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Pro-poor growth in Indonesia

Challenging the pessimism of Myrdal's *Asian Drama*

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Abstract: This chapter addresses the unrelenting pessimism in *Asian Drama* about Indonesia's development prospects. This pessimism was based on two key realities: the poor level of governance demonstrated by the Sukarno regime (partly a heritage of Dutch colonial policies) and the extreme poverty witnessed in rural areas. Using historical and modern data on the Indonesian economy, the chapter explains the policy approach that resulted in three decades of rapid, pro-poor growth during the Suharto regime. The Asian financial crisis in 1998 caused the Suharto regime to fall and introduced democratically elected governments. After a decade of stagnation, economic growth returned to the rapid rate seen during the first three decades of the Suharto regime, but it is no longer pro-poor.

Keywords: governance, Indonesia, pessimism, poverty, pro-poor growth
JEL classification: B25, I32, N55, O53

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1 Introduction

Two powerful, vicious circles drove Gunnar Myrdal's pessimism about the development prospects of South and Southeast Asia. The first was the pervasive poor governance that he termed the 'soft state', usually controlled by corrupt, rent-seeking elites who were uninterested in economic policies that might bring widespread gains in welfare. The second was the debilitating nutritional status of most of the rural population, too poor and unproductive to even put enough food on the tables for their families, thus reducing their productivity even further. These downward spirals, visible in many countries in the early-to-mid-1960s when Myrdal was researching and framing *Asian Drama*, were especially 'dramatic' in Indonesia. No one at the time seemed to doubt his judgement that the country was the showcase example for development pessimism. This chapter tries to explain why that pessimism turned out to be unfounded.

When the First Five-Year Plan of the Suharto government (REPELITA I), which ran from 1969 to 1974, was drafted, the entire economic team was aware of Myrdal's pessimism about development prospects in South Asia broadly (including Southeast Asia), and his especially harsh judgement about the prospects for Indonesia. The Plan anticipated growth in per capita incomes of about 3 per cent per year, and this was widely viewed as optimistic. But the subsequent half-century proved that far more was possible. Per capita economic growth of nearly 5 per cent per year was sustained over more than three decades, pulling tens of millions of Indonesians above the nutrition-based poverty line. The trauma of the Asian financial crisis in 1998 hit Indonesia hard, both economically and politically. But it recovered from this as well, in the context of a surprisingly smooth transition from military dictatorship to widespread participatory democracy. Much of the story of the democratic era is necessarily about politics and governance, and this paper focuses on these and the accompanying economic trade-offs.

Three themes run through this paper, interconnected yet discrete enough to merit their own headings: (1) the story of economic growth and its accompanying structural transformation of what was a largely rural economy in 1968; (2) the record on poverty alleviation that was mostly a result of that economic growth, but which was enhanced by a *conscious policy* of connecting poor households to the growing economy; and (3) the political transformation that began well before the 1998 fall of the Suharto regime, and which continues to this day.

The main message from this experience is succinct but powerful: the poor in Indonesia have been very closely connected to economic growth in the country, benefiting differentially when the economy was growing rapidly, and suffering disproportionately when the economy is not growing, or suffers a major crisis, as in 1998. Of all the countries discussed by Myrdal, Indonesia's record from the late 1960s to the mid-1990s was one of the most 'pro-poor', and from the late 1990s to the mid-2000s one of the most traumatic. But once again the country recovered from chaos to build a successful economy with a rising middle class and aspirations of regional leadership.

The paper closes with a review of the economic record of the various democratically elected presidents since 1999, and a prognosis of likely progress for the next quarter-century. Indonesia will celebrate the centenary of its independence in 2045.

2 Understanding Indonesia's pathway out of poverty

Myrdal was fully aware of the historical significance of the structural transformation in Western societies as the route out of poverty for agrarian populations, although he apparently did not think the process was relevant to the Asian societies he was observing in the mid-1960s.[1] The structural transformation of poor, agrarian economies into rich, industrial- and service-based economies located largely in urban areas is arguably the only sustainable pathway out of poverty. Surplus labour from agricultural households migrates to more productive off-farm employment, generating a process of economic growth. Productivity growth in the agricultural sector is also needed as a way to feed workers in the cities and keep labour productivity in agriculture from falling too far behind labour productivity in urban areas. A large gap in incomes between the two sectors creates severe political tensions, and we will see these play out in Indonesia after 1998.

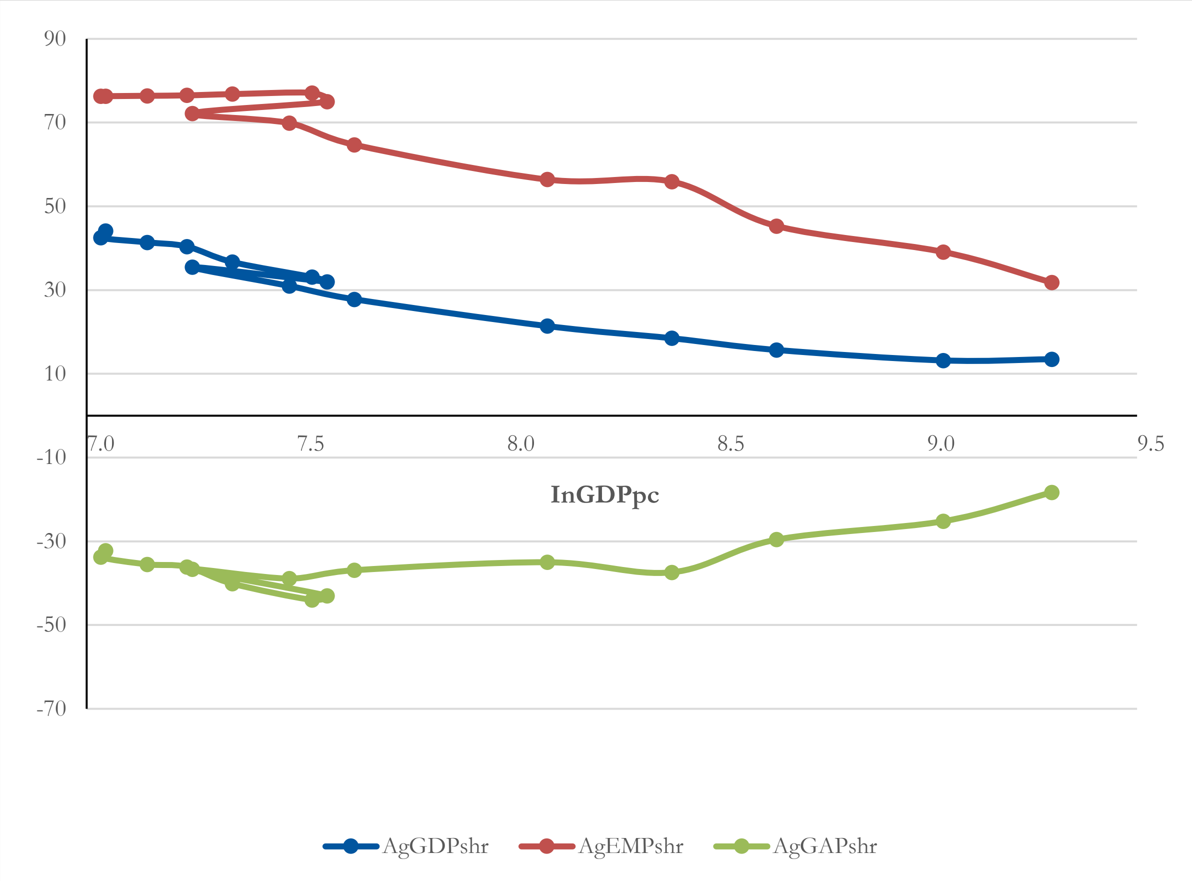
2.1 The dynamics of structural transformation

Two variables drive the structural transformation story: the share of agriculture in gross domestic product (GDP) (AgGDPshr) and the equivalent share of the agricultural labour force in total employment (AgEMPshr). The difference between these two shares measures the gap in labour productivity between the agricultural and non-agricultural sectors (AgGAPshr). AgEMPshr is nearly always larger than AgGDPshr, and thus labour productivity in agriculture is lower than in non-agriculture (Timmer 2015; Timmer and Akkus 2008).

Figure 1 shows these three basic variables for Indonesia from 1880 to 2016. The common pattern of structural transformation is readily apparent—both sectoral employment and contribution to GDP decline relatively smoothly after the economic chaos of the Great Depression and the Second World War. The gap between these two variables also tends to decline (absolutely; by definition it tends to be negative), but remains negative. Even most advanced countries did not reach parity between rural and urban incomes until late in their development. The United States, for example, reached parity about 1980 (Gardner 2002).

[1] The term 'structural transformation' does not appear in the 35-page index to the three-volume set (Myrdal 1968).

Figure 1: Long-run patterns of structural transformation in Indonesia, 1880–2016



Note: the data used in Figure 1 for measuring structural transformation include four variables, of which the first three are:

- AgEMPshr: percentage share of agricultural employment in total employment;
- AgGDPshr: percentage share of agricultural GDP in total GDP;
- AgGAPshr: percentage share of agricultural employment in total state employment minus the percentage share of agricultural GDP in total GDP (AgGDPshr – AgEMPshr).

Values for the third variable are typically negative because the share of the labour force working in agriculture is nearly always larger than the contribution of those workers to GDP. This definition makes Figure 1 easy to interpret.

The fourth variable is the logarithm of per capita GDP for each decade (lnGDPpc) (see Table 4 for source and details). The decadal data used in Figure 1 are presented in Table 1.

Source: Author's illustration based on updated data from Timmer (2017) and Bolt et al. (2018).

Table 1: Decadal data used in Figure 1

	1880	1890	1900	1910	1920	1930	1940
AgGDPshr	44.1	42.5	41.4	40.4	36.7	33.1	32
AgEMPshr	76.3	76.3	76.4	76.5	76.8	77.1	75
AgGAPshr	–32.2	–33.8	–35.5	–36.1	–40.1	–44.0	–43
GDPpc	1,147	1,134	1,267	1,392	1,551	1,876	1,944
lnGDPpc	7.045	7.034	7.144	7.238	7.347	7.537	7.573

	1950	1960	1970	1980	1990	2000	2010	2016
AgGDPshr	35.5	31.0	27.8	21.4	18.5	15.7	13.9	13.5
AgEMPshr	72.2	69.9	64.7	56.4	55.9	45.3	39.1	31.8
AgGAPshr	–36.7	–38.9	–36.9	–35.0	–37.4	–29.6	–25.2	–18.3
GDPpc	1,410	1,776	2,074	3,283	4,414	5,664	8,425	10,911
lnGDPpc	7.251	7.482	7.637	8.097	8.393	8.642	9.039	9.298

Source: Author's illustration based on updated data from Timmer (2017) and Bolt et al. (2018).

Labour productivity in agriculture has two components: the physical yield of commodities on the land at the disposal of the farm household, and the value of that output in home consumption or in the market. Agricultural labour productivity, and farm incomes, can be raised by policies affecting output prices, as well as by investments that raise physical yields of crops and livestock. Of course, markets also affect agricultural commodity prices and significantly influence the cost of policy choices to alter them. For tradable commodities such as rice, it is much easier for policy to affect the domestic market price than the farm yield. High rice prices help close the gap between rapidly rising urban incomes and lagging rural incomes. They also encourage domestic rice self-sufficiency, which been the politically articulated approach to poverty reduction and food security in Indonesia since the mid-1970s.

2.2 Initial conditions: where does the path begin?

Booth (2016) makes a powerful argument that the initial conditions for much of modern Indonesia's economic development were laid down by Dutch colonial policies in the nineteenth and early twentieth centuries. Certainly Myrdal, in writing *Asian Drama* in the mid-1960s, was acutely aware of the differential impact of British, French, and Dutch colonial legacies on the development paths of their former colonies, and the Dutch come out rather badly in his assessment. But does that matter 50 years on? Are the relevant 'initial conditions' the reality that Myrdal was observing in the mid-1960s, which was quite grim, or does the story need to start much earlier?

As Booth emphasizes, there is no neat answer to this question. The title of her book indicates that her preference is to start with the colonial legacy.[2] A short paper does not have that luxury, but Figure 1 does provide useful historical perspective. Indonesia suffered greatly from the Depression and Second World War—the level of per capita GDP was still depressed (by 10 per cent) in 1950 compared with 1920. Compounding the problem, Indonesia missed much of the growth spurt experienced in other parts of Asia between 1950 and 1970—per capita GDP was only 15 per cent higher in Indonesia after those two decades (and almost all of that growth came between 1967 and 1970, after the fall of Sukarno), whereas Japan, for example, had per capita GDP that was more than 400 per cent higher.

There will be more colonial history in subsequent sections, but the basic starting point for this paper is the mid-1960s, when Myrdal was writing and when much of the development profession was forming its first impressions of Indonesia. Based on his review of the Dutch colonial and

[2] The full title is *Economic Change in Modern Indonesia: Colonial and Post-Colonial Comparisons*.

Sukarno era economic record, he is unrelenting in his pessimism for Indonesia's future economic prospects, as the following brief quotes indicate:[3]

> It was in their refusal to permit any significant advance toward responsible government that the Dutch, together with the French, stood out in comparison with the British as the guardians of a reactionary imperialism. …. Holland's stubborn refusal to accede to the moderate demands of indigenous nationalists, as well as its practice of reserving even the less elevated positions in the colonial administration to Dutch and Eurasian residents, drove the forces of nationalism into conspiratorial channels and militant agitation. (p. 164)
>
> Without collective cabinet responsibility for major policy directives, government proved grossly ineffective and unstable. There were six cabinets between 1945 and 1948, seven between 1949 and 1957 …. Corruption, graft and fraud on a colossal scale were conspicuous features of public life. (p. 367)
>
> Furthermore, it has been suggested that Indonesian 'national income per head in the middle of the fifties was below the 1939 level, … probably below the 1929 level and may even be below the level of 1919,' [citing Benjamin Higgins] and the evidence shows a sharp decline since 1957. As things look at the beginning of 1966, there seems to be little prospect of rapid economic growth in Indonesia. (p. 489)

Of course, the next 50 years played out quite differently.

3 The evolution of the Indonesian economy

Indonesia is the original home of the dual economy. Boeke's experience during the Dutch colonial administration of Java led him to identify two types of economic agents—'rational' and 'traditional'—with almost entirely separate spheres of economic activity (Boeke 1946). Lewis (1954) built his Nobel-Prize-winning model of the dual economy with unlimited supplies of labour on the behaviour of such agents. Indonesia's history has modern lessons.

3.1 The historical setting for Indonesia's growth experience[4]

Indonesia is an archipelago nation, with thousands of islands. The soils are mostly volcanic on Java, and they support intensive rice cultivation. The laterite soils on the Outer Islands are most productive in tree crops and natural rainforest. Indonesia's agriculture is dominated by wet- and dry-season rice cultivation and a variety of tree crops for export. There has been long-term experience with international trade, and Muslim traders established Islam peacefully by the sixteenth century.

Under Dutch colonial rule, which started in the fifteenth century and ended with independence in 1945, the trade and tax regime favoured Dutch extraction of income, except for a brief period at the beginning of the twentieth century, when Dutch public opinion supported a more developmental approach to the colony, known as the 'ethical policy'. However, this policy

[3] The quotes are from Volume I of *Asian Drama* (Myrdal 1968).

[4] Much of this early history is drawn from Timmer (1975).

collapsed with world prices for export commodities in the 1920s, and Indonesia experienced especially poor economic management during the Great Depression. The Dutch forced the Netherland East Indies to stay on the Gold Standard well after their regional competitors, including the Japanese, devalued. The colonial authorities did build a significant network of irrigation canals, roads, ports and shipping facilities, and railroads. There was, however, very little investment in education of the local population. Only 3.5 per cent of the population was attending school in 1939, compared with 13.3 per cent in 1995. The historical record suggests there was severe poverty in the mid-nineteenth century, which fell gradually until the 1920s. Poverty increased rapidly from the Great Depression until the end of the Second World War.

The Sukarno government took control after declaring independence in 1945, and put 'politics in command' after 1958. It severely neglected agriculture and adopted an 'inward looking' development policy; the result was economic and political chaos by the mid-1960s. Incomes fell and the hyper-inflation in 1965–66 had an impact on virtually everyone. The post-war recovery had helped reduce poverty, but the poverty rate increased rapidly as inflation soared and the economy collapsed. Probably 70 per cent of the population was 'absolutely poor' by 1966. Average food energy intake was about 1,600 kilocalories per day. Hunger was widespread.

3.2 Pro-poor growth in historical perspective

Thanks to the painstaking historical research of Pierre van der Eng (1993a, 1993b, 2000, 2002), it is possible to construct a long-run indicator of how well the poor have fared since 1880 (see Table 2). Van der Eng's time series data from 1880 to 1990 can be divided into five main epochs: Dutch colonial exploitation of the Indonesian economy (1880–1905); the 'ethical policy' era when efforts were made by the Dutch to improve living standards of native Indonesians (1905–25); the tumultuous period during the Great Depression, Pacific War, and fight for independence (1925–50); the Sukarno era (1950–65), whose 'guided economy' after 1958 created the economic turmoil that was observed by Myrdal; and President Suharto's 'New Order' regime in the 1965–90 period, which is the main focus of this paper. The original van der Eng data end in 1990 and the results reported here depend on that dataset.

Three sets of calculations for each epoch are shown in Table 2. The first column shows the trend growth rate of incomes per capita (YPC), as estimated from a semi-logarithmic time trend for the respective time period. These growth rates vary widely. There was a sharp deterioration over the quarter-century of economic chaos from 1925 to 1950, which contrasts equally sharply with strong growth in both the 'ethical policy' era under the Dutch and, strikingly, in the Suharto era. Over the entire time period for which van der Eng reports these data, per capita incomes rose 0.89 per cent per year.

Table 2: Long-run patterns of pro-poor growth in Indonesia[5]

Time period	Growth rates (%)		Income elasticity for KCAL	Index of pro-poor growth (IPPG)[6]
	YPC	KCAL		
Dutch colonial exploitation, 1880–1905	0.33	–0.34	0.051	
			0.165	0.05
'Ethical policy' under the Dutch, 1905–25	1.63	1.39	0.878	
			2.805	4.57
Depression, the Pacific War, and the fight for independence, 1925–50	–2.42	0.78	0.333	
			1.064	–2.57
The Sukarno era, including the 'guided economy' period, 1950–65	1.46	0.68	0.509	
			1.626	2.37
The 'New Order' regime of Suharto, 1965–90	3.45	2.10	0.595	
			1.901	6.56
The long-run averages, 1880–1990	0.89	0.22	0.313	
			1.00	0.89

Source: Timmer (2004b).

The second column in Table 2 shows the similarly estimated time trend for intake of food energy, as measured from food balance sheet data on kilocalories (Kcal) consumed per capita per day, on average for each year from 1880 to 1990. During two epochs this time trend was negative, which indicates a decline in nutritional status on average for the whole society and the strong likelihood of significant increases in hunger among the poor. During such episodes, poverty was rising. A sharply positive trend in food energy intake, however, as during the 'ethical policy' era and the early Suharto era, suggests that income growth was reaching the poor and improving their access to food. Over the entire time period, the trend in food energy intake was just 0.2 per cent per year.

The relationship between the variables underlying these two trends is also reported in Table 2. The third column reports the average income elasticity of demand for food energy (KCAL), which is estimated from the annual data for each epoch. Importantly, the pattern of coefficients is similar for the income elasticities and the rate of change in food energy intake. The logic connecting the two is straightforward. Engel's law suggests that the income elasticity of demand for food (of which energy is an important component for the poor) is a declining function of income level. When income growth includes the poor, their higher income elasticities for food energy raise the income elasticity observed on average. It is thus possible to infer what is happening to the poor

[5] Details of the regressions are shown in Timmer (2004b), which also provides a full explanation of the analytical relationship between the overall incidence of poverty and the average income elasticity of demand for food energy.

[6] The IPPG is calculated as the product of the growth rate in per capita income times the 'standardized' income elasticity of demand for food energy (KCAL), where the base income elasticity is the value for the entire time period from 1880 to 1990 (0.313). Growth rates are calculated as least squares time trends of logarithmic values of incomes per capita (YPC) and average daily per capita food energy intake per capita (KCAL). The 'top' value for the income elasticity of demand for food energy for each epoch is estimated as a constant elasticity value from a double logarithmic function. The 'bottom' value re-scales this estimated value, with the 1880–1990 average of 0.313 equal to 1.000. As an example, the IPPG value of 6.56 for the Suharto era from 1965 to 1990 results from the OLS-estimated rate of growth in per capita income of 3.45 per cent, times the 'standardized' income elasticity of 1.901. This standardized value is computed by scaling up the OLS-estimated income elasticity for the period of 0.595 from the historical base income elasticity of 0.313. Thus 0.595/0.313 = 1.901, and 3.45 × 1.901 = 6.56.

during long-run periods of economic growth (or decline) by analysing these changes in food energy intake (Timmer 1996).

This approach works, of course, only for those societies in which the poor wish to increase their food energy intake when their incomes increase—that is, when they are still on the rising part of the Engel curve. This is the case for Indonesia. Even in 2002, at least the bottom half of the income distribution had significantly positive Engel elasticities for food energy. This half of the population subsisted on less than US$2 per day (World Bank 2003a, 2003b).

Finally, Table 2 carries this inference process to its logical conclusion, by constructing a crude 'index of pro-poor growth'. The scale is somewhat arbitrary, but it is based on an analytical relationship between the overall incidence of poverty and the observed, average income elasticity of demand (see the derivation and proof in Timmer 2004b). The income elasticity of food energy for the entire period from 1880 to 1990, estimated to be 0.313, is used as the long-run base, scaled to 1. It is multiplied by the long-run growth rate in per capita incomes, 0.89 per cent per year, to generate the long-run average IPPG of 0.89. The income elasticity for each separate epoch is then scaled relative to the long-run average, and multiplied by the growth rate in per capita incomes to generate the IPPG for each epoch. Note that *the IPPG incorporates both the growth and the distributional dimensions of pro-poor growth*, and this index is thus a country-specific version of equation 1 in 'Concept paper on operationalizing pro-poor growth' (World Bank 2004).

As shown in Table 2, the IPPG has varied dramatically over time, from –2.53 during the 1925–50 epoch, to 4.57 during the 'ethical policy' era of 1905–25. The index is surprisingly high during the Sukarno era, when economic policy is widely regarded to have been a disaster. But a combination of a modest recovery from the quarter-century of depression and wars, with average per capita incomes rising 1.5 per cent per year, and a large average income elasticity for food energy, suggest that what growth there was did actually reach the poor.

The strongest pro-poor growth has been from 1965 to 1990. The data analysed in Table 2 only carry the story to 1990, which is well before the Asian financial crisis in 1997/98. The quarter-century from 1965 to 1990 has an IPPG of 6.56, which is more than seven times the long-run average and nearly half again as large as during the next best epoch, from 1905 to 1925. Clearly, something quite outside earlier historical experience was going on during the first two and a half decades of the Suharto era. What made this era so pro-poor?

3.3 The 'New Order' government of Suharto: why was growth so 'pro-poor'?

In the early years of the Suharto government, pre-OPEC (1966–73), there was a need to establish stability and consolidate political power. In this process, there was an important role for the food logistics agency (Bulog) in stabilizing rice prices, and for donor assistance, especially the provision of food aid. Major investments were made to stimulate agriculture: irrigation rehabilitation, the introduction of high-yielding varieties of rice from the International Rice Research Institute (IRRI), fertilizer imports and distribution, and the BIMAS programme of extension and farm credits. Because median farm size was less than 1 ha, rice intensification had widespread benefits, although larger farmers (those who cultivate about 1 ha of land) benefited the most in the early years (Afiff and Timmer 1971).

Macroeconomic stability was achieved through a balanced budget and donor-provided foreign borrowing, with all proceeds going to the Development Budget (Hill 1996; World Bank 1968). Poverty fell rapidly as the economy stabilized and grew 5–6 per cent per year in per capita terms, and as food production and overall food supplies rose sharply. Still, absolute poverty was thought to be about 60 per cent in 1970. The first official poverty estimates, based on the 1976 National

Socio-Economic Survey (SUSENAS), indicate a national poverty rate of about 40 per cent (see Table 3).

Even for an oil exporter, coping with high oil prices (1973–83) is not the luxury it might seem. To be sure, there was rapid expansion of the economy as the role of the state expanded, but much of this expansion was in inefficient public-sector investments. Accompanying the real appreciation of the rupiah was declining profitability of tradable goods production, especially in agriculture (Warr 1984). During the mid-1970s there was a growing sense of income inequalities and severe poverty in rural areas, although the regional and commodity dimensions of the poverty masked its economic roots.

Table 3 shows estimates of income distribution and the share of the population below the poverty line, using data that are from a variety of sources, including from official Indonesian government statistical sources. These historical data provide comparisons of poverty and inequality from several methodological approaches and update the key data to 2016. Further historical data are illustrated at the sectoral level in Figure 1, which charts the structural transformation of the economy from 1880 to 2016.

Table 3: Measures of inequality and poverty in Indonesia, 1932–2016

Year	Gini coefficient (a)				Share of the population below the		
	Rural	Urban	Total		(50 per cent of median)		BPS
					Indonesia	People	
1932	0.52	0.57	0.56		26.3	16.4	–
1939	0.58	0.53	0.60		–	–	–
							–
1942	0.60	0.53	0.60		27.6	20.0	–
							–
1953	0.51	0.49	0.55		25.4	21.1	–
1959	0.46	0.47	0.51		23.9	22.3	–
							–
1975	0.16	0.31	0.28		9.4	12.2	–
1976	–	–	–	–	–	–	40.1
1980	0.13	0.27	0.24		5.4	8.0	28.6
1985	0.19	0.20	0.24		5.4	8.9	–
1987	–	–	–	–	–	–	17.4
1990	0.15	0.20	0.24		6.2	11.1	15.1
1993	0.16	0.27	0.31		10.2	19.1	13.7
1999	0.17	0.23	0.32		11.7	23.9	–
2005	0.16	0.19	0.34		13.3	29.8	16.0
2008	0.12	0.22	0.37		15.4	36.2	15.2
2012	–	–	0.42 (c)		–	–	12.0 (c)
2014	–	–	0.42 (c)		–	–	11.0 (c)
2016	–	–	0.38 (c)		–	–	10.5 (c)

Source: Author's illustration based on: (a) van Leeuwen and Foldvari (2016: 386, table 5); (b) van Leeuwen and Foldvari (2016: 391, table 6); (c) World Bank (2017: 30–31).

Income distribution deteriorated sharply between 1976 and 1978, confirming the growing anxieties. The technocrats took a highly original strategic approach to what was then diagnosed as

'Dutch disease', with a devaluation in November 1978 that came as a big surprise to financial markets. After this, tradable goods production rapidly recovered, especially in agriculture. Poverty rates after 1978 fell, driven by a significant recovery in the share of income garnered by the bottom 40 per cent of the distribution (Papanek 2004).[7]

By the early 1980s the oil boom was over. It became necessary to restructure the economy for a world of low commodity prices in world markets, which is the basic story from 1983 to 1993. Agriculture continued to grow, and rice prices were stable (this stability amounted to protection against the low prices in world markets). The government pursued aggressive exchange rate protection via further devaluations in 1983 and 1986 (Hill 1996; Thorbecke 1995). Massive investments in rural infrastructure from earlier oil revenues began to pay off in higher production and lower transactions costs for marketed goods (and improved labour mobility). Industrial output surged in the latter part of the period, led by labour-intensive manufactured exports.

The manufacturing sector contributed 29.2 per cent of the growth in GDP between 1987 and 1992, a radical increase from the 10 per cent contributed during the recovery from 1967 to 1973 (Hill 1996, 2000). Large-scale and sustained economic deregulation led to better incentives for exports, and these were matched by incentives for foreign direct investment (FDI). Manufactured exports responded even faster than policy makers had hoped, and contributed almost *half* of all exports by 1992, up dramatically from the 3 per cent in 1980. The fortuitous 'push' in FDI from Japan and the 'pull' from the attractive climate in Indonesia thus allowed manufactured exports to play a significant role in employment generation by the end of the 1980s.

There was also a boom in the non-tradable economy. National income accounts, however, are not kept according to this distinction–hence the data are more impressionistic.[8] Nonetheless, just as the export economy was booming in the late 1980s and early 1990s, and overall GDP was growing by nearly 7 per cent per year, roughly half of that growth was made up of non-tradable goods and services. According to the Mellor model of poverty reduction (Mellor 2000, 2017), production of non-tradable goods and services, especially in rural areas, provides the economic link between higher incomes from both agriculture and manufacturing wages, and serves to pull people out of underemployment in rural areas—and out of poverty.

The Mellor model stresses the role of producing *rural non-tradables* that are locally consumed—processed foods, construction, trade, and small-scale manufactures—as the 'ladder' for underemployed workers in agriculture to begin the climb to modern jobs at higher wages. *In most poor, rural economies this non-tradable sector is demand-constrained.* That is, expanding it, and the number of jobs it creates, does not depend on better access to capital or to management skills, but on greater purchasing power among local consumers. Thus Mellor emphasizes rising profitability of agriculture—through higher productivity, not higher prices. Higher prices for agricultural output, especially food, do not contribute much to added demand for non-tradable goods and services

[7] A sharp debate, totally confidential, took place in mid-1978 between advisers concerned about 'Dutch disease' and its impact on rural incomes and poverty, who argued for a significant devaluation of the rupiah, and the trade and industry advisers, who argued for a revaluation because of foreign exchange surpluses (Timmer 1994). The devaluation in November 1978 set the exchange rate at Rp 625 per US dollar, instead of revaluing to what the market expected, which was Rp 380 per US dollar.

[8] It is hard to define the components of the non-tradables sector, although some items are fairly obvious, such as local services, construction, and low-quality local manufactured goods with a limited market appeal beyond the immediate vicinity. Even modern industrial goods produced at high cost behind tariff barriers are non-tradable. Obviously, poor transportation facilities lead to high marketing costs, meaning that many potentially tradable goods are non-tradable. Lower transactions costs and lower tariff barriers are among the surest ways to improve competition and market efficiency.

because the higher food prices choke off demand for non-food items, except from farmers with significant surpluses to sell. The growing wages of workers in a rapidly expanding manufacturing export sector also contribute to higher demand for the output from the non-tradables sector.

This Mellor model is a three-sector version of the standard Lewis model of the dual economy. In Mellor's version there are two 'commercial' sectors—industry and modern agriculture. The latter has come to use modern technology and is market-driven, a departure from the traditional rural economy envisioned by Lewis (1954). Relatively separate from the commercial sectors is the 'non-tradable' sector, which is informal and mostly rural. The two commercial sectors are the 'engines of growth' because of their potential for rapid productivity gains. Connecting them to the 'non-tradable' sector, however, is the key to a high 'elasticity of connection' between overall economic growth and rapid poverty reduction. This is the sector in which most of the poor make a living (Timmer 1997, 2002). *Unless demand from rising incomes in the commercial sectors spills over to this non-tradables sector, the poor tend to be left out of the growth process.*

The combined boom in agriculture, manufacturing, and non-tradables means the period from the late 1970s to the mid-1990s is one of the most 'pro-poor growth' episodes in modern economic history. This result is a surprise to many. The extensive economic restructuring that took place in the 1980s was expected to create widespread unemployment and lead to lower wages for unskilled labour. Instead, agricultural growth continued, labour-intensive exports surged, and poverty continued to decline throughout the period of restructuring (Ravallion and Huppi 1991).[9]

Figure 1 provides an illuminating view of the structural dimensions of this growth. AgGDPshr declines steadily as the economy is growing fairly rapidly—about 3.6 per cent per year per capita between 1970 and 2010. But AgEMPshr declines only slowly in the early stages of growth, from 1970 to 1990, and then declines quite rapidly as the rural economy is integrated into the dynamic urban economy via better roads, communications, and an educated rural labour force in search of economic opportunities. The rapidly narrowing AgGAPshr after 1990 reflects the falling poverty rates shown in Table 3.

Corruption and increasing distortions in resource allocation from 1993 to 1998 followed the interests of the Suharto family, especially the children (and grandchildren!). These interests distorted trade policy and public-sector investments, and had visible effects on competitiveness, which were partly masked by the inflow of FDI (Cole and Slade 1996). As the economy boomed, deregulation lost steam, first in the Bulog commodities, then more broadly. The performance of the overall economy started to suffer, although poverty levels in 1996, the last SUSENAS report before the crisis, dropped to their lowest levels ever. Absolute poverty, measured in a comparable fashion to the poverty statistics reported first in 1976, fell below 12 per cent.

The three decades of superb economic results were over. The Asian financial crisis hit in late 1997. Investors started to lose confidence in the ability of the Suharto government to cope, especially after the new cabinet was named in April 1998, packed with Suharto cronies and relatives. The crisis caused a massive depreciation of the rupiah, which eventually led to chaos in the domestic rice market (Schydlowsky 2000). Spiralling rice prices late in 1998 led to huge increases in poverty, which is estimated to have reached over 30 per cent of the population by the peak in late 1998 or early 1999. This was a dismal period for economic growth and poverty reduction.

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[9] It should be noted that the rice sector in particular was protected from the worst pressures of low prices in world markets, and the substantial devaluations in 1983 and 1986 provided enhanced profitability for the rest of the tradable sector, with spillover effects on incomes in the non-tradable sector.

3.4 The 'democratic era' (1999–)

After Suharto's surprise resignation in late 1998, Indonesia successfully elected a democratic legislature in 1999, which in turn selected a new president, Abdurrahman Wahid, a popular Islamic scholar and cleric who headed Nahdlatul Ulama (NU), the country's largest Islamic organization. Wahid attempted to reform the military's role in government and was ultimately impeached by parliament for that effort and accompanying corruption scandals. He was replaced by his vice-president, Megawati, the daughter of Sukarno. She served for three years, but was defeated in the election by her former coordinating minister for politics and security, Susilo Bambang Yudhoyono.

Representative democracy brought forth a new political economy of economic policy. Populist voices ostensibly spoke on behalf of the poor. With two decades of experience, it remains to be determined whether Indonesia's pro-poor growth experience under a highly centralized and politically dominant regime put down sustainable, even irreversible, roots, or whether the very foundations of the strategy will come undone under political challenge.

It is already clear that the transition from the autocratic rule of Suharto, an era of economic policy designed and administered by an insulated group of skilled technocrats, to a politically responsive system has been difficult for both economic growth and its connection to the poor. There are few public institutions in place to protect economic policy from polemicists.

As part of a broad donor effort to help Indonesian development, after the fall of Suharto the World Bank led an effort to help the country cope with corruption in the national government. The main vehicle was to promote decentralization of political power (World Bank 2001). Domestic reform groups supported this agenda and responsibility for schools and most local services devolved to *kabupaten* ('county') levels in 2002 in a 'big bang' political decentralization. Not surprisingly, given the speed, this transfer was made without adequate funding, policy guidelines, or training of local officials (Alm et al. 2001).

Inevitably, perhaps, corruption at the local level has become rampant. Local 'trade' policies are being used to enforce commodity taxes and trade barriers, especially for rice. Partly because of the resulting 'compartmentalism' in the economy, and the higher transactions costs for most economic activities caused by these activities, donor interest and activity have focused on improved local governance. The stakes are high. Ongoing research by the Social Monitoring and Evaluation Research Unit (SMERU), the most influential local research institute focusing on poverty issues, indicates that measures of the 'quality' of local governance were closely associated with the rate of poverty reduction between 1999 and 2002 (Sumarto et al. 2004).

The country is clearly paying the price for decades of forgone institution building, especially in the arenas of property rights and rule of law. The new democratic governments have found it difficult to make rapid progress in these arenas, although more has been accomplished than many observers credit (MacIntyre 2003; Ramage 2004). The government of Susilo Bambang Yudhoyono (known universally as SBY) (2004–14) and the current government of Joko Widodo (again, universally known as Jokowi) (2014–) have made significant strides in strengthening transparency in government and addressing corruption.

Their records on economic growth and poverty reduction are respectable but not outstanding relative to regional and historical performance. The data on per capita GDP in Table 4, for example, show Indonesia's record of economic growth per capita by political era since 1880. Per capita GDP in constant 2011 US dollars fell by 4.38 per cent per year from 1996 to 1999 during the Asian financial crisis, and then recovered by 3.31 per cent per year from 1999 to 2005. Still, from its peak in 1996, before the crisis, until the previous peak in per capita incomes was restored in 2005, incomes per capita grew just 0.6 per cent per year. It took a long time for democratic governments to figure out how to manage the economy.

Table 4: Economic growth in Indonesia, 1880–2016

Year	RGDPNA*pc* (2011 US dollars)	Average annual increase/decrease (%/year)	Notes on historical era
1880	1,147	0.36	Dutch colonial exploitation
1905	1,255	1.37	Dutch 'ethical policy'
1925	1,648	–0.62	Depression, war, fight for independence
1950	1,410	1.14	Sukarno era
1966	1,690	4.47	Suharto era
1996	6,269	–4.38	Asian financial crisis
1999	5,481	3.31	Fall of Suharto; recovery to previous peak
2005	6,663	4.59	Democracy in command
2016	10,911		

Note: The average annual rate of economic growth from 1996, the peak year before the crisis, and its full recovery nine years later, in 2005, is just 0.6 per cent per year. Maddison Data Project note: 'In addition to the $CGDPpc$ series, we provide a measure of growth of GDP per capita that relies on a single cross-country price comparison, for 2011. This series is also expressed in 2011 US dollars (and $CGDPpc = RGDPNApc$ in 2011), but its defining feature is that it tracks the growth rate of GDP per capita as given in country National Accounts (or their historical reconstructions). Following PWT [Penn World Tables], we refer to this measure of real GDP per capita as $RGDPNApc$. This series is primarily useful for comparing growth rates of GDP per capita over time.'

Source: Author's illustration based on data from the Maddison Data Project (Bolt et al. 2018).

By 2005, however, the new SBY government was able to restore investor confidence, both foreign and domestic, and the economy started to grow rapidly again. Between 2005 and 2016, per capita GDP grew by 4.59 per cent per year, slightly faster than during the 30 years of the Suharto regime (see Table 4). But the return to rapid economic growth was not mirrored by changes in poverty. Between 2010 and 2016, the poverty rate only declined from 13.3 per cent to 10.9 per cent. Most other welfare indicators track these statistics on the poverty rate. This is respectable progress, but leaves Indonesia lagging other countries in its region and income category. Economic growth is no longer 'pro-poor'.

4 Political economy and governance

The standard story to explain the political economy of the Suharto regime's emphasis on agriculture (and pro-poor growth) relies on conflict between traditional political forces—communist-inspired peasants and workers faced opposition from an authoritarian military (Simpson 2008). Buying off the peasants was cheaper than repression. Rural development was seen as the least-cost approach to political stability. Large-scale ethnic (Chinese) businesses bought protection from Suharto and his military allies and received lucrative import and operating licences in return. When these highly protected businesses, and their closely associated banks, collapsed in the Asian financial crisis, the entire regime came unravelled. The vacuum of political institutions, deliberately created by Suharto to remove any challenge to his authority, exposed the country to years of political chaos and weak leadership. This standard story suggested there was only modest hope that the presidential election in September 2004, when Megawati ran against SBY, would return the country to strong leadership and rapid, pro-poor growth.

As with most stories based on conventional wisdom, there are substantial elements of truth in this one. But it misses what distinguishes the Suharto regime from otherwise similar military dictatorships around the world: its focus on *development* and the effort to improve the welfare of the poor by connecting the rural economy to rapid economic growth. Fear of radical peasants wielding scythes simply does not explain this passion, or the massive budgetary resources devoted to it. Oil revenues helped, to be sure, but the basic strategy was already laid down before the OPEC price shock. A much more nuanced story is needed, one that includes the complexities of the structure of political power and the role of leadership. The remainder of this paper attempts to provide some of that nuance by tracing the political economy of poverty through a governance lens to the problems caused by the massive decentralization that was the first priority of the new democratic government.

4.1 The political economy of pro-poor growth

Political scientists speculate on the nature of the political coalition assembled by Suharto to maintain and strengthen his hold on power. This coalition was held together by the distribution of economic resources, often in the form of lucrative access to such easily marketable commodities as oil or timber. Import licences for rice, wheat, sugar, and soybeans were equally lucrative. Bulog controlled these closely in the interests of the Suharto regime. Whether the pro-poor policies, and results, of the regime were tied to keeping these interest groups satisfied, even at the expense of faster economic growth in the short run, is the subject of active debate, especially because Bulog, despite being 'privatized' in 2003, established close ties with the husband of President Megawati and successfully lobbied for renewal of Bulog's monopoly control over trade in most agricultural commodities. The ability of Bulog to stall the deregulation process in the early 1990s is seen by some observers (including this one) as an early signal that the entire growth process was running off the rails into corrupt and distortionary cronyism. From this perspective, the collapse of the formal sector during the Asian financial crisis was not such a surprise, as it had become increasingly dominated by these interests (Cole and Slade 1998; Stern 2003, 2004).

The most debated political economy aspect of the New Order government was the near-schizophrenia between macro and sectoral policies. What is so puzzling is why macroeconomic policy was left largely in the hands of very talented, but highly apolitical, technocrats. Persuasive arguments are made that they provided access to the donor community, which has been a strong, almost lavish, supporter of Indonesia since the late 1960s (Simpson 2008). But another argument is simply that the technocrats delivered the economic growth the country so desperately needed. In a comparison of the political economy of growth in the Philippines and Indonesia, Thorbecke (1995) came to the following conclusion:

> In the final analysis, the most fundamental difference between the development environments in the two countries relates to the macroeconomic policy management and the role of the technocrats. In Indonesia, the latter followed a consistent, far-sighted, credible, and enlightened macroeconomic policy that was outward-oriented and provided a framework within which both economic growth and poverty alleviation could occur. In particular, the key policy instrument that the technocrats relied on was an appropriate exchange rate. Even at the height of the oil boom, when Indonesia was swimming in petro-dollars and was generating large balance-of-payments surpluses, and when the natural inclination would have been to let the rupiah appreciate, instead the technocrats devalued the currency to protect the traditional tradable sectors—foremost among them agriculture—and recycled large parts of these windfall profits back into agriculture. This policy contributed substantially to the phenomenal poverty alleviation process in the rural

> areas that characterized Indonesia in the seventies and eighties. (Thorbecke 1995: 34–35)

The technocrats had no political base of their own. They depended entirely on their patron, Suharto, to implement their plans and policies. The president was an active participant in every major macroeconomic decision, especially the timing and magnitude of changes in the exchange rate. Professor Widjojo Nitisastro, the acknowledged dean of the technocrats, receives high praise for his ability to manage the economic team and to consolidate their advice when he explained pressing economic issues to the president. His close colleague, Radius Prawiro, makes the following observation:

> All the people in the economic team were intelligent and dynamic men with no shortage of self-esteem. It was Widjojo, however, who quickly became the unofficial yet acknowledged head of the group. Widjojo was an expert in both demographics and economics. He was a brilliant strategist and a person of vision with a long-term focus. He was an excellent listener and without resorting to domination or relying on the authority of conferred title, Widjojo was able to guide a team comprising many of Indonesia's most capable and influential economists. He brought out the best in each member. He kept meetings moving without imposing rigid procedures or formality. Widjojo was a natural leader. Throughout his career, he deliberately kept a low profile and yet if there is anyone who deserves the title of 'architect' of Indonesia's economic development, it is Widjojo. (Prawiro 1998: 83)

Despite the control of the economic team over macroeconomic policy, with the president's equally clear support and blessing, Suharto used trade policy to protect special interests in his circle and even beyond, sometimes with no more apparent rationale than a nationalist interest to develop a modern industrial capacity. The role of good economic governance and political commitment to poverty reduction is a key lesson from this experience, but the paradox is why the autocratic Suharto regime provided both ingredients for so long, and why the new democratic governments have not.

Part of Suharto's commitment to the rural economy seems to have come from the highly visible politics, and power, of food security. The drive for higher agricultural productivity—a key ingredient in pro-poor growth in the circumstances Indonesia faced during this period—was fuelled at least in part by the desire for households, and the country, to have more reliable supplies of rice than were available, at least historically, from world markets. When the world rice market quite literally disappeared for several months during the world food crisis in 1973, Indonesia's dependence on imported rice to stabilize domestic prices highlighted its vulnerability to external markets beyond its control—the opposite of food security in the minds of most Indonesians—and showed how important it was to increase rice production (Timmer 2000). A ratcheting up of policy attention to agriculture and budget support for rural infrastructure followed the traumatic loss of control of rice prices in 1972–73.

From this perspective, the political economy of pro-poor growth since the tumultuous events surrounding the Asian financial crisis seems quite perverse, especially policies with respect to the rice economy, which are intended to generate that growth. There is, however, a rationale that explains the new political economy. Behind the Suharto regime's commitment to pro-poor growth were two important constituencies: one that backed economic growth itself; and the other that expressed concern for the poor. The growth coalition was made up of the modernizing elements of the military, the business elite not already comfortably protected by anti-growth protectionist measures, and most of the rural sector, which was near starvation in the mid-1960s.

The voices for the poor included many of this same coalition, but for somewhat different reasons. The military was concerned about rural unrest. It did not have the coercive resources to suppress it by force alone. The Jakarta political elite, led by President Suharto, increasingly staked its credibility on political stability. Both the urban and rural poor could pose a threat to that, as the 1974 Malari riots demonstrated.[10] Increasingly, the donor community came to stress the importance of poverty reduction. The World Bank made a major commitment in the late-1980s to the analytical work that surfaced in its 1990 report on poverty (World Bank 1990).

The fortuitous intersection of the growth and poverty coalitions thus offered the Suharto regime a political opportunity to do well by doing good. In the context of powerful opportunities to stimulate rapid growth in rural areas through high-payoff investments in rehabilitating irrigation systems and rural infrastructure and the importation of new rice technologies, a cumulative process started that built both rapid growth and poverty reduction into the basic dynamics of the Indonesian economy. *But the process started in the agricultural sector.*

This cumulative process appeared to have ended in the early 1980s, as prices for agricultural commodities collapsed in world markets, oil prices declined, and the whole growth process seemed threatened. Fortuitously, again, but under the determined guidance of the technocrats, and with the full support of the president, the economy was restructured to make it more open to foreign trade and investment, just as Japan and Korea came looking for opportunities to invest in labour-intensive manufacturing facilities. Only with the economic and political collapse in 1998 did this source of pro-poor growth disappear (and with it the patron of the technocrats). In its place, a new populist-driven strategy of poverty alleviation has emerged.

The political appeal of the new democratic strategy for dealing with poverty—direct fiscal and food transfers to the poor—is obvious. In principle, these transfers have immediate and visible impact on the recipients, and the political 'pitch' for the programmes makes it sound as though the government is actively committed to poverty reduction. Although democracy has probably *increased* the size and influence of the political coalition concerned about poverty, it has greatly *undermined* the coalition supporting economic growth as the main mechanism for dealing with it.

In the political rhetoric since 2003, poverty reduction is no longer linked to economic growth. Instead, the agency distributing subsidized rice to the poor, Bulog, has built an 'anti-poverty' political coalition similar to the one that long supported food stamps in the US Congress. Support in the USA came from conservative rural legislators eager to have additional markets for the food that is produced in surplus by their farm constituents and from urban liberals who have in their constituency many poor people who use food stamps as a major source of income.[11]

Similarly, Bulog is the agency that procures rice domestically with budget support from parliament, and distributes this rice to the poor at low prices that are, again, subsidized by the budget. Bulog has mobilized political support from two constituencies concerned with poverty: first, for its rice procurement programme, on the grounds that it helps rice farmers; and second, for its implementation of the 'special market operations' (OPK) programme that delivers subsidized rice to the poor. As Stephen Mink (2004) of the World Bank observed, no parliamentarians have been willing to take on both dimensions of the rice programme simultaneously. As a result, the huge

[10] One of the major grievances of the student rioters was the loss of control over rice prices in the previous year, and the continuing high rice prices.

[11] Political polarization in the USA now threatens this longstanding coalition between rural farm interests and interests determined to help the urban poor.

budget subsidies that accrue to Bulog to run these programmes, and the corruption that accompanies them, go unchallenged.[12]

Rebuilding the economic growth coalition in support of the poor is proving difficult. It depends on the underlying conditions of economic governance—political stability, rule of law, control of corruption, and so on—that moved in the wrong direction for several years after democratic governments were elected. Probably the best that can be done in the short run is to minimize policy damage to the interests *of the poor* while trying to improve the effectiveness of the programmes transferring resources directly *to the poor*.[13]

4.2 Trends in governance at the national level

A focus on the quality of governance at the national level is an essential component of any effort to understand, in political economy terms, the historical and emerging patterns of support for pro-poor growth. The poor themselves seldom have an active voice in the strategies that influence the growth process, and they rely on government officials to act on their behalf. In addition to its 'voice' on behalf of the poor, governance is now seen as a major factor in the growth process itself. First, such dimensions as government effectiveness and regulatory quality influence growth directly. Second, dimensions such as rule of law and control of corruption influence growth indirectly and in the longer run.

Understanding the quantitative significance of this influence is difficult because the components of governance are so hard to measure. Still, measures of voice and accountability improved between 1996 and 2002, and this improvement signalled the switch to reasonably representative democratic government. There have been steep declines, however, in political stability, regulatory quality, and control of corruption (Kaufmann et al. 2003). This deterioration has immediate ramifications for the pace of economic growth, as it affects investment in a direct manner. FDI was negative between 1998 and 2004. A concern is that such poor governance affects the extent to which economic growth actually reaches the poor. That is, governance itself might be a decisive factor influencing *both* dimensions of pro-poor growth performance.[14]

There is accumulating evidence of this connection at the regional level. Indonesia conducted a massive decentralization of many governmental functions in 2001. Research has attempted to judge the quality of local governance and its impact on poverty reduction between 1999 and 2002.

4.3 The role of governance at the regional level

The experiment with decentralization of government services to the *kabupaten* level presents challenges and opportunities. The challenges are obvious enough, and have stimulated important efforts by the government of Indonesia and its major donors to provide legal guidelines and

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[12] The most complete historical analysis of the Indonesian experience with direct food deliveries to the poor (originally OPK, but then called RASTRA, and now about to disappear in favour of cash transfers for most recipients) is offered by Timmer et al. (2018).

[13] Early in 2018, the Jokowi government announced significant changes in how the 'rice for the poor' program would be administered. Most urban poor now receive pre-paid debit cards that can be used to buy rice (and other essentials) in local markets. Direct deliveries are still used in many areas of the Outer Islands where food markets are not as well developed.

[14] It should be noted that the analytical effort to measure the components of governance at the national level was sponsored by the World Bank but never officially adopted. Its directors, representing the member countries directly, objected to the often critical characterization of their own countries.

financial incentives to make the new structure work. The opportunities are equally obvious. Design and implementation of many basic services in health, education, and business regulation are now closer to the people and far more transparent. Whether they become more responsive is the key challenge to democracy.

One opportunity for researchers that stems from the decentralization is the introduction of a great deal of variance into local government activities, which had been precluded by the strong centralization of power during the Suharto regime. With variance comes an opportunity to analyse what works and what does not. Obviously, it is too early to see many systematic effects, but researchers at SMERU have examined initial data to determine if rough measures of the quality of local governance matter for poverty reduction (Sumarto et al. 2004).

Perhaps the most interesting result comes from a survey of 87 cities and *kabupatens* for which a research team was able to construct an index of bureaucratic culture at this level. There were four levels: 'disruptive, less conducive, conducive, and very conducive' in fostering the local business environment. None of the districts had a disruptive climate, and 12 were 'less conducive', 61 were 'conducive', and 14 were 'very conducive' (Sumarto et al. 2004: 28).

Using *kabupaten*-level reports from the SUSENAS reports for 1999 and 2002, the researchers then compared the mean level of poverty reduction for each of these categories of local bureaucratic culture. The overall mean level of poverty reduction for all 87 cities and districts was 7.8 per cent between the two years, but it was only 3.4 per cent in the 'less conducive' environments, 7.0 per cent in the 'conducive' environments, and 15.1 per cent in the 'very conducive' environments. Local 'good governance', at least as measured by this index of bureaucratic culture with respect to business climate, is associated with an immediate impact on poverty reduction.

5 Looking forward to 2045: optimism or pessimism?

Much of this paper has been spent looking backward, trying to understand the historical, and positive, reversal in the fortunes of the poor in Indonesia after 1967, and the challenges the poor have faced in the transition from the authoritarian Suharto regime to real democracy. The issue here is to look forward: can the poor place their hope in economic growth guided by democratic governments, or will they need to seek redress through other venues?

First, a brief restatement of the results of the economic and political history of the past 50 years is in order. The declining role of agriculture in the economy and employment is the clearest lesson, especially because Indonesia has used investments in the rural economy and policies to increase financial incentives for the sector as a way to connect poor households to rapid economic growth. A significantly reduced agricultural sector, in relative terms vis-à-vis labour force and GDP contributions, removes a number of policy instruments to help the rural poor (see Figure 1 for a graphical depiction of the declining share of agriculture in both employment and GDP).

These historical lessons are interesting, of course, but the most important reason for spending the time and energy to understand the often paradoxical record is to offer useful insights into the future. In particular, how do democratic governments move forward on an agenda of pro-poor growth? This concluding section attempts to answer that question.

Press reports out of Indonesia were not encouraging after the Asian financial crisis in 1997/98 and Suharto's decision to resign in mid-1998. The country had been through a historic drought. Only imports of six million metric tons of rice in 1997/98—20 per cent of consumption—kept per capita supplies at their trend level. The Asian financial crisis swept Indonesia in its fullest fury. The dominant political regime, which had spent 30 years building a support structure to ensure its continued survival, collapsed. When that structure collapsed, it seemed that there was nothing.

But in fact the Suharto government had left a legacy of political involvement on the part of the entire population. Every five years, elections were held for members of parliament, who subsequently elected the president. No serious doubts existed about the ultimate outcome of these elections, but they were taken very seriously by the government. Jakarta routinely voted against the government, as did Aceh in Northern Sumatra. High-level officials in the government were tasked to ask 'why?' What was the government doing wrong? The end result was a population that was used to voting, and counting on their votes being heard. When Suharto stepped down in mid-1998, general elections were called to elect a new parliament. It was empowered to name a new president.

Still, the question remains: how does a society cope with three such massive shocks in the span of just a year? If 1966, in the famous words of President Sukarno, was 'the year of living dangerously', what was 1998? The quiet answer, in retrospect, is 'the year of transformation to a freer and fairer society'. This is not the stuff of headlines. The headline grabbers are the Bali and Marriott bombings, judicial ineptitude and outright corruption, human rights abuses by the military, and continuing games played by Jakarta's political elite (McBeth 2003).

Little noticed is the steady progress that is being made. If occasional jabs at foreign companies by local courts still roil investors, the clear competence of the new constitutional court is unreported. The petty (and not so petty) corruption of newly empowered local governments makes news and is troublesome. But the open competition to create good business environments at the local level will probably have more long-term impact (Ramage 2004).

Amid the gloom and doom, the historical resilience and successes of Indonesian society need to be appreciated and valued. From a long-run perspective, the Indonesian experience with pro-poor growth provides genuine hope that desperately poor societies can escape from the worst manifestations of their poverty in a generation, provided appropriate policies are followed. Much of East and Southeast Asia provide evidence for the reality of this hope. This is a direct challenge to Myrdal's pessimism.

This is also a critically important message for the Indonesia of the future, unsure as it is over what path to follow under democratic governments. In its broadest outlines, that path is clear. The three-tiered strategy of growth-oriented macroeconomic policy, linked to product and factor markets through progressively lower transactions costs, which in turn are linked to poor households whose capabilities are being increased by public investments in human capital, is a general model accessible to all countries, including the future Indonesia (Timmer 2004a).

Investments in infrastructure and human capital are at the heart of the public-sector dimensions of this model, and the Jokowi government clearly recognizes this (*The Economist* 2018). The pace of investments in infrastructure to lower transactions costs and in human capital to improve the capabilities of the poor still depends on the country's ability to generate public revenues and incentives for private participation (World Bank 2017). A fairer and more effective form of public taxation is essential if the new government is to make these investments. The design of these pro-poor mechanisms of public finance is urgent, because foreign resources, from donors and foreign consumers of petroleum, are becoming less available, although FDI could increase substantially with the right policies in place. There is no escaping the hard fact that these resources dictate not only the pace of economic growth but also the extent to which that growth reaches the poor. With the right pro-poor growth model in place, continued foreign assistance and private investment could have a very high payoff in both dimensions.

Indonesia's success from 1967 to 1997 did not just happen as the accident of market forces. It was planned, nurtured, and largely financed by an activist government intent on reducing poverty as rapidly as possible. Although Myrdal was pessimistic in the late 1960s that such a 'developmental state' could emerge in Indonesia, he likely would have agreed that the authoritarian Suharto government did what was necessary for economic success and rapid poverty reduction. Democratic governments with similar commitment can do the same in the future.

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