



NADI INSTITUTE

Article Type: Research

The Challenge of Graduation: Structural Fragility, the Middle-Class Squeeze, and the Risk of the "Chilean Paradox" in Indonesia

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ARTICLE HISTORY**Received:**

24 February 2026

Reviewed:

28 February 2026

Revised:

2 March 2026

Accepted:

7 March 2026

Abstract

In July 2023, the World Bank upgraded Indonesia to Upper Middle-Income Country (UMIC) status. While this marks a milestone in economic development, Indonesia has effectively remained in the middle-income trap for over four decades. This study investigates the structural and social challenges threatening Indonesia's transition to a high-income economy, specifically through the lens of the "Chilean Paradox"—a situation where macroeconomic stability coexists with social unrest due to middle-class dissatisfaction. Using a qualitative analysis of secondary data, this article identifies three critical barriers: premature deindustrialization, the vulnerability of the "aspiring" middle class, and a low tax-to-GDP ratio. The findings suggest that Indonesia's current growth model, which relies on consumption and commodities, fails to provide the high-quality jobs and social security needed by the middle class. Without significant policy reforms in industrialization and social protection, Indonesia risks facing long-term stagnation and social instability.

Keywords: Middle-Income Trap, Premature Deindustrialization, Chilean Paradox, Middle Class, Indonesia, Social Protection

Introduction

Indonesia's economic journey in the 21st century is a story of resilience. After the 1998 Asian Financial Crisis, the country successfully stabilized its economy and maintained steady growth. A significant achievement occurred in July 2023, when the World Bank reclassified Indonesia from a Lower Middle-Income Country to an Upper Middle-Income Country (UMIC), citing a Gross National Income (GNI) per capita of US\$ 4,580 (World Bank, 2023a). This status suggests that Indonesia is on the right track toward its "Golden Indonesia 2045" vision.

However, a long-term view reveals a more concerning reality. Indonesia first entered the lower-middle-income bracket in the early 1980s. Except for a brief decline during the 1998 crisis, the nation has stayed in the middle-income category for over 40 years (Basri, 2023). In comparison, countries like South Korea and Taiwan moved from low-income to high-income status in less than 30 years. Indonesia's slow progression indicates it is caught in the "Middle-Income Trap" (MIT), a situation where a country grows to a certain level but fails to advance further due to a lack of innovation and productivity.

Recently, economists have warned that Indonesia might face a "Chilean Paradox." This term refers to a country that has strong economic numbers—such as high GDP growth and low inflation—but suffers from social instability because the middle class feels squeezed and ignored (Edwards, 2023). In Chile, despite being the wealthiest nation in Latin America, massive protests erupted in 2019 because the middle class felt that the cost of living was too high and public services were inadequate.

Indonesia shows similar signs. While the official poverty rate is low (9.36%), nearly half of the population belongs to the "aspiring middle class"—people who are not poor but are not financially secure (World Bank, 2020). They do not receive government social assistance, yet they struggle to afford quality healthcare and education. This article analyzes these challenges by focusing on two main issues: the decline of the manufacturing sector ("premature deindustrialization") and the exclusion of the middle class from social protection.

Literature Review

2.1. The Middle-Income Trap

The Middle-Income Trap occurs when a developing country loses its competitive edge in exporting labor-intensive goods because wages have risen, but it is not yet able to compete with advanced economies in high-skill, high-technology markets (Eichengreen et al., 2013). According to empirical studies, a country is considered trapped if it remains in the lower-middle-income range for more than 28 years (Felipe et al., 2012). Indonesia has already exceeded this time limit. To escape the trap and reach high-income status by 2045, Indonesia's economy needs to grow consistently at 5% to 7% per year, driven by productivity rather than just raw materials.

2.2. Premature Deindustrialization

Historically, developed countries like the United States or Germany only started shifting from manufacturing to services after they became rich. Manufacturing was the key to their prosperity because it created many formal jobs and introduced new technologies. However, Rodrik (2016) observed that developing countries today are losing their manufacturing sectors much earlier and at much lower income levels. This phenomenon is called "premature deindustrialization." It is dangerous because it forces workers to move from farms directly to low-productivity service jobs, bypassing the industrial phase that is crucial for building a strong middle class.

2.3. The Chilean Paradox

The Chilean Paradox highlights the disconnect between macroeconomic success and microeconomic reality. Edwards (2023) explains that even when a country reduces poverty, inequality and the quality of public services can create deep dissatisfaction. This is explained by the theory of "relative deprivation" (Runciman, 1966), which states that people judge their well-being by comparing themselves to others. In Indonesia, as the middle class grows, they become more sensitive to inequality and corruption. If their expectations for a better life are not met, frustration can lead to social unrest (Basri & Wihardja, 2024).

Structural Analysis: Why the Economy is Stalled

The primary economic barrier for Indonesia is the weakening of its industrial base. The manufacturing sector, which should be the engine of growth, is shrinking before it has fully matured.

3.1. The Decline of Manufacturing

Data shows a clear trend of premature deindustrialization in Indonesia. The manufacturing sector's contribution to GDP peaked at around 32% in 2002 but has steadily declined to approximately 18.3% in 2023 (World Bank, 2024). Unlike Vietnam, which has aggressively attracted foreign factories to become a global export hub, Indonesia has struggled to maintain its industrial competitiveness.

One major cause was the commodity boom in the 2000s. The high prices of coal and palm oil caused the Indonesian currency to strengthen, making manufactured exports like textiles and electronics more expensive for foreign buyers (Basri, 2023). Additionally, Indonesia's trade policies have often been protectionist. Complex regulations and high logistics costs have made it difficult for Indonesian companies to join Global Value Chains (GVCs). While neighbors like Thailand and Vietnam integrated into global production networks for electronics, Indonesia remained focused on its domestic market.

3.2. Stagnant Productivity

Economic growth can come from adding more inputs (labor and capital) or from using those inputs more efficiently. The latter is measured as Total Factor Productivity (TFP). The rapid growth of East Asian economies was driven by high TFP growth. In contrast, Indonesia's growth has been driven mostly by adding more workers and capital.

Research indicates that TFP growth in Indonesia has been negative or negligible in recent years (Asian Productivity Organization, 2023). A negative TFP means the economy is becoming less efficient. This creates a "high-cost economy" where it takes more and more investment to generate the same amount of growth. Without improving productivity through technology and innovation, Indonesia cannot pay the high wages characteristic of a developed nation.

3.3. The Shift to Informal Services

When workers leave agriculture in Indonesia, they often do not find jobs in factories. Instead, they enter the service sector. However, this is not the high-value service sector (like finance or IT) seen in rich countries. It is dominated by low-end, informal activities such as motorcycle taxi driving (*ojek online*) or small-scale trading (Rothenberg et al., 2016).

These informal jobs provide a safety net, but they do not offer career progression, skill development, or social security. Productivity in this sector is low, which drags down the overall national productivity. Furthermore, because these workers are in the informal sector, they do not contribute significantly to the tax base, limiting the government's ability to invest in public services.

The Middle-Class Squeeze

The condition of the middle class is the central element of the Chilean Paradox. In Indonesia, the middle class is often celebrated, but the data reveals they are economically fragile.

4.1. The Vulnerable Majority

There is a significant gap between the statistical definition of "not poor" and the reality of being financially secure. Indonesia's national poverty line is set at a low level (approx. Rp 550,000 per month). While only 9.36% of the population falls below this line, a much larger group—about 45% to 50%—is classified as "aspiring middle class" (World Bank, 2020).

This group has moved out of poverty but has not reached the security of the true middle class. They are highly vulnerable to economic shocks. A job loss, a health emergency, or a rise in food prices can easily push them back into poverty. Recent trends show that the "secure" middle class (approx. 20% of the population) is not growing as fast as expected and is facing significant pressure (Basri, 2023).

4.2. "Mantab": Eating Savings

A worrying indicator of this pressure is the phenomenon known locally as *Mantab* (Makan Tabungan), which translates to "eating into savings." Data from the Indonesia Deposit Insurance Corporation (LPS) shows that savings growth for accounts with balances under Rp 100 million has slowed down or declined (LPS, 2024).

This suggests that lower-middle-class households are using their savings to cover daily living expenses. This is caused by the rising cost of living, particularly food inflation, which hits middle-income households harder than the wealthy. Unlike the poor, who receive government aid like cash transfers (BLT) and food subsidies, the aspiring middle class typically does not qualify for this assistance. They bear the full burden of inflation, leading to a decline in their discretionary spending power.

4.3. The "Missing Middle" in Social Protection

The Indonesian social protection system has a "missing middle" problem. Government programs target the bottom 40% of the population. For example, the Family Hope Program (PKH) and subsidized health insurance (PBI-JK) are effective for the poor (TNP2K, 2023).

However, the aspiring middle class is excluded. They are considered too rich for aid but are often too poor to afford private health insurance. Many work in the informal sector and struggle to pay the premiums for the national health insurance scheme (BPJS Kesehatan). This exclusion creates a sense of unfairness. They see the poor getting help and the rich having resources, while they are left to fend for themselves. This dynamic mirrors the grievances that fueled social unrest in Chile (Edwards, 2023).

Institutional and Fiscal Challenges

The government's ability to fix these problems is limited by weak institutions and low tax revenue.

5.1. The Low Tax Ratio

Indonesia collects a very low amount of tax relative to the size of its economy. The tax-to-GDP ratio has hovered around 10% for the last decade, which is far below the OECD average of 34% and lower than regional peers like Thailand and Vietnam (OECD, 2023).

This lack of revenue puts the government in a difficult position. It wants to improve education, health, and infrastructure, but it lacks the funds to do so at the necessary scale. The tax burden is also uneven. The formal middle class (employees) pays income tax automatically, while the large informal sector and some wealthy individuals remain undertaxed. Reforms to increase the Value Added Tax (VAT) to 12% are controversial because they disproportionately affect the consumption of the middle class, further reducing their purchasing power.

5.2. Governance and Efficiency

Institutional quality is crucial for escaping the Middle-Income Trap. Indicators from the World Bank show that Indonesia lags behind South Korea and Taiwan in areas like "Control of Corruption" and "Regulatory Quality" at similar stages of development (Kaufmann et al., 2010).

Corruption and bureaucratic inefficiency increase the cost of doing business. This is reflected in the high Incremental Capital Output Ratio (ICOR), which has risen above 7.0 (Ministry of Investment, 2024). A high ICOR means that investment in Indonesia is inefficient. This inefficiency deters high-quality foreign investment that could bring technology and good jobs, leaving the country reliant on natural resource extraction.

The Demographic Deadline

Time is running out for Indonesia to implement these reforms. The country is currently enjoying a "demographic dividend," meaning it has a large working-age population compared to children and the elderly.

However, this window of opportunity is closing. Projections by the National Development Planning Agency (Bappenas) indicate that the dependency ratio will start rising again in the late 2030s as the population ages (Bappenas, 2023). By 2045, Indonesia will be an aging society. If the country has not become rich by then, it faces the risk of "getting old before getting rich." An aging population requires higher spending on healthcare and pensions. Without a strong economy and a robust tax base, supporting this elderly population will place a heavy burden on the younger generation.

Furthermore, the quality of the current workforce is a concern. The stunting rate among children remains high at 21.5% (Ministry of Health, 2023). Stunting affects brain development and future productivity. A workforce that suffered from stunting in childhood will struggle to compete in a high-tech global economy, making it even harder to escape the Middle-Income Trap.

Policy Recommendations

To avoid the Chilean Paradox and graduate to high-income status, Indonesia needs a new strategy.

7.1. Re-Industrialization

The government must revive the manufacturing sector. The current policy of "downstreaming" (*hilirisasi*)—processing natural resources like nickel domestically—is a good start. However, it needs to expand beyond just smelting metals (which creates few jobs) to manufacturing complex products like electric vehicle batteries and components (Basri, 2023). This requires reducing trade barriers to lower the cost of inputs and integrating Indonesia into global supply chains.

7.2. Universal Social Protection

The "missing middle" must be addressed. Social protection should be expanded to cover the aspiring middle class. This could involve moving towards a universal health coverage model that does not rely heavily on premiums from informal workers, funded by broader tax reforms. An unemployment insurance scheme for informal workers is also necessary to provide a safety net during economic downturns (ILO, 2024).

7.3. Fiscal Reform

To fund these programs, Indonesia must increase its tax ratio. Instead of just raising VAT rates, the government should focus on broadening the tax base. This includes taxing wealth and capital gains more effectively and using digital technology to bring the informal sector into the tax system without overburdening small businesses (OECD, 2023).

7.4. Investing in Human Capital

Education reform should focus on quality, not just access. Indonesia's PISA scores (a measure of student performance) are consistently low (OECD, 2019). Improving teacher quality and aligning vocational training with industry needs is essential. Additionally, reducing stunting must remain a top national priority to ensure the productivity of the next generation.

Conclusion

Indonesia stands at a critical crossroads. The upgrade to Upper Middle-Income status is an achievement, but it does not guarantee future prosperity. The structural problems of premature deindustrialization, low productivity, and a vulnerable middle class create a real risk of stagnation.

The "Chilean Paradox" serves as a warning: economic growth on paper is not enough if the benefits are not shared and if the middle class feels insecure. To reach the vision of "Golden Indonesia 2045," the government must move beyond business-as-usual. It needs to build a new social contract that protects the middle class and implement an industrial policy that creates high-quality jobs. The demographic window is closing, and the time for bold reforms is now.

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