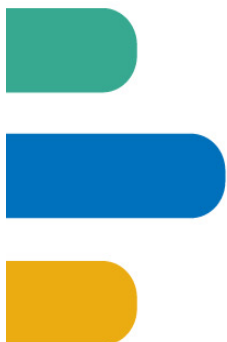


# THE CAUSES AND CONSEQUENCES OF INCREASING INEQUALITY IN INDONESIA: A LONG TERM VIEW

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Forum Kajian Pembangunan  
Bank Indonesia Institute  
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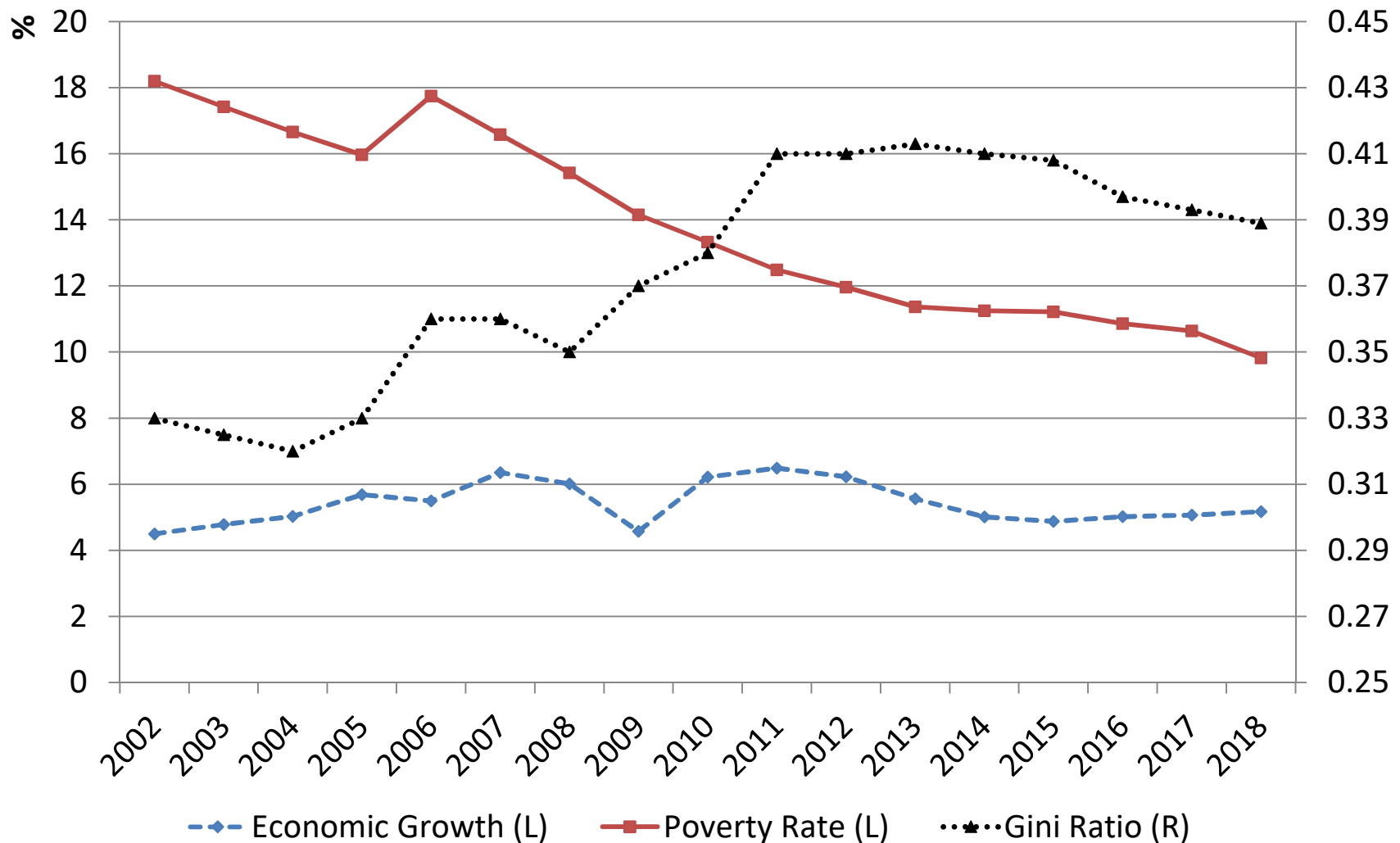


# Overview





# Post-crisis Indonesia: Economic growth is positive and stable, poverty declines, but inequality has increased

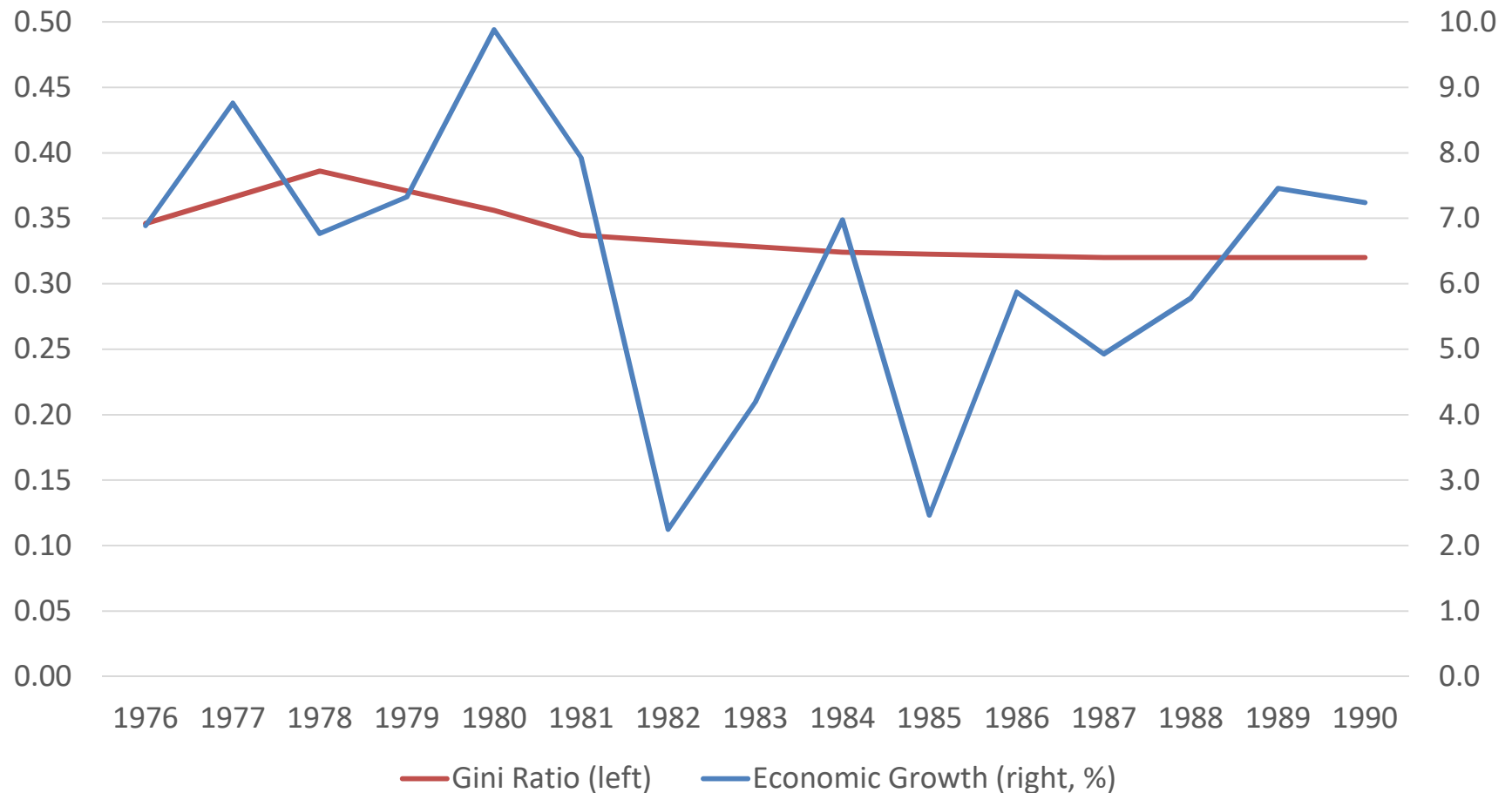


Source: BPS



# Indonesia during the 1970s & 1980s: High economic growth without increasing inequality

Indonesia's Inequality and Economic Growth, 1976-1990

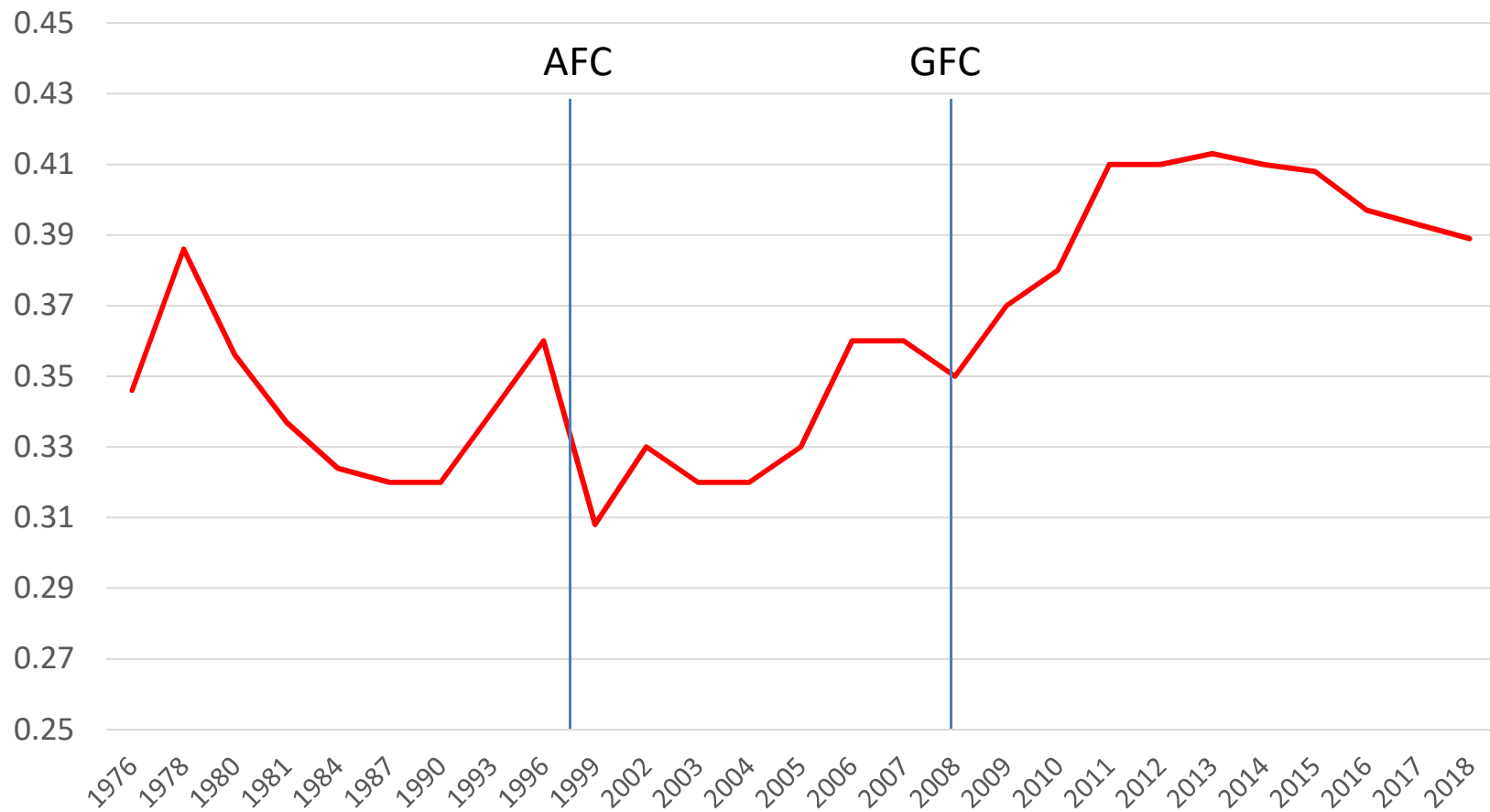


Source: BPS



# Actually inequality started to increase after 1990, but Asian Financial Crisis brought it down again temporarily

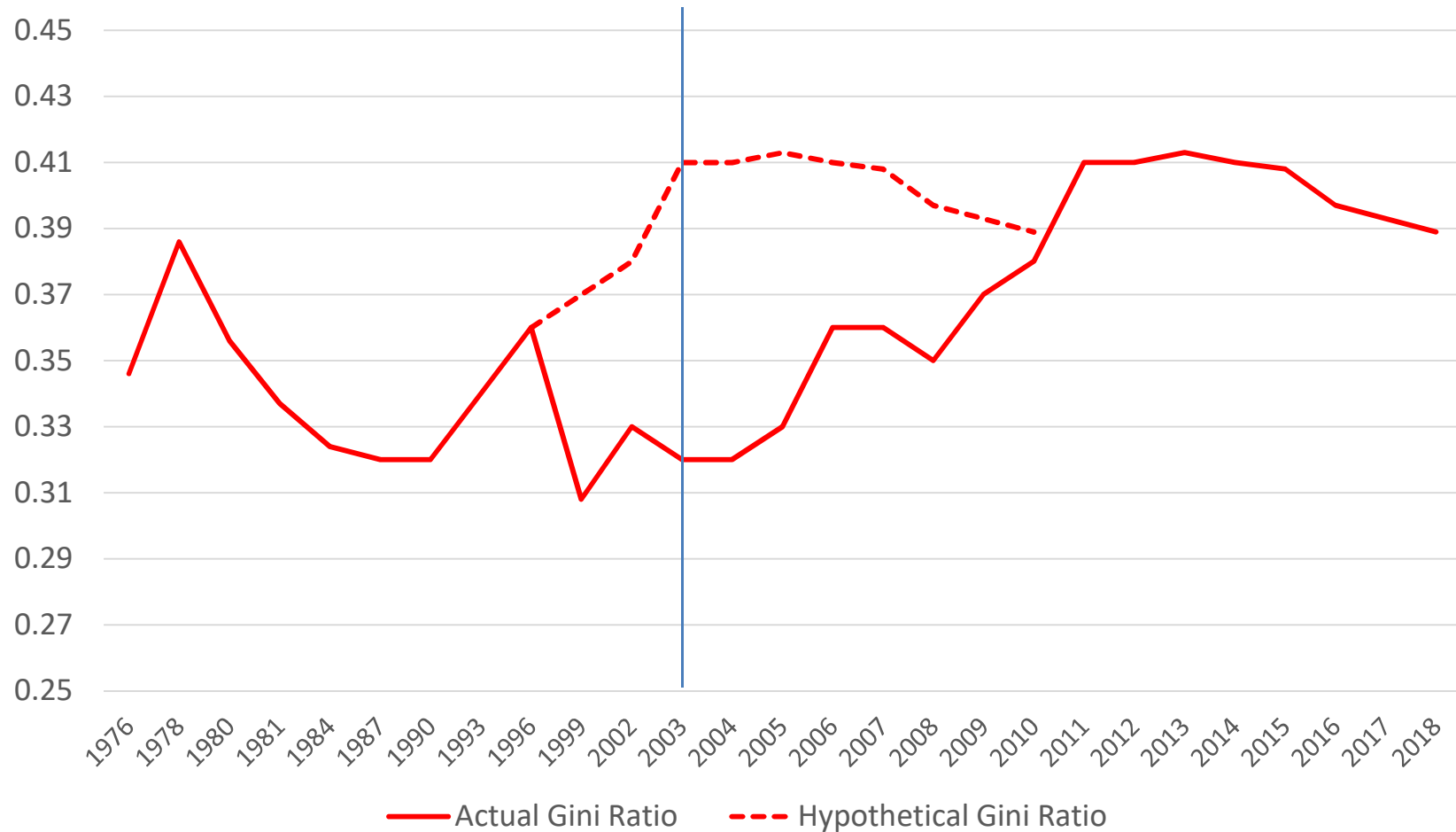
Indonesia's Inequality (Gini Ratio) Trend, 1976-2018



Source: BPS

# Had there been no crises, GINI Ratio of 0.41 would have been achieved by 2003

### Actual and Hypothetical Gini Ratio





# The Causes





# Conjectures on the driver of the increase in inequality

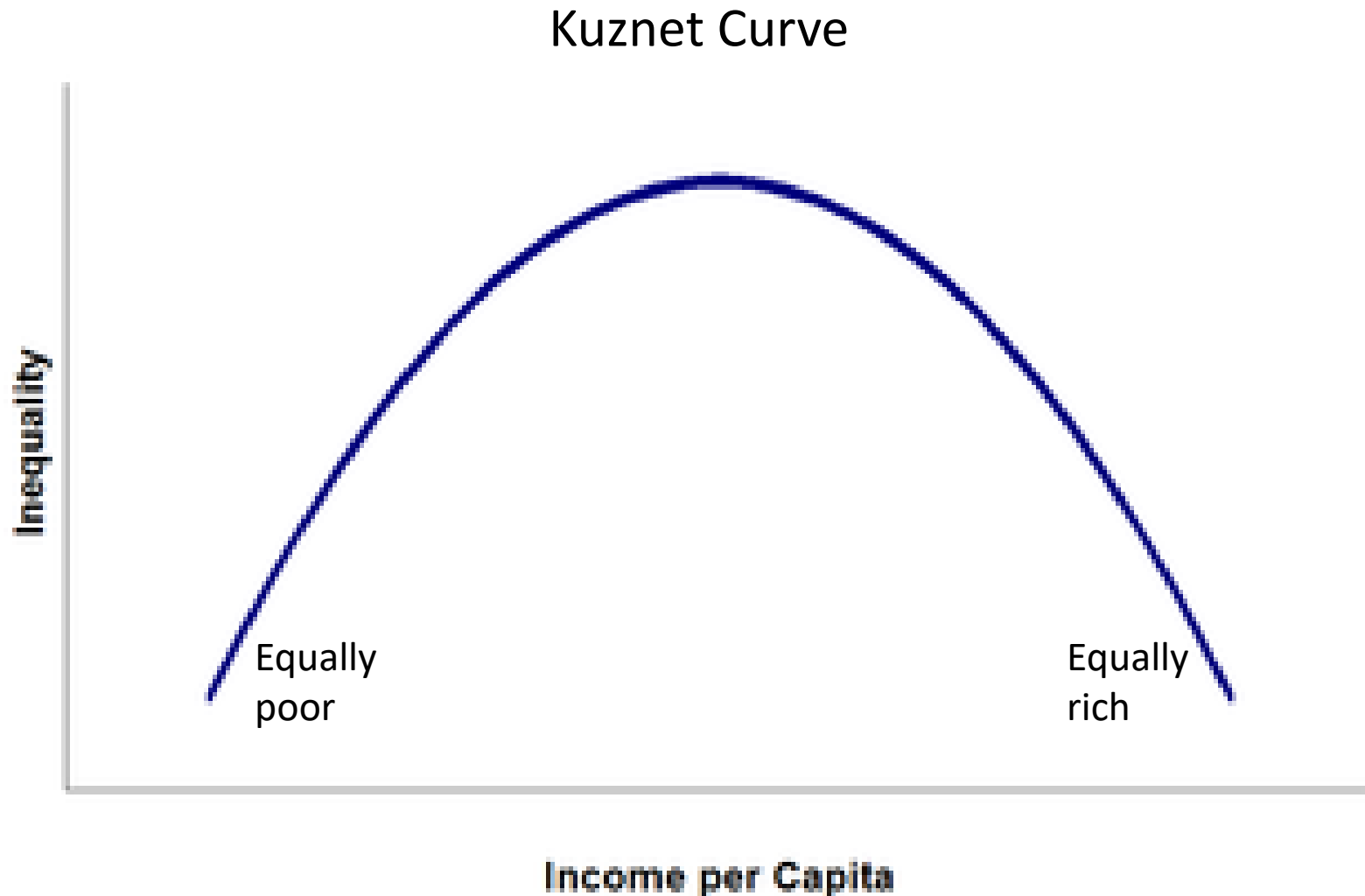
Basri (2018):

- Labor saving technology, increasing skill premium
- Rigidity in the labor market due to labor law
- Financial market liberalization
- Commodity boom, Dutch disease
- Inequality in access to education, health, financial services, infrastructure
- Poor quality of infrastructure
- Demography: aging population
- Corruption and high cost economy

Piecemeal analysis → Need a framework on the determinants of **increasing** inequality



- Kuznet hypothesis: Never applied in
- Indonesia during 1970s-1980s. Does it apply
- now?



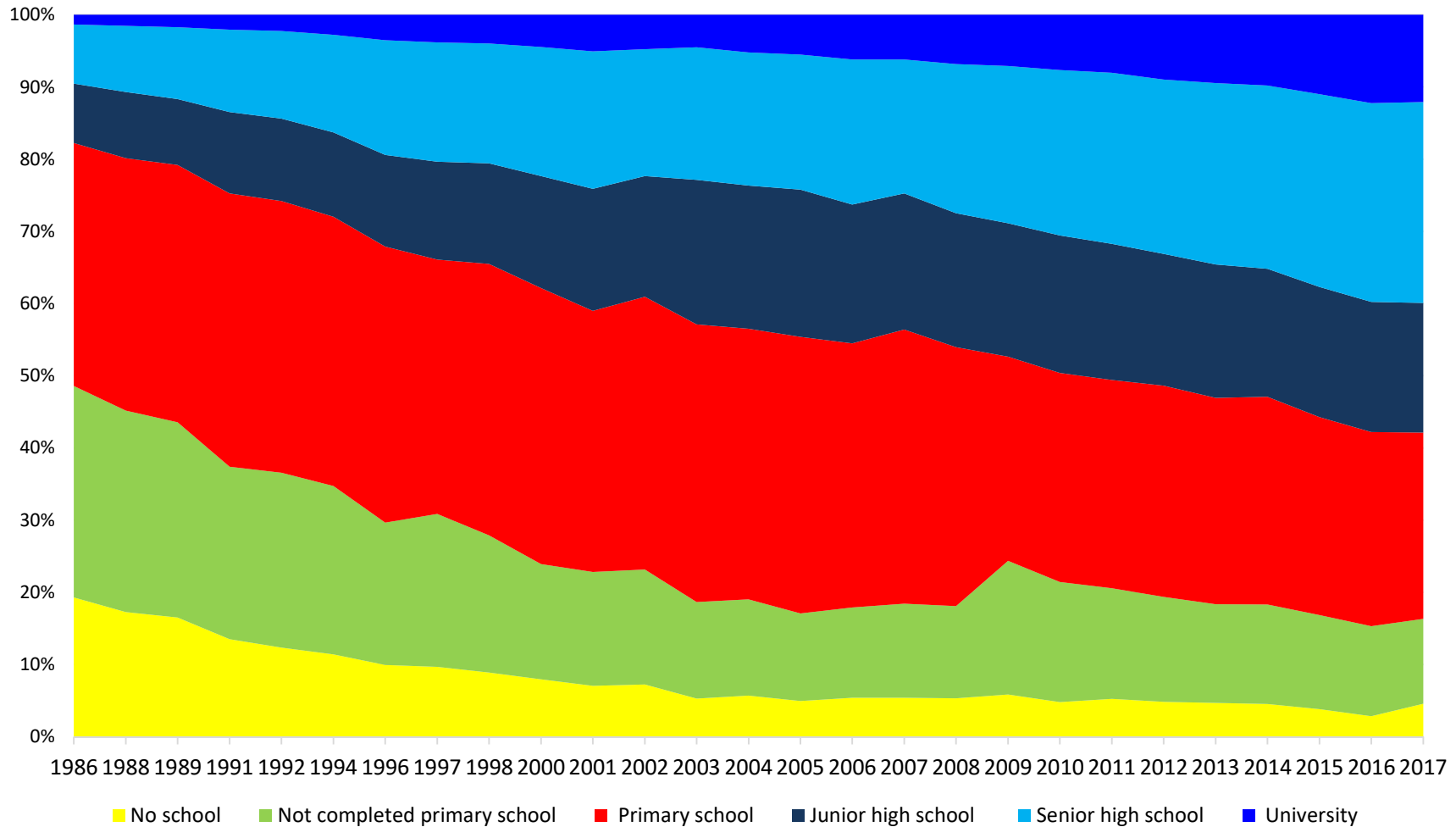


# Method for estimating the contribution of structural factors to increasing inequality

- Structural Factors:
  - Education level
  - Economic sector
  - Rural-urban location
  - Informal-formal worker
- Effects:
  - Endowment effect: The effect of change in composition of a structural factor on inequality
  - Price effect: The effect of change in return to a structural factor's component on inequality
- References:
  - Bourguignon *et al.* (2001)
  - Pieters (2011)

Education expansion has increased the average education level of Indonesian labor force

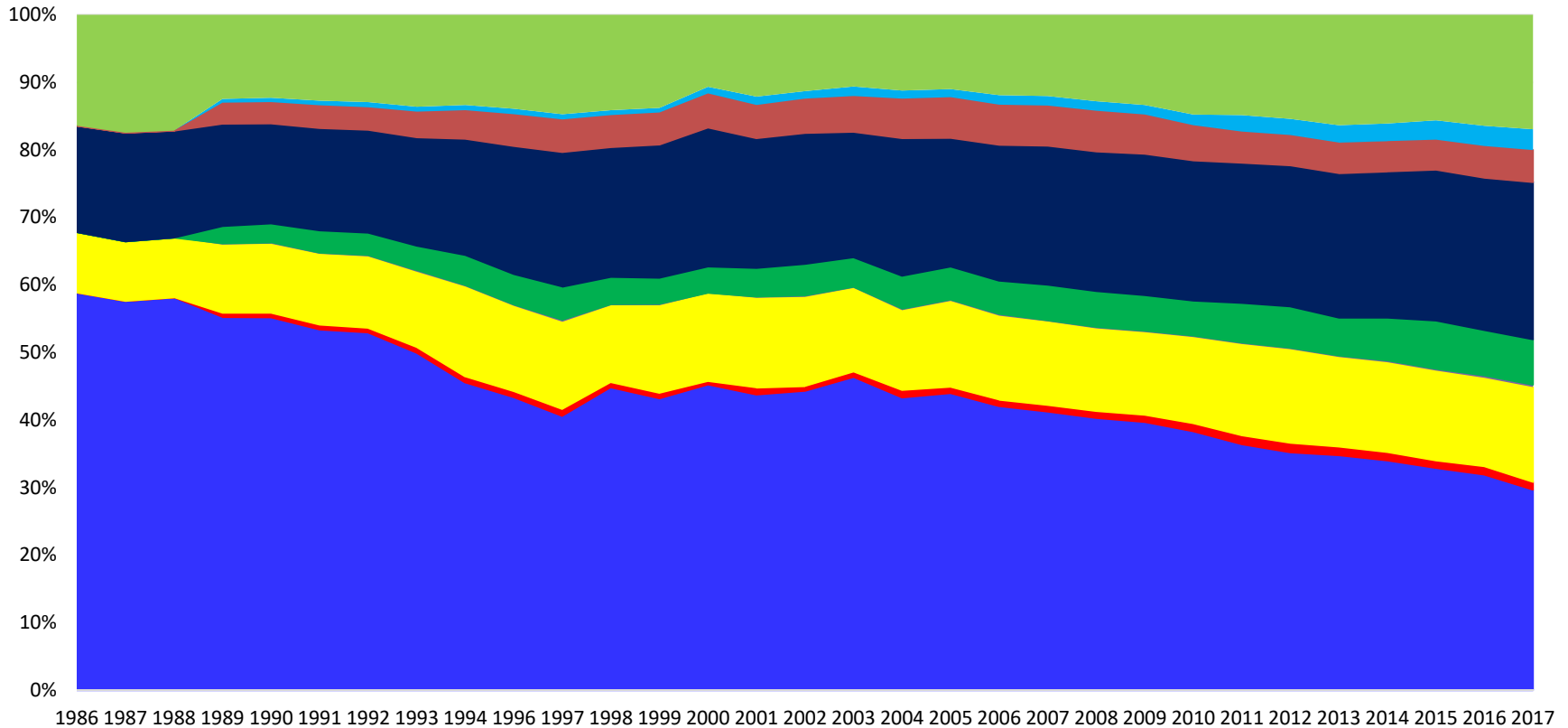
Share of employment by level of education





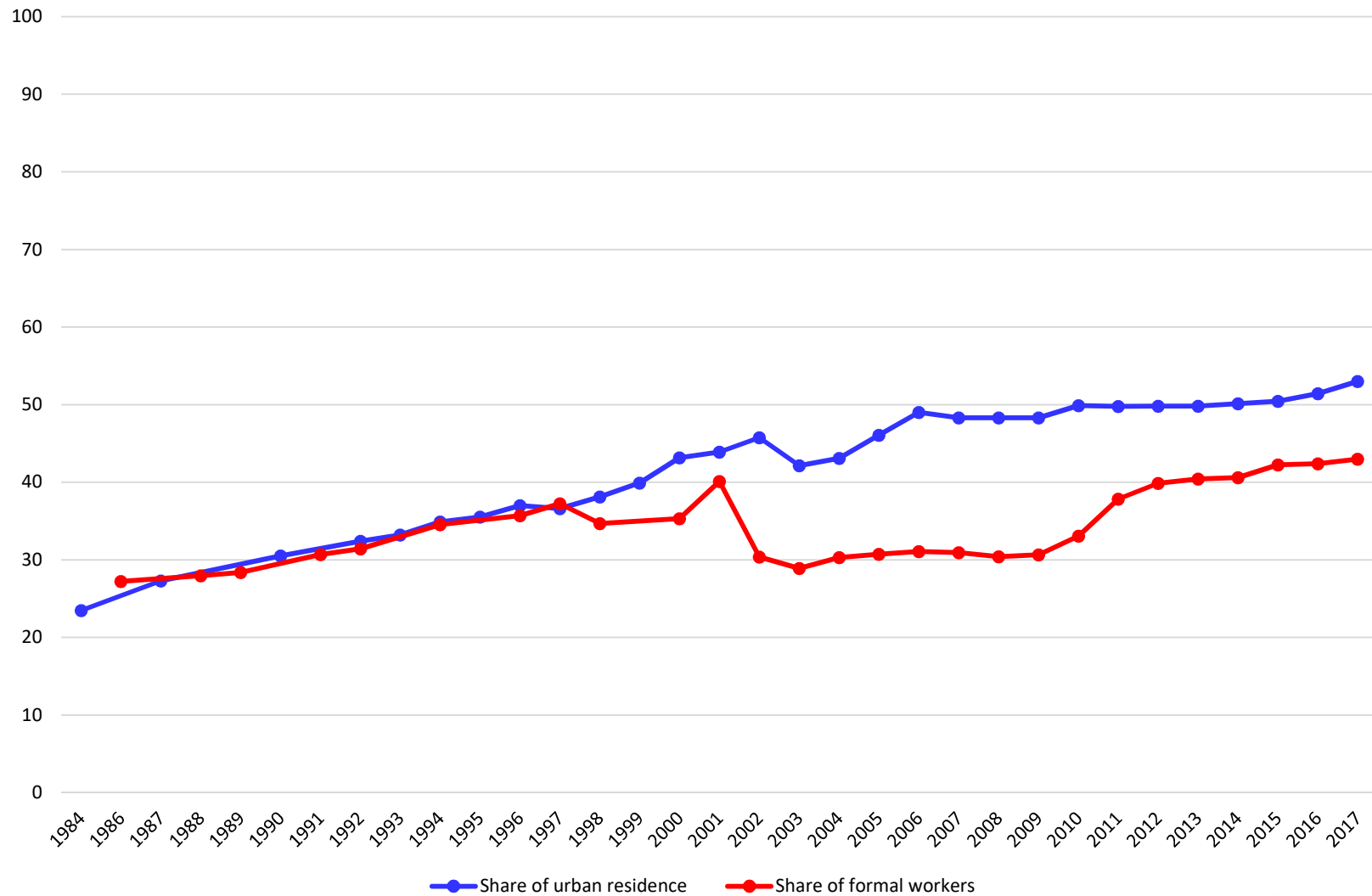
# The dominant sector of employment has shifted from agriculture to services

Share of employment based on sectors



- Agriculture
- Mining
- Manufacture
- Water and Electricity
- Construction
- Trade, hotels, and restaurant
- Transportation and communication
- Finance and real estate
- Other services

# More and more Indonesians live in urban areas and work in the formal sector





More than 80% of the increase in inequality during 1992-2011 was due to changes in the structural factors

### Contribution of Changes in the Composition of Structural Factors on the Increase in Inequality, 1992-2011 (%)

Factor	Endowment Effect	Price Effect	Total
Education level	30.03	4.71	34.73
Employment sector	5.05	7.06	12.11
Rural-urban location	18.64	-9.41	9.23
Informal-formal worker	14.12	14.12	28.24
Total	67.83	16.47	84.30

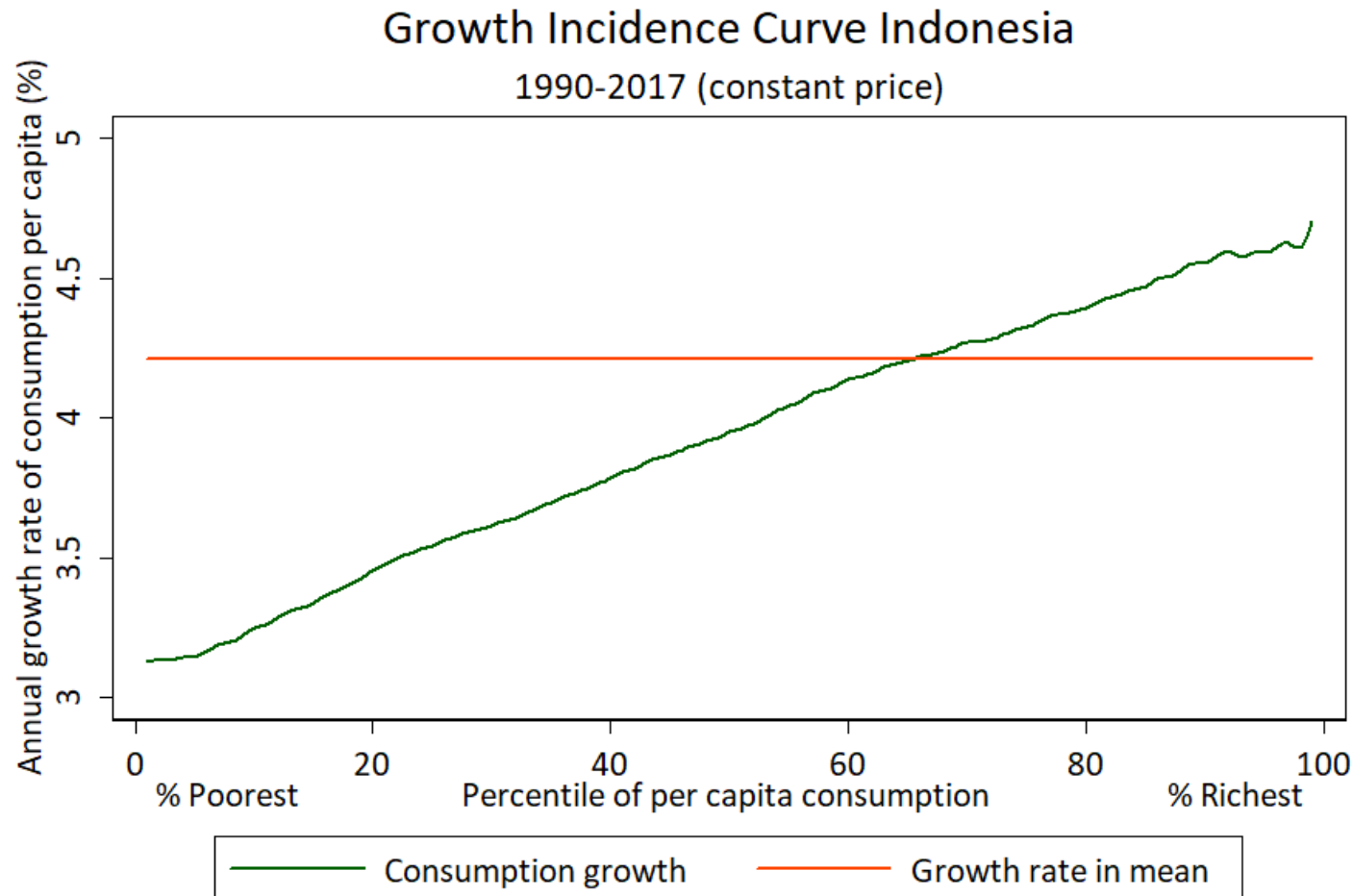


# The Consequences





# Everybody benefits from economic growth. Why worry about increasing inequality?

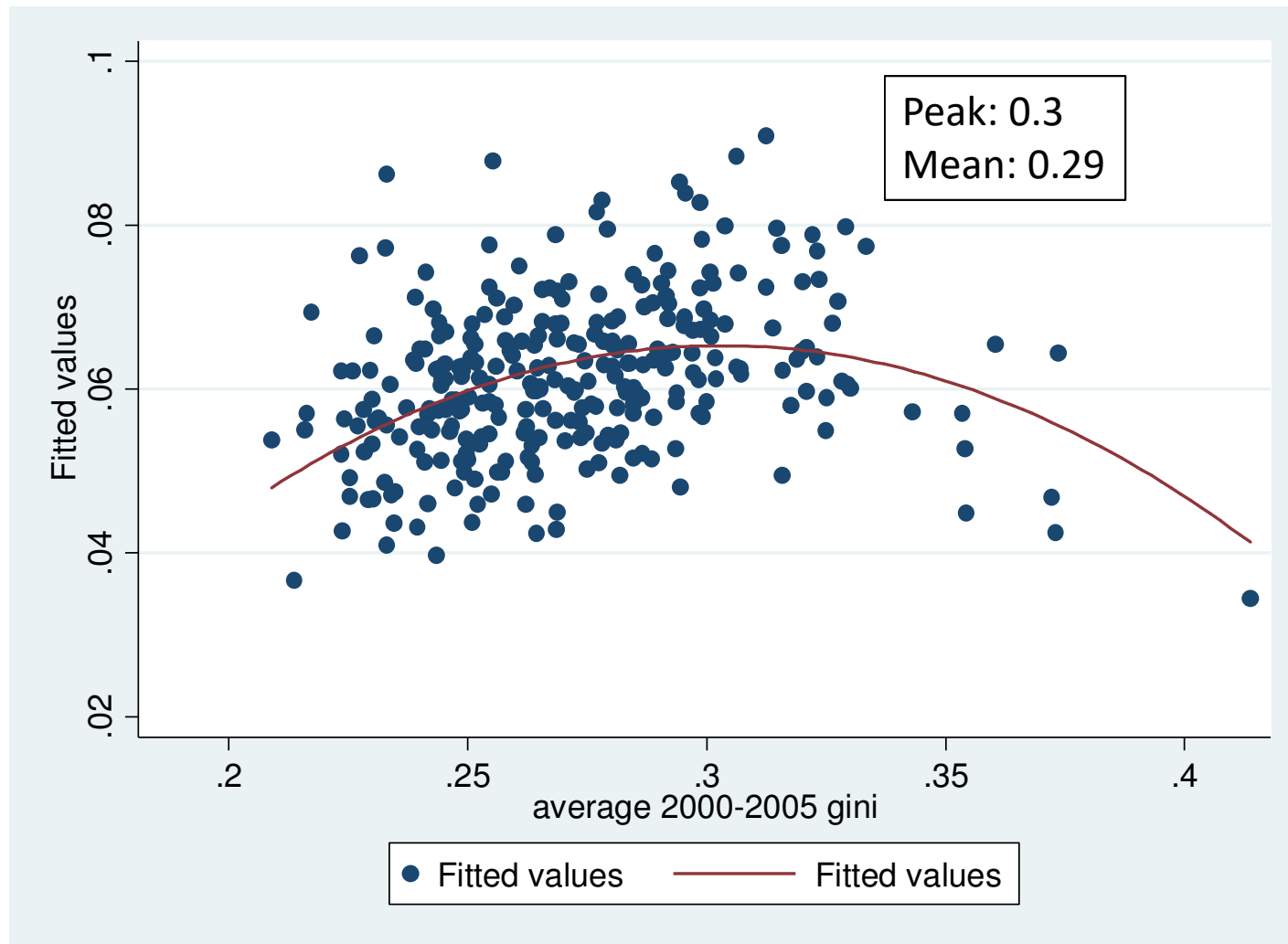


Source: Susenas. Authors' calculation





# Increasing inequality will eventually (1) reduces economic growth, .....



Source: Yumna et al., 2014



..... (2) reduces the power of economic growth to reduce poverty, .....

$$r = -3,699 (1 - i) g + residual$$

r = rate of change in poverty  
i = inequality (Gini Ratio) at initial period  
g = economic growth



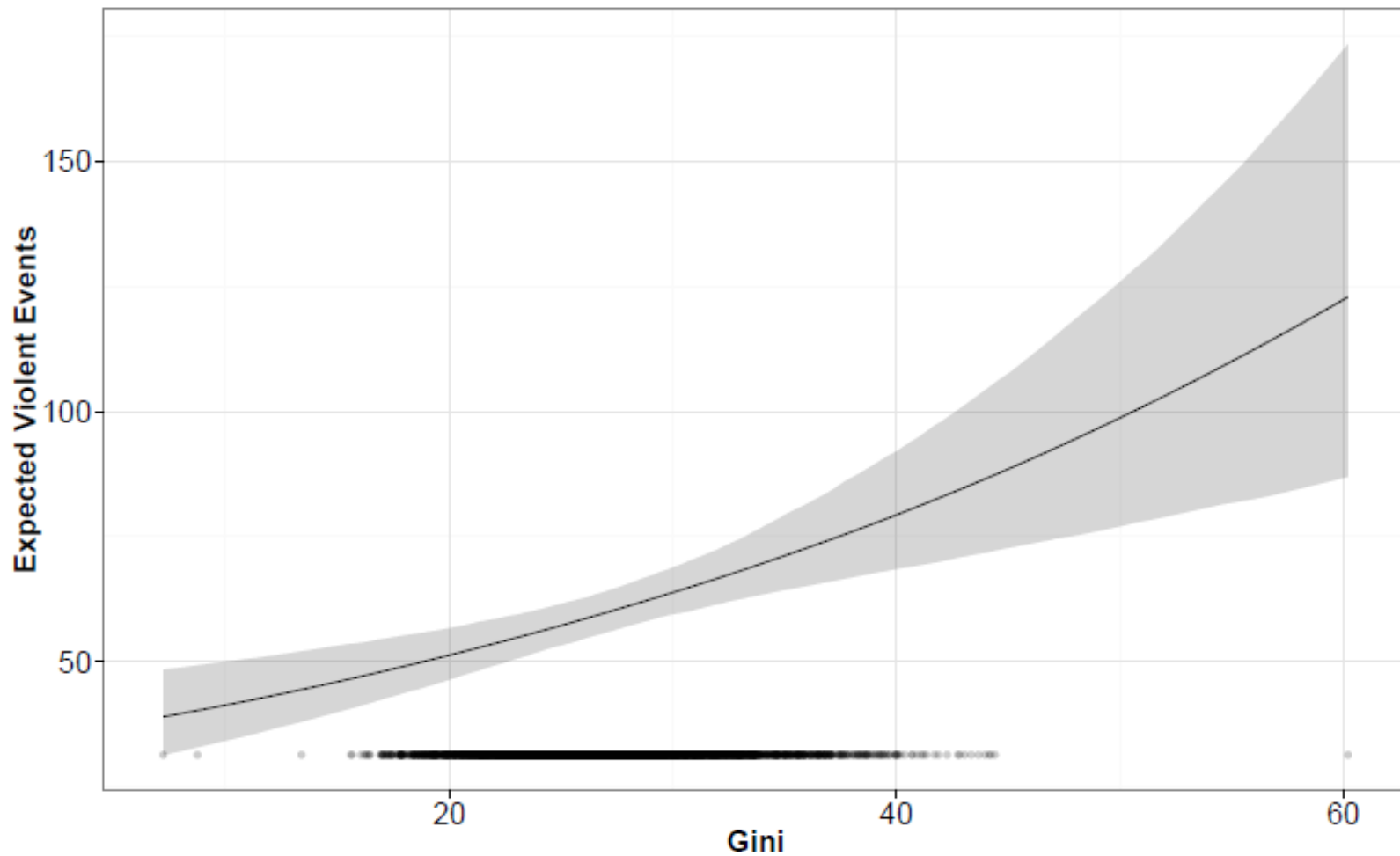
Inequality and Growth Elasticity of Poverty



Source: Suryadarma *et al.* (2010)



..... and (3) increases violent social conflict



Source: Pierskalla & Sacks, 2014

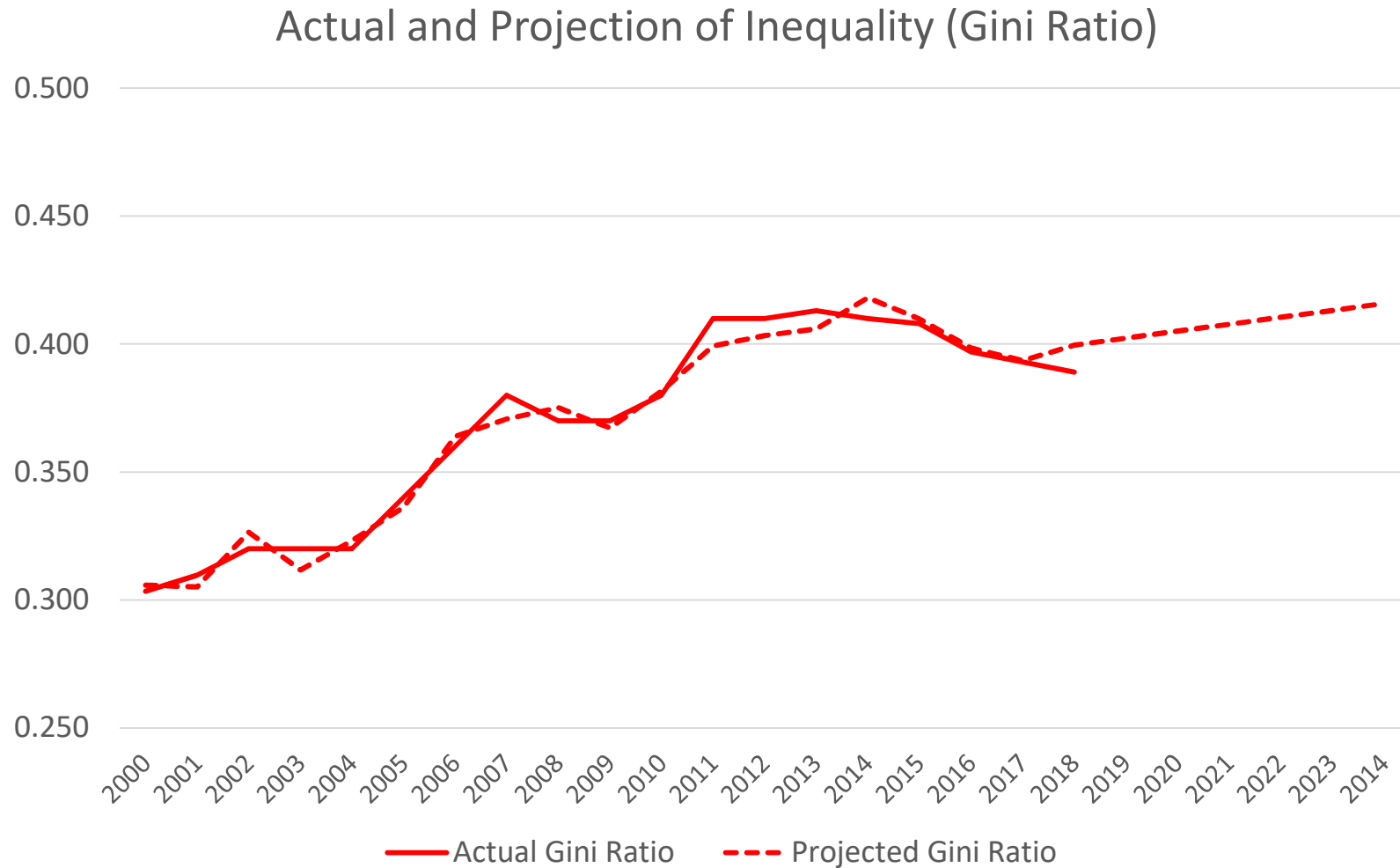


# Medium Term Outlook





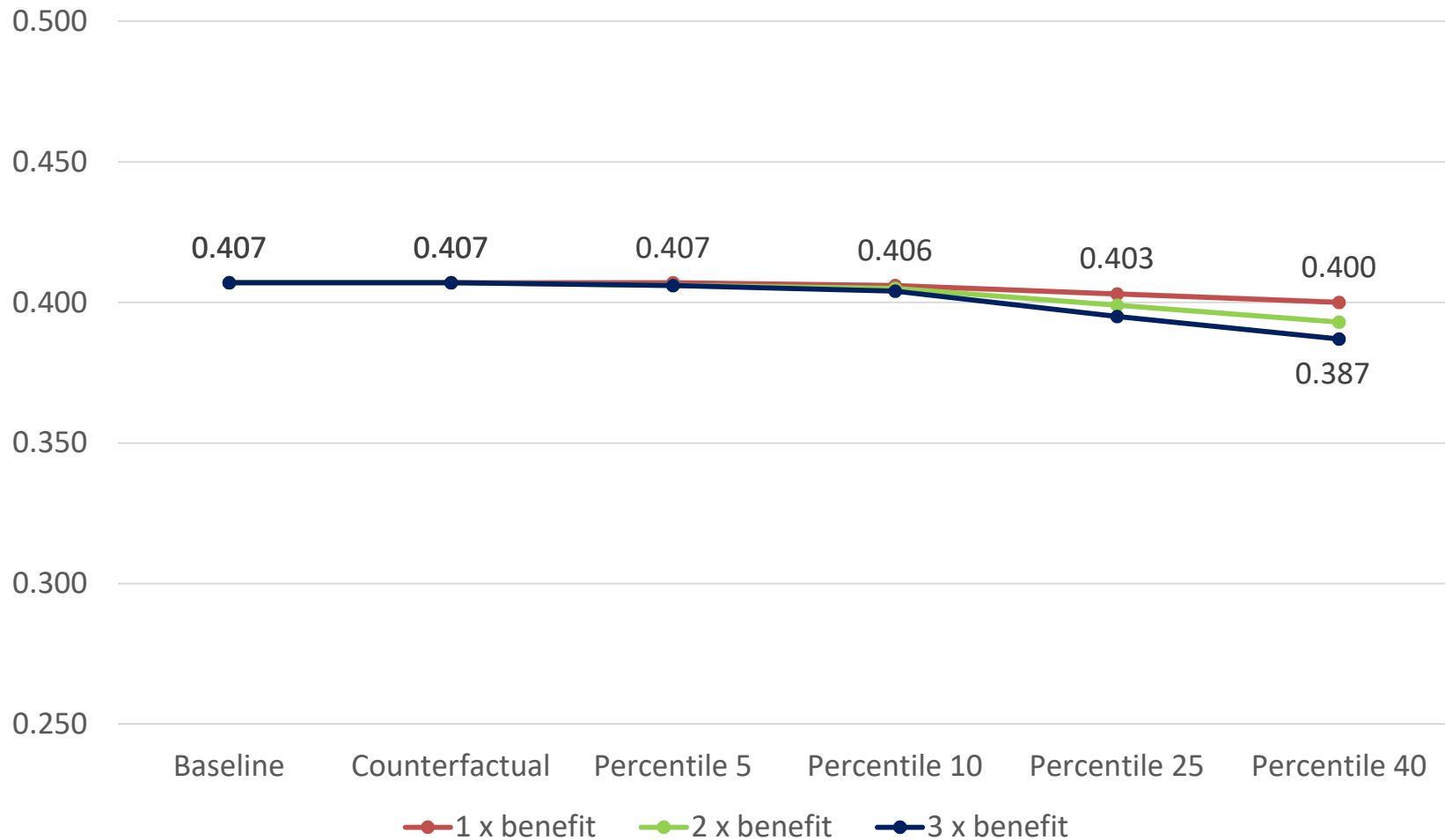
# Outlook: Structural factors will not yet bring inequality down in the medium term





# A very large investment in cash transfer will only have a limited impact on inequality

### The Impact of Cash Transfer on Gini Ratio





## Conclusion

- The increase in inequality in Indonesia is mainly due to development, which has brought changes in the economic and social structure
- Given that Indonesia is still in the increasing trajectory of Kuznet curve, a Gini Ratio of 0.4 or higher is the new normal
- To reach the decreasing trajectory of Kuznet curve sooner, where inequality will start to go down, Indonesia needs to speed up the structural transformation through:
  - Expanding education services further
  - Fostering industrial development
  - Facilitating formalization of economic activities
  - Increasing the rate of urbanization



# THANK YOU



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