize prices.

#### **A. Financial Liberalization**

In 1983 Indonesian banking system implemented a new deregulation, marked the beginning of financial liberalization in Indonesia. Table 15 shows how the liberalization in the financial sector could contribute to decrease the lending rate from 21.49% in 1985 to 11.79% in 2012. Nevertheless, interest rate spread (lending rate minus deposit rate) is still quite high. The financial liberalization and directed lending scheme by GOI had influenced the interest spread. Directed lending policy can reduce profitability of banks, so that banks may charge higher interest rates on other commercial loans thus raising overall spread (Dagva, 2006). The high interest rate spread could signify a number of structural and other problems, such as a lack of competition in banking industry, scale diseconomies, and high operating costs.

Recent studies on the relationship between financial development and poverty have been inconclusive. Evidently the impact of financial development on economic growth and its impact on the reduction of poverty are related issues, as growth is a powerful way to reduce poverty (Bruno, Ravallion and Squire, 1999). In Indonesia case, the financial liberalization has led to decreasing interest rate. As shown in Table 15, this reduction of interest rate has increased gross domestic investment that finally led to economic growth.

However, the increasing economic growth led by the financial liberalization may not be directly perceived by Indonesian poor.

Financial liberalization increasing access to financial may go to those who work in formal sector. Meanwhile, most of Indonesian poor work in informal sector or even unemployed. Thus, complementary policy like microfinance institution for the poor is really needed. This micro financing scheme may help the expansion of the micro or small medium enterprises (MSMEs) thus could increase employment creation. Finally, one thing to be considered by GOI regarding financial liberalization is that more freedom of action of banks and other financial intermediaries can increase the opportunities to take on risk, thereby increasing financial fragility (Bank of Indonesia, 2010).

**Table 15: Trends in Interest Rate and Its Spread (%) (1985 – 2012)**

Description	1985	1995	2005	2011	2012
Deposit rate	18.00	16.72	8.08	6.93	5.95
Lending Rate	21.49*	18.85	14.05	12.40	11.79
Interest rate spread	6.10*	2.13	5.97	5.47	5.85
Real deposit rate	9.56	7.29	-2.37	1.53	1.67
Real lending rate	11.56*	9.42	3.60	7.05	7.51
Gross Domestic Savings (% of GDP)	29.71	30.59	29.33	34.38	33.79
Gross Domestic Investment, <i>net inflows</i> (% of GDP)	27.96	31.93	25.08	32.94	35.34
Foreign Direct Investment (% of GDP)	0.35	2.15	2.92	2.27	2.26
Stock Traded, total value (% of GDP)	0.004**	7.13	14.66	16.49	10.44

Source: World Development Indicators

Note: \* is the 1986 value; \*\* is the 2008 value.

Related to financial inclusion issue, the number of MSMEs is around 51.3 million units or 99.91% of the business unit totals. MSMEs could absorb 97.1% of total workers and its contribution to GDP was up to 55.6%. Nevertheless, around 60% of Indonesia population including these MSMEs has no financial access. Thus, policies carried by GOI are by giving credit to them by commercial banks and non-bank financial institution. There is also program named People's Business Loan (Kredit Usaha Rakyat /KUR). These aimed at making them more financially included. While the exclusion of people from financial services will only perpetuate their poor lives, financial inclusion will link the previously excluded group with the formal economy and they will eventually contribute more to a country's economic growth.

## B. Trade Liberalization

Economic theory offers many reasons to expect a country's trade liberalization to stimulate its economic growth, such as by reaping economies of scale, improving performance in the face of new competition, and benefiting from better inputs and technologies available from abroad. Trade liberalization could affect the poor of countries. However, none of these outcomes is guaranteed, so ultimately whether trade does or does not stimulate countries' incomes is an empirical matter.

Trade liberalization can affect the poor through complex pathways, such as by operating through price changes, employment impacts, and changes in government revenue and spending. Some critics against liberalization express concern that poor farmers will suffer if freer trade reduces the prices of staple foods. However, the evidence suggests that many of the poorest farmers are actually net buyers of staple foods, and so

would benefit from lower prices of staple foods. In fact, in many cases the poorest farmers are actually net consumers of staple foods, buying more than they sell. In Indonesia itself, 80 percent of households are net consumers of rice, even though half of them are growing rice. For these households, a drop in the price of rice represents a net gain. Dartanto (2010) found that a 60 per cent increase in world rice price raises the head count index by 0.81 per cent which is equivalent to an increase in the number of poor by 1,687,270. Dartanto and Usman (2011) found that a 40 per cent increase in world price raises the head count index by 0.204 percentage point which equals 427,971. This evidence confirmed that the poor in Indonesia will get more benefit when the international price of staple foods decreased.

As shown in Table 16, trade liberalization in Indonesia (shown by indicator Trade as percentage of GDP) has an increasing trend from 1985 until 2012. In these periods, export composition is largely dominated by manufacturing goods. This trend has already shifted from year 1985 when export was largely dominated by fuel. As the opposite, Indonesia is now becoming the net importer of fuel. However, this trend of export & import commodity still brought surplus to the Indonesia trade balance at least until year 2012.

**Table 16: Trade Reforms and Performance**

Indicators	1985	1995	2005	2011	2012
Weighted Mean Tariff (%), applied tariff					
Primary Products	5.81 (1989)	4.84	3.33	1.48	na
Manufactured product	15.55 (1989)	13.11	4.74	3.36	na
All products	12.96 (1989)	10.84	4.39	2.59	na
Trade Performance					
Exports Growth rate	-7.80	7.72	16.60	13.72	2.11
Imports Growth rate	5.28	20.94	17.78	13.47	6.70
Exports of goods and services as % of GDP	22.20	26.31	34.07	26.33	24.26
Imports of goods and services as % of GDP	20.45	27.65	29.92	24.92	25.81
Trade as % of GDP	42.65	53.96	63.99	51.24	50.07
Trade deficit <i>Net trade in goods and services (BoP, current US\$, in million)</i>	na	na	8,411.23	23,524.55	21,560.07
Exports Composition					
Agricultural raw materials exports (% of merchandise exports)	5.98	6.64	5.05	7.52	5.94
Food exports (% of merchandise exports)	9.96	11.39	11.68	16.33	17.92
Fuel exports (% of merchandise exports)	66.60	25.36	27.61	34.14	33.59
Manufactures exports (% of merchandise exports)	13.04	50.61	47.18	34.16	36.18
Imports Composition					
Agricultural raw materials imports (% of merchandise imports)	4.12	6.18	3.45	3.19	2.62
Food imports (% of merchandise imports)	6.91	8.84	8.08	9.43	8.25
Fuel imports (% of merchandise imports)	12.54	7.51	30.78	23.11	22.37

Manufactures imports (% of merchandise imports)	72.11	72.91	54.55	59.74	62.44
Trade taxes as % of total revenue collection - <i>Taxes on international trade (% of revenue)</i>	5.17 (1991)	4.53	3.14	4.47	na

na = not available

Source: Author's Calculation based on data from World Development Indicators and Central Statistical Agency (BPS)

Because of its liberalization and due to the regulation of WTO about freer trade, tax and tariff collected by GOI from international trade was decreasing from year 1985 to 2012. Weighted tariff to all products has significantly decreased from 12.96% in 1985 to 2.59 in 2012. Nevertheless, trade tax reduction has not been significantly decreased. As shown in table 16, trade taxes as percentage of total revenue collection was 5.17% in 1985 and only slightly decreased to 4.47% in 2011. This is to say that the revenue from international trade keep increasing, even though the tariff has been reduced.

The first inflow of FDI to Indonesia was when the GOI passed the law on foreign investment in 1967. In the 1970s, FDI inflow in Indonesia was concentrated in the oil and gas sector. FDI started to flow to other sectors in Indonesia from 1980s until the 1997 financial crisis. In that period, Indonesia enjoyed an abundant flow of both foreign and domestic investments. These happened because the GOI has deregulated almost all sectors after the end of the oil boom in 1982 (Wie, 2006). Followed by some deregulation in sectors such as the removal of trade protection regime in the late 1990s, government policy has been focused on promoting FDI in the wider base like manufacturing sector and to stimulate export (export-oriented FDI). At that moment there was no doubt that FDI has been functioning as a new engine for growth and the main source of non-oil revenues in lieu of a decline in oil export earnings in that period.

In particular, the effects of trade reform on different sectors and different income groups depend on who initially benefited from trade protection. Meanwhile, several case studies highlighted the fact that trade liberalization creates losers as well as winners, and in many cases the losers include substantial numbers of the poor. Evidence on labor market impacts from trade liberalization was mixed: wages and employment rose in some cases and fell in others (USAID, 2005). However, USAID (2005) is more inclined to the conclusion that the impact of freer trade on wages or employment is "remarkably small". Those effects depend heavily on labor regulations. Regulations that make it difficult for workers to move from one job to another are very damaging for the poor. As in Indonesia, a the regulation said that firm must pay two years' wages as compensation before firing a worker, it becomes much costlier for firms to shed labor in response to lost protection, and deters workers from moving to growing sectors.

## **VI. SOCIAL POLICIES AND POVERTY REDUCTION: A NEW DIRECTION FOR POVERTY REDUCTION STRATEGIES**

When the poverty rate approaches a single digit, the rate of poverty reduction has begun to slow down with inequality rise significantly. In this condition, the macroeconomic policies might not be effective to boost the rate of poverty reduction. The poverty reduction policies should be focused on more targeted policies. In order to improve Indonesian social policies and poverty alleviation programs, the government has established National Team for the Acceleration of Poverty Reduction (TNP2K) under the Vice President Office.<sup>3</sup> The TNP2K

<sup>3</sup> The new elected government in the 2014 election may not continue or may restructure

plays an important role to provide new strategies toward more effective poverty reduction programs by developing national targeting system using the unified database. Thus, all poverty alleviation programs at all level government should utilize this unified database. The unified database included detail information of 40% of the poorest population is expected to improve accuracy in targeting and integrated packages of social assistance.

The strategies were organized around three clusters under the policy formulation working groups. Cluster 1 is the working group on social assistances and protection; cluster 2 is the working group on community empowerment; and cluster 3 is the working group micro and small-medium enterprises. *Cluster 1: Social Assistance Program.* This working group focuses on monitoring and evaluating the major social assistance programs that are targeted at individuals or household/family. The programs are Unconditional Cash Transfers (BLT), Conditional Cash Transfers (PKH), Social Health Assistance for the Poor (JAMKESMAS)—currently transformed into BPJS Health (see Box 1), scholarship Programs (BSM), and Rice for the Poor (RASKIN) program. *Cluster 2: Community based Development Program.* The main task of this working group is to support community empowerment approach and coordinate the various programs under National Program on Community Empowerment (PNPM). The activities involved are the improvement of village infrastructure through labor-intensive projects, provision of revolving fund that is given to women, and also developing community capacity through training and implementation of good governance. *Cluster 3 – Micro, Small and Medium Enterprises Program.* The main program under this cluster is guaranteed loan for micro, small and medium enterprises (KUR). It covers the support on financing, product marketing, capacity building and management.

### **Box 1. Universal Coverage of Health Insurance**

The enforcement of the SJSN (*Sistem Jaminan Sosial Nasional*) Law No. 40/2004 and the BPJS (*Badan Penyelenggara Jaminan Sosial*) Law No. 24/11 is a milestone for the Government of Indonesia (GoI henceforth) to realize UCHI for improving health financing and health care access in Indonesia. The SJSN law forces all Indonesian to have insurance; thus, it will be effective to expand coverage of health insurance. By 2019, all Indonesian will be covered by health insurance. It means there only five years for achieving UCHI in Indonesia. As of January 1<sup>st</sup>, 2014, GoI will implement *Jaminan Kesehatan Nasional* (National Health Security System) as the initial stage for UCHI.

The current condition, there are only 72% of the 245 million people in 2012 covered by the current health insurance types in Indonesia. The Indonesian health insurance types include: 1) health insurance for the poor (JAMKESMAS) covered 35.18%, 2) social health insurance schemes for civil servants (ASKES, ASABRI) covered 7.32%, 3) conditional mandatory health insurance for private employees (JPK JAMSOSTEK) covered 2.86%, 4) local schemes of health insurance (JAMKESDA) covered 18.56%, 5) employer provided health care (self-insured) covered 6.89%, and 6) traditional commercial health insurance schemes covered 1.2%.

There are six important issues on achieving UCHI in Indonesia (Dartanto, 2014): 1) coverage of UCHI means that there are still remaining 68.7 million uninsured people; 2) lack of health facilities, unequal distribution among regions as well as unequal quality of services are important issues to be urgently solved; 3) the fiscal burden of central government accomplish UCHI; 4) how much reasonable premium and how much benefit will be received by member are still debatable; 5) the regulation and organization of BPJS health; and 6) monitoring and evaluation of the program implementation.

A well-designed of health insurance improves the access to health care and protects against the financial burden of paying for medical expenses. In the long run, the universal health insurance will improve human capital as well as boost the sustainable economic growth. This social health insurance should be one of priorities for the new government of Indonesia to accelerate the rate of poverty reduction and curb rising inequalities.

## **VII. CONCLUDING REMARKS**

The Indonesia's experience in tackling poverty over the last 30 years, despite some impediments such as the Asian financial crisis in 1997-1998, has been perceived to be a remarkable success story in Asia. The rate of poverty reduction in Indonesia has begun to slow down with inequality continuing to rise significantly. The Gini coefficient has substantially increased by roughly 0.08 for a decade from 0.33 in 2002 to 0.41 in 2012. The current challenge faced by Indonesia is that how to accelerate the rate of poverty reduction and to curb rising inequalities by making growth and policies more inclusive that allows the poor to benefit more equitable from the development process.

Examining the macroeconomic data for last three decades, this study found that the elasticity of poverty to growth (national poverty line) has declined sharply in three decades. During 1980s, economic growth was inclusive since the welfare of the poor was growing faster than the rich. Thus, economic growth can reduce both the poverty rate and inequality in Indonesia. One percent of economic growth could reduce the poverty rate by 0.72 percentage point and also the Gini index by 0.0021 point. Unfortunately, the growth during 1990s and 2000s became less inclusive as indicated by the shrinking in the elasticity of

poverty to growth and the positive elasticity of inequality to growth. Moreover, the elasticity of employment to growth declined continuously from 1.12 (1985) to 0.21 (2012). During 2000s, the employment (job opportunities) was insensitive to economic growth.

There are several possible reasons for less inclusive growth in Indonesia. First, the Indonesian economy is moving into more services oriented economy and capital-intensive sectors such as mining, financial and telecommunications. These sectors only employ fewer and skilled labor and thus, depriving the poor to benefit from a rising economy. Second, the productivity of industrial sector and service sector is more than seven-fold and three-fold of agriculture's productivity respectively. This condition coupled with the continuous decrease of farmer exchange value has made the welfare for those working in the agriculture sectors left behind others.

At the macroeconomic level, the government polices both fiscal and monetary policies have moved to the right direction. For example, the expenditure on health, education, social safety net, and product subsidies are still maintained at a minimum level (even increase) similar to the pre-crisis level. The role of indirect taxes, which previously were dominant, had decreased and direct taxes dominated the government revenue. However, the main drawback of budget allocation is a huge allocation on fuel subsidies, a low allocation on infrastructure development and no serious concern on developing agriculture sectors. In the term of monetary policy, Bank of Indonesia has issued the Regulation of Bank Indonesia (PBI) no 14/22/2012 which requires 20% from total loans from each bank to be allocated to the small- medium enterprise sector to support poverty reduction and curb inequalities. However, there is a huge imbalance in loans given by commercial bank in Indonesia, both in the terms of sectoral (service sectors) and regional disparities (the western part of Indonesia).

The necessary condition for inclusive growth is the stable macroeconomic condition and sound economic fundamentals that can ensure more resilience economy to any internal and external shocks. However, the sufficient condition for inclusive growth should be micro level policies such as financial inclusion policies, improving access to education, health insurance and other social policies.



## REFERENCES

- Agustina, C. D. R. D., Granado, A., Javier, F., Bulman, T., Wolfgang, F. and Ikhsan, M. (2008), Black Hole or Black Gold? The Impact of Oil and Gas Prices on Indonesia's Public Finances. *The World Bank: Policy Research Working Paper 4718 (WPS 4718)*. Available at <  
<http://econpapers.repec.org/paper/wbkwbrwps/4718.htm>> [Accessed 12 April 2011]
- Ali, I. and Son, H. H. (2007), Measuring Inclusive Growth, *Asian Development Review* Vol. 24 No. 1, pp. 11-31.
- Banerjee, A. V. and Duflo, E. (2005), *Growth Theory through the Lens of Development Economics*, Amsterdam: North Holland, vol. 1A, pp. 473–552.
- Bank Indonesia (2010), *Developing a financial inclusion strategy: The case of Indonesia*. The 2010 AFI Global Policy Forum.
- Boldbaatar, Dagva (2006), *Measurement and Implication of Commercial Banks' Interest Rate Spread in Selected SEACEN Countries*. The South East Asian Central Banks (SEACEN): Malaysia.
- Bruno M., Ravallion, M. and Squire, L. (1999), *Equity and Growth in Developing Countries: Old and New Perspectives on the Policy Issues*. The World Bank: Policy Research Working Paper 1563. <http://elibrary.worldbank.org/doi/pdf/10.1596/1813-9450-1563>
- Coudouel A., Dani A.A. and Paternostro S. (2006), Poverty and social impact analysis of reforms: lessons and Examples from Implementation, World Bank: Washington D.C.
- Dagva, B. (2006), Measurement and Implication of Commercial Banks' Interest Rate Spread in Selected SEACEN Countries, The South East Asian Central Banks (SEACEN): Malaysia.
- Dartanto, T. and Otsubo, S. (2013), Intra-generation Poverty Dynamics in Indonesia: Lessons on Household's Mobility into (out) of Poverty during 1993-2007, Paper presented at the 23th PRSCO Conference and the 4<sup>th</sup> IRSA, Padjajaran University, 2-4 July 2013.
- Dartanto, T. (2013a), The Determinants of Fertility in Southeast and South Asian Countries: An Analysis of Panel Data 2003-2008, *Journal of Economic Cooperation and Development*, Vol.37 No.3 pp.1-22.
- Dartanto, T. (2013b), Reducing Fuel Subsidies and the Implication on Fiscal Balance and Poverty in Indonesia: A Simulation Analysis, *Energy Policy*, Vol.58 pp.117-134.
- Dartanto, T. and Nurkholis (2013), The Determinants of Poverty Dynamics in Indonesia: Evidence from Panel Data, *Bulletin of Indonesian Economic Studies*, Vol.49 No.1, pp. 61-84.

- Dartanto, T. (2014), Issues of Coverage, Services and Fiscal on Implementing *Jaminan Kesehatan Nasional*, The Presentation Material of Workshop “Grand Design Pemantauan dan Evaluasi Jaminan Kesehatan Nasional”, Jakarta, March 27, 2014.
- Dartanto, T and Usman (2011), Volatility of World Soybean Prices, Import Tariffs and Poverty in Indonesia: A CGE-Microsimulation Analysis, *Margin-the Journal of Applied Economic Research*, Vol.5: 2 (2011), pp.139-181. DOI: 10.1177/097380101100500201
- Dartanto, T. (2010), Volatility of World Rice Prices, Import Tariffs and Poverty in Indonesia: A CGE-Microsimulation Analysis, *Economics and Finance Indonesia*, Vol. 58, No. 3, pp. 335-364.
- De Silva, I. and Sumarto, S. (2013), Dynamics of Pro-Poor Growth in Indonesia: An Examination of the Poverty-Growth-Inequality Triangle, Draft ADB Report.
- Goeltom, M. S. (2008), The Transmission Mechanisms of Monetary Policy In Indonesia, *BIS Paper No.35*.
- Grant, James (1991), *Child survival and population growth: chapter 5 of The State of the world's children 1991*, UNICEF: Information Division.
- ILO (2011), *Economic and Employment Diagnostic Analysis in East Java*, Report of the ILO Workshop: East Java.
- LPEM FEUI, PSE KP UGM, PSP-IPB (2004), Finding Sources of Pro-Poor Growth in Indonesia, JICA Report.
- Margherita, C. and de Mello, L. (2009), *The Determinants of Employment and Earnings in Indonesia: A Multinomial Selection Approach*, OECD Economics Department Working Papers 690, OECD Publishing.
- Marks, Stephen V. (2003), *the Value Added Tax in Indonesia: The Impact of Sectoral Exemptions on Revenue Potential and Effective Tax Rates*, Technical Report, USAID/ECG, Jakarta, Indonesia. Available at [http://pdf.usaid.gov/pdf\\_docs/PNACS917.pdf](http://pdf.usaid.gov/pdf_docs/PNACS917.pdf) [Accessed 10 October 2008].
- Palanivel, T. (2013), Inclusive Growth and Policies: The Asian Experience, Presented Material at ADB-UNDP Workshop 11-12 July, 2013.
- Rahayu, Sri and Febriany, Vita (2007), *Moving Out of Poverty: Understanding Freedom, Democracy, Governance, and Growth from the Bottom-up. Indonesia Case Study: North Maluku and East Java*, Jakarta: SMERU Research Institute.
- Suryahadi, A., Hadiwidjaja, G. and Sumarto, S. (2012), Economic growth and poverty reduction in Indonesia before and after the Asian financial crisis. *Bulletin of Indonesian Economic Studies*, Vol. 48 No.2, pp. 209-227.
- Son, Hyun H. (2008), *Conditional Cash Transfer Program: An Effective Tool for Poverty Alleviation?*, ADB: ERD Policy Brief Series No.51. Available at [http://www.adb.org/Documents/EDRC/Policy\\_Briefs/PB051.pdf](http://www.adb.org/Documents/EDRC/Policy_Briefs/PB051.pdf) [Accessed 24 June 2011]

USAID (2005), *The Impact of Trade Liberalization on Poverty*, Summary of Proceedings from a Conference: Washington DC.

Wie, T. K. (2006), *Policies for Private Sector Development in Indonesia*, Asian Development Bank.

World Bank (2005), *World Development Report 2006: Equity and Development*, Washington: World Bank.