

SMES, PURCHASING POWER PARITY, LABOR WAGES, AND ECONOMIC STRUCTURE ON POVERTY REDUCTION IN CENTRAL JAVA

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Abstract

The detrimental effects of poverty highlight the need to understand factors influencing its reduction. This study aims to examine whether SME performance, purchasing power parity (PPP), labor wages, and economic structure impact poverty levels. The study finds that PPP and labor wages significantly contribute to poverty reduction, whereas the number of SMEs, employment rates, and economic structure have not effectively alleviated poverty in Central Java. This result may be linked to the impact of the COVID-19 pandemic, which markedly increased poverty levels during the study period. We recommend that the Central Java Government take measures to strengthen SMEs by improving access to capital and providing training, diversify the economy to create job opportunities in low-income areas, boost PPP through cash transfers, raise wages by implementing minimum wage policies and subsidies, and re-evaluate the economic structure to foster inclusive growth for sustainable poverty reduction.

Keywords: *poverty; purchasing power parity; median labor wages; economic structure*

INTRODUCTION

Globally, poverty remains a key issue for all nations, including Indonesia. According to the BPS Indonesia in 2019, Indonesia's high poverty rate has declined very slowly over the years. In the last two decades (2001–2018), the poverty rate decreased by only 0.5% on average, with a reduction of about 720,000 people annually. Nonetheless, the Poverty Gap Index and Poverty Severity Index remain elevated at 2.78% and 0.77%, respectively (Nursini, 2020). Poverty inevitably leads to negative impacts (Firmansyah et al., 2023) such as increasing income disparity and environmental decline (Khan et al., 2022), causes malnutrition in communities (Siddiqui et al., 2020) and highlights severe deprivation due to inadequate sanitation, limited healthcare, and insufficient education. Additionally, employment challenges are exacerbated by reliance on the informal sector (Sunde, 2024). The lack of resources can also impact overall community well-being, leading to enduring challenges for both individuals and society as a whole.

Traditionally, poverty refers to income poverty, where individuals or families are considered poor if their income falls short of covering basic necessities, such as food and essential living costs (Alkire & Fang, 2019). The World Bank defines the international poverty line at \$1.90 in terms of PPP, classifying individuals with income or spending below this level as poor. Poverty can be classified as absolute, where income fails to cover basic needs like food, shelter, and education, or

relative, based on income distribution across social layers. It can also be chronic or transient, regional or individual, and differ between urban and rural areas (Zhou & Liu, 2022).

Central Java ranks as the province with the second-highest poverty rate, following East Java (Feriyanto et al., 2020) their government did not meet the 2013-2018 National Development Plan targets to reduce poverty to 8-10% and improve income distribution through family-based social protection, community empowerment, and expanded economic opportunities for low-income populations (Andrietya et al., 2020) which underscores the urgency of the situation and highlights the significant challenges faced by many communities within the region. To effectively combat this persistent issue, it is essential for the government to take appropriate and targeted action.

Small Medium Enterprise commonly known as SMEs are vital component in improving Indonesia's economic conditions (Masduki, 2022). They play an essential role in both advanced and emerging economies, acting as primary sources of employment and income, promoting social cohesion, and encouraging innovation (Abisuga-Oyekunle et al., 2020). Hadi Putra & Santoso, (2020) believes that SMEs collectively make up 95% of businesses worldwide and employ 60% of the workforce. They create job opportunities, absorb labor, and offer a safety net, particularly for low-income individuals, enabling them to engage in productive economic activities. Their economic impact is notably substantial in developing countries like Indonesia, where SMEs represent up to 99% of all employment and can contribute as much as 60.4% of total investment. Rusliana et al., (2023) also believes that SMEs have the potential to accelerate economic transformation and significantly improve the standard of living for many people and reduce poverty.

As of 2021, data from the Ministry of Cooperatives and SMEs shows that Indonesia had 173.431 units of SMEs, which contributed 61.07% to the GDP, amounting to 8,573.89 trillion IDR. Their numbers continue to rise across all regions, particularly in Central Java. According to the Ministry, the number of registered SMEs, employment generated by SMEs, total assets, and income exhibited a steady upward trend throughout the study period, including during the COVID-19 pandemic (2020–2021), as shown in Table 1.

Table 1. Development of SMEs, Employment, Assets, and Income in Surakarta, 2018–2022

Year	SMEs (Units)	Number of Employees (Person)	Total Asset (Billion IDR)	Total Income (Billion IDR)
2018	143.738	1.043.320	29.824	55.691
2019	161.458	1.312.400	38.158	67.550
2020	167.391	1.298.007	38.353	67.087
2021	173.431	1.311.015	38.521	68.242
2022	180.579	1.330.343	38.898	68.581

Source: Ministry of Cooperatives and SMEs Central Java Province. 2023

In addition to SMEs, efforts to improve PPP are also an effective means of alleviating poverty. PPP is determined using price data from member countries and relies on a wider range of goods compared to exchange rates, including both tradable and non-tradable items. The precision of PPP in converting the international poverty line into national currencies is essential for generating accurate global poverty statistics (Majumder & Ray, 2020; Wang et al., 2020). Masroor & Asim, (2019) agrees that the presence of SMEs in developing countries can gradually help increase the PPP of their citizens. Thus, in relation to poverty reduction, an increase in PPP tends to lower poverty levels, as people are able to access essential goods and services more easily, if purchasing power is low, people are vulnerable to poverty, especially during periods of inflation or economic crisis.

Brülle et al. (2019) and Sotomayor (2021) also believes that policies aimed at increasing average labor wages effectively reduce poverty and inequality. By increasing workers income, it can help them meet their basic needs, which in turn can stimulate the local economy and create new job opportunities (Bassier & Ranchhod, 2024). The activities of SMEs and their capacity to absorb labor are directly influenced by how wages are distributed. This wage distribution plays a crucial role in the fight against poverty, as it determines workers ability to meet basic needs and maintain a reasonable quality of life.

According to the Institute for Demographic and Poverty Studies in 2023, a rise in wages that fails to keep pace with inflation may not effectively boost workers purchasing power. When wages stagnate or rise only slightly, workers may struggle to afford essential goods and services, especially when commodity prices are on the rise. This imbalance places a strain on their ability to maintain an adequate standard of living, ultimately impacting both their well-being and productivity which may lead to a cycle of poverty. Data on PPP values alongside the median wages in Central Java from 2018 to 2022 is shown in Table 2.

Table 2. Purchasing Power Parity (PPP) and Median Wages in Central Java Province

Year	PPP	Median Wage (IDR/weeks)
2018	0.798	1.690.000
2019	0.775	1.800.000
2020	0.813	1.800.000
2021	0.817	2.000.000
2022	0.827	2.000.000

Source: Ministry of Manpower, 2023

Efforts to alleviate poverty, beyond focusing on an individual approach, can also be made through a national-level approach, such as by considering the economic structure (Lin, 2019). In the case of Central Java, this means focusing on the regional economic structure. Economic structure refers to the composition of each sector's role within the economy, classified by primary, secondary and tertiary sectors, as well as by different industries or business fields (Setiawan, 2016). Christiaensen & Martin, (2018) believe that the economic structure can influence the reduction of poverty. It can also influence regional resilience by affecting the sectoral structure, industry specialization and diversity, as well as the size of firms (Ženka et al, 2021).

Drawing from the background discussed earlier, it can be concluded that the role of SMEs, improvements in PPP, labor wages, and economic structure are important factors in reducing poverty levels. Several studies have established that SMEs contribute significantly to poverty reduction (Fahrudi, 2020; Mbuyisa & Leonard, 2016; Moradi et al., 2020), while others emphasize how SMEs and labor wages alleviate female poverty in least-developed countries by enhancing consumption, investment, and savings (Anderson & Mdemu Komba, 2017; Maksimov et al., 2017). Additionally, literature links rising purchasing power and optimized economic structures to sustainable livelihood foundations (Nugroho et al., 2021; Cui et al., 2023). These previous studies suffer from significant limitations. Most existing research heavily focuses on isolated case studies in specific least-developed nations, which limits the generalizability of their findings to broader economic contexts. Furthermore, prior literature often treats these variables including SMEs, wages, PPP, and economic structure as independent, fragmented elements. Consequently, there remains a critical gap in understanding how these elements jointly interact to influence poverty. This study addresses this limitation by offering an integrated framework that analyzes the simultaneous interactions of these variables, thereby providing a more comprehensive approach to poverty alleviation.

However, existing literatures frequently overlook the spatial and structural heterogeneities that exist within sub-national regions. Prior studies generally treat regional economies as homogenous entities, thereby failing to capture the contrasting dynamics between urban (cities) and rural (districts) areas. Furthermore, the reliance on aggregated economic data in previous research often masks the distinct characteristics of regional income, particularly how wage distribution and economic structures uniquely interact at the local level to influence poverty. To address these critical limitations, this study investigates poverty levels across districts and cities in Central Java by employing a bifurcated analysis. By separating the datasets into distinct district and city categories, this research accounts for regional characteristics and variations in spatial economic behavior. Additionally, we analyze the economic structure through regional income at current prices to capture a highly detailed, localized understanding of these areas. This approach fills the empirical gap by unraveling the

nuanced connections between wage distribution, economic structure, and localized poverty that aggregated macro-level studies fail to observe.

METHODS

This study uses a quantitative approach to analyze the influence of independent variables on poverty levels, with a focus on the Central Java Province. It employs secondary panel data, consisting of time-series observations from 2018 to 2022 and cross-sectional data from 29 districts and 6 cities. The research aims to: 1) evaluate the effect of the number of SMEs on poverty, 2) examine how the number of workers in SMEs impacts poverty, 3) investigate the influence of PPP on poverty, 4) assess the effect of median labor wages on poverty, and lastly 5) explore the relationship between the regional economic structure and poverty.

In this research, data on the number of SME units and employment in Central Java Province were obtained from the Central Java Ministry of Cooperatives and SMEs while PPP and median labor wages data was sourced from the Ministry of Manpower. The regional economic structure variables represented using dummy variables, categorizing districts and cities based on their regional income at current price according to business sectors from 2018 to 2022. This categorization focuses on two sectors first, sector A (agriculture, forestry, and fisheries) and sector C (manufacturing industry). If a district or city has a higher regional income at current price value in sector A than in sector C, it is classified as an agricultural area. Conversely, if Sector C have higher regional income at current price value, the area is classified as an industrial area. The variable definition and measurement of this study presented in Table 3.

Table 3. Variable Definition and Measurement

Variable	Definition	Measurement	Source
Poverty	Poverty is a socioeconomic condition in which individuals or households are unable to meet their basic needs and maintain a minimum standard of living.	Percentage of population below poverty line	BPS
SMEs	Small and Medium Enterprises (SMEs) are business entities engaged in productive economic activities that operate within the criteria established by national regulations.	Number of registered SMEs	Ministry of Cooperatives
PPP	Purchasing Power Parity (PPP) refers to the level of purchasing power of individuals or households, reflecting their ability to acquire goods and services necessary for daily living.	Purchasing Power Parity index	BPS
Labor Wages	Labor wages refer to the monetary compensation received by workers in exchange for their labor or services performed within a specified period.	District/City Minimum Wage	BPS
Economics Structure	Economic structure refers to the composition and distribution of economic activities across different sectors within a region, reflecting the relative contribution of each sector to the regional economy.	GRDP at current prices by sector	BPS

As aforementioned before this research using secondary data which collected over five years, from 2018 to 2022. This study uses a quantitative approach to explore the relationships between several independent variables and poverty levels as the dependent variable. One of the independent variables considered is the number of SME units, employment levels within SMEs, PPP, median labor wages, and the regional economic structure. The study aims to understand how these factors collectively influence poverty levels. The analysis will employ a panel data regression model, as detailed below:

$$Poverty_{it} = \alpha + \beta_1 SME_{it} + \beta_2 LaborAbsorbed_{it} + \beta_3 PPP_{it} + \beta_4 LaborWages_{it} + \beta_5 EconomicStructure_{it} + e_{it} \dots \dots \dots \text{(model 1)}$$

Based on the equation used the dependent variable $Poverty_{it}$ represents poverty levels in each district or city. First independent variables $\beta_1 SME_{it}$ represent the number of SME units, $\beta_2 LaborAbsorbed_{it}$ represent the number of workers employed by SMEs, $\beta_3 PPP_{it}$ represent purchasing power parity level, $\beta_4 LaborWages_{it}$ represent median labor wages and lastly $\beta_5 EconomicStructure_{it}$ representing regional economic structure. Before conducting the analysis, we will first perform heteroscedasticity tests to ensure that the parameter estimates in the model are BLUE or knowing as Best Linear Unbiased Estimator, the variance of the error term ($\text{var}(\mu_i) = \sigma^2$) must remain constant, indicating homoscedasticity. Heteroscedasticity occurs when this assumption of constant variance is violated. In multiple linear regression, meeting the homoscedasticity assumption is crucial for obtaining reliable estimates (Handayani, 2023). By validating the data in this way, we aim to achieve reliable conclusions that accurately reflect the relationships among the variables.

Following this, we will select the most suitable model to represent the panel data regression analysis results by considering three primary models: Common Effect (CE Models), Fixed Effect (FE Models) and Random Effect (RE Models) The selection of the appropriate model involves various statistical tests, such as the Chow test to decide whether and the Hausman test. Through these tests, we aim to identify the model that best fits the data characteristics, thereby enabling a more accurate and reliable interpretation of the relationships between variables. All analyses are conducted using EViews 9.0 software.

RESULTS

Between 2018 and 2020, Central Java Province held the second-highest poverty rate in Indonesia. Data from the Central Statistics Agency shows that in 2018, the total number of people living in poverty in Central Java was 3.867.000. There was a decline in poverty levels in 2019, However, the situation deteriorated once more in 2020 and 2021 because of the COVID-19 pandemic. Brebes Regency recorded the highest number of people living in poverty, with 286.140 individuals, while Magelang City had the smallest poverty population among the districts, with 7.450 people.

In 2021, Central Java Province recorded a GRDP at current prices of IDR 1.420.799,91 billion, reflecting a 3.32% growth over 2020. This growth followed a 2.65% economic contraction in 2020 due to the Covid-19 pandemic. When examining Central Java's GRDP structure by business sectors at current prices in 2021, the Processing Industry sector contributed the largest share at 34.31%, This is followed by Agriculture, Forestry, and Fisheries (13.68%), Wholesale and Retail Trade, including Car and Motorcycle Repair (13.75%), and Construction (11.12%). Together, these four sectors account for 73.04% of Central Java's economic activity, underscoring their importance to the regional economy.

Before we jump into the prior analysis, heteroscedasticity test was conducted to identify any variations in the residual variance across observations. This study employs the Glejser test to identify heteroscedasticity. The findings of the Glejser test are shown in Table 4, which reveals no evidence of heteroscedasticity in the data.

Table 4. Heteroscedasticity Test Result

F-statistic	1.834477	Prob. F (5.169)	0.1086
Obs*R-squared	9.009070	Prob. Chi-Square (5)	0.1087
Scaled explained SS	8.928640	Prob. Chi-Square (5)	0.1119
F-statistic	1.834477	Prob. F (5.169)	0.1086

Following the preliminary diagnostic tests, the next step was to determine the most appropriate panel data regression model. The first step in this process is to decide between the CE Models and FE Models using the Chow test and the results of the Chow Test reveal that the cross-section chi-square probability value is below 0.05, indicating statistical significance. This leads to the rejection of the null hypothesis (H_0), which favors the CE Models, in favor of the alternative hypothesis (H_1), which favors the FE Models. Thus, the FE Models are deemed more appropriate than the CE Models for this analysis. The next step is to conduct the Hausman Test, 0.0041. The model selection test results confirm that the FE Models is the most suitable model for this study. The results of the fixed effects regression analysis are presented in Table 5.

Table 5. Fixed Effect Model Result

Variable	Coefficient	t-statistic	Prob.
<i>C</i>	105.3857***	10.20790	0.0000
SMEs	0.002154**	2.523653	0.0128
Labor Absorbed	-2.34E-05	-0.632397	0.5282
PPP	14.58752*	1.933019	0.0553
Labour Wages	-8.97E-06***	-2.845095	0.0051
Economic Structure	1.208563	0.227625	0.8203
<i>Adjust R-Squared</i>		0.994432	
<i>f-statistic</i>		13.1266	

Notes: *** $p < 0,01$; ** $p < 0,05$; * $p < 0,10$

Source: Author Processed

The results of the fixed effects model are presented in Table 5. The model demonstrates a high explanatory power, with an adjusted R-squared of 0.9944, indicating that approximately 99.44% of the variation in poverty can be explained by the independent variables included in the model. Furthermore, the F-statistic of 13.1266 confirms that the model is statistically significant, suggesting that the explanatory variables jointly influence poverty.

Regarding the individual variables, the number of SMEs has a positive and statistically significant effect on poverty at the 5% significance level. This finding indicates that an increase in the number of SMEs is associated with a higher poverty rate. This result may reflect that the expansion of SMEs is dominated by micro-scale enterprises with relatively low productivity and limited capacity to generate substantial income, thereby limiting their contribution to poverty reduction.

The labor absorbed by SMEs does not have a statistically significant effect on poverty. This suggests that variations in employment generated by SMEs during the observation period were insufficient to produce a measurable reduction in poverty. PPP exhibits a positive effect on poverty and is marginally significant at the 10% significance level. This finding indicates that changes in purchasing power are associated with changes in poverty, although the statistical evidence is relatively weak and should therefore be interpreted with caution. The coefficient of labour wages is negative and statistically significant at the 1% significance level, indicating that higher labor wages contribute to poverty reduction. This result supports the argument that improvements in workers' earnings enhance household purchasing power and welfare, thereby reducing the incidence of poverty. Finally, the economic structure variable does not have a statistically significant effect on poverty, suggesting that differences in the sectoral composition of the regional economy alone are insufficient to explain variations in poverty across districts and cities in Central Java during the study period.

DISCUSSION

The results suggest that the number of SMEs and the labor absorbed by SMEs have an insignificant impact on poverty levels. Therefore, it can be concluded that the number of SMEs has a positive and significant effect on poverty levels and unemployment issues which indicates that SMEs in the Central Java province have not yet been able to help alleviate poverty. This finding contrasts with previous research conducted by Fahrudi, (2020), Mbuyisa & Leonard, (2016), Moradi et al., (2020) and Sugiharti et al., (2023) who discovered that SMEs can negatively affect poverty levels. This could be attributed to various factors, including limited resources, both in terms of capital and human capital (Prasanna et al., 2019; Razak et al., 2018), which hinder the development of SMEs. This is further compounded by a lack of support from the government (Park et al., 2020), This has hindered the growth of SMEs. Furthermore, the effects of the COVID-19 pandemic during the study period may have played a role in the rise of poverty (Pereira & Oliveira, 2020), a challenge that SMEs alone could not address and requires alternative solutions.

The PPP variable has a significant and positive impact on poverty at a 10% significance level. This is in line with the views of Masroor & Asim, (2019) and Nugroho et al., (2021) who agree that increasing the PPP of citizens can help reduce poverty. Next, the labor wages variable shows a significant negative impact on poverty levels. This is consistent with previous studies by Bassier & Ranchhod, (2024), Brülle et al., (2019) and Sotomayor, (2021) who believe that policies aimed at increasing average labour wages can effectively raise workers income. This, in turn, helps them meet their basic needs, stimulates the local economy, and creates new job opportunities, ultimately contributing to a reduction in poverty levels.

Lastly, economic structure has a insignificant positive impact on poverty which means that the regional economic structure does not affect the poverty level. This contradicts the views of Christiaensen & Martin, (2018) and Ženka et al., (2021) who believe that the economic structure can influence poverty reduction. This may occur due to a lack of inclusivity (van Niekerk, 2020), where the economic structure in Central Java province focuses only on certain sectors, which may not align with the needs of low-income and rural communities that are not yet ready to undergo an economic transition.

To address poverty issues in Central Java, policies should focus on strengthening SMEs by improving access to capital, providing training, and offering government support to help businesses grow. Efforts to diversify the economic structure and make it more inclusive are essential, particularly by promoting sectors that create widespread employment opportunities for rural and low-income populations. Additionally, increasing PPP through targeted cash transfers and improving wages via minimum wage laws and wage subsidies can contribute to poverty reduction. Finally, reassessing the regional economic structure to ensure it aligns with the needs of the population and fosters inclusive growth is crucial for long-term poverty alleviation.

CONCLUSIONS

This study examines how the number of SMEs, labor absorbed, PPP, labor wages and economic structure influence Central Java Province poverty levels. Using FE model in panel data analysis regression from 35 districts/cities in 2018 to 2022. We found that PPP and labor wages have a significant impact on poverty alleviation, whereas the number of SMEs, labor absorbed, and the economic structure have not been successful in reducing poverty in Central Java. Policies should strengthen SMEs by improving capital access and training, diversify the economy to create jobs for low-income areas, increase PPP through cash transfers, raise wages with minimum wage laws and subsidies, and reassess the economic structure to ensure inclusive growth for long-term poverty reduction.

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