Global Poverty & Inequality Dynamics Research Network

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Researching structural change & inclusive growth

GPID Country Note 1

POVERTY, INEQUALITY, AND STRUCTURAL CHANGE IN INDONESIA

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Note: This note draws in places from Sumner (forthcoming) and various publications by the authors.

SUMMARY

This country note focuses on Indonesia. Indonesia experienced rapid structural change from the 1970s to the late 1990s. This structural change was accompanied by more or less steady (expenditure) inequality and falling poverty at the national poverty line. Structural change, however, stalled in 2000s as manufacturing shares of GDP and employment and exports fell back. Poverty reduction slowed. Employment growth weakened and inequality rose dramatically.

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The ESRC Global Poverty and Inequality Dynamics (GPID) research network is an international network of academics, civil society organisations, and policymakers. It was launched in 2017 and is funded by the ESRC's Global Challenges Research Fund.

The objective of the ESRC GPID Research Network is to build a new research programme that focuses on the relationship between structural change and inclusive growth.

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THE DEVELOPER'S DILEMMA

The ESRC Global Poverty and Inequality Dynamics (GPID) research network is concerned with what we have called 'the developer's dilemma'.

This dilemma is a trade-off between two objectives that developing countries are pursuing. Specifically:

1. Economic development via structural transformation and productivity growth based on the intra- and inter-sectoral reallocation of economic activity.
2. Inclusive growth which is typically defined as broad-based economic growth benefiting the poorer in society in particular.

Structural transformation, the former has been thought to push up inequality. Whereas the latter, inclusive growth implies a need for steady or even falling inequality to spread the benefits of growth widely. The 'developer's dilemma' is thus a distribution tension at the heart of economic development.

Overview

Indonesia experienced rapid structural change from the 1970s to the late 1990s. This structural change was accompanied by more or less steady (expenditure) inequality and falling poverty at the national poverty line. Structural change, however, stalled in 2000s as manufacturing shares of GDP and employment and exports fell back. Poverty reduction slowed and employment growth weakened and inequality rose dramatically.

Although it is the case that much labour, GDP and exports moved away from low productivity agriculture and absolute poverty fell dramatically – deeper questions remain: the relatively large proportion of the labour force – over a third - that remains in agriculture, and the fact that output and exports in high value added sectors of manufacturing are dominated by foreign investment and that upgrading to higher value added points in global value chains remains a challenge. Further, although absolute poverty fell by the national poverty line, poverty at slightly higher lines remains substantial and top incomes data and asset inequality data point towards higher levels inequality than that observed in the household survey expenditure. Gini.

Three inter-related issues are likely to become more pressing in the non-to-distant future: first, the extent to which 'premature deindustrialization' is real and a problem vis-a-vis productivity and employment growth and the extent to which the service sector might provide productivity and employment growth opportunities. Second, and related, is the issue more broadly of the weakening growth elasticity of employment. Third, whether a 'middle-income trap' – by which we mean a growth slowdown or a weakening of productivity growth – is real and an issue governments can do something about in the short-term. The commodity boom of the early to late 2000s has led to larger natural resource sectors than might otherwise have been the case, real exchange rate appreciation and a squeeze on other tradeable sectors. At the same time, regional competition from labour intensive manufacturers is likely to intensify rather than disappear.

This brief discusses trends in income inequality and poverty, sectoral shifts and policies for inclusive transformation. In the discussion we compare Indonesia with Malaysia and Thailand.

1. Trends in Income Dimensions of Inequality and Poverty

The 1970s to mid-1980s

Consumption inequality was in general very low by developing country standards in Indonesia in 1970 but relatively high in Thailand and Malaysia (the latter of which has data for income inequality). Indonesia and Malaysia's Ginis, by national estimates, rose very slightly through the 1970s and then fell slightly in the 1980s (Thailand only has a Gini estimate for the end of the period).

Poverty rates at $2.50 per day (2011 PPP) – the average poverty line across all developing countries estimated by Hoy and Sumner (2016) – were already below one in ten people by the early 1980s in Malaysia. However, they were higher in

Thailand at about 1 in 3 of the population and much higher in Indonesia where almost 9 in 10 of people lived below $2.50 per day. At more reasonable poverty lines of $5 per day – the average poverty line for all countries – or $10 per day – a poverty line developed by Lopez-Calva and Ortiz-Juarez (2014) and associated with low probability of falling back into poverty – even Malaysia and Thailand had notable poverty counts. However, $2.50 poverty was falling in the early 1980s in each of Malaysia, Indonesia and Thailand (MIT).

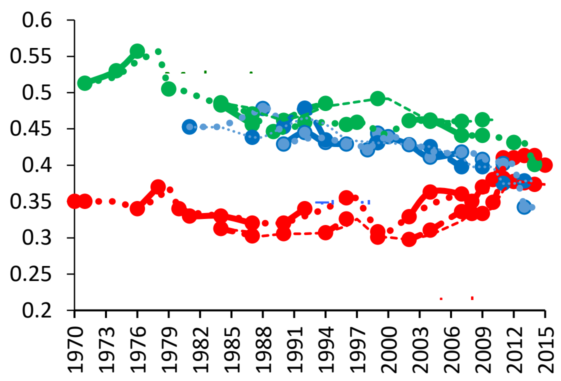
Mid-1980s to mid-1990s

Overall, the Gini was steady in Indonesia until the mid-1990s when it rose slightly. Poverty rates at the lower poverty line of $2.50 per day (2011PPP) fell across Malaysia, Indonesia and Thailand. The falls in Indonesia and Thailand were dramatic. Rates at the $10 poverty line were much more 'sticky' through the late 1980s though they fell in the early 1990s.

2000 to the present

Growth was more inclusive in Malaysia and Thailand than in Indonesia in the sense that the Gini fell in Malaysia and Thailand whereas it rose in Indonesia. Poverty rates at $2.50-per-day fell across the countries to the point that it is plausible to say absolute poverty has been eradicated in Malaysia and Thailand. In Indonesia, absolute poverty still affects one in four of the population, but this fell from two-thirds of the population in the late 1990s.

Figure 1. Indonesia (red), Malaysia (green) and Thailand (blue): Gini, 1970-present



Sources: Sumner (forthcoming) based on World Bank Povcal (dotted) & National Sources (line). Note: Malaysia = income; Indonesia and Thailand = consumption survey.

2. Inequality, Poverty and Sectoral Shifts in Population and Production

1970s to mid-1980s

Over the period there was a decline in the importance of agriculture, albeit gently, and an unambiguous jump in manufacturing as a share of output and employment across Malaysia, Indonesia and Thailand. The value-added increase in Malaysia and Thailand was gradual. In contrast, the value-added increase in Indonesia was substantial and fast at much lower levels of GDP per capita. Employment in manufacturing increased much less significantly.

The transformation of the export structure from one of agricultural raw materials, and ores and metal exports towards manufactured exports was rapid in Indonesia. The speed of the change in the shares of manufactures in exports was phenomenal. Import composition changed radically too over a short period. Most notably, manufacture imports fell dramatically in Indonesia and Thailand. Food imports fell dramatically too in all three countries due to domestic food production increases. Indonesia and Thailand experienced large increases in the significance of fuel imports demonstrating the emerging vulnerability to oil price movements.

Mid-1980s to mid-1990s

The outcomes of the mid-1980s to the mid-1990s were spectacular though ultimately unsustainable (based on exchange rate movements of the US$ and Japanese Yen and interest rate differentials leading to the consequential massive relocation of Foreign Direct Investment and finance capital). There were dramatic increases in GDP shares to manufacturing in value added and equally striking increases in shares of employment too. Not surprisingly, value added and employment shares diminished in agriculture accordingly. The experience of non-manufacturing and service was more mixed. Value added shares in services only increased in Malaysia (despite the high growth rates noted above). However, employment shares in services increased notably in Thailand and Indonesia in the latter part of the period.

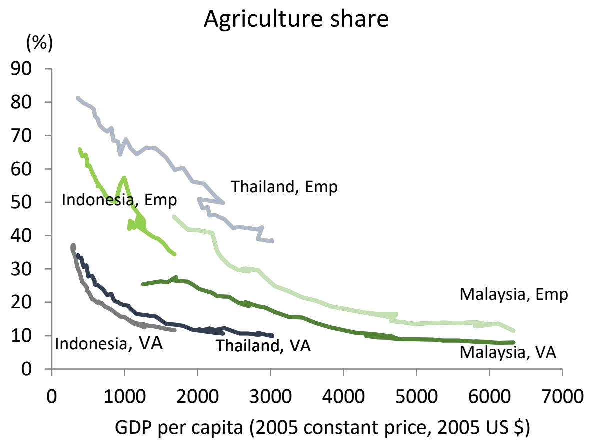
There were very large and rapid increases in the share of manufactures in exports. In Indonesia, the manufacturing share amounted to more than half of exports, and in Thailand and Malaysia this reached close to three-quarters of exports. The proportion of high tech in those manufacture exports also increased substantially, though from a low base in Indonesia. In Thailand, a quarter of the manufacturing exports were high tech exports. In Malaysia, almost a half of the manufacturing exports were high tech exports. Agriculture, food, fuel, ore and metal exports all fell as shares consequentially. Import shares shifted too. Shares of fuel fell substantially, and food imports fell in Malaysia and Thailand. The share of manufactures in imports rose to around three quarter or more of imports suggesting that the three countries were importing and assembling manufactured goods for export.

2000 to the present

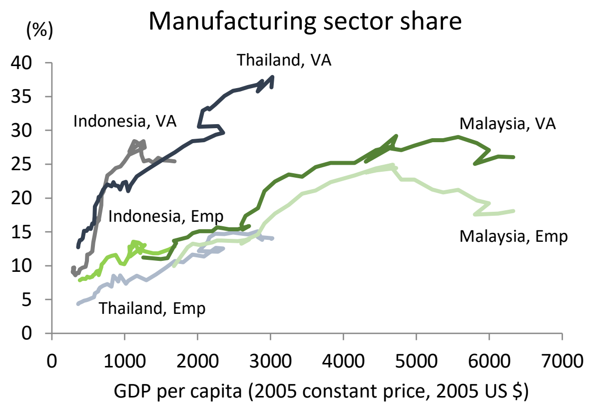
The period since the mid-to-late 1990s has been one where structural transformation has differed between changes in share of value added and employment. Value added in agriculture declined slightly across the three countries and employment shares in agriculture continued to fall, rapidly so in Indonesia and Thailand. Value added shares in manufacturing fell in Indonesia and Malaysia whilst plateauing in Thailand. Employment shares in manufacturing were stagnant and even fell substantially in Malaysia suggesting this was a weak period for the manufacturing sector. In contrast, employment and value added shares rose in services across the three countries with the exception of a slight decline in value added shares in services in Thailand.

The composition of exports shifted substantially though in differing directions. Shares in manufacturing exports fell notably, with large declines in Indonesia and Malaysia though less so in Thailand. Furthermore, the share of high tech in those manufacturing exports fell substantially. At the same time, fuel exports and exports of ores and metals rose reflecting the commodity boom of the 2000s. The import composition also shifted. Fuel imports and ores and metal imports increased.

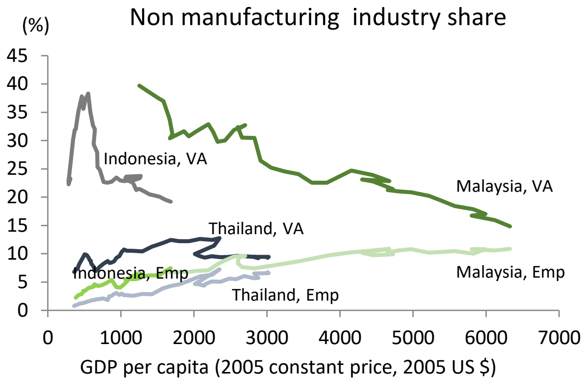
Figure 2. Indonesia, Malaysia and Thailand: employment and value-added shares, 1970-present



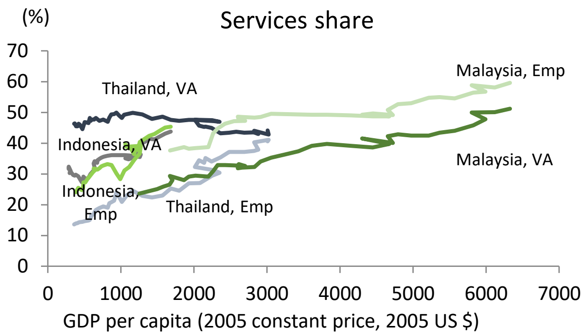
Source: GGDC, 10-sector database; UN Population division



Source: GGDC, 10-sector database; UN Population division



Source: GGDC, 10-sector database; UN Population division



Source: GGDC, 10-sector database; UN Population division

Source: Sumner (forthcoming)..

3. Policies for Inclusive Transformation and Growth

Historic policies for inclusive transformation and growth

A set of three inter-linked factors can explain how Indonesia (as well as Malaysia and Thailand) managed to keep rising inequality in check by counter-balancing the forces unleashed by structural transformation with activist public policy which ensured that disparities between rural and urban incomes, skilled and unskilled labour wages, did not expand as much as they might have otherwise.

First, and counter-intuitively, there was a focus on rural and agriculture development. This was done through extensive and substantial public investments in rural infrastructure, employment creation, and rural development which ensured cheap basic food stuffs. The public investments in the rural and agricultural sector in this way thus provided a counter-balance to upward pressure on inequality by counter balancing the likely impact of structural transformation in bringing relatively more benefits the urban sector than the rural sector.

Second, and again counter-intuitively, there was a focus not on real wage growth but a focus on widespread employment growth. The gains of productivity growth were not translated into matching real wage growth, rather into widespread employment creation. This was done – of course – implicitly and explicitly through repressive labour institutions. However, more importantly, the provision of cheap and widely available food and price controls weakened the pressures for real wage rises. At the same time employment-intensive growth ensured many people benefited from growth in the most tangible way possible: direct participation in employment. This focus on employment growth ensured that effects of rising real wages in urban or manufacturing areas as a result of structural transformation were counter-balanced.

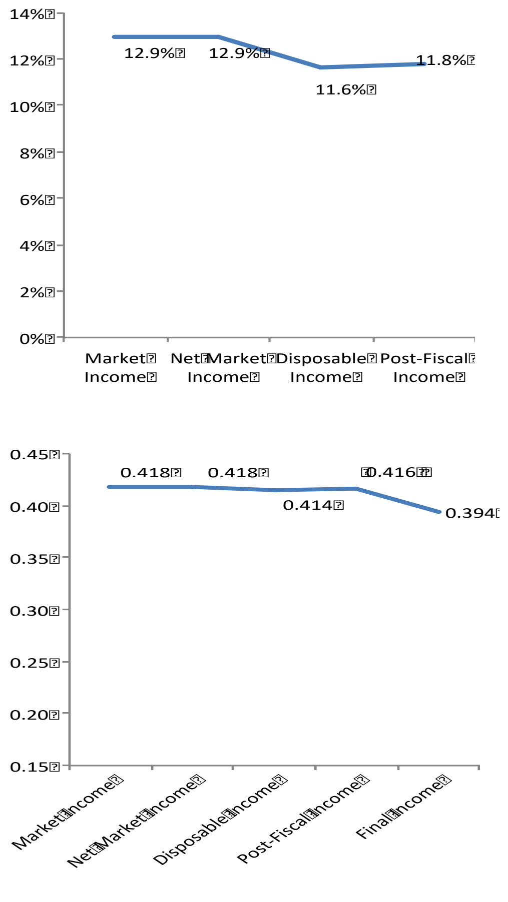
Finally, and once again counter intuitively, there was little in the way of immediate redistributive programmes such as transfers but a large focus on redistributing the near future (rather than the present) wealth via large public investments and the consequential mass expansion of primary and lower secondary education to completion. This had the effect of equalising opportunities and again, addressing the distributive pressures that structural transformation may bring, given the benefits of ST might disproportionately help more skilled labour, by containing the skills premium between skilled and unskilled workers.

Recent policies

The election platform of Indonesia's current president, Jokowi, and his previous policies as Mayor of Solo and Governor of Jakarta suggest that he has a specific interest in improving the living standards of the poorest and reducing poverty (see discussion in Yusuf and Sumner, 2015). These objectives require policies on growth and, often, short-run transfers, as well as changes to social policy and entitlements. They can also require greater medium-term investment in education and health care, for example, to redistribute the benefits of economic growth and create opportunities. The question of which part of Indonesian society has benefited most from economic growth and trends in inequality during democratisation was highlighted in mid-2014, during the presidential campaign, not only because Jokowi was known for enacting specific social policies as mayor and governor.

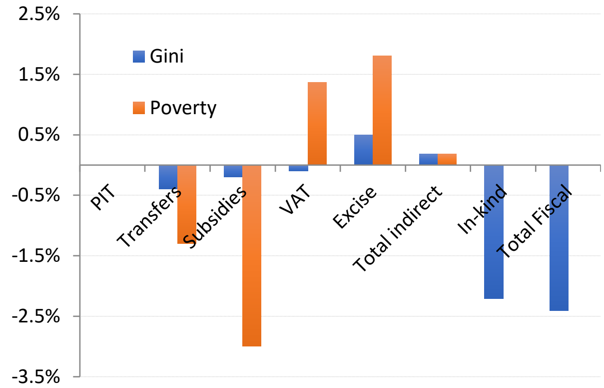
What has happened to inequality and poverty since Jokowi's inauguration? Much depends on the distributional impacts of the reallocation of highly regressive fuel subsidies to infrastructure and social spending and what happens to the price of staple foods such as rice. The new president inherited consumption inequality that was on an upward path, slowing GDP growth, and a slowing rate of poverty reduction. Poverty and inequality data since his election has been mixed. The upward rise of inequality appears to have stabilised. However, poverty reduction in the Jokowi period - November 2014 to September 2016 – fell just 0.26% per year. This is only half of the annual reduction during the previous administrations. This is because economic growth slowed, food prices rose, farmers' real wages fell slightly; and the disbursement of fuel-price compensation through the Family Welfare Savings Program was delayed during the first quarter of 2015. The Gini, in March 2016, was 0.397 (its lowest since 2011).

Figure 3. Impact on poverty and inequality of fiscal policy, 2012 (change in poverty rate and Gini)



Source: Jellema et al., (2015)

Figure 4. Welfare changes due to Fiscal Policy Components, 2012 (percentage point increases/reductions)



Source: Jellema et al., (2015)

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