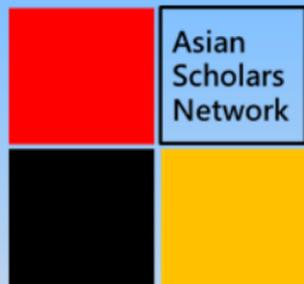


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# The Impact of Economic Openness and Growth on Poverty Alleviation in Indonesia

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**Abstract:** *Poverty is a concern for almost all countries, including Indonesia. Many poverty reduction policies have been implemented and have brought significant results for poverty reduction. Another approach to poverty reduction is through the effects of economic openness and economic growth. This study uses secondary data from 2000-2018 with an Error Correction Model of regression. This study aims to describe the conditions of economic openness and poverty in Indonesia and analyze how economic openness and growth contribute to poverty reduction. The study results show that foreign direct investment inflow does not significantly impact poverty because it may not provide employment suitable for low-income families' conditions. In the short and long term, international trade and economic growth are crucial factors in poverty reduction. The study results also show that government policies are the primary key to reducing poverty.*

Keywords: Poverty alleviation, economic openness, government role, Error Correction Model

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## 1. Introduction

Poverty is a big problem for developing countries like Indonesia. The Indonesian government tries to reduce poverty through many policies and strategies. Apart from the various poverty reduction strategies commonly used, one interesting approach to poverty reduction is economic openness. The economic openness approach in reducing poverty is indeed indirect. Several previous studies have shown that economic openness will have a significant impact on poverty reduction. Another alternative approach to poverty alleviation strategies is economic openness. Economic openness will encourage economic growth, which would increase public welfare and reduce poverty.

Ames et al. (2002) and Ravallion (1997) found a negative correlation between economic growth and poverty, but the growth alone is insufficient for poverty reduction. Theoretically, the economy's openness will reduce poverty, although empirically, results are ambiguous. Economic openness can be seen from the magnitude of the flow of goods and the flow of capital entering and exiting in a country or indicated through trade and investment. The trade can affect poverty through several channels, notably through macroeconomic and microeconomic mechanisms.

Some previous studies show that economic openness has a significant influence on poverty reduction. Some researchers explain that the relationship is significant but is indirect and partly shows a different magnitude of the short-run and long-run impact of economic openness poverty reduction.

Indonesia experiences the challenges of openness and globalization. The Gross Domestic Product Indonesia experienced significant growth. However, in the first quarter of 2020, Indonesia's year on year growth eased to 2.97 percent, below the government target of 4.04 percent (Statistics Indonesia, 2019). This condition is the weakest pace since 2001. Household consumption is the main factor of Indonesian economic growth. Based on the sectoral data, the industry has an enormous contribution to GDP. The most important is manufacturing, contributing 24 percent of the total GDP within the industry. Since 2000, Indonesia has been recording consistent trade surpluses due to robust export growth. However, from 2012 to 2014, Indonesia started recording trade deficits, as exports shrank due to the global economic crisis. After that crisis, the trade balance was getting better, and recording the surplus trade balance.

On the other hand, even though it has a good track record on poverty alleviation strategies, Indonesia still experiences income disparity and poverty in urban and rural areas. As of 2019, Indonesia's poverty rate stood at 9.4 percent of the total population, lower than 2018 (9.66 percent). This data means that around 25 million people live below the poverty line (Statistics Indonesia, 2019). Poverty remains an ingrained problem in Indonesia despite its success in cutting its poverty rate to a single-digit level in 2018.

Based on the background, this study proposes economic openness as an essential policy option to reduce poverty through economic growth. The research objectives are

- 1) to describe the condition of poverty and economic openness in Indonesia
- 2) to analyze how economic openness and growth in Indonesia have contributed to its poverty reduction.

Because previous research shows differences in long-run and short-run effects, this study applies the Johansen Co-integration approach for the long run and the standard Error Correction Method (ECM) for the short run. This study's practical contribution shows the current condition of the relationship between economic growth, openness, and poverty, based on time-series data. It will fill the gap of empirical studies that depend on cross-section regression analysis. The result has an important policy implication and lesson learned for Indonesia.

## **2. Literature Review**

There are various definitions of poverty - from the simplest indicators to more complex and comprehensive indicators. In general, households' purchasing power per capita or expenditure in expenditure quintiles is a measurement of poverty. These monetary indicators of poverty used the amount of household income or consumption. According to this definition, people are categorized as poor if and only if they do not have sufficient income to meet a certain welfare level.

The World Bank (2000) measures poverty lines based on one's income. Someone who has an income of less than USD 1 per day is categorized as poor. If their income or consumption does not exceed the defined poverty line, they are poor. Ames et al. (2002), UNDP (2000), and BAPPENAS (2002) state that poverty is a situation where a person has no income to meet his daily needs (especially food) and without the ability to support basic human needs for a sustainable life. Thus, poverty is a multidimensional problem: an economic problem and a social, political, and cultural problem.

The relationship between poverty, economic openness, and economic growth is an impressive thing to discuss. Two arguments show a strong correlation between economic growth and

poverty reduction. First, Economic growth is significant, so only targeted policies to increase growth can reduce poverty. Second, only policies that succeed in reducing poverty can produce higher aggregate growth (Rodrik, 2000).

The poor's income growth is strongly correlated with economic growth, although the relationship will vary in each country depending on government policies and social and economic conditions (Hoekman, 2017). On the other hand, a critical economic policy element is trade openness. The openness of trade is a necessary step towards achieving poverty reduction because openness promotes the efficient allocation of resources through comparative advantage, allows the dissemination of knowledge and technological progress, and encourages competition in domestic and international markets (McCulloch, Winters & Cirera, 2001; Hoekman, 2017, pp. 33-34; Chang, Kaltani, & Loayza, 2009). Trade liberalization can reduce poverty because it will increase the average income and provide more resources to tackle poverty (McCulloch, Winters, & Cirera, 2001; Hoekman, 2017).

Theoretically, trade can influence poverty reduction through two paths: macroeconomics and microeconomics (Brambila & Porto, 2017). In macroeconomics, trade affects economic growth and will be beneficial to the poor. While in microeconomics, trade affects poverty through the impact on household behavior. Trade liberalization changes prices. This price change will affect consumption decisions. Higher prices reduce real spending, while lower prices increase it.

Previous studies on the relationship between economic growth, economic openness, and poverty reduction showed mixed results and had no general relationship since the impact on poverty. The impact of openness on poverty depends on the structure of poverty (Hertel et al., 2003), the structure of trade (Harrisson, 2007), and the poverty policy (Aksoy & Beghin, 2005; Anderson & Martin, 2005; Bhagwati & Srinivasan, 2002; Dollar & Kraay, 2002). Several studies show that trade makes a crucial contribution to poverty reduction.

Developing countries need to integrate into international markets is also very important to end poverty and not leave anyone behind. Previous research found that trade and economic openness play an important role in reducing poverty due to increased knowledge and technology transfer, ultimately creating employment opportunities. Higher foreign direct investment will impact technology in new business practices and domestic companies to increase productivity, encourage economic growth, and ultimately reduce poverty (Ferreira & Rosi, 2001; UNCTAD, 2013). In contrast to other findings, several studies have not shown a significant positive correlation between economic openness and poverty (UNCTAD, 2013; Rodrik, 2000). Akmal et al. (2007) found that the process of trade liberalization in Pakistan did not have a significant impact on poverty.

### **3. Methodology**

This paper is a quantitative descriptive study. This study used secondary data from 2000-2018 to see the effect of growth and economic openness in reducing poverty. Secondary data used is sourced from the Indonesian Statistics Agency. The variables used in the study are (i) poverty Headcount index, (ii) Gross Domestic Product, (iii) Trade openness is measured by net export divided by GDP ( $NX/Y$ ), (iv) Foreign direct investment is measured by ratio outward FDI to GDP ( $FDI_o/Y$ ) and ratio inward FDI to GDP ( $FDI_i/Y$ ), (v) Government expenditure to GDP, and (vi) Gini Coefficient.

The model is estimated by the Error Correction Model (ECM) and developed from Tsai & Huang's (2007) and Pozveh (2010) papers. The equation is:

$$Poverty = f(GDP, \frac{X}{GDP}, \frac{M}{GDP}, \frac{FDI}{GDP}, G, Gini) \quad \dots 1)$$

$$Poverty = \alpha_0 + \alpha_1 GDP + \alpha_2 \frac{X}{GDP} + \alpha_3 \frac{M}{GDP} + \alpha_4 \frac{FDI}{GDP} + \alpha_5 G + \alpha_6 Gini + e_t \quad \dots 2)$$

When the data are co-integrated, there is a long-run relationship between variables. So the ECM can be formulated as

$$\Delta poverty = \alpha_0 + \alpha_1 \Delta GDP + \alpha_2 \Delta \frac{X}{GDP} + \alpha_3 \Delta \frac{M}{GDP} + \alpha_4 \Delta \frac{FDI}{GDP} + \alpha_5 \Delta G + \alpha_6 \Delta Gini + \alpha_8 EC_{t-1} + e_t \quad \dots 3)$$

$$ECT = (Poverty - \beta_0 - \beta_1 GDP - \beta_2 \frac{X}{GDP} - \beta_3 \frac{M}{GDP} - \beta_4 \frac{FDI}{GDP} - \beta_5 G - \beta_6 Gini) \quad \dots 4)$$

In this case, coefficient  $\alpha_i$  is a short-run coefficient while is the  $\beta_i$  long-run coefficient. OLS's coefficient shows the short-run effect, while in the ECM model, it shows the long-run effect. ECT shows the adjustment process towards the equilibrium point.

The hypothesis is the export, FDI, and economic growth is generally conducive to poverty reduction in the short run and long run. Import has a negative impact on poverty in the long run. After all, the import can jeopardize job creation, but not in the short run because import can reduce price levels. Inflation and the Gini coefficient has a negative effect on poverty.

#### 4. Discussion and Result

##### Indonesia Economic Openness Condition

Indonesia's trade balance from year to year marks the Indonesian economy's openness. As an activity prone to world economic shocks, the value of Indonesia's exports and imports also experienced a decline in performance in the years when the global monetary and crisis occurred. Export performance declined significantly in 2009 when the global crisis was more significant than the 1998/1999 monetary crisis.

The growth of export and import fluctuate on a similar pattern. When export increases, so do an import. In 2013, exports fell by 3 percent while imports fell by 4 percent. In the following two years, the decline in imports was much sharper than the decline in exports. In 2017, Indonesia's exports increased by 16.2 percent, while imports increased by 15.6 percent. This increase still occurred in 2018 and 2019 at a smaller percentage. Indonesia's trade balance experienced a deficit in 2012, 2013, 2014, and 2018. The deficit trade balance in 2018 was - 8.75 billion USD due to the vast growth of imports.

**Table 1: Indonesia Trade Balance 2000-2019**

Year	Trade balance (billion USD)	Growth of Export (%)	Growth of import (%)
2000	28.60	27.65	39.62
2001	25.35	-9.34	-7.61
2002	25.87	1.48	1.05
2003	28.50	6.82	4.03
2004	25.06	17.24	42.92
2005	27.95	19.66	24.02
2006	39.73	17.67	5.83
2007	39.62	13.19	21.95

Year	Trade balance (billion USD)	Growth of Export (%)	Growth of import (%)
2008	7.82	20.08	73.48
2009	19.68	-14.96	-25.05
2010	22.11	35.42	40.10
2011	26.06	28.97	30.79
2012	-1.66	-6.62	8.03
2013	-4.07	-3.93	-2.64
2014	-2.19	-3.60	-4.52
2015	7.67	-14.55	-19.91
2016	9.53	-3.44	-4.93
2017	11.83	16.21	15.65
2018	-8.57	6.71	20.22
2019	3.50	-6.78	-8.85

Source: Indonesian Statistics

On the other hand, in general, the value of FDI entering Indonesia tends to fluctuate. Similar to Indonesia's trade activities, the value of FDI also suffered from the monetary crisis of 1998/1999 and the global crisis of 2008/2009. Before the crisis, namely the period 1990-1997, the value of FDI in Indonesia reached the highest value in 1996 with a total FDI of USD 6,194 million. In the period 1995-1997, the value of FDI in Indonesia reached over USD 4 billion. The increasing interest of foreign investors to invest in Indonesia cause the FDI to increase. The increase in interest was allegedly related to Government Regulation No. 20/1994 imposed by the government on foreign investment in Indonesia during this period. This statistic shows the value of foreign direct investment (FDI) net inflows in 2019 amounted to approximately 23.56 billion U.S. dollars.

### Indonesia Poverty Condition

This article used the word bank indicator to measure poverty, namely, the poverty gap and the Headcount index. Based on World Bank (2000) indicator, there are four categories of poverty gap (i) Poverty gap at \$1.90 a day, (ii) Poverty gap at \$3.20 a day, (iii) Poverty gap at \$5.50 a day, and (iv) Poverty gap at national poverty lines.

**Table 2: Indonesia Poverty Gap (%)**

Year	Poverty gap at \$1.90 a day (2011 PPP) (%)	Poverty gap at \$3.20 a day (2011 PPP) (%)	Poverty gap at \$5.50 a day (2011 PPP) (%)	Poverty gap at national poverty lines (%)
2000	9.1	31.1	55.9	
2001	7.7	29.0	54.0	
2002	4.2	21.2	46.0	
2003	4.3	20.7	44.9	3.1
2004	5.2	21.5	45.5	3.0
2005	4.3	19.8	43.8	2.9
2006	6.3	23.4	47.1	3.7
2007	4.7	19.9	42.6	5.1
2008	4.3	18.8	41.7	2.8
2009	3.5	17.4	40.3	2.5
2010	2.9	15.1	36.0	2.2
2011	2.3	13.7	33.8	2.1
2012	1.9	12.7	32.8	1.9
2013	1.4	11.3	30.8	1.8
2014	1.2	10.2	29.0	1.8
2015	1.2	9.0	27.0	1.8
2016	1.0	8.3	24.7	1.8
2017	0.9	7.1	22.7	1.8

Source: World Bank

Table 2 shows in 2017, the poverty gap at \$1.90 a day (2011 PPP) is already below 1 percent. This condition shows that the most profound poverty is getting lower. On the Poverty gap at \$3.20 a day (2011 PPP), Indonesia's poor is still about 7 percent in 2017. On the Poverty gap at \$5.50 a day (2011 PPP), decreasing in poverty decreased significantly since 2000. In 2000 around 50% of Indonesian people were still in this category, but in 2017 there was only 22.7 percent. This condition shows the efforts of the Indonesian government to reduce poverty successfully.

**Table 3: Indonesia Poverty headcount ratio (%)**

Year	Poverty headcount ratio at \$1.90 a day (2011 PPP) (% of the population)	Poverty headcount ratio at \$3.20 a day (2011 PPP) (% of the population)	Poverty headcount ratio at \$5.50 a day (2011 PPP) (% of the population)	Poverty headcount ratio at national poverty lines (% of the population)
2000	39.3	79.9	95.7	18.9
2001	35.5	77.6	94.8	18.4
2002	23.0	65.2	89.7	18.2
2003	22.6	62.7	88.6	17.4
2004	23.9	63.0	88.6	16.7
2005	21.1	61.3	87.5	16.0
2006	27.4	65.7	89.3	17.8
2007	22.5	58.5	84.8	16.6
2008	21.4	56.6	84.6	15.4
2009	18.2	54.7	83.7	14.2
2010	15.7	48.1	77.8	13.3
2011	13.3	45.0	74.4	12.5
2012	11.7	43.5	73.6	12.0
2013	9.4	40.7	71.0	11.4
2014	7.9	37.8	69.0	11.3
2015	7.2	33.1	67.0	11.2
2016	6.5	30.9	62.3	10.9
2017	5.7	27.2	58.6	10.6
2018	4.6	21.5	73.9	9.6

Source: World Bank

Another poverty criterion used is the poverty headcount ratio, which is a percentage of the population. Table 3 shows that the poverty headcount ratio at \$ 1.90 a day, \$ 3.20 a day, \$ 5.50 a day, and the national poverty line tends to decrease yearly. This data indicates that poverty in Indonesia is decreasing over time. In 2017, the poverty headcount ratio at the national poverty line had reached 10.6 percent, much smaller than in 2000, 18.9 percent.

Indonesia is a successful example of government intervention in reducing poverty despite running a relatively slow decline. Formulation of development policies in Indonesia itself is influenced by the world's thoughts such as growth strategy, growth distribution, Appropriate technology, basic need development, sustainable development, or empowerment.

### Regression Result Discussion

This paper uses the ECM regression method to analyze how Indonesia's economic openness and growth have contributed to its poverty reduction. The ECM regression requires D.F. and ADF tests at the level and first difference. The DF and ADF test results in table 4 show that all variables co-integrate at the first difference level so that this study can use the ECM model.

**Table 4: D.F. and ADF test result**

Variable	Level		First difference	
	DF	ADF	DF	ADF
export_idn	-0.9816	-1.5527	-3.5168	-3.4610
fdi_idn	-0.5190	-1.4263	-1.4263	-2.8791
g_idn	-1.3252	-2.0853	-2.0358	-2.0294
gdp_idn	-5.0192	-2.1174	-4.0850	-3.9279
gini_idn	-1.1915	-0.9416	-3.4224	-3.4996
import_idn	-0.7712	-1.8368	-3.7492	-3.6220
poverty_idn	-0.7621	-2.0160	-4.1529	-4.0255

Source: data processed

Because the data are co-integrated, it can do short-term and long-term regression. Regression results show that there are only two significant variables in the short run, namely exports/GDP and imports/GDP. If the ratio of exports to GDP rises by 1 percent, poverty will increase by 0.8 percent. The increase in exports (while GDP is constant) or a decrease in GDP (while exports constant) caused the increase of export/GDP. In the case of Indonesia, the proportion of the increase in exports on average is small. Indonesia's export growth tends to be stagnant. So, the increase in this ratio is more due to a decrease in GDP. GDP depicts welfare, so if GDP falls, on average, it will drive poverty to increase. Besides, because Indonesia's index competitiveness is relatively low, exports are usually driven by depreciation. When a currency weakens, poverty on average will also increase.

On the other hand, an increase in the ratio of imports to GDP would reduce poverty by 0.47 percent. This situation is because the increase in imports indicates an increasing purchasing power. The increase in purchasing power is in line with the poverty reduction. In the long run, the export/GDP variable no longer has a significant effect. While imports/GDP still have a significant effect. An increase in the import/GDP ratio by 1 percent will reduce poverty by 0.18 percent.

Another indicator of economic openness, namely FDI, does not significantly affect poverty reduction in Indonesia. This finding is likely because the incoming investment did not provide new employment for workers from low-income families. FDI entering Indonesia, on average, brings new technology that requires skilled labor. Low-income families, as we know, are usually trapped in vicious circles. Low-income families do not have access to education, so it will be difficult to enter employment, which results from FDI.

**Table 5: Regression Result**

Variable	OLS		ECM	
	Coefficient	t-statistic	Coefficient	t-statistic
C	2.516950	1.109529	-0.041151	-2.498640
LOG(GDP_IDN)	-0.165485	-0.444442	-0.188710	-1.163019
LOG(EXPORT_IDN/GDP_IDN)	0.801912*	2.599182	0.200552	1.311182
LOG(IMPORT_IDN/GDP_IDN)	-0.475369*	-2.216585	-0.183318*	-1.946742
LOG(FDI_IDN/GDP_IDN)	-0.009128	-0.152771	-0.004316	-0.154955
LOG(G_IDN)	0.175444	0.576958	0.305276*	2.200356
LOG(GINI_IDN)	-0.744054	-1.131384	-0.180053	-0.500366
ECT(-1)			-0.558594*	-3.167687

Source: data processed

In the long run, the role of government is significant. The significant coefficient of government expenditure indicates this condition. Increase government spending by 1 percent will reduce poverty by 0.3 percent in the long run. This result shows that the government has a massive

role in reducing poverty. In general, the government's effort to reduce poverty was successful, although it has not suppressed it to under 5 percent.

From the policy side, the Indonesian government has created various programs to reduce poverty and provide social security for low-income families. The Government of Indonesia has implemented various programs in efforts to reduce poverty. These programs purpose to meet basic needs, improve socio-economic conditions, and improve poor families' welfare. There are three clusters of Indonesian poverty programs.

- 1) Cluster I is an Integrated family-based social assistance program. This program provides social assistance and protection to meet basic human needs. This program guarantees that everyone has access to food, health services, and education.
- 2) Cluster II is Community development poverty alleviation programs. This program aims to empower communities to use their potential and resources to get out of poverty and take a broader role in their area. This program is group-based community empowerment.
- 3) Cluster III is a micro-enterprise, empowerment poverty alleviation program. The program aims to support micro and small enterprises through financial access, business and management training, and entrepreneur counseling.

Based on the regression results, it appears that FDI is not a factor that drives poverty reduction. International trade is a more dominant factor compared to foreign investment. The role of export and import factors are critical factors in this model. This study shows that the GDP element as a numerator in the international trade ratio has a more substantial effect. Thus, exports must be pushed towards creating value-added income for poor families.

## 5. Conclusion

Indonesia's economic openness is evident from the sound trade balance and net foreign capital inflows. This economic openness encourages stable and robust economic growth. A significant result in this study is that FDI, both in the short and long term, is not a factor that reduces poverty. This finding shows that the incoming FDI does not create enough employment opportunities for low-income families. Net foreign capital inflow tends to bring in new technology that requires an educated workforce, even though most low-income families are families with low education.

The regression results show that the economy's short-term openness with the indicator of the ratio of exports and imports to GDP has a significant effect on poverty reduction. Because the proportion of Indonesia's exports is relatively small, this condition also shows that a decrease in GDP or welfare will encourage poverty to rise. Moreover, because the Indonesian products' competitiveness index is relatively small, depreciation is suspected of raising poverty. This finding shows that the government needs to safeguard people's welfare and the rupiah exchange rate to provide more stable poverty reduction programs.

In the long run, the ratio of imports to GDP and government spending has a significant impact. As reflected in government spending, the government's role in poverty reduction is the primary strategy for reducing poverty. The four poverty reduction programs: (i) enhancing and developing social protection programs, (ii) increasing access to basic services, (iii) empowering the poor, and (iv) prioritizing inclusive development are appropriate policies and strategies. The poverty reduction program could not be a burden to the government only. The support of all stakeholders will optimize the impact of the poverty alleviation program.

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