

THE IMPACT OF FOREIGN DIRECT INVESTMENT ON POVERTY REDUCTION. A SURVEY OF LITERATURE AND A TEMPORARY FINDING FROM INDONESIA

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Abstract

Developing countries in Asia, Africa and Latin America have come increasingly to see foreign direct investment (FDI) as a source of economic development, modernization, income growth, employment, and so poverty reduction. This is reflected by their currently pursued economic policies, which is explicitly intended to improve conditions to attract FDI and to maximize the benefits of the presence of FDI in their domestic economy. Since the Asian financial crisis in 1997, Indonesia has become much more liberal in its economic policies to attract more FDI to increase its economic growth and hence (though not mentioned explicitly in official policy statements) to alleviate poverty in the country. The main aim of this study is to ascertain whether since the establishment of New Order government led by Soeharto in 1966 up to now FDI have been played a crucial role in determining economic growth and hence poverty reduction in Indonesia. Based on a literature survey on the role of FDI in poverty alleviation, this paper argues that FDI may have positive effects on poverty reduction mainly through three ways: (1) labor intensive economic growth with export growth as the most important engine, (2) technological, innovation and knowledge spillover effects from FDI-based firms on local economy, and (3) poverty alleviation government programs or projects financed by tax revenues collected from FDI-based firms. A temporary finding based on secondary data only from Indonesia is very likely to support the role of FDI in poverty alleviation through that first way in the country. While, no evidence so far to prove the importance of the second and third ways in transferring the benefits of FDI to the poor in Indonesia, as no studies so far have been undertaken.

1. Introduction

Developing countries in Asia, Africa and Latin America have come increasingly to see foreign direct investment (FDI) as a source of economic development, modernization, income growth, employment, and so poverty reduction. This is apparently reflected by their currently pursued economic policies, which is explicitly intended to improve conditions to attract FDI and to maximize the benefits of the presence of FDI in their domestic economy. Over the past two decades these countries have implemented broad ranging economic reforms, including the liberalization of their foreign trade and investment regimes and domestic markets and privatization of state companies, which has had an effect on the flow and nature of foreign investment.

Indonesia, especially since the Asian financial crisis in 1997, has become much more liberal in its economic policies to attract more FDI to increase its economic growth and hence (though not mentioned explicitly in official policy statements) to alleviate poverty in the country. However, as compared to the pre-1997 economic crisis period, Indonesia has been relatively unsuccessful in attracting FDI in spite of very large increases in global flows. Among ASEAN, or among other Asian countries also affected by the 1997 crisis such as South Korea and Thailand, Indonesia has attracted considerably less FDI than anticipated, in spite of its explicitly improving investor-friendly macroeconomic policy framework. Foreign investors cite a range of reasons for their reluctance to invest in Indonesia. These include corruption, crime, political insecurity and economic instability. There appears to be general uncertainty about Indonesian economic prospect, rather than any specifically identifiable factors. This poor investment response, both domestic and foreign, in Indonesia is a particular disappointment to the Indonesian government, which has reformed economic policy since the 1997 economic crisis with the financial help from the International Monetary Fund (IMF) with the intention of creating an investor-friendly environment. The primary objective of this reform is developmental. It is clear that international capital inflows are a fundamental element in economic performance. Poverty is almost invariably linked to low or stagnated economic growth and unemployment. It is generally argued that investment is essential for generating economic growth and hence creating new job opportunities, and thus also for alleviating poverty. Where domestic resources to finance investment are limited, foreign capital inflows are necessary.

The main aim of this study is to ascertain whether since the establishment of New Order government led by Soeharto in 1966 up to now FDI has been played a role as an important engine for economic growth and hence poverty reduction in Indonesia. By assessing the impact of FDI on economic development as measured by growth in GDP per capita and on reduction in absolute poverty in the country, the study seeks to shed light on appropriate policies to pursue in order to encourage higher volumes of FDI and to optimize its impact on poverty reduction. This paper does not attempt to trace the micro- or household level impact of FDI in Indonesia. Many empirical studies in other developing countries show that parent firm survey evidence does not

in general permit analysis of trends in household income in the host economy; or whether labor and environmental standards are harmed or improved by the presence of foreign firms. Findings of these studies also do not differentiate impacts on welfare at a highly disaggregated sectoral level. These are, of course, important research questions in assessing the overall impact of FDI in developing countries.

For this purpose, *first*, this paper conducts a literature survey on the benefit of the presence of FDI on poverty reduction in developing countries. Second, as its empirical part, to examine the impact of FDI on poverty reduction in Indonesia, the paper analysis the long-term growth trends of FDI, GDP and poverty in Indonesia. So, the structure of the paper is organized as follows. Chapter 2 reviews the literature on the impact of FDI on poverty reduction in developing countries. Chapter 3 deals with possible negative outcomes of the presence of FDI in developing countries. Chapter 4 provides a descriptive analysis of long-run development trends of economic growth, income distribution and poverty in Indonesia since the 1970s. Chapter 5 looks at some evidence on the impact of FDI on poverty reduction in Indonesia at the macro level. While, at the micro level, this chapter discusses briefly “local community development” programs conducted by some foreign mining companies in Indonesia. Concluding remarks and the need for further research are given in Chapter 6.

2. Implications of FDI for poverty alleviation: review of the literature

It is widely believed that, given the appropriate host-country policies and a basic level of development, benefits that might accrue from FDI include employment creation, the acquisition of new technology and knowledge, human capital development through employee training in new business ventures (for example multinational relocating), contribution to international trade integration, creation of a more competitive business environment and enhanced local/domestic enterprise development, flows of ideas and global best practice standards aiding international competitiveness and increased tax revenues from corporate profits generated by FDI. All of these forms of benefits are expected thus to contribute to higher economic and employment growth, which is the most important/effective tool for achieving improvements in human well being or alleviating poverty in developing countries.

Unfortunately, empirical evidence regarding what impact FDI has had on poverty reduction in developing countries is limited, including in where so far there is only a few studies tried to analyze empirically this relationship. However, there is general consensus that FDI is no panacea, but, it can have a positive impact on poverty reduction in developing countries (through a variety of ways as mentioned above), provided that mechanisms are in place in the host country to have these positive effects. In other words, the impacts of FDI on poverty and other social goals of development depend principally on many factors, such as host country policies and institutions, the quality of investment, the nature of the regulatory framework, the flexibility of the labor

market, and many others (Mayne, 1997).

Among these various forms of FDI contributions, it is widely believed that the most important one for reducing poverty is widening access to employment, especially productive employment. Experiences in many developing countries shows that insufficient job opportunities are the result of inadequate levels of investment, both domestic and foreign.¹ Low investment also makes other forms of poverty alleviation more difficult, because lower rates of economic growth than the rate of population growth means that each year more people are added to the ranks of the poor. Domestic and foreign investors are potential sources for capital formation (Saravanamuttoo, 1999).²

It should be emphasized that many FDI impacts are inherently difficult to measure. The academic literature typically approaches the issue in one of three ways. The first is in the context of the determinants of economic growth. In international comparisons of economic growth, FDI is introduced as an explanatory variable, together with a range of interactive or conditional variables (e.g., trade orientation, human capital, institutional quality). The hypothesis is that, other things being equal, a larger presence of FDI is associated with a faster economic growth, and the latter is associated with a faster growth of employment, and a rapid reduction of poverty. But, whether this assumed relationship between economic growth, employment creation and poverty reduction can be true in reality, it depends on the assumption that the enhanced higher economic growth by FDI is labor intensive. This implies that the effective way to transfer the benefits of FDI to the poor is through “labor intensive” economic growth. The second methodology focuses on technology spillovers and transfer of other intangible assets from foreign to domestic firms, as measured either through firm-level case studies or an analysis of cross-section industry data. This way provide only a proximate and partial picture: the former is limited by the sample size and the flows are generally not quantified; the latter is presumptive and inferential rather than demonstrated. The third way is through analyzing the allocation of tax revenues collected from foreign firms to economic activities that benefiting directly or indirectly the poor.

2.1 Through “Labor-Intensive” Economic Growth

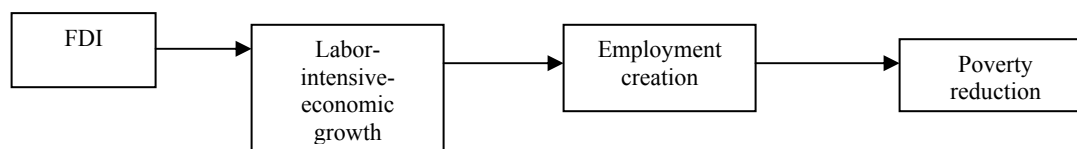
In the general development debate, economic development as measured by growth in GDP per capita is

¹ Of course the relationship is more complex than this. Investment is not always of a form appropriate for significant employment creation, and increasing capital intensity in production may lead to fewer job opportunities in the context of economic growth. However, generally speaking, low levels of investment result in low rates of job creation, and high investment has an accelerator effect on domestic investment and on economic growth (Jenkins and Thomas, 2002).

² Generally, poorer countries have insufficient domestic resources available to meet their investment needs because of their low domestic saving. Low domestic saving is often attributed to, amongst other factors, low per capita incomes; low export-to-GDP ratios, and poor financial intermediation (UNECA, 1995). As argued in Jenkins and Thomas (2002), while there is limited scope for poor countries to increase domestic savings, any increase that there may be is unlikely to be sufficient to meet total investment requirements. So, foreign investment is needed to reduce the gap between desired gross domestic investment and available domestic savings. As explained further in Jenkins and Thomas (2002), long-term capital inflows, whether direct investment or long-term loan and portfolio capital, are evidently desirable. FDI has advantages other than constituting simultaneously a source of funds and foreign exchange.

viewed as an important, but not sufficient, means of achieving improvements in human well-being or reduction in poverty. The basic framework of analysis here is thus the phenomenon of trickle-down effects of economic growth, provided that mechanisms exist to facilitate such trickle-down effects to the impoverished.. The most important mechanism by which trickle-down occurs is via economic growth-led employment creation (Diagram 1).

Diagram 1: Relation between FDI and Poverty Reduction through Economic Growth



The role of FDI as a growth engine

This analytical framework has three (3) important related issues. The first issue is the role of FDI as an engine for economic growth in the host country. A number of studies have been undertaken to determine whether FDI impacts positively on economic growth. Two types of studies, i.e. macro and micro, have generally been conducted to study the relationship between FDI and economic growth. Micro studies usually find no positive evidence that FDI makes a positive contribution to economic growth. Macro studies, on the other hand, which frequently include a variable for inflows (or the stock) of FDI, often find FDI to positively affect economic growth under certain conditions. For instance, a study by Borensztein *et al.* (1998) tested the effect of FDI on economic growth in a cross-country regression framework. They used data on FDI received by developing countries from industrial countries only. They found some indications that FDI has a positive effect on economic growth, but this impact was dependent on the human capital stock in the host economy. The higher productivity of FDI holds only when the host country has a minimum threshold stock of human capital. Thus, FDI contributes to economic growth only when a sufficient absorptive capability of the advanced technologies that it brings is available in the host economy. The results suggest that most of the effect of FDI on economic growth likely derives from efficiency gains rather than an overall higher induced level of investment.

Findings from other studies using the same analytical framework such as from Dollar and Kraay (2001), Rama (2001), and Kolstad and Tøndel (2002) also support the notion that the role of FDI is important when it comes to increased economic growth in developing countries.

Nair-Reichert and Weinhold (2001) argue, however, that traditional panel and time series estimators often impose homogeneity assumptions across countries in studies of the relationship between FDI and growth. Their findings, meanwhile, show strong evidence of considerable heterogeneity across countries. This indicates that incorrectly imposing the homogeneity assumption on the data can lead to biased estimates and faulty policy

implications. To circumvent the problem, the authors use mixed, fixed, and random (MFR) panel data estimation to test for causality between FDI and economic growth in developing countries. Results from the MFR estimation differ substantially from traditional panel data causality results. While traditional tests suggest a significant and uniform impact on growth from FDI, this study finds the causal relationship between investment (foreign and domestic) and economic growth in developing countries to be highly heterogeneous. While domestic investment seems to be strongly correlated contemporaneously with growth, it is not generally a strong causal determinant of future growth. In addition, the study finds a causal relationship from FDI to growth and there is some evidence that the efficacy of FDI is greater in more open economies, although this relationship is highly heterogeneous across countries. The study also finds no statistically significant role for human capital in economic growth, but this does not mean that human capital is unimportant, since the relationship between human capital and growth is quite complex and may not be adequately captured in linear models.

Also Carkovic and Levine (2002) dispute the generally positive findings on the FDI-growth relationship. They argue that the many macroeconomic studies that find a positive link between FDI and growth do not fully control for endogeneity, country-specific effects, and inclusion of lagged dependent variables in growth regressions. After controlling for these statistical problems, the authors find that FDI inflows do not exert an independent influence on economic growth. The studies mentioned above illustrate the ongoing controversy regarding the importance of FDI on economic growth. While an exhaustive literature has already emerged to support each side of the debate, closure remains elusive.

Jenkins and Thomas (2002) argue that FDI can contribute to economic growth not only by providing foreign capital but also by crowding in additional domestic investment; so it increases the total growth effect of FDI. In an analysis of panel data for 58 developing countries, Bosworth and Collins (1999) found that about half of each dollar of capital inflow translates into an increase in domestic investment. Their findings suggest a foreign resource transfer equal to 53-69% of the inflow of financial capital. However, when the capital inflows take the form of FDI, there is a near one-for-one relationship between the FDI and domestic investment. A study by Borensztein *et al.* (1998) tested the effect of FDI on economic growth in a cross-country regression framework. The authors found some evidence of a “crowding-in” effect, i.e., that FDI is complementary to domestic investment. A one dollar increase in FDI inflows is associated with an increase in total investment in the host economy of more than one dollar. This implies that FDI exerts a positive effect on domestic investment, ranging from 1.5 to 2.3, probably due to the attraction of complementary activities that dominate the displacement of domestic competitors.

Another important channel through which FDI can have a great contribution to economic growth in developing countries is by supporting export growth of the countries. In the literature, export growth is often

associated with trade liberalization, though the latter also means more imports. So, there are two basic questions here. First, is there a positive correlation between trade liberalization or export growth in specific and economic growth. Second, is there also a positive link between FDI and export growth. With respect to the first question, economic theory offers many reasons to expect trade liberalization or export growth to stimulate economic growth, as openness provides many benefits including access to global market, technology and to appropriate intermediate and capital goods and raw materials; and the benefits of increased economies of scale and market competition.³ Over the 1990s the conviction that openness is good for economic growth was fostered by several highly visible and well-promoted cross-country studies from e.g. Dollar (1992), Sachs and Warner (1995), and Edwards (1998).⁴ Winters *et al.* (2002) argue, however, that, while trade liberalization is likely to benefit economic growth under any circumstances (because they enlarge the set of opportunities for economic agents), a quasi-permanent effect on economic growth almost certainly requires combination with other good policies as well, including investment policies.

With respect to the second question, a study by Balasubramanyam *et al.* (1996) tested the hypothesis that export-promoting (EP) countries enjoy greater efficiency from FDI using a production function in which FDI is considered an additional input to domestic capital and labor. They argue that, since it is a prime source of human capital and new technology for developing countries, the FDI variable captures the externalities, learning by watching, and spillover effects. The results suggest that FDI is an important engine for export growth in developing countries. Blomström and Kokko (1996) review empirical evidence on host country effects of FDI, and they found that multinational companies play an important role for export growth in their host countries, but the exact nature of the impact of FDI varies between industries and countries. Thomsen (1999) reviews the role of FDI in the economic development of Indonesia, Malaysia, the Philippines and Thailand, and he found that FDI has been, to varying degrees, a key factor driving export-led growth in these countries. Foreign firms have played a leading role in the sectors with the fastest growth such as electronics. In all four countries, however, development strategies have included a selective approach to investment promotion. Partial openness has allowed foreign firms to contribute to rapid export-led growth. But in many cases, indigenous capabilities have not been developed sufficiently in those export sectors so as to allow a sustainable development. Sun (1998) investigates the export growth impact of FDI flows into China during the period 1979-96. The study indicates that FDI has significantly promoted export growth in China by contributing to domestic capital formation and transferring technology. By using a two-stage probit model, Aitken *et al.* (1997) test the hypothesis that FDI-based companies act as export catalysts using panel data for 1986-90 for 2104 Mexican manufacturing firms

³ See Grossman and Helpmann (1991) or Lucas (1988), for example, for a discussion.

⁴ Recently, however, these have received rough treatment from Rodriguez and Rodrik (2001), who argue, *inter alia*, that their measures of openness are flawed and their econometrics weak. Moreover, as argued in Winters *et al.* (2002) and Harrison (1996), liberal trade is usually only one of several indicators of openness used, and one which often seems to weigh rather lightly in the overall result.

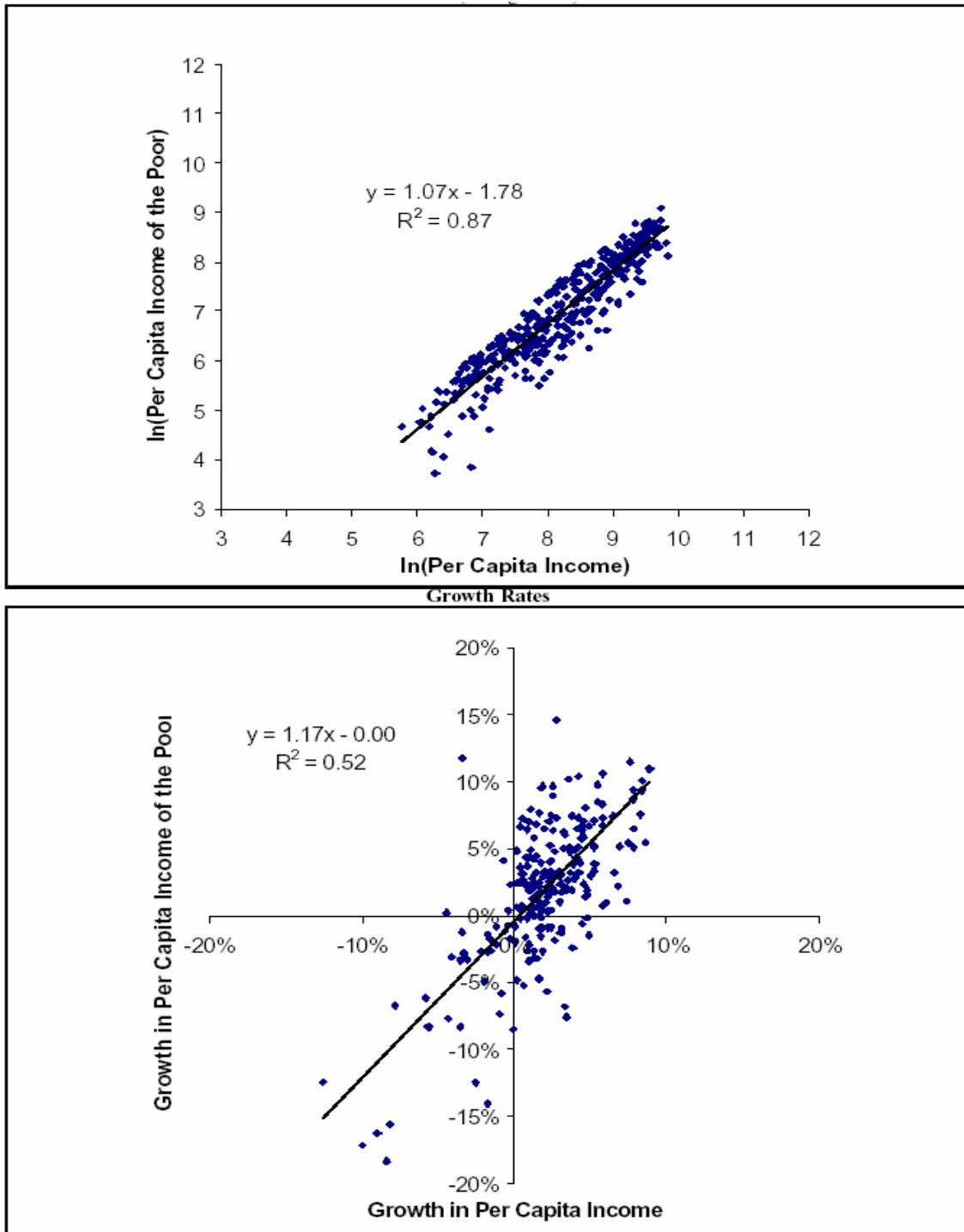
following Mexico's trade liberalization in 1985. The findings show that the probability that a domestic firm exports is positively correlated with proximity to FDI-based companies affiliates, even when other factors such as overall industrial activity, capital city proximity, and so on, are controlled for. Export propensity is uncorrelated with the concentration of exporters generally. This suggests that export spillovers are restricted to activities of FDI-based companies, with affiliates being a natural conduit for information about foreign markets and technology, and so on. Foreign firms may be seen as natural conduit[s] for information about foreign markets, foreign consumers, and foreign technology, and they provide channels through which domestic firms can distribute their goods. With these findings, they conclude that besides their contributions through joint ventures, foreign firms can serve as catalysts for other domestic exporters. Other studies by Taylor (1998), Blomstrom (1990), Levine and Renelt (1992), and Wacziarg (2001) also come with the same results suggesting that FDI does play a key role in linking trade liberalization and economic growth, and they conclude thus that poor investment policies which discourage FDI, could undermine trade benefits.

The widely believe that FDI has positive effects on export growth in developing countries is simply because FDI may provide access to new overseas markets and may also serve to improve efficiency and productivity, and to increase competition in the host country (Cotton and Ramachandran, 2001). Most foreign firms, especially multinational companies from industrialized countries are well connected globally in terms of access to financial markets, consumer outlets and transportation networks (Jenkins and Thomas, 2002). All these contributions will at last increase export opportunities for the host country

Does economic growth benefits the poor?

The second issue is the question of whether there is a negative and significant correlation (trade-off) between economic growth and poverty. Dollar and Kraay (2000) investigated this phenomenon by estimating the link between the income of the poor (defined as the bottom 20% of the income distribution) and overall income or per capita GDP. They used data on income of the poor and mean income for 80 countries over 40 years. The study further examines the poverty-growth relationship in cases of poor countries versus rich countries, crisis periods versus normal growth periods, and the recent period compared to earlier times. Their study also introduces other institutions and policies into the analysis and asks whether these influence the extent to which growth benefits the poor. The basic finding (Figure 1) is that as overall income increases, on average incomes of the poor increase by exactly the same rate. None of the efforts to divide the data points into different groups changes the basic relationship between incomes of the poor and growth. As for the impact of policies and institutions, their study found that openness to international trade as well as improvement in rule of law (e.g. property rights) raise incomes of the poor by raising overall per capita GDP. Overall, their findings suggest

Figure 1: Economic Growth and Poverty



Source: Figure 3 in Dollar and Kraay (2000)

that the general effects of FDI on growth are indeed essential, that growth tends to lift the incomes of the poor proportionately with overall growth. Deininger and Squire (1996) found that, for the 95 growth spells for which data on income shares were available, there was no systematic link between growth and inequality, but there was a strong positive relationship between growth and poverty alleviation. In particular, growth benefited the

poor in the vast majority (87.5%) of cases, whereas economic decline hurt the poor disproportionately (in five out of seven cases). Similar evidence also provided by Ravallion and Chen (1997). By using data from household surveys for 67 developing and transitional economies over 1981-94, they found that almost always, poverty fell with growth in average living standards and rose with contraction. By regressing the growth of average income for the poorest 20% and the poorest 40% of the population against the growth of GDP per capita, Roemer and Gugerty (1997) found that on average the poor do benefit from economic growth. An increase in the rate of per capita GDP growth translates into a one-for-one increase in average income of the poorest 40%. For the poorest 20%, the elasticity of response is 0.921. Another conclusion of this study is that income distribution changes only very slowly, and that a policy that aims at redistributing income at the expense of economic growth may have very low payoffs in terms of poverty reduction. By using data on income distribution for 27 developing countries, Timmer (1997) estimates the impact of average per capita income growth on the growth of per capita income of each income quintile. He found that the elasticity of overall growth and the growth in the per capita income of the poorest quintile was only 0.8 (and significantly less than one) and rose steadily to slightly greater than one for the richest quintile. With this result, he argues that the apparent failure of growth to reach the poor in the countries with wide income gaps, while disappointing, should not be taken as a general indictment of economic growth itself.

From the literature, there is also evidence that the benefits are not equally distributed. For instance, a recent research conducted by te Velde and Morrissey (2002a,b) on the effects of FDI on wages in five East Asian economies (Korea, Singapore, Hong Kong, Thailand and Philippines) and the effects of foreign ownership in five African countries (Cameroon, Ghana, Kenya, Zambia and Zimbabwe) comes with an important conclusion that foreign firms tend to pay higher wages in developing countries, but skilled workers tend to benefit more than less-skilled ones. Based on their findings, they argue that, while FDI may support development overall, more attention should be focused on the distribution of gains from FDI, notably effects on wage inequality

Also, a review made by IMF (2000) on the progress made in recent decades in raising real incomes and alleviating poverty in developing countries shows that the progress in raising real incomes and alleviating poverty has been disappointingly slow in many countries and the relative gap between the richest and the poorest countries has continued to widen. In Africa, the level of real per capita income in recent years is lower than it was 30 years ago. More broadly, the number of very poor (defined as those living on less than US\$1 per day) has remained roughly unchanged over the past decade, and only limited progress has been made in reducing the share of the world population living in poverty. According to this paper, it is more likely that the explanation of the unsatisfactory performance of many developing countries lies in the interplay of economic and political factors that vary by country. Nevertheless, experience in the successful developing countries clearly points to macroeconomic stability, sound institutional arrangements, and openness to trade as factors

that are conducive to, or at least associated with, high sustainable growth. Experience in the poorest countries highlights poor education and health, ineffective governance, weak rule of law, and wars as frequent impediments to prosperity. Important conclusions from this paper are that there is no single formula for kick-starting growth, and the positive effect of the presence of FDI also depends very much, among others, on “conducive political and social environments” in the host country.

The same question can also be raised with respect to the relationship between trade expansion (as assumed to be an important element of economic growth) and poverty. In other words, does trade liberalization or export growth in particular benefits the poor? Despite that there is a consensus that the essential precondition for sustained poverty reduction is rapid and sustained economic growth, and, one way to achieve that is through a rapid and sustained growth of export, to answer this question is not easy. The link between trade and poverty can be said a new area of study,⁵ and it is still theoretical.⁶ Due to the complexity of the linkages between trade and poverty, the empirical evidence until now on trade and poverty is limited to studies of general market reforms and economic growth on the one hand, or case studies on the other.⁷ Only few empirical studies have been undertaken so far. For instance, based on their recent studies on the benefits of FDI in five East Asian economies and five African countries, te Velde and Morrissey (2002a,b) argue that if FDI contributes to export growth, it supports increases in national income that offer the potential to benefit the poor. In this case, FDI does not reduce poverty directly, but it helps to create an enabling economic environment.

Winters *et al.* (2002) assess the current state of evidence on the widely debated issue of the impact of trade expansion on poverty in developing countries. The result shows that there is relatively little empirical evidence addressing this question directly, but a lot of related evidence concerning specific aspects. They argue strongly that: *there can be no simple generalisable conclusion about the relationship between trade liberalisation and poverty, so that the picture is much less negative than is often suggested in popular debate. In the long run and on average, trade liberalisation is highly likely to be poverty alleviating, and there is no convincing evidence that it will generally increase overall poverty or vulnerability. But trade reform also involves important adjustments, and there is evidence that the poor may be less well placed in the short run to protect themselves against adverse effects and take advantage of favourable opportunities* (page i). Dollar and Kraay (2001), which examined the effects of changes in trade volumes on the poor, conclude that since there is little systematic evidence of a relationship between changes in trade volume and changes in income share of the

⁵ The trade-poverty debate has two main important arguments. On one side, trade expansion creates many new opportunities; it gives better long-run prospects for more open economies, and more access to new markets for producers as well as consumers. While, on the other side, increase in trade may also have some adverse effects: not everyone gains equally; some may lose, especially in the short-run, and even domestic markets can be destroyed (McCulloch, 2004).

⁶ A conceptual framework decomposing the links between trade and poverty has been developed by Winters (2000a,b,c).

⁷ See Bannister (2001) and Winters *et al.* (2002) for surveys of literature/empirical studies on this particular issue.

poorest, the increase in growth rates that accompanies expanded trade leads to proportionate increases in incomes of the poor.

From the above discussion, overall, it can be concluded that the exact growth-poverty relationship depends principally on many factors including, and probably this is the most important one, the extent to which governments have pursued policies that enable low-income groups to take advantage of growth opportunities.

Degree and Nature of Poverty Reduction Effect of FDI-led economic growth

The third issue is the degree and nature of poverty reduction effect of FDI through its economic growth effect. With respect to the degree, the main concern here is: whether the economic growth induced by FDI does indeed have a significant impact on employment creation and thus a great effect on poverty reduction? While on average (based on available studies) economic growth benefits the poor, there are a number of countries where this has not happened or the degree is low (World Bank, 2000a). Yet, from the literature it appears that, there is no clear recipe for translating economic growth into poverty reduction for all country cases. Different countries may well require somewhat different approaches to ensure that growth leads to poverty reduction. Also, as said before, the degree varies among countries, depending on many factors mentioned before.

The total employment effect of FDI can be categorized into indirect and direct effects. By promoting both forward and backward production linkages with domestic industries and other sectors, for instance via subcontracting systems between a foreign firm and local subcontractors who supply spare parts, components or semi-finished goods to the foreign firm, additional employment is indirectly created and further economic activity stimulated. In many cases, indirect employment creation effect of FDI is stronger than its indirect effect. For instance, a study in Kenya show that FDI made a modest contribution with regard to total employment creation because direct employment creation was small while no evidence on its indirect employment creation which may suggest that foreign firms operated in that country have no production linkages with local firms (Nzomo,1971). In contrast to this, based on his observation, Aaron (1999) states that likely FDI was directly responsible for 26 million jobs in developing countries worldwide. In addition, for every one direct job created by FDI it was estimated that approximately 1.6 additional jobs were indirectly created through production linkages between FDI and local sectors. So, it can be argued that the more linkages foreign firms have with local/domestic economy, especially through production subcontracting and investment linkages, the higher the degree of poverty reduction effect of FDI.

The poverty reduction effect of FDI also depends on the nature of its employment creation effect. The big question here is about the structure of workforce employed in foreign firms, either by level of education or sex. With respect to level of education, even if foreign firms does succeed in creating employment, income

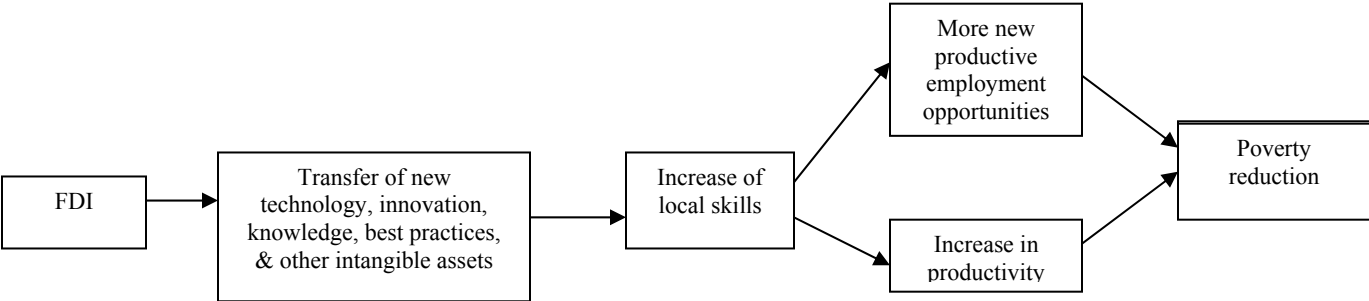
inequality may become more skewed or wage differential between income groups will be exacerbated, as employment is given to more educated, typically wealthy elites, or there is an urban emphasis (Gardiner, 2000). This is most likely to occur where FDI is found in enclaves in an otherwise underdeveloped economy, as is the case in the oil industry in Angola (Jenkins and Thomas, 2002). At last, this will crowd out potential benefits of the presence of FDI to the poor section of the population, which are mainly low educated/unskilled people.

With respect to sex, some studies provide evidence showing that FDI appears regularly to be a key source of employment for women in developing countries. With this, Jenkins and Thomas (2002) stress that the implications for poverty alleviation are important. Cotton and Ramachandran (2001) give the reason for this, based on their research, which has shown that the earnings of women are most often allocated to improving the health and nutritional well-being of their children, and any increase in women’s employment and/or increases in their wages are likely to improve the quality of life in households where women work.

2.2 Through Transfer of New Technology, Knowledge, and Other Intangible Assets

The ultimate impact of FDI on economic growth in the host countries depends not only on the performance of foreign firms, but also on the diffusion of new technologies, innovations, knowledge, new best practices and other intangible assets from FDI throughout the economy of the host countries. The transfer of such intangible assets in the form of new business ventures (for example multinationals relocating) also often results in higher wages for production workers and is a much less volatile form of international investment than portfolio investment flows (Bhorat and Poswell, 2003). At least theoretically, the diffusion of all these intangible assets will increase efficiency and productivity, and hence income per worker in the host country (Diagram 2):

Diagram 2: Relation between FDI and Poverty Reduction through the Diffusion of New Technologies, Innovations, Knowledge, Best Practices, and Other Intangible Assets



Such intangible assets may be transmitted across borders by various mechanisms. For example, foreign buyers of exports from developing countries may provide the demand for upgrading, as well as some level of technical assistance to domestic firms, imported capital goods may embody improved technology, technology licensing given by developed countries allows developing countries to acquire innovations, and expatriates

transmit knowledge.⁸ Yet, arguably the most effective means of transferring best practice is FDI, since it tends to package and integrate elements from the various methods (Klein *et al*, 2000). By using data on FDI received by 69 developing countries for 1970-89 from industrial countries only, a study of Borenzstein *et al* (1998) tested the effect of FDI on economic growth in a cross-country regression framework. The result suggest that FDI is an important vehicle for the transfer of technology, contributing relatively more to economic growth than domestic investment, but the result holds only when there is some threshold stock of human capital.

Several studies show that effective diffusion is possible and works, for example, through subcontracting arrangements between foreign firms and local/domestic firms. Batra and Tan (2000) investigate the relationship between inter-firm production linkages and productivity growth using evidence from Malaysian manufacturing. They found that, differently with local large-sized firms, foreign firms in Malaysia are more likely to subcontract to foreign and local suppliers, and rely more heavily on the latter. Production function results show that having any subcontracting links with other firms is associated with higher productivity, a relationship that is large, positive and statistically significant. Local subcontractors were less productive when they first became suppliers compared to the survey point, suggesting that the productivity increased over time. While, from their earlier study in 1997, investigating the productivity effect of employee sponsored and other training programs using data from a survey of 2200 companies, they found that the productivity of local firms lags behind that of foreign firms because local firms invest relatively less in training and new technology. This finding suggests that technology can be effectively acquired besides through licensing agreements and technology embodied in new equipment, also via subcontracting arrangements with FDI-based firms (Batra and Tan, 1997).

If technical, entrepreneurial and management skills in developing countries are scarce, the training of local personnel to fill senior positions brings about an important diffusion of these skills that FDI can contribute. Jenkins and Thomas (2002) argue that if FDI serves to multiply job opportunities in host countries, this will not only help to address unemployment and raise wages, but also encourage investment in human capital through the transfer of skills and knowledge to the local workforce via both on-the-job and specialized training. According to them, one way in which skills may be transferred from FDI-based foreign firms to locals is via joint ownership of assets: if foreign firms permit domestic investors to hold a share of the equity, human capital is diffused as well as profits being distributed. On the other hand, if management positions are filled by expatriates, skills diffusion is less likely to accrue to the host country.⁹

Many studies have investigated whether domestic firms with foreign investors or those linked with foreign firms through e.g. subcontracting arrangements, raise productivity more than other domestic firms in developing

⁸ See e.g. Lim and Fong (1982) and Johansson and Nilsson (1997).

⁹ . There is some evidence shows that the ability of FDI to develop managerial and other skills to the local workforce was negligible, suggesting that important positions in foreign firms were filled by their own people, while local people employed in very low position such as plant workers and administrators (Kim, 1985; Pigato,2000).

countries. To the extent that such studies show that domestic firms with foreign investors or linked to foreign firms outperform wholly domestic-owned firms, this suggests that FDI constitutes the better overall mechanism to improve performance, e.g. productivity, through improvements in management and technology. For instance, Blomstrom and Kokko (1996, 1997) review empirical evidence on host country effects of FDI, and they found that multinational companies play an important role for productivity in their host countries, but the exact nature of the impact of FDI varies between industries and countries. The characteristics of the host country's industry and policy environment are important determinants of the net benefits of FDI.

However, there are also some cases, particularly in Africa, which show that such diffusion of technology and other best practices by FDI did not work very well. For instance, a study by Cockcroft and Riddell (1991) suggests that FDI made a negligible contribution to productivity in most African countries during the 1980s. Also many cases show that new technologies, innovations and knowledge brought by FDI were not suitable for use in labor-abundant developing countries. Many foreign firms in developing countries are capital intensive, so they failed to create many jobs in the countries. Jenkins (1986), for example, provides some evidence on this problem based on his survey of subsidiaries of multinational corporations in South Africa in 1985. The survey revealed a tendency for foreign firms to adopt an increasingly capital-intensive mode of production, using technologies developed abroad. The reasons given for this trend were (i) increased efficiency; (ii) lower unit costs; (iii) a shortage of skilled labor and therefore a need to use labor-saving techniques; (iv) reduced dependence on increasingly expensive and militant labor; (v) the lack of alternative production methods (in new industries or for new products); (vi) a tendency for the parent company and its subsidiaries to use uniform production techniques all over the world; and (vii) the need to preserve international standards of quality. Most firms surveyed acknowledged that both technology and new products were almost exclusively developed abroad with other markets in mind.¹⁰

Based on their recent study on the effect of FDI on employment creation in southern Africa, Jenkins and Thomas (2002) stress that output growth in foreign firms or domestic firms linked with FDI (e.g. in form of subcontracting production linkages) is not always accompanied by significant employment growth. Rising capital intensity and improved productivity may limit the benefits of FDI in terms of ongoing job creation.

¹⁰ So, besides whether new technologies brought by FDI are suitable for the host countries, the question is: whether the potential for domestic diffusion by FDI can be exploited or not in the host countries. It certainly will depend on the absorption capacity of the host country, irrespective of the nationality of owners. Two most important factor that determines the absorption capacity in the host country is higher quality of the labour force and infrastructure (Borenzstein, *et al*, 1998, Caves, 1999, Djankov and Hoekman, 1998, and Mody and Wang, 1997) and the way the domestic market (output and factors of production) work such as the adopted competition system (Bromstrom and Kokko, 1996). Other critical factors that determine whether or not any improvements in technology or increases in productivity in developing countries are actually realised from FDI are the policy and performance of the foreign firms and the receptiveness of the host country to technological advancements (Jenkins and Thomas, 2002).

Bhorat and Poswell's (2003) paper attempts to examine how new technology and trade growth may have worked together in affecting South African labor market outcomes and poverty through the role of FDI. The paper finds that: (1) both trade and technology have served to reinforce a trend of increasing demand for highly skilled labor, generally at the expense of those with few skills. So far, the ability of trade and new technologies to create employment for the lower skilled and very poor seems exceptionally limited. Thus, unskilled workers and those in poor households undoubtedly bear the brunt of any adjustment costs associated with greater openness; (2) the type of foreign direct investment (FDI) South Africa has received since 1995 has not been of the kind that would stimulate economic development. Rather, South Africa's FDI flows appear to be more likely either to have no impact on employment or to lead to short term job losses; and (3) trade flows and technological change strongly reinforce an inequitable distribution of household income, with FDI's role remaining marginal.

Still in Africa, Ramachandran and Shah (1997) found that only domestic firms with majority foreign ownership that performed well. Caves (1998) and Tybout (2000) show that domestic large firms linked to FDI tend to be most productive, suggesting that the impact of the diffusion is likely to be more effective on large firms than smaller ones. Large firms usually have better trained workers and infrastructure to absorb transferred technologies and other intangible assets than what small firms have. Biggs *et al* (1995) investigate the production function for manufacturing companies in Ghana, Kenya and Zimbabwe in the early 1990s, using 1992-3 RPED Survey data. The study shows that there were more foreign-owned firms than wholly domestic-owned firms conducted in-house training of employees, and both foreign ownership and technology transfer are found to have a significant impact on firm efficiency.

Studies in Latin America also come with the same evidence. For instance, recent research by the Overseas Development Institute (te Velde, 2002) has examined how FDI affects the distribution of income and wages of skilled and less skilled workers in particular. It shows that FDI did not have an inequality-reducing or poverty reduction effect in Latin America. There are possible exceptions, such as Colombia, but even here FDI may have played a relatively minor role in reducing inequality or poverty. On the contrary, there are indications that FDI may have increased wage inequality in Bolivia and Chile. As stated in the report, poor people are more likely to gain from the presence of FDI only when less skilled workers gain. The presence of FDI can have a negative consequence for income distribution, for example when foreign firms introduce new and skilled-biased technologies (such as electronic firms in Costa Rica) favoring specific groups or when previously publicly-owned monopolies are taken over by foreign firms with fewer or no social objectives, which can increase wage inequality.

Aitken and Harrison (1999) used panel regressions of more than 4,000 Venezuelan plants between 1976 and

1989 to investigate backward and forward production linkage effects, and spillovers in the same industry. The findings show that an increase in foreign ownership is correlated with declines in the productivity of larger wholly domestically-owned firms in the same industry as foreign firms tend to invest in more productive sectors and more productive domestic firms with better trained workers. The benefits of FDI have largely been internalized by joint ventures. While, other local firms with low skilled workers, predominating the poor people, are not affected by the presence of FDI even in the same industry or sector.

Graham (1995) surveys the theoretical and empirical literature on the economic consequences of FDI for both host countries. Based on the overall finding, he concludes, inter alia, that positive effects of FDI come about largely through the transfer of new technology, knowledge and other intangible assets, leading to productivity increases and improvements in the efficiency of resource allocation.

Bende-Nabende (1998) investigates whether FDI has caused spillover effects that have led to economic growth of the ASEAN countries over the period 1970-94. The paper shows that FDI has stimulated economic growth by spilling mainly through its impact on workforce training and skill-upgrading, followed by technology transfer, international trade and learning by doing. FDI has also created incentives for human skills improvement, and governments in the countries under review have played an important role in the process of improving human skill quality through “formal” channels with FDI-based firms.¹¹

Another study is from Blomstrom *et al* (1983) with some evidence from Mexican manufacturing industry regarding the spillover effect of FDI. It shows that only for local firms with joint ventures with FDI gains benefits from the presence of FDI, or through production linkage/subcontracting effects. So, the presence of FDI tends to increase the gap in productivity and average wage level of workers between a small group of local firms linked to FDI and the remaining large group of local firms in the same industry.

2.3 Through the Allocation of Tax Revenue Collected from Foreign Firms

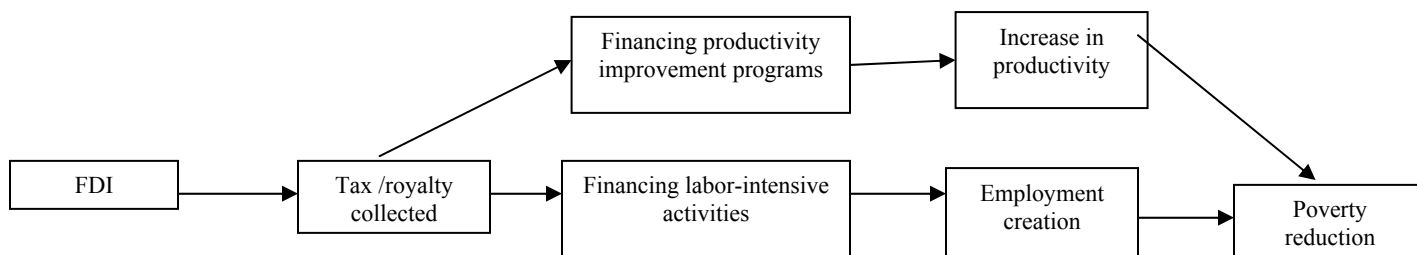
The third way that FDI can have a positive effect on poverty reduction is through taxation of foreign subsidiaries, which raises government revenues, which in turn can be used to funding various social development programs, including productive improvement and development of labor-intensive economic activities (such as industry and agriculture) or poverty alleviation oriented projects (Diagram 3).

But, whether this type of indirect benefit from FDI on poverty alleviation in the host countries can be realized, it depends on at least three pre-conditions. First, tax systems in the host countries should be attractive for investment, including from abroad. If, for instance, corporate tax rates in the host countries are too high as compared to other potential countries for FDI, it may deter foreign investment. Internationally compatible

¹¹ See also Fan (2002) for a survey of theoretical studies on the spillover effects from FDI and a case study in China.

corporate tax rates should reduce incentives to engage in ‘transfer pricing’, a practice, which reduces tax revenue in the host economy. Second, whether or not government budgets gain sufficiently from taxing foreign subsidiaries depends on what policies and agreements are in place to ensure that tax revenue and/or royalties are really collected. In reality, this is not always the case as foreign firms often use transfer pricing to minimize tax burden. UNCTAD (1999) notes that reforms to restrictions on profit remittance and double taxation treaties should have reduced the use of transfer pricing to withdraw income from the host economy. But it is argued in the report that this issue remains a concern for developing countries. For instance, it appears from a study conducted by UNCTAD that about 84% developing countries participating in a survey believed that affiliate companies hosted in their economy shift income to parent firms in order to reduce tax liabilities. The study concludes that transfer pricing continues to be an issue, with action required at both the national level and in the context of international investment arrangements (Jenkins and Thomas, 2002). Third, whether the collected tax from FDI is used for financing employment creation or poverty alleviation oriented programs or projects such as development of labor-intensive projects or small and medium enterprises, or to support the development of a safety net for the poor, or it is used to finance imports of components or raw materials for domestic capital-intensive industries.

Diagram 3: Relation between FDI and Poverty Reduction through Tax Revenue collected from FDI-based firms



3. Main Issues of Concern

Overall, despite the potential of FDI to enhance economic growth and poverty reduction in developing countries through three ways as discussed above, there are at least two main issues of concern. First, the monopolistic tendencies of foreign subsidiaries may crowd out domestic investment or industries, and thus the presence of FDI may increase instead of reducing poverty in the host countries (Gardiner, 2000). Increased rivalry between domestic and foreign firms could be beneficial in terms of promoting competition, improving efficiency amongst inefficient firms, and ensuring the most productive allocation of scarce resources. However, foreign firms, especially large multinational companies with superiority in technology, information, human resource, capital, marketing, distribution, and have advertising power may create anticompetitive impacts, e.g. displacement of domestic firms or investment. Other possible negative outcomes or “crowding-out” effects of

FDI: bidding scarce resources (e.g., skilled labor, credit) away from domestic firms, or squeezing out domestic supply networks as new foreign entrants bring with them integrated upstream and downstream supply chains. Such powerful foreign multinational companies tend to be monopolistic or oligopolistic, and they are able to engage in predatory pricing to restrict prospective entrants from gaining access to the market. All these outcomes will result in a contraction in total industry size, a reduction in employment, and an increase in poverty. Nevertheless, the literature concedes that crowding out is the more rare event, and that the benefits of FDI tend to be more prevalent, especially enhanced competition, improved efficiency and increased innovation (Cotton and Ramachandran, 2001).

Another study is from Graham (1995) who surveys the theoretical and empirical literature on the determinants of FDI and the economic consequences of FDI for host countries. Based on the overall finding, he concludes, inter alia, that FDI can have both positive and negative economic effects on host countries. While, there are some positive effects, negative effects can arise from the market power of multinational corporations and their associated ability to generate very high profits, or from domestic political interference by multinational corporations. This overall finding, however, suggests that the evidence of negative effects from FDI is inconclusive, while the evidence of positive effects is overwhelming.

Second, the form in which FDI occurs may influence the extent of employment benefits for the host countries from the presence of foreign firms. A significant proportion of worldwide FDI in the 1990s has been in the form of mergers and acquisitions, as opposed to investment in new plants/factories, where aggregate economic activity or production necessarily increases (Jenkins and Thomas, 2002). So, at least in the short term, acquisitions or mergers may have fewer benefits (or larger costs) than investment in new plants/factories for the host country. The *World Investment Report 2000* from UNCTAD explores many of the concerns associated with the impact of acquisitions by foreign companies in developing countries. These include the view that acquisitions do not necessarily add to productive capacity; the observation that a change in ownership frequently has an adverse impact on employment and production, which may actually decline as rationalization takes place in the case of acquisitions; the possibility of market dominance of strategic sectors by new foreign owners; and the possibility of reduced competition as domestic firms are eliminated (UNCTAD, 2002).

4. Economic growth, income distribution and poverty in Indonesia since 1970s.

Actual impact of FDI on economic growth and poverty reduction in Indonesia can be assessed by comparing the economic performance without the presence of FDI during the Old Order period under Soekarno and the economic performance backed by FDI and foreign borrowing from donors during the New Order period led by Soeharto. During the Sukarno era (1949-1966), the Indonesian economy was characterized by “inward looking” development policy, including against FDI, especially from the West. This “closed door” policy accompanied

by political chaos in that time had led to severe neglect of agriculture, stagnated manufacturing industry, hyper-inflation, and the economy collapsed.

During the turmoil in the transition between the Sukarno and Suharto regimes late in 1966 and early in 1967, probably 80% of the population was “absolute poor”, lived on tiny, fragmented and scattered farms, with average food energy intake less than 1600 kilocalories per day. This meant that hunger was widespread (van der Eng, 2000). During that transition period, the average Indonesian earned only roughly US\$50 a year, and most people had little or no access either to rudimentary health care or to basic amenities of life such as safe drinking water or adequate shelter. About 60% of adult Indonesian could not read or write and close to 65% of the country’s population lived in absolute poverty.

In the early years of the Suharto government, there was a need to establish macro economic stability and consolidate political power, and as the first step, the government established the food logistics agency (BULOG) to stabilize rice prices and at the same time to protect reasonable income for farmers. With stable rice prices accompanied with improved macro economic management and money supply control, the government could push down the inflation rate from above 500% by the end of the Soekarno era to less than 10% within a short period. In that time, there was also a need, or can be said, very urgent, donor assistance, especially the provision of food aid. When relative political stability was restored, and after the government launched the first five year economic development plan (Repelita I) in 1969, capital from many donor countries started to inflow into the country, and with this, major investments were made to stimulate agriculture: irrigation rehabilitation, the introduction of high yielding varieties (HYVs) of rice, fertilizer imports and distribution, and the BIMAS program of extension and farm credits. Also, supported by donor-provided foreign borrowing and through a balanced budget, macro economic stability was achieved.

Also since the beginning of 1970s, a series of donor-supported economic reform programs have been implemented, and FDI also started to come into the country. In the initial phase of the New Order period, the economic development reform architect gave priority to achieving economic stability and reconstruction with the emphasis on development of agriculture by launching so-called the green revolution. This soon followed by industrialization, and industrial output surged in the latter part of the period, led by labor-intensive manufactured exports. Large scale and sustained economic deregulation in the 1980s led to sharply better incentives for export, and these were matched by incentives for FDI. The fortuitous “push” in FDI from Japan as the yen appreciated rapidly, and the “pull” from the attractive climate in Indonesia allowed manufactured exports to play a significant role in employment generation by the end of the 1980s (Timmer, 2004).

With the technical and financial supports from donor countries and the World Bank under the umbrella of IGGI coordinated by the Dutch government, and backed up by FDI from industrialized countries, Indonesia experienced a sustained rapid economic growth since the 1970s. It had caused the real income per capita to

increase and the adult illiteracy to drop significantly; other social indicators also improved significantly since then (Table 1). Almost universal entry into primary education was achieved in the early 1980s, and the net enrollment rate has been maintained at nearly 95% at the primary level since then. Life expectancy at birth rose from 55 years in 1970 to 66 years in 2000, and the estimated proportion of children dying before reaching their fifth birthday fell from 125 per 1,000 for those born in 1980 to 52 per 1,000 for those born in 1998 (World Bank, 2001).

Table 1 Selected Social Indicators of Indonesia and Other Developing Countries, 1970-2000

Indicators	Beginning Period	Ending Period
	<u>1970</u>	<u>2000</u>
Average Per Capita GDP (in 1999 PPPS)*		
- Indonesia	940	2,882
- East Asia & Pacific	875	4,413
- South Asia	1,051	2,216
	<u>1980</u>	<u>1999</u>
Infant Mortality (per 1,000 live births)		
- Indonesia	90	42
- East Asia & Pacific	55	35
- South Asia	119	74
- Low & Middle Income Countries	86	59
Life Expectancy at Birth (years)		
- Indonesia	55	66
- East Asia & Pacific	65	69
- South Asia	54	63
- Low & Middle Income Countries	60	64
Primary Gross Enrolment Ratio (%)**		
- Indonesia	107	113
- East Asia & Pacific	111	119
- South Asia	77	100
- Low & Middle Income Countries	96	107
Secondary Gross Enrolment Ratio (%)**		
- Indonesia	29	56
- East Asia & Pacific	44	69
- South Asia	27	49
- Low & Middle Income Countries	22	59
Adult Illiteracy (% of people aged 15 and above)***		
- Indonesia	13(M), 27(F)	9(M),19(F)
- East Asia & Pacific	13(M), 29(F)	8(M),22(F)
- South Asia	41(M), 66(F)	34(M),58(F)
- Low & Middle Income Countries	22(M),39(F)	18(M),32(F)

Notes: * Figures are three-year averages, centered on the year shown.

** The most recent data pertain to 1997, instead of 1999.

*** M=male, F=female

Source: Balisacan et al. (2002).

What can be regarded as a miracle is that Indonesia had a reasonably low inequality at the start of the New Order, which the economy was characterized by a peasant economy with small land holdings. In that time the Gini ratio (based on consumption expenditure) was about 0.35 and in the early 1990s it fell to 0.32, and after that raised again to 0.34 in 2002 (Table 2). There was also reasonable achievement in lowering inter-regional inequality, either within provinces or

between rural and urban areas (Table 3). The low level of inequality significantly enhanced the poverty reducing effect of rapid economic growth (Chowdhury, 2002).

The sustained rapid economic growth also led the poverty incidence to drop significantly. Data from the National Socio-Economic Survey (SUSENAS) conducted by the National Central Bureau of Statistics (BPS) show that the percentage of the population below the poverty line dropped from 40% to around 11% during

Table 2 Inequality in Income Distribution in Selected Countries/Group of Countries: 1970s to mid-1990s

Country/Group of Country	Gini Coefficient (average per year)		
	1970s	1980s	1990s
Newly Industrialized Countries (NICs)			
-Hong Kong	0.41	0.37	0.45
-South Korea	0.33	0.39	0.34
-Taiwan	0.28	0.28	0.31
-Singapore	0.41	0.41	0.39
China	na	0.32	0.38
ASEAN			
-Indonesia	0.33	0.33	0.34
-Malaysia	0.50	0.51	0.48
-Thailand	0.43	0.43	0.52
-Philippines	0.49	0.46	0.45
South Asia			
-India	0.30	0.31	0.30
-Bangladesh	0.36	0.39	0.28
-Pakistan	0.30	0.32	0.31
-Sri Lanka	0.38	0.42	0.30
OECD	na	0.33	0.34
Transition counties (East Europe)	na	0.25	0.29
Middle East & North Africa	na	0.41	0.38
African Sub-Sahara	na	0.44	0.47
Latin America & Caribbean	na	0.50	0.49

Note: na=data not available

Source: BPS (SUSENAS) various issues, and Deininger and Squire (1995, 1996).

Table 3 Gini Coefficient of Consumption Expenditure in Indonesia by Urban and Rural: 1965-2002

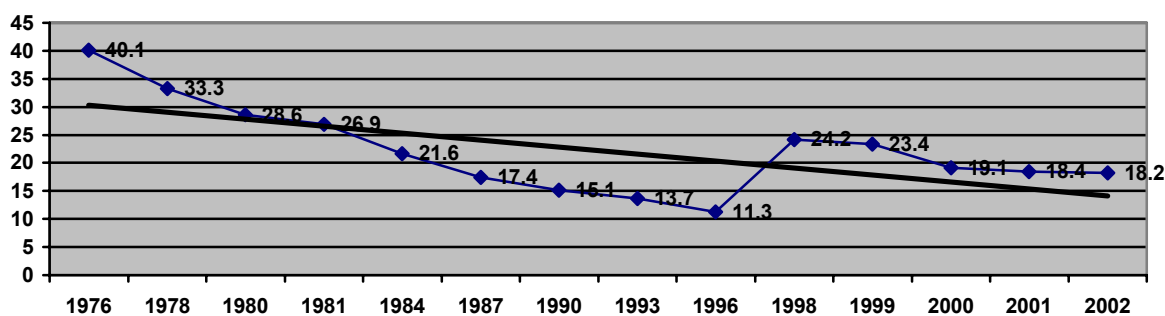
Year	Urban	Rural	National
1965	0.34	0.35	0.35
1970	0.33	0.34	0.35
1976	0.35	0.31	0.35
1978	0.38	0.34	0.40
1980	0.36	0.31	0.34
1981	0.33	0.29	0.33
1984	0.32	0.28	0.33
1986	0.32	0.27	0.33
1987	0.32	0.26	0.32
1990	0.34	0.25	0.32
1993	0.33	0.26	0.34
1994	0.34	0.26	0.34
1995	0.35	0.27	0.35
1996	0.37	0.28	0.36
1997	0.35	0.26	0.37
1998	0.33	0.26	0.32
1999	0.34	0.26	0.33

2002	0.35	0.26	0.34
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Source: BPS (SUSENAS) various issues.

1976-1996.¹² The biggest drop in poverty incidence was happened during the 1970s up to the early 1980s with 13 percentage points, while during the period 1981-93 the decline was only 16 percentage points (Figure 2). Before 1993, the BPS defined the national poverty line as the total expenditure needed to satisfy an energy requirement of 2,100 calories per capita per day. But, since 1993, the BPS has adopted the basic needs approach for both food and non-food calculations. Fifty-two food items have been chosen, and their quantities have been determined after being scaled-up to satisfy the 2,100 calories requirement, and the SUSENAS implicit prices have been used since then to derive the poverty line (Asra, 2000).¹³

Figure 2: Percentage of Total Population Living Under the Poverty Line, 1976-2002



Source: BPS (SUSENAS)

According to Timmer (1997, 2002), the decline of poverty during the Soeharto period was mostly driven by macro economic policy, especially control of inflation and management of the real exchange rate, and secondarily by sector-specific trade and investment policies. In his recent article (Timmer 2004), he argues that the interaction between macro policy and poverty reduction is especially important in Indonesia because of the strong interface between the tradable and non-tradable sectors. Rapidly rising demand for the goods and services produced by the non-tradable sector, mostly in rural areas, seems to be the short-run driver for pulling underemployed labor out of rural households, and thus out of poverty. The interface between the tradable and non-tradable sectors is mediated by both demand and supply responses.

¹² SUSENAS provides detailed expenditure data on more than 60,000 households every three years. Less detailed data from a “core” questionnaire are available annually for about 200,000 households. Because of differences in approach, it has been difficult to match up results from the two different questionnaires.

¹³ Studies on economic development in Indonesia during the Suharto years can be found in e.g. Timmer (2004), Hoffman and Rodrick-Jones (2004), Hill (1996), and the “Survey of Recent Developments” in each issue of the *Bulletin of Indonesian Economic Studies* during that period.

When economic crisis occurred in 1997/1998, poverty in Indonesia increased again sharply, i.e. from 11.3% in 1996 to 24.2% in 1998 (Table 4). Even, several studies conducted since the crisis by such as ADB (2000), Suryahadi et al. (2000) and Skoufias (2000) argued that the number of new poor people/households caused by the crisis could be much higher than officially announced by the BPS data. However, Daly and Fane (2002) argued that much of the apparent rise was due to an increase in the poverty line. According to their own calculation, relative to the former poverty line, the poverty rate rose from 11% in 1996 to 17% in 1998. Relative to the new poverty line, the rate increased from 18% in 1996 to 24% in 1998 and then declined slightly to 23% in 1999.¹⁴

Table 4 Poverty Line, Number and Percentage of Population Living under the Poverty Line: 1976-2001

Year	Poverty Line (Rp/capita/month)		Poor People (%)			Number of Poor People (million persons)		
	Urban	Rural	Urban	Rural	National	Urban	Rural	National
1976	4,522	2,849	38.8	40.4	40.1	10.0	44.2	54.2
1978	4,969	2,981	30.8	33.4	33.3	8.3	38.9	47.2
1980	6,831	4,449	29.0	28.4	28.6	9.5	32.8	42.3
1981	9,777	5,877	28.1	26.5	26.9	9.3	31.3	40.6
1984	13,731	7,746	23.1	21.2	21.6	9.3	25.7	35.0
1987	17,381	10,294	20.1	16.1	17.4	9.7	20.3	30.0
1990	20,614	13,295	16.8	14.3	15.1	9.4	17.8	27.2
1993	27,905	18,244	13.4	13.8	13.7	8.7	17.2	25.9
1996	42,032	31,366	9.7	12.3	11.3	9.6	24.9	34.5
1998	96,959	72,780	21.9	25.7	24.2	17.6	31.9	49.5
1999	92,409	74,272	19.4	26.0	23.4	15.6	32.3	48.0
2000	91,632	73,648	14.6	22.4	19.1	12.1	25.2	37.3
2001	100,011	80,382	9.8	24.8	18.4	8.5	28.6	37.1
2002	Na	Na	14.5	21.1	18.2	13.3	25.1	38.4

Source: BPS

Just as the economic contraction in 1998 caused a sharp increase in poverty rate, the rebound of the country's economy in the following two years, albeit modest, led to a drop again in poverty incidence, from 24.2% in 1998 to 23.4% in 1999, and in 2002 the rate was 18.20% (see Table 4). Recent information from the government indicates that in 2003 the poverty rate was 17.4%. Whereas, according to recent World Bank estimates, with US\$1/capita/day as poverty line, percentage of population classified as poor declined from 12% in 1999 to 7.4% in 2003, and with US\$2/capita/day, declined from 65.1% in 1999 to 53.4% in 2003 (Table 5) (LPEM, 2004). So, the major thrust of the evidence is that the worst is indeed over and that the incidence of nation-wide poverty is apparently moving back towards pre-crisis levels, suggesting that a social recovery from the crisis seems to be in progress. But, overall, the poverty rate in Indonesia is still high as compared to its lowest level of 15.1% in 1990. Even, data from the National Family Planning Agency (BKKBN) show that in

¹⁴ Daly and Fane (2002) argued that measured poverty after the onset of the crisis may have slightly overstated real poverty because the anti-poverty programs that provided benefits in kind, i.e. subsidized rice, scholarships and subsidized health care and nutrition, would not have affected the expenditure-based measures of poverty, even though they reduced real poverty, because their benefits were not included in measured expenditure.

2001 the percentage rate of poor families in Indonesia reached around 50.07, which was more than half of total families in the country.

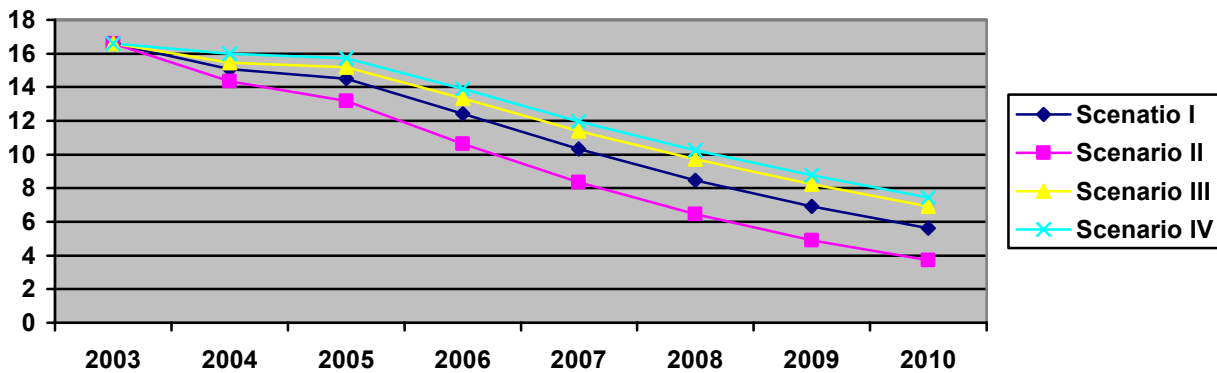
The experience of Indonesia as described above suggests strongly that economic growth has been the main important engine for poverty reduction. A simulation of poverty reduction by different rates of economic growth and gini ratios shows that in the period 2003-2010 with moderate or baseline growth (scenario I), poverty as measured by head count (HC) index declines from 16.58 to 5.61. While, with growth + 1% and constant gini coefficient (scenario II) poverty is expected to fall by a larger percentage to 3.73, and by a smaller percentage to 6.92 with growth -1% and constant gini coefficient (scenario III). Even, with growth -1% and gini coefficient increased by 1% (scenario IV), poverty is expected to decline by more than 50% from the level in 2003 to 7.45% (Figure 3).

Table 5 Percentage of Poor People with Poverty Line US\$1/Cap/Day and US\$2/Cap/Day in Indonesia, 1990-2003

Year	US\$1/Cap/Day	US\$2/Cap/Day
1990	20.6	71.1
1993	14.8	61.6
1996	7.8	50.5
1999	12.0	65.1
2002	7.2	53.5
2003	7.4	53.4

Source: World Bank, quoted from LPEM (2004).

Figure 3 Simulation of National Poverty Reduction (HC Index) by Different Scenarios on Economic Growth and Gini Coefficient



Source: LPEM (2004).

Foreign firms in Indonesia are mainly located in urban areas. So, it can be expected that urban poverty rather than rural poverty will be most affected by the presence of FDI, as available evidence indicates that foreign firms absorbed mainly urban labor force and have business linkages with urban domestic firms. The important implication of this is that in examining the effect of the presence of FDI on poverty, a distinction between urban and rural poverty may be relevant.

Data from SUSENAS show that number of poor people in urban areas declined by 15% from 10 million people in 1976 to about 8.5 million people in 2001, or from 38.8% to almost 9.8% of total population, but increased again in 2002 to 13.3 million people or 14.5% of total population in that year. During the new order period (before the crisis), the decline of poverty occurred in both urban and rural areas. Before 1980, poverty incidence in urban areas was lower than in rural areas. However, from 1980-1993 (except in 1984), the reverse was true. Since 1993 up to 1996, the BPS data based on its methodology of determining the poverty line show that a return to the pre-1980 situation of lower poverty incidence in urban than in rural areas occurred (see Table 4).

Asra (2002) tried to estimate the relative contribution of economic growth and equity to poverty alleviation in urban and rural areas respectively by using decomposition formulae used by Ravallion and Huppi (1991).¹⁵The results show that during the period 1981-90, poverty incidence declined from about 28% to 17% (Table 6). Most of this drop in poverty can be attributed to higher mean consumption at a given consumption expenditures distribution. This growth impact was more prevalent during the 1990s (before the crisis). The decomposition shows that the change in consumption expenditures distribution has had an adverse effect on poverty alleviation, as in that period inequality of consumption expenditures as measured by the Gini coefficient increased slightly. If data on consumption expenditures distribution based on constant price rather than current price were used, the results might be different. Unfortunately, such data for urban and rural areas are not available.

Table 6 Decomposition of changes in poverty measures into consumption and redistribution effects, 1981-90 and 1990-96

Period	Higher mean consumption	Changes in Consumption expenditure distribution	Residual	Consumption point elasticity of poverty at initial year
Urban				
Head-count (HC) index				
1981-90	105.73	-10.57	4.84	-2.12
1990-96	136.89	-45.07	8.18	-2.88
Poverty gap index				
1981-90	97.97	-3.45	5.48	-3.03
1990-96	163.16	-68.30	5.14	-4.57
Distributionally sensitive index				
1981-90	95.24	2.33	2.43	-3.91
1990-96	200.03	-103.86	3.83	-6.27
Rural				
Head-count (HC) index				
1981-90	58.54	41.31	0.15	-2.51
1990-96	174.77	-89.94	15.18	-3.61
Poverty gap index				
1981-90	55.11	53.54	-8.66	-3.50
1990-96	149.93	-70.38	20.45	-5.46
Distributionally sensitive index				
1981-90	56.10	60.83	-16.93	-4.51
1990-96	137.66	-62.05	24.39	-7.37

Source: Calculations of Asra (2000)m based on consumption expenditures data from the SUSENAS.

¹⁵ The estimates of poverty measures were derived by using consumption expenditures distribution based on current market price (from SUSENAS data) and two possible Lorentz curve specifications: general quadratic and beta Lorentz curves.

From his own study on the country's experience with economic growth and poverty reduction, Timmer (2004) emphasizes that, "economic growth in Indonesia has always benefited the poor. There are episodes when income inequality increased and episodes where it decreased, so Indonesia has experienced both "weak" and "strong" pro-poor growth. During economic decline and crises, the poor have been badly impacted. But there are no episodes where the poor were worse off during periods of economic growth (with the possible exception of rural areas during the "Dutch Disease" era in the mid- to late-1970s)"(page 5).

Poverty is a highly multidimensional phenomenon or process, which, by implication, obtains from an array of factors. The conventional definition of poverty pertains to income poverty, that is, the inability of people to meet the basic needs of life.¹⁶ The World Development Report 2000 identifies institutional, social, economic and human factors as the major causes of poverty. In the Indonesian context, since poverty mainly afflicts agricultural and self-employed households, the most important source of poverty in the country is lack of development in agriculture.¹⁷ The reason to take less developed agriculture as the most important source of poverty in Indonesia is simply because the majority of the poor in Indonesia come from agricultural and self-employed households. Official data (SUSENAS) on distribution of poor families by occupation in Indonesia indicate that the vast majority of poor families are in agricultural work, predominantly on farms (Table 7). In percentage, data from SUSENAS 2002 show that almost 70% of the poor people in rural areas work in agriculture, and even agricultural activities played a dominant role as a source of income for the urban poor (Table 8). This evidence may support the notion that with its low productivity and hence real income per farmer/worker, agriculture is the main important source of poverty.

Table 7 Distribution of Poor Families by Occupation, 1999-2002 (number of heads of families in 000 persons)

	1999	2000	2001	2002
Unemployed	4.063	3.560	2.349	3.072
Agriculture	25.997	20.109	23.375	20.605
Industry	6.069	5.380	4.401	4.471
Services	11.840	9.784	6.984	7.571
Total	47.969	38.833	37.109	35.719

Source: BPS (SUSENAS, various issues).

Table 8 Distribution of Poor People (Household Head) by Sector and Area: 2002 (%)

Sector	Urban	Rural
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¹⁶ The use of participatory methods to study poverty has revealed that there is more to poverty than just lack of income to meet the basic requirements of life. Some of the additional dimensions to poverty include (i) powerlessness - which refer to a sense of insecurity, helplessness against corruption in public service delivery and general exploitation by service providers, and vulnerability to natural and economic shocks; and (ii) isolation from the larger society and other socioeconomic infrastructure (Okidi, 2000).

¹⁷ That is why it is generally believed that in a large agrarian economy like Indonesia, only the agricultural sector interventions have a serious claim to poverty reduction, or as argued by Mason and Baptist (1996), direct ways that policy can help to reduce poverty in Indonesia are through improving the operation of product, land, and capital markets, particularly where the regulatory environment now works to reduce farm profitability or inhibit entry to productive enterprises by the poor.

Agriculture	31.11	69.09
Forestry	0.23	1.34
Fishery	1.48	2.23
Mining	1.25	0.49
Industry	12.17	4.98
Electricity	0.10	0.02
Construction	9.67	3.63
Trade	14.06	5.00
Transportation	8.94	2.73
Finance	0.69	0.08
Services	8.14	2.40
Others	0.04	0.06

Source: BPS (SUSENAS).

This notion is also supported by evidence provided by Pradhan *et al*'s (2000) from their study using data from SUSENAS February 1996 and February 1999. As shown in Table 9, the agricultural sector consistently had the highest poverty incidence as well as the highest contribution to the total number of poor people during the period under investigation. This evidence reflects two things. First, people in the agricultural sector have always been relatively poorer than those in other sectors. Second, the sector remains the largest source of employment, which might also explain to a certain extent the lower average real income per capita in the sector as compared to other sectors. The combination of these two factors explains the persistence of the agricultural sector as the largest contributor to the number of people living under poverty line, even though its importance had declined markedly from about 68.5% in February 1996 to around 58.4% in February 1999.

Table 9 Poverty Incidence and Contribution to Total Poor by Main Sector of Occupation: February 1996 and February 1999 (%)

Sector	February 1996		February 1999	
	Poverty rate	Contribution to total poor	Poverty rate	Contribution to total poverty
Agriculture	26.29	68.54	39.69	58.38
Trade, hotel, and restaurant	7.96	8.10	17.63	11.13
Manufacturing industry	10.69	5.71	22.92	7.71
Civil, social, and private services	5.73	5.72	13.13	7.36
Transport and communication	8.85	3.32	24.02	5.58
Construction	14.04	5.42	28.97	5.52
Receiving transfer	6.58	1.86	15.57	2.65
Mining and quarrying	15.34	1.01	29.81	1.00
Others	13.29	0.10	32.00	0.27
Finance, insurance, and leasing	1.24	0.06	5.23	0.23
Electricity, gas, and water	6.10	0.16	14.48	0.17

Source: Pradhan et al. (2000).

Land is the most important store of wealth in agrarian societies, and in Indonesia it is typically distributed very unequally. This fact challenges the common presumption that the majority of poverty in Indonesia emerges from the poorest farm households. Data from agricultural census indicate that Indonesian agriculture is dominated by large and increasing number of small-scale family farms. Recent agricultural census indicates that in 2003 there were 25.437 million land-using farmers, 13.663 million or almost 57% of which were marginal farmers with less than 0.5 ha of land under their control. In 1993 the number of land-using farm households was

20.518 millions or grown by 1.8% per year, whereas the number of marginal farmers was 10.804 million or increased by 2.6% per year during the 1993-2003 period. In Java, the number of land-using family farms and the marginal farmers increased by respectively 1.5% and 2.4% per year (Table 10).

The average land size per farmer will continue to decline in the future especially in Java where the majority of population and poverty in the country are located. The reason is that, while, total agricultural land in Indonesia still continued increasing, in Java it has been declining with an increasing rate since early 1990s. This decelerating trend of total agricultural land in Java is fairly reasonable. On one hand, potential agricultural land for new land expansion right now (and in the future) is only available in outside Java, particularly in the eastern part of the country. On the other hand, agricultural land conversion to other functions will continue accelerating at an increasing rate, as a direct effect of industrialization, population growth and urbanization.

Table 10 Number and growth rate of land-using farms and marginal farmers in Indonesia: 1993-2003

Category	1993			2003		
	Java	Outside Java	Indonesia	Java	Outside Java	Indonesia
Number (million)						
- Marginal farmers	8.067 (69.8)*	2.737 (30.6)	10.894 (52.7)	9.989 (74.9)	3.674 (33.9)	13.663 (56.5)
- Land-using farms	11.564	8.954	20.518	13.336	10.841	24.176
- Agricultural households	11.671	9.116	20.787	13.964	11.472	25.437
Growth rate per year, 1993-2003 (%)						
- Marginal farmers				2.4	3.4	2.6
- Land-using farms				1.5	2.1	1.8
- Agricultural households				2.0	2.6	2.2

Note: * = % of land-using farms

Source: BPS

This problem has been aggravated since the Indonesian government has gradually reduced its supports for agricultural development since mid 1980s, and since the economic crisis the government has reduced or stopped its input subsidies (fertilizers, seeds). This policy has resulted in increasing production cost, reflected by the declining of paddy-fertilizer price ratio (Simatupang, et al., 2004).

5. FDI and Its Impact in Indonesia

5.1 Recent Trend

In the modern history of Indonesian economy since the New Order regime, FDI has played a leading role in sustained economic growth of the country. Although only a small share of total investment and employment creation in the country, FDI has been a key factor driving export-led growth in Indonesia. Foreign firms have by no means been the only actors, but they have played a very crucial role in domestic industries with the fastest export growth such as electronics, shoes, and garments. Through FDI, the Indonesian economy has rapidly been

transformed from agriculture and the exploitation of raw materials into producers and exporters of many manufactured goods.

Indonesia is among the most open in the developing countries to foreign investment. The New Order government recognized the powerful role that foreign investors could play in fuelling export-led growth, and since the implementation of Repelita I, the government introduced “pro-FDI policies” to attract such investment. As a result of FDI inflows, the country was among the world’s fastest growing economies before the 1997 crisis. At the same time, however, the years leading up to the crisis revealed a growing disquiet in Indonesia about its continuing ability to attract FDI in the face of competition from countries such as China. Related to the issue of possible investment diversion, questions were raised about whether FDI inflows were contributing sufficiently to technology transfer, industrial upgrading, employment creation and hence poverty reduction.

In the ASEAN context, Indonesia together with Malaysia, Thailand and the Philippines (the ASEAN4) have collectively been among the most important destinations for FDI outside of the OECD area (Table 11). As a group, they have been the fifth most popular host to FDI world-wide in the 1990s, though a long way behind China. Thomsen (1999) analyses FDI inflows into the ASEAN4 over the past two decades, as reflected in Figure 4. Inflows are divided by GDP in each case in order to remove the effect of market size, inflation and currency movements. The figure also indicates the stability of FDI flows in 1997, in spite of the crisis. Only in Indonesia where a shift in the direction of growth in FDI flows happened in 1997. Investments, including from FDI in Indonesia have been discouraged by the unstable political environment emerged since the 1997 crisis (Table 12).

Table 11. Total FDI inflows by country, 1990-97 (U.S.\$ million)

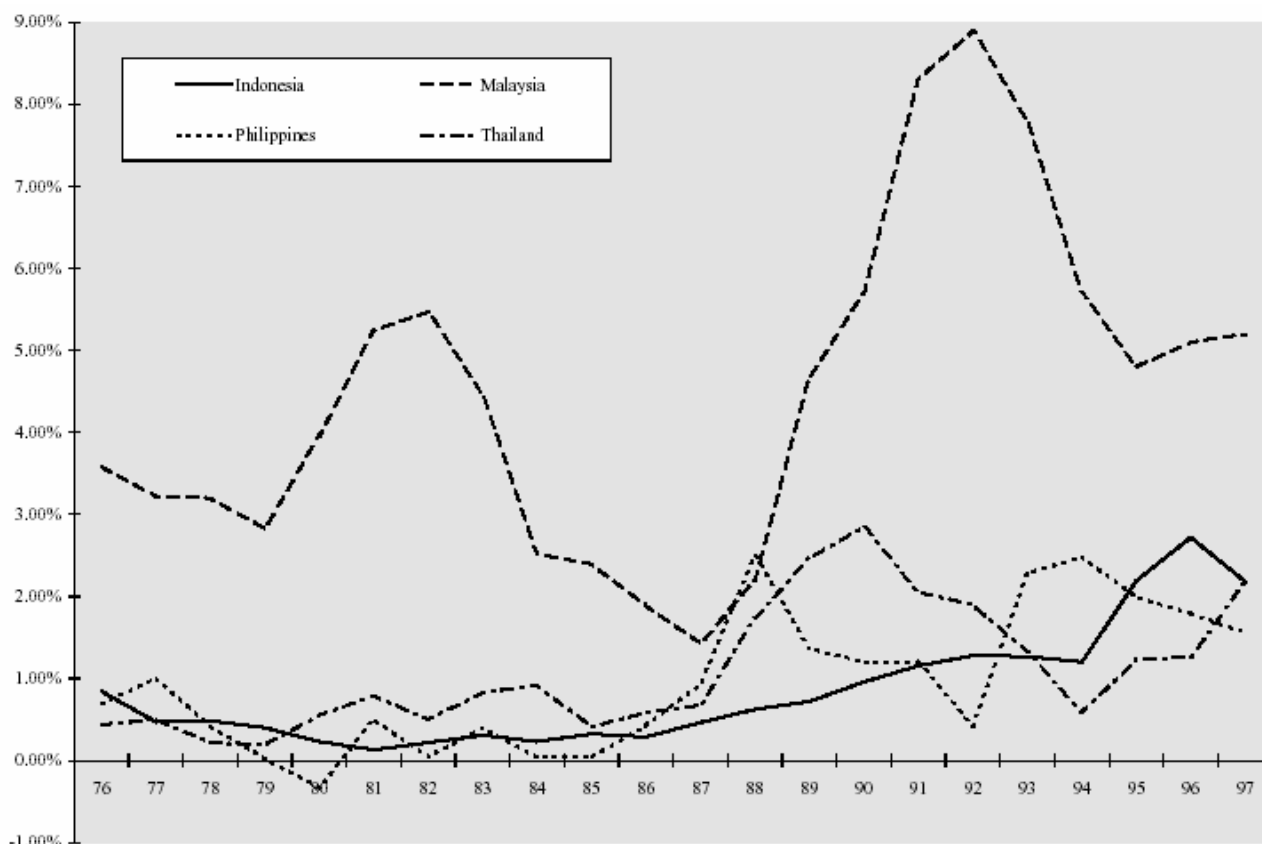
No	Country	Value	No	Country	Value
1	USA	414 074	21	Denmark	18 177
2	China	200 578	22	Thailand	17 177
3	UK	176 889	23	New Zealand	17 083
4	France	149 587	24	Poland	15 882
5	BLEU	84 008	25	Colombia	15 798
6	Netherlands	70 743	26	Hungary	14 945
7	Spain	68 068	27	Norway	14 412
8	Mexico	58 850	28	Hong Kong	14 239
9	Canada	53 818	29	Portugal	12 909
10	Australia	52 212	30	Russia	12 774
11	Singapore	49 173	31	Venezuela	11 890
12	Sweden	47 546	32	Chinese Taipei	11 443
13	Brazil	44 228	33	Peru	11 215
14	Malaysia	35 177	34	Korea	10 534
15	Italy	30 394	35	Austria	10 438
16	Argentina	30 120	36	Japan	10 310
17	Indonesia	23 684	37	Nigeria	10 093
18	Germany	21 475	38	India	9 957
19	Switzerland	20 188	39	Israel	8 398
20	Chile	19 085	40	Philippines	8 379

Source: Data OECD in Thomsen (1999)

Earlier, the growth of FDI in Indonesia was strongly related to import substitution policies pursued to promote industrialization in the country. Strategic sectors were protected from foreign competition through high tariffs. In some sectors foreign investment was proscribed, and in most it was heavily circumscribed. Foreign investors were limited to minority shares of companies, could not own the land on which their factories were built, were required to transfer technology and sometimes to divest after a number of years. Many foreign companies nevertheless invested during this period to participate in the economic rents resulting from import protection (Thomsen, 1999).

The switch from import substitution policies to export promotion policies began in Indonesia in early 1980s; whereas Malaysia and Thailand started to promote exports as early as the 1970s. Rather than replacing import

Figure 4: FDI Inflows as percentage of GDP in Indonesia, Malaysia, Thailand and the Philippines, 1976-1997



Source: Figure 1 in Thomsen (1999)

Table 12 Development of FDI in ASEAN (bill. US\$), 1991-2002

Economies	1991-1996 (average)	1998	1999	2000	2001	2002
Indonesia	3,0	-0,4	-2,7	-4,6	-3,3	-1,5
Malaysia	5,4	2,7	3,9	3,8	0,6	3,2
Philippines	1,2	1,7	1,7	1,3	1,0	1,1
Thailand	1,9	7,5	6,1	3,3	3,8	1,1
Singapore	6,9	7,6	13,2	12,5	10,9	7,7
Brunei	0,2	0,6	0,7	0,5	0,5	1,0
Cambodia	0,1	0,2	0,2	0,1	0,1	0,05
Laos	0,05	0,05	0,05	0,03	0,02	0,02

Myanmar	0,3	0,7	0,3	0,2	0,2	0,1
Vietnam	1,2	1,7	0,2	1,3	1,3	1,2

Source: UNCTAD (2003).

substitution, export promotion was super-imposed on the pre-established structure. The restrictions on FDI for the domestic market remained largely intact; indeed, some of them are enshrined in national constitutions. There has nevertheless been some relaxation in the implementation of these policies over time. Local content requirements have been curtailed as a result of the TRIMs agreement, except in the automobile sector, and divestiture requirements (where they exist) are not rigorously enforced. There has been some further relaxation of policies, often on a temporary basis, as a result of the crisis, but the basic regulatory structure for domestic-oriented investment remains in place (Thomsen, 1999)..

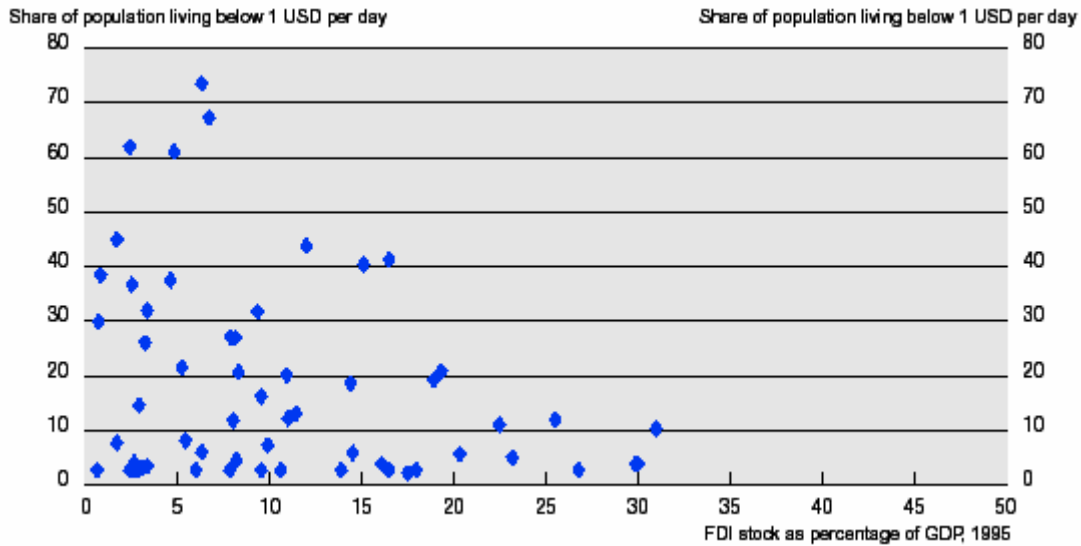
5.2 The Impact

At the Macro Level

Though no studies so far on the social consequences of FDI, especially on poverty, in Indonesia, it can be assumed that the net effect of FDI on poverty in the country is positive: the number of new employment created is larger than the number of employment destroyed by the presence of foreign firms. This assumption is simply based on existing studies using cross country data. For instance, in their cross country study, Dollar and Kraay (2001) find that FDI as a proportion of GDP is significantly correlated with per capita GDP growth. They find that a 1% increase in the FDI to GDP ratio would result in a cumulative effect of a 13% increase in average incomes over the course of a decade. When running cross country fixed effects regressions, Rama (2001) also finds a strong relationship between the FDI to GDP ratio and increases in the level of wages by occupation. He too finds a large effect with a 1% increase in FDI being associated with a 1% increase in wages.

Another evidence is given by OECD (2002) using data on share of population living below 1 USD per day and FDI stock as percentage of GDP in 1995 from 60 developing countries, including Indonesia, which support the notion that FDI may help reduce poverty and improve social conditions in the countries under review (Figure 5). Based on this evidence, the report concludes that the beneficial effects of FDI on poverty reduction are potentially stronger when FDI is employed as a tool to develop labor-intensive industries in developing countries.

Figure 5: Poverty and FDI stock in 60 developing countries, 1996

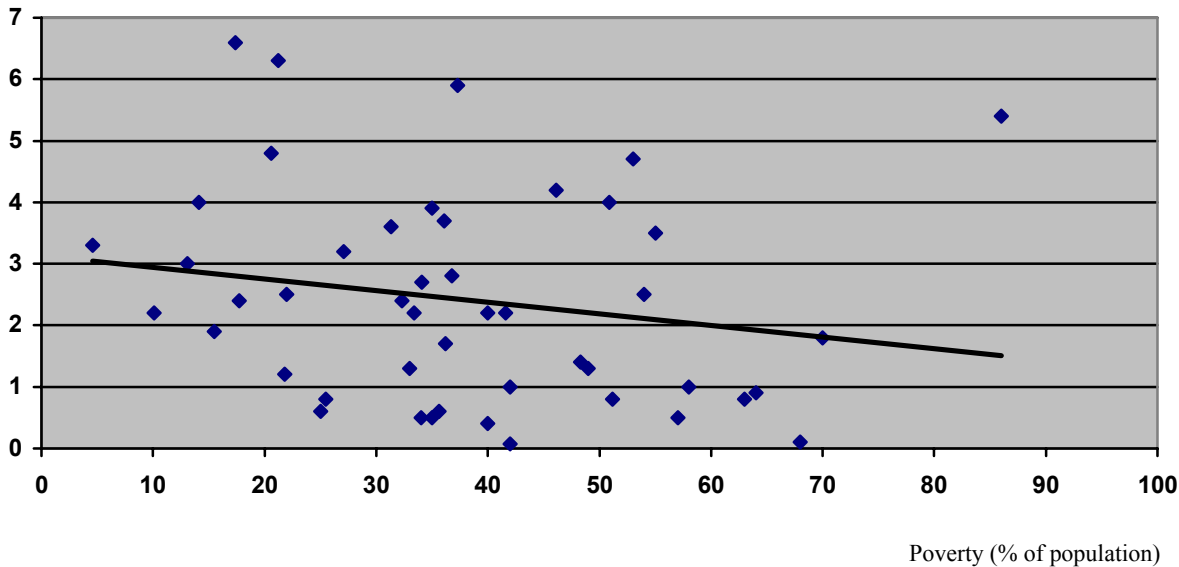


Source: World Development Indicators in OECD (2002).

In addition, by using data 2000 from The World Development Report 2003 on poverty and FDI in 47 developing countries in Asia, Africa and Latin America, own plot also suggests a negative correlation between FDI and poverty (Figure 6). Poverty is measured as a percentage of total population and FDI as a percentage of GDP.

Figure 6: Poverty and FDI/GDP ratio in 47 developing countries, 2000

FDI/GDP (%)



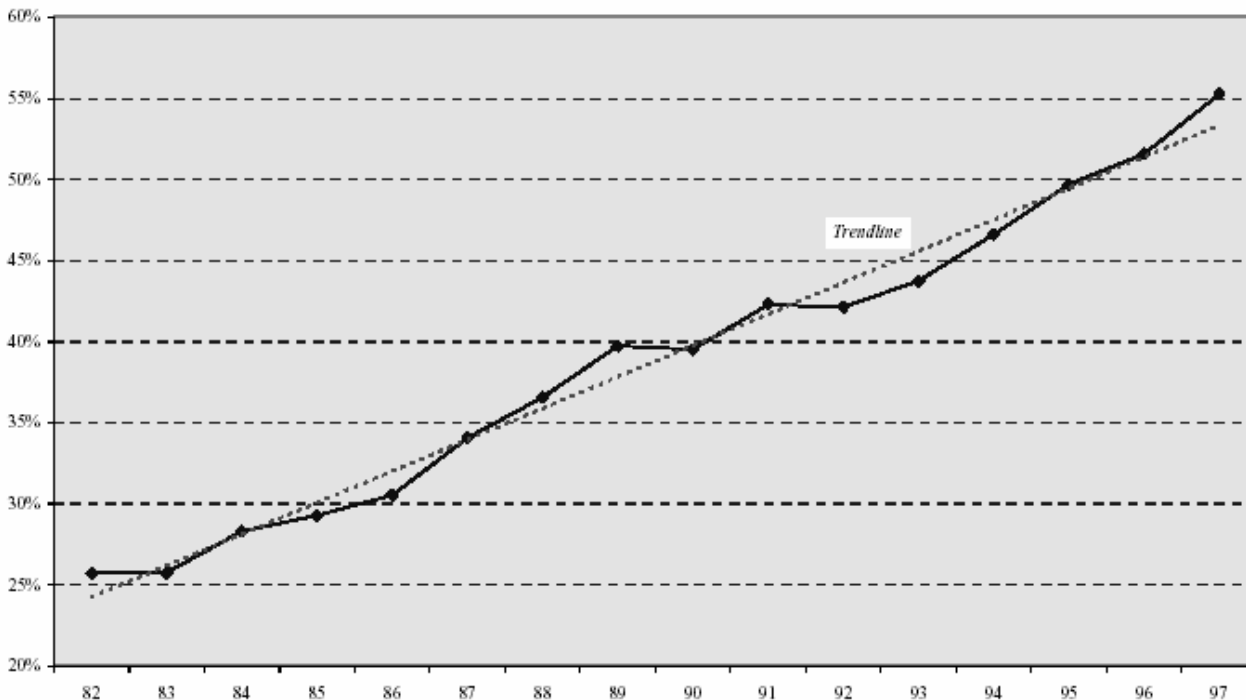
Source: data from World Development Report (World Bank, 2003).

One important contribution of FDI to the Indonesian economy has been export growth, especially of manufactured goods. The experience of successful economic development in this country during the era of New Order regime (before the 1997 crisis) amply demonstrates how FDI can play a leading role in bringing about rapid, export-led economic growth. As with other ASEAN4, rapidly rising exports in Indonesia especially

during the 1980s had made Indonesia the envy of the developing countries. But, unfortunately, economic development is more than economic growth, as the crisis has made abundantly clear. Indonesia has not managed to translate economic growth through FDI into something more durable, which builds on existing indigenous capabilities.

Thomsen (1999) analyses the contribution of FDI to export-led growth in ASEAN economies, including Indonesia. As illustrated in Figure 7, his study shows that exports have doubled as a percentage of GDP in Indonesia, Malaysia, Thailand and the Philippines (ASEAN4) since the early years of 1980s, with very little annual variation along the long-term trend. Exports have nevertheless grown more at some times and in certain sectors than in others. At a sufficient level of disaggregation, the study shows that the correlation between export growth and FDI inflows is often strong, and the fastest growth was in the late 1980s when exports grew from 30.5% to 39.7% of GDP in three years. Between 1989 and 1992, the comparable growth was only 2.6 percentage points. These variations correspond roughly to the rapid growth in FDI inflows in the late 1980s and relative stagnation of such inflows in the early 1990s. Thomsen argues that exports would have increased even without FDI, as can be seen in those sectors in which foreign investors are not important, but the ASEAN4 would probably not have experienced the rapid acceleration of exports in the past decade without the presence of FDI. In Indonesia, exports have been the main engine of economic growth, particularly since the mid-1980s up to the crisis period.

Figure 7: Exports as percentage of GDP in Indonesia, Malaysia, Thailand and the Philippines, 1982-1997



Source: Figure 8 in Thomsen (1999).

Export growth of manufactured goods in Indonesia to which FDI has made an important contribution is especially from labor-intensive manufacturing industries such as garments, leather products, including shoes, and electronics. The role of FDI in development of labour-intensive export oriented manufacturing industries in Indonesia is also emphasized in Timmer's (2004) study: "*economic growth in Indonesia has always benefited the poor,..... This performance was based on a conscious strategy of integrating the macro economy with the household economy by lowering the transactions costs of operating in the markets—factor markets and product markets—that provide links between the two levels of the overall economy. Luck also played a role, as powerful new agricultural technology became available just as the country was putting in place the economic strategy to make it effective. Later, foreign direct investment arrived from Northeast Asia just as Indonesia needed to restructure its manufacturing sector to be more labor intensive and export oriented*" (pages 5 & 6).

But, one important question remains: whether the involvement of FDI in export-oriented manufacturing industries in Indonesia has reached its optimal total employment creation effect in the industries? No doubt that through export-oriented FDI, Indonesia was able to shift quickly towards a manufacturing-based economy in which economic growth was driven by rapidly expanding exports. But, as shown in Thomsen (1999), many of export-oriented foreign firms in Indonesia are highly import dependent. In some manufacturing industries, imports represent 80%-90% of the value of exports (Table 13). According to Thomsen, the high import dependence ratio for FDI-related exports is symptomatic of the poor production linkages between foreign affiliates and the local economy. Such poor linkages not only reduce the scope for technology transfers through FDI, which could assist in local industrial upgrading, but also limit the total employment effect of FDI from its optimal level.

Table 13. Imports and exports in the electronics sector in selected Asian economies, 1994

	Republic of Korea	Chinese Taipei	Singapore	Indonesia	Malaysia	Thailand
<i>Exports of electronics products (US\$ million)</i>						
All electronics products	11,630	14,681	34,262	1,665	14,768	6,387
Automatic data processing equipment	3,395	9,090	21,878	193	4,726	3,680
Communication equipment*	8,234	5,591	12,385	1,473	10,042	2,707
<i>Share of finished goods in exports (%)</i>						
All electronics products	80.4	60.0	67.1	80.2	65.3	64.8
Automatic data processing equipment	85.5	54.9	66.6	49.9	30.9	57.5
Communication equipment*	79.6	68.4	76.4	84.1	81.5	74.8
<i>Imports of parts as a percentage of exports of finished goods</i>						
All electronics products	18.7	12.6	32.7	26.7	38.5	60.1
Automatic data processing equipment	24.3	8.5	28.9	33.2	95.4	79.4
Communication equipment*	16.3	17.8	39.3	26.2	28.4	40.0
<i>Imports of parts as a percentage of total exports</i>						
All electronics products	15.0	7.5	21.9	21.4	25.2	39.0
Automatic data processing equipment	20.0	4.7	19.4	16.6	29.5	45.7
Communication equipment*	13.0	12.2	26.5	22.0	23.1	29.9

Note: * Telecommunications and sound recording and reproducing apparatus and equipment; and semiconductors.

A different approach in analyzing the impact of export growth enhanced by FDI on poverty through its employment creation effect is used by McCulloch (2004). He argues that trade expansion will benefit some sectors, but hurt others. These different effects are reflected in changes in production volume, wages and employment. Therefore, to understand the poverty impact of export growth, the attention must be given to the following three questions. First, which sectors or industries are gaining and which are losing. Second, in which sectors are the poor employed. Third, what happened to wages and employment in these sectors. With respect to the first question, based on BPS data, McCulloch (2004) provide some evidence on changes in exports, labor share and labor income by sectors. The total percentage change in exports is positive during the period under study, although there is some variation among the sectors. Sectors which are identified with negative change are such as footwear, plywood (and the like), and rubber industries, and some service sectors. With respect to labor share, its total percentage change is negative, although most of the sectors have experienced an increase in their labor share. While, total percentage change in labor income is positive but very small, and only a few sectors have negative growth (Table 14).

Table 14 Percentage changes in exports, labor share and labor income by sectors: 1995-2000

Sector	Export	Labor Share	Labor Income
Agriculture	-22.2*	7.5**	Na
Crude oil	6.2	131.6	145.9
Animal oil & vegetables oil	39.4	46.5	104.2
Knitting mills	91.0	-37.5	19.5
Wearing apparel	12.3	38.0	54.9
Leather products	72.6	15.3	99.0
Footwear	-39.7	-2.3	-41.1
Plywood & the like	-38.5	13.8	-30.0
Furniture & fixtures	55.0	3.1	59.8
Paper & cardboard	143.7	18.3	188.3
Printing & publishing	264.1	-8.6	232.7
Smoked & crumb rubber	-56.1	13.7	-50.0
Machinery & apparatus	190.2	1.8	195.5
Electrical machinery & apparatus	358.2	8.3	396.2
Communication equipment & apparatus	190.0	0.5	191.4
Restaurant	-32.3	-0.8	-32.8
Hotel	-34.0	-1.6	-35.0
Bank	-51.5	-55.7	-78.5
Total***	14.2	-11.7	0.8

Note: na: no data available; * 1997-2001; ** 1997-2002; ***not include agriculture

Source: McCulloch (2004), calculated from BPS data; for agriculture: own calculation from BPS data.

With respect to the second question, as shown earlier, about 70% of the poor people in rural areas work in agriculture, and even agricultural activities played a dominant role as a source of income for the urban poor. Next important sectors for urban as well as rural poor are manufacturing industry and trade. These are three sectors that generally are assumed to be most affected directly by trade liberalization.

Regarding the third question, based on BPS data, McCulloch's (2004) analysis shows that percentage changes in total employees and real wages vary between sectors. Textile and garment industries, machine and equipment industry, and construction are among those who experienced decline in total employees and real wages (Table 15).

This evidence indicates that overall exports during the period studied rose but the labor share of exports fell at the same time, and so the net result was very slow growth in labor income. The poor, especially in rural areas, are concentrated in agriculture. Export of the sector declined but its labor share increased. Booming industries saw rising both employment and wages, while contracting industries the reverse. But some sectors that are important as main sources of income for the poor saw rising employment with falling wages suggesting increases in the supply of labor to these sectors as other sectors reduced labor.

Table 15 Percentage Changes in Total Employees and Real Wages by Sector: 2000-2002

Sector	Employee	Real Wages
Oil & gas	26.3	36.6
Textile industry	-11.9	-4.7
Garment industry	-5.2	-3.2
Leather industry	-22.1	20.1
Wood and its products industry	20.3	-46.7
Paper & pulp industry	89.8	22.8
Publishing, printing & recording industry	21.3	-12.2
Rubber and its products industry	30.6	18.5
Machine and equipment industry	-32.8	-53.7
Electric machine and its equipment industry	53.3	71.4
Construction	-40.0	-51.1
Domestic trading	39.8	-46.9
Total*	-15.3	-11.9

Source: McCulloch (2004); calculated from BPS data

Another approach is by analyzing aggregate data on trade, GDP and poverty rate, which may give some indication on the links between trade and poverty (Table 16). Trade (in goods and services) as a percentage of GDP increased from 41.5% in 1990 to 60.1% in 2001; or shares of export and import (goods and services) in GDP rose from respectively 25.3% and 23.7% in 1990 to 35.4% and 28.5% in 2002. While, poverty rate, on the other hand, increased from 15.1% in 1990 to 18.2% in 2002. This evidence shows a positive rather than a negative correlation between trade growth and poverty reduction. But, as explained before, the increased poverty incidence during that period to a larger extent was due the economic crisis in 1997/98.

Table 16 Trade and Poverty in Indonesia

Description	1990	1998	2000	2001	2002
Trade in good and service, %GDP	41.5	79.8	62.8	60.1	-
Export in good and service, %GDP	25.3	53.0	43.0	42.3	35.4
Import in good & service, %GDP	23.7	43.2	31.7	34.9	28.5
Poverty rate (%)	15.1	24.2	19.1	18.4	18.2

Because poverty in Indonesia remains largely an agricultural phenomenon, the most direct way for policy to contribute to reducing poverty is to focus on development of agriculture to improve productivity and hence real income per capita of farmers and agricultural workers and competitiveness of products. So, analyzing data on FDI by sector is also an approach to answer the question: how is the role of FDI in agricultural sector in Indonesia, or whether FDI has given a significant contribution to the development of agriculture as it did to export-oriented manufacturing industries.

As compared to countries like Thailand and Malaysia, Indonesian agriculture is still underdeveloped, which is characterized by low or even declining productivity and competitiveness. Especially since the 1997 economic crisis, the country's import dependency on food has increased significantly. No doubt, that the low or declining productivity and competitiveness is due to shortages in technology, human resource, infrastructure, supporting industries, and other necessity inputs (Diagram 4). Such shortages are caused by, among others, lack of investment, particularly from private sector, including FDI. It appears from data provided by the National Investment Coordination Agency (BKPM) that agriculture has been among a few sectors of the economy that absorbed FDI very little. As illustrated in Figure 8, in terms of number of projects, agriculture received relatively only a very small part of annual total approved FDI projects, as compared to manufacturing and trade sectors.

Diagram 4 Relation between Development of Agriculture and Poverty Reduction

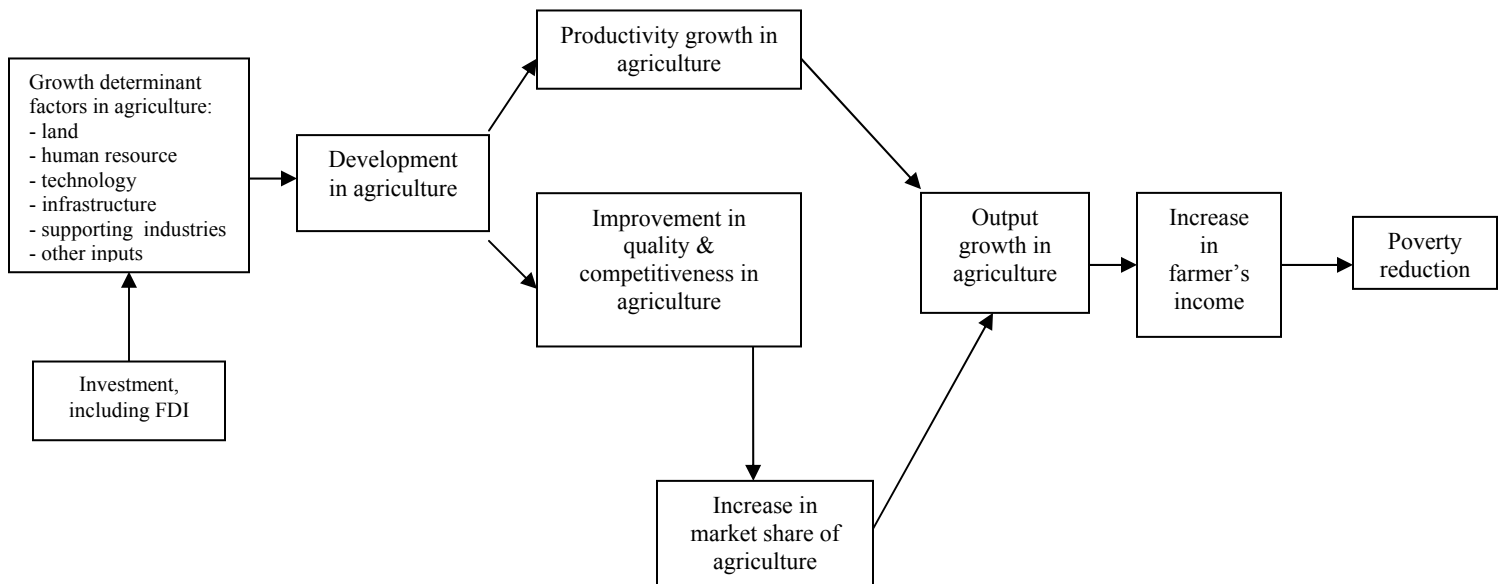
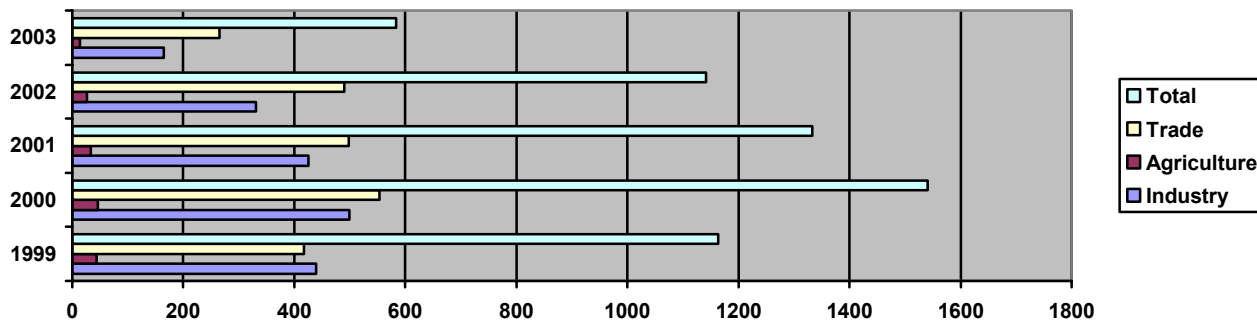


Figure 8 Distribution of Approved FDI projects by three Sectors: Industry, Agriculture and Trade, 1999-2003 (31 July) (number of projects).



Source: BKPM.

However, during the Soeharto period, the government had made a huge investment in agricultural/rural infrastructure (roads, communications networks, market infrastructure and ports, and irrigation and water systems) Many of them were built as labor-intensive public works, making millions of jobs available to unskilled labor willing to work at local market wages. Such investments have had a major impact on making overall economic growth more pro-poor.¹⁸ Even, from his own observation of the history of economic growth and poverty reduction in the 1970s and 1980s, Timmer (2004) concludes that infrastructure investments had a more immediate impact on the poor than investments in human capital, which were the long-run route out of poverty. The financing for these projects came not from FDI but mostly from the Central Government, whose budget until the early 1980s depended first on foreign aid and then on oil revenues, and this was the era of the most massive rural investments.

Besides export promotion, as discussed before in Chapter II of this paper, another enduring potential benefit to developing countries from FDI is the transfer of technology (and other intangible assets). High export growth can drive rapid economic growth over long period, but technology transfers can do much more to promote sustainable development by enhancing indigenous capabilities in the host countries. Studies attempting to measure technology transfers to the ASEAN4 resulting from FDI have tended to find that such transfers have generally been limited. In Indonesia, Saad (1995) found that technology transfer has taken place mainly through on-the-job training and has been limited to basic technological capabilities. Based on his study on the role of FDI in development of manufacturing industry in Indonesia, Thee (1998) concludes that FDI and its related technology transfer have not generally been effective at developing indigenous industrial technological capabilities.

At the Micro Level: Local Community Development Programs

¹⁸ This evidence during the decades of 70s and 80s is overwhelmingly supportive of the view that active policy concern for a dynamic rural economy, including, at times, active protection of the rice economy from depressed prices in world markets, made the overall economic growth process more pro-poor than it would have been otherwise (Papanek, 2004).

In the mining sector, foreign firms are required not only to minimize the impacts of their operations on the surrounding environment, and to return all land disturbed by their operations to a productive and useful state, but also to stimulate the economic and social welfare of communities in the surrounding areas of their operations provided through the use of an active participatory approach to various programs needed by the communities.

PT. Kaltim Prima Coal (KPC) is one among several foreign mining corporations that are very active in providing local community development programs. PT. KPC is an Indonesian company jointly and equally owned by BP of the UK and Rio Tinto of the UK and Australia. Under the terms of a Coal Agreement which expires in 2021, Indonesia gives PT. KPC license to explore, produce and market coal from its agreement area in East Kalimantan. Its operation are located at Sangatta, the capital of the East Kutai Regency (Kutim), which is 50 km north of the equator on the east coast of Kalimantan.

The main important items of local community development programs conducted by PT. KPC as its commitment to stimulate the economic and social welfare of communities in the surrounding areas of its mining operations include the following:

1. Community apprenticeship program, which was begun in 1999.
2. Construction of school buildings.
3. Provision of scholarships, including entrepreneurship practice program.
4. Construction of many access roads to a number of surrounding villages.
5. Various training programs, which in 2002 and 2003 there were 15 different programs, including organizational management training, cocoa planting program, agribusiness program.
6. English and computer course in 2002 for the students of primary and junior high schools.
7. Development of micro credit institution, which was established in a co-operation with the local community.
8. Provision of technical and non-technical supports to increase the living standard of people living near the site, as an alternative way to fulfil the need for fresh water fishing.
9. Supports for the development of agriculture by providing banana seeds which were planted in areas covering 354 hectares and by supporting the production of organic fertilizer, NPK plus.

Another foreign mining cooperation, which also very active in local community development, is PT. Freeport Indonesia (PT-FI) in the province of Papua. Since this gold mining company began development activities more than 30 years ago, PT-FI has invested US\$5 billion for infrastructure both for the use of the company and for the public in southern Papua. Among other developments, this includes roads, an airport, heliports, an electrical distribution system and modern communications systems. To assist the local community

in the surrounding areas of its operations, the company has built hospitals, schools, places of worship, housing and community facilities; has instituted a comprehensive series of health and educational programs; and commenced training and small business development initiatives.

Overall, though at the macro level, there is evidence that these two mining companies have contributed to the growth of regional GDP of the provinces where they are operated, and they employed many local people, evidence at the micro level is still very limited. It needs studies at this level to answer questions such as: whether the small business development initiative conducted by PT-FI, in which it includes subcontracting arrangements with local people as suppliers of certain intermediate goods has encouraged the birth of many local small firms or has created multiplier effects on local employment and income, or whether supports for the development of agriculture by PT.KPC has resulted in a significant increase in production of bananas and hence incomes of the farmers.

6. Concluding Remarks

The long experience in Indonesia during the New Order government has proved that FDI could make significant contributions to economic development. This Indonesian experience also gave a good example that whether-and the ways in which-FDI is beneficial or harmful to the poor in the host country depends on the context in which the investment takes place and in which the resulting economic activity operates. This is particularly true of the policy environment in the host country and especially policies that direct the benefits of FDI towards the poor, directly and indirectly. In the implementation of its 'open door' policy towards FDI, the New Order government has offered a number of incentives. But, at the same time, the government has also made some policies and regulations that aimed to optimize the benefits of FDI to the poor, or at least to protect the poor from possible negative effects of the presence of foreign firms. The policies include closure of certain sectors, industries, or activities to FDI and restrictions on modes of entry, which aimed to prevent possible negative effects of the presence of foreign firms on local small and medium activities and consumption expenditure burden of the poor; 'local content' and 'subcontracting' policies aimed to reduce the import dependency of domestic industries and at the same time to develop production linkages between FDI and local small and medium enterprises (SMEs); regional minimum wage aimed to guarantee reasonable labor income; and local community development programs requirement for foreign mining corporations.

Though not enough evidence, these policies and regulations accompanied the 'open door' policy adopted by the New Order government seemed to be effective that have directed more of the fruits of FDI-led economic growth to the poor. But this is only one side of the story. The other side of the story is the possibility of negative effects of the presence of foreign firms on local economic activities, and no evidence on this side. The possible negative effects can be in the form of 'crowded out' local firms by superior foreign firms or as a consequence of incentives given to foreign firms that often created distortions in domestic output as well as inputs markets. So,

a more comprehensive study, especially at the micro level, is still needed, especially to answer many the following questions:

1. How is the link between foreign firms and the domestic/local economy especially in terms of production linkages through subcontracting arrangements with local SMEs and investment; what are the key factors in determining the development of subcontracting?
2. Whether there are “crowding out effects” of the presence of FDI on the local/domestic economic activities; particularly SMEs in the same sector/industry ?
3. How is the impact of “local community development” programs conducted by multinational companies on the reduction of poverty and improvement in income distribution in the local economy? How is the sustainability, and what are the crucial conditions/factors that determine the sustainability of such programs?
4. What domestic incentive to FDI that often create market distortions and affect negatively economic activities of the poor?

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