CHAPTER II
LITERATURE REVIEW

2.1 Theoretical Review

2.1.1 Economic growth theory

Rostow theory is about growth and basically it is the theory of derivation of development and modernization. In this case, Rostow usesthe metamorphosis growth, growth as an organism. In terms of economics, it means the revolution from traditional to modern. Rostow theory is known as a five-stage scheme that all modern people have been passed a traditional way. Rostow has conducted some efforts to achieve the high mass consumption. One of the efforts is capital.A capital can do much to the economic terms and develop a country. The capital here refers toa tax policy, foreign investment, and exchange rate of international trade. Therefore, it can be concluded that what Rostow's need to develop the growth is a capital, for example in Indonesia there is what is called a small-medium enterprise or *Usaha Kecil Menengah* which canhelp the economic condition, and also need capital to make it larger and successful(Fakih, 2001).

2.1.2 Criticism of the Theory of Modernization and Growth

In addition to make the GNP(growth national product) grow,almost all strategies of economic development have been criticized because they were considered fail to keep the welfare of the people. The strategies made unemployment and inequality rate get worse, and increased the absolute poverty as well. This theory cannot reach the poor people in the world, like the people struggling their life from death. Inversely, this theorycauses the rich getsricherand the poor getpoorer.

Because some scholars did not agree about the theory, then there is a theory called ‘growth and equity’. The concept is not fully developed yet. All the approach of ‘growth and equity’ has a common aspect, based on the traditional development belief that the growth or increasing GNP does not give benefits to the poor in developing countries, as soon as possible to them. It can be seen that the poor need helps as soon as the world or the country can give because they are struggling to cope with life. Fakih (2001) said that a revolution does not happen in the poor country, but it is successful in some countries like Taiwan, Korea, Hong Kong, Israel, Japan, Singapore, and Sri Lanka. It can be seen that most of the countries now hasbeen a developed country having a good economy known by the world.

2.1.3 Trickle-down Effect

The trickle-down theory is an economic idea which states that decreasing marginal and capital gains tax rates especially for corporations, investors and entrepreneurs can stimulate production in overall economy. According to trickle-down theory proponents, this stimulus leads to economic growth and wealth createthe benefits to everyone, not just those who pay the lower tax rates.

According to the trickle-down theory, if tax rates are lower, people have an incentive to work more because they get to keep more of the income they earn. Then, they start to spend or invest that income, and either of these activities will improve everyone’s prosperity, not just the prosperity of those in the highest income brackets. What more, in the end, the government may actually collect

more income tax despite the lower tax rates because of the additional work performed.

The successful of development growth theoryhappened in many countries. The condition that the growth brings effects and benefits because there are 'trickle-down effect' happening everywhere. For example,the advantages for the health service. Malaria and smallpox anticipation become effective in rural areas in many developing countries.

Trickle-down effect somehow looks rather like transmission of good economic towards the poverty. The researcher comprehends from this theory that 'trickle-down effect' did not transmit from the rich to the poor people. It can be seen in Indonesian country, how much the rich people who have so many assets and money then why the poverty is just getting larger and larger. It is depressed to see the rich people play with money and throw the money like a trash to buy a bag with a really high price. On the contrary, there are children who cannot buy a bag even in the lower price for going to school. It might not happen if the rich people are generous and care about the poor. It may affect to the overall economic condition, but did not seem to affect to the decrease of the poverty rate.

2.1.4 Economic Growth and Poverty

When trying to lower the poverty, it will slow the rate of growth.The same argument is that countries with lower inequality will experience the slower growth. In particular, if there were redistributions of income or assets from the rich to the poor, even though a progressive taxation, the concern was expressed that savings will fall. However, while the middle class generally has the highest

saving rates, the marginal saving rates of the poor, when viewed from a holistic perspective, are not small. In addition to financial savings, the poor tend to spend additional income on improved nutrition, education for their children, improvements in housing conditions, and other expenditures, especially at poverty levels, represent investments rather than consumption(Todaro and Smith, 2012).

There are at least five reasons why policies focused on reducing poverty levels does not lead to a slower rate of growth (Todaro and Smith, 2012). Firstly, a large poverty creates a condition that the poor do not have an access for credit and then cannot pay the tuition fee for their children's education. Therefore, people having many children is a source for the parents as an investment in the future. These factors cause per capita growth less than it would be if there is greater equality. Secondly, the rich people in many poor countries that invest their money in the big scale of their income in the local economy is not listed as frugality. Thirdly, the low level of income and the low level of the poor people'slife limit their ability to have a good health, nutrition, and good education.As a resultthis conditionwill decrease their productivity and automatically lower the growth. Forthly, the increase of income level for the poor people will increase the demand of domestic goods such as foods and clothes. Compared with the rich people who spend their money for importing goods,The decrease of poverty in a large number will be stimulating a healthy economic condition. Then, a large inequality and absolute poverty should be a reference to fast the growth. Promoting rapid economic growth and reduce poverty are not mutually conflicting objectives(Todaro and Smith, 2012). Based on the

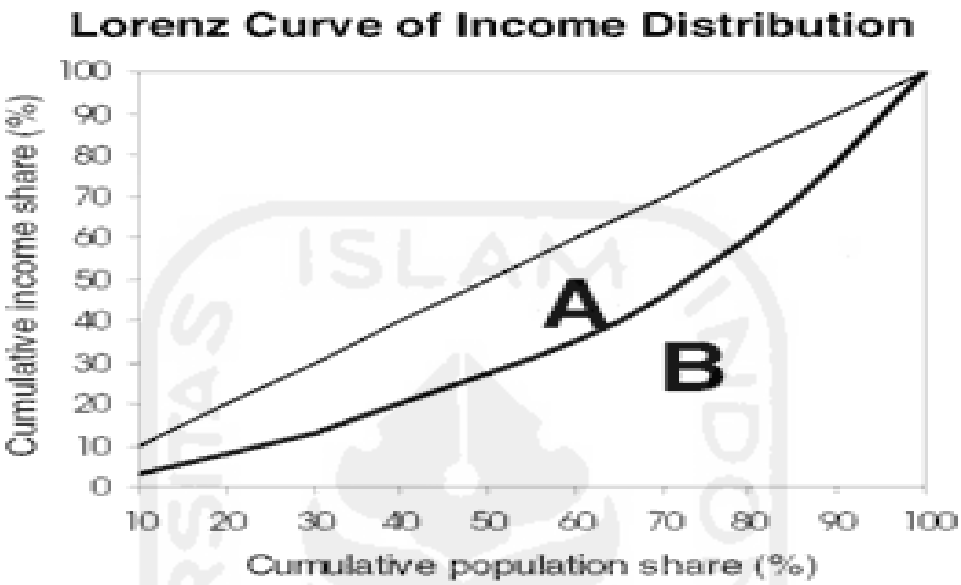
researcher's perspective, to solve this problem, like the circle of the poverty in Indonesia, following what the US have done in their fiscal policy can be an alternative solution. For example,by giving a direct fund to the unemplyment, a people who are not in a working age, and soon. It can be seen that Indonesia already conducted programs such as cash to the poor, and also a subsidy for certain goods such as for gasoline, rice and soon, but surelythis was not running well and not really contribute to the poor. Indonesia needs to do the same as what the developed country has done eventhough it might not totally reduce the poverty. Of course, with an assumption that another variable is constant because Indonesia has not much capital as what the developed country has.As whatRostow already mentioned that havingthe capital can help developinga country and bring the poverty down.

2.1.5 Gini Ratio and Poverty

The Gini index is a measurement of the income distribution of a country's residents. This number, which ranges between 0 to 1 and is based on resident's net income,defines the gap between the rich and the poor, with 0 representing perfect equality and 1 representing perfect inequality.

Gini ratio is about inequality. There is a relationship between inequality and the growth. Todaro and Smith (2012) said people having distributions of GNI and increasing the percentage of GNI are those who will receive.Thus, when only the rich can contribute to the distribution of income, that what makes the Gini ratio or the gap between the poor and the rich people getting worse.

Graph 2.1



(Sources: web.worldbank.org)

From the Figure above, the Lorenz curve puts the cumulative income share on the vertical axis against the distribution of the population on the horizontal axis. It can be seen from the line which is cross in between the cumulative income share percentage and the cumulative population share percentage, it shows that the income share received by 20% population is 20% of the income share. On the other hand, in that line,it is in the perfect equality if each individual had the same income so that the income distribution curve is the straight line known as the line of the total equality graph. The Gini coefficient is calculated as the area A divided by the sum of areas A and B. If the income is distributed well, then the Lorenz curve and the line of the total equality are combined and the Gini coefficient will be zero. This means that if one person receives all the income, the Lorenz curve

will be at (0,0), (100,0) points, and the locations of A and B are the same, it will lead to a value of 1 for the Gini-coefficient .

Inequality means different things to different people (Litchfield, 1999). It was happened in the past century until now, inequality number is too large not only the percentage of inequality but also the fact that people can feel everywhere. The differences get larger from yearto year. There are families using a luxury car priced a billion rupiah. In contrast, there are families that cannot fulfill their daily basic needs such as food, shelter, cloth, and health.

Inequality is often studied as a part of analyses covering poverty and welfare, but these three are different actually (Litchfield, 1999). Discussed by sen (1976) in Litchfield (1999), Inequality has a limited concept than welfare. However, these three concepts have a close relation. Some poverties incorporate inequality in its definition, for example, about what sen's poverty measure containing the Gini coefficient among the poor.

Firstly, the discussion about poverty and welfare by Litchfield (1999) stated that both of them are related. However, Sen's said that the relationship between poverty and welfare is not significant.The poor people also can have their welfare even though they do not have a commodity because welfare is not always about owned wealth. In this case, sen's statement is not really true because many people do not feel the welfare because they are lack of money and have less commodity. Secondly, in relation to inequality and poverty, the researcher thinks that both of them are closely related because in fact inequality is always associated with poverty.

2.1.6 Inflation and Poverty

Inflation is a condition when the price of goods and services increase so high and the value of rupiah depreciates. Inflation happens when money supply is larger than goods and services circulating in the market. On the other hand, it is a condition when government prints money as often as possible but not followed by a commodity. How is the chronologic theory between inflation and poverty? Let's see when inflation increases the price of goods and services, this will also increase the living cost automatically.For example,ifnowadays people have $2 dollar a day, it can be used to buy basic needs, but when the inflation happens then people cannot fulfill basic needs anymore because the value of money is decreasing and the price of goods and services is increasing. That is why the researcher has correlated that the inflation can drive the increasing poverty rate.

Cardoso argued that inflation affects poverty mainly through its impact on real wages. He also said that the empirical evidence showing that wages increase more slowly than prices during episodes of rising inflation in LatinAmerica. This argument thought that the inflation brings the wage slowly but the price increase more rapidly. In case that rupiah depreciates, it is hard for people to buy goods and services. And, this drives the poverty to increase (Cardoso, 1992).

2.1.7 Investment and Poverty

In relation to foreign direct investment (FDI) and poverty reduction (Klein, 2011), FDI is a key ingredient of successful economic growth and development in developing countries, partly because the very essence of economic development is the rapid and efficient transferred and cross boarder

adoption of ‘best practice’. The theory shows the relation between growth theory and poverty.It was said that the good investment will drive to good growth and the good growth will drive to good economics and it will reduce the poverty rate as the benefit.

Acquisition of the new technology, employment creation, and human capital, is an example of investment. Many scholars widely believe that the benefits accrued from FDI may include the development, contribution to international trade integration, domestic investmentenhancement, and increasing tax revenue generated by FDI. All these benefits are expected to contribute to the higher economic and employment growth which is an effective tool for achieving improvement in the reduction of poverty (Hung, 2016).

2.2 Previous study

A research conducted by Susanto (2014) with entitled ‘the impact of economic growth, inflation and minimum wage on poverty in Java’.This research used the dynamic panel data regression based on Error correction Model (ECM). Susanto (2014) stated that there are three ways to sustain the growth and poverty reduction in his research, which are: (1) direct channels, such as the goverment program to provide services for basic health, education and sanitation, (2) market channels, a condition where growth helps the poor through economic linkages, and (3) policy channels, where the government give a subsidy, fiscal transfer and public investment.Susanto (2014) was found that: (1) economic growth has a negative impact on the poverty rate in Java, (2) inflation has a positive impact on poverty rate in Java,(3) higher economic growth correspondsto a lower poverty

rate, while inflation corresponds to a higher poverty rate and (4)the minimum wage has no impact on poverty rate in Java.

A research by Dahquist (2013) with a title 'Does Economic Growth Reduce Poverty?' using the empirical analysis cross-sectional regression, analyzed the relationship between poverty and economic growth across low- and middle-income countries, the case of Brazil. The empirical results (Dahquist, 2013)found that economic growth does indeed reduce poverty and the level of growth is strongly related to the decrease of poverty. However, the economic growth is not enough to be a tool when the level of extreme poverty is high.

A research by Suryahadi et al (2012) entitled'Economic Growth and Poverty Reduction in Indonesia before and after the Asian Financial Crisis' tried to find the relationship between the economic growth and poverty reduction in Indonesia before and after the Asian financial crisis (AFC). The result of this paper found that Indonesia has a significantly slower poverty reduction after AFC than before AFC. During both these periods, the growth of service sector is the largest contributor to poverty reduction. After AFC, industrial sector growth has become largely unrelated to poverty reduction even though the sector growth for poverty reduction is controlled only to rural areas.

A research by Cardoso (1992) entitled 'Inflation and Poverty' discussed about the regressive nature of the inflation tax and the limited benefit for individuals who live below the poverty line. It also argued that inflation affects poverty through the impact on real wages: the empirical evidence found that wages increase more slowly than process during episodes of rising inflation in

Latin America. The paper also discusses programs that can sustain the stabilization which is less costly causing the increase of poverty than others. Both orthodox programs attempted to reduce inflation by the implementation of income policy that was not helped yet the poor in Latin America.

A research by Kholis (2012) entitled '*Dampak Foreign Direct Investment terhadap pertumbuhan ekonomi Indonesia; studi makro ekonomi dengan penerapan data panel'*. This research analyzed the effect of Foreign Direct Investment (FDI) on economic growth in Indonesia in the period of 2006 to 2010. The method of analysis used pooled least square (PLS). The variables used in this study are economic growth, growth of FDI, growth of export and growth of import. By applying the panel data model, itwas expected to knowthe degree of the presence of FDI in promoting economic growth in Indonesia. Calculation results showed that the growth of FDI and import growth have a negative impact on economic growth in Indonesia, while the growth of exports has a positive effect on economic growth. These result indicated that the main driver of economic growth still depends on exports.

A research by Hung (2016) entitled 'Impacts of Foreign Direct Investment on Poverty Reduction in Vietnam'used two regression analyses to evaluate the relationship between FDI and economic growth, and then the impact of growth and FDI on poverty reduction in provinces and cities in Vietnam. The data used to analyze was the panel data collected in the period of 1992 to 2002 and used 12 provinces and cities located in the northern to the southern of Vietnam. Econometric models also used in this paper to evaluate the relationship among the

inflows of FDI. The researcher found that:(1)the inflows of FDI in a province showed positive and significant effects on the economic growth,(2) the economic growth in the province has a positive and significant impact on the reduction of poverty,and (3) the inflows of FDI have a direct and strong positive and significant impact on the poverty reduction in a province. It has proven that it is consistent with the assumption of the direct and indirect effects of FDI on reducingthe poverty.

An empirical study by Chani et. al (2011) entitled'Poverty, Inflation and Economic Growth: Empirical Evidence from Pakistan'. This study aimed to investigate the role of economic growth and inflation by explaining the frequency of poverty in Pakistan. ARDL bound testing approach in this research to co-integration confirmed the existence of long run relationship among the variables of poverty, economic growth, inflation, investment and trade openness over the period of 1972-2008. Empirical results showed that the economic growth has a negative impact and inflation has a positive impact on poverty where the role of investment and trade openness in poverty reduction in the short run is not significant.

A research done by Talukdar (2012) with a title 'The Effect of Inflation on Poverty in Developing Countries: A Panel Data Analysis',aimed to study the effect of inflation on poverty in developing countries. The researcher analyzed the effect of inflation on poverty with a panel dataset comprised of 115 developing countries over the period of 1981-2008. The dataset comprised of observations in each country based on the data available in 3 year intervals. The previous studies

indicated that poverty is also affected by factors such as income, external debt, educational attainment, and quality of governance.Besides inflation, this study tookthe factors as independent variables and the poverty as the dependent variable. By using the regression analysis, the study tried to find an evidence that inflation in general is positively correlated with poverty while income educational attainment and quality of governance showed a negative correlation with poverty in most of the specifications. Apart from the study of all the countries combined, the researcher separately analyzed the effect of inflation on poverty in low income countries, lower middle income countries, and upper middle income countries to see whether the effect of inflation is similar or different in countries with different levels of income. The researcher found that although in most of the cases inflation shows a positive and statistically significant correlation with poverty, however, in the case of low income countries, the relationship between inflation and poverty is negative and statistically insignificant under certain specifications.

2.3 Hypotheses

Based on the problem formulation, the relevant theories presented that are supported by the prior study, this research's hypotheses are as follows:

1. Economic growth negatively affects the poverty line
2. Inflation rate positively affects the poverty
3. Investment rate negatively effects the poverty line
4. Poverty rate negatively affects the Gini ratio