

The Impact of Rising Inequality on Growth and Unemployment in Indonesia: What Does the Evidence Say?



Increasing Inequality in Indonesia

Consumption inequality has been rising in Indonesia over the last decade (see Figure 1). Before the onset of the Asian financial crisis (AFC) in 1997, Indonesia experienced little change in inequality. From 1980 to 1996, the Gini ratio (a standard economic measure of inequality), based on household consumption, fluctuated between 0.32 and 0.36.¹ While the impact of the AFC brought down inequality to Indonesia's lowest level since 1980 (0.30 in 2000), this was largely because the crisis hit those who were relatively well-off in urban areas harder than it hit Indonesia's poor in rural areas.

Key Messages

- Inequality has been on the rise in Indonesia during the last decade.
- Consumption inequality (inequality on how much households spend) affects future economic growth.
- Increases in education inequality (inequality on levels of educational attainment) have dire consequences for future unemployment rate.
- Rising inequality poses significant risk for the economy and human development.
- It is important to put policies in place to address inequality.

However, since recovering from the AFC in the early 2000s, the Gini ratio has increased rapidly and has reached new records of 0.41 in 2011 and 2012. Of course, rising inequality is not restricted to Indonesia; there is growing concern about the current trend of rising inequality across the world.²

Nonetheless, while some argue that inequality in income or consumption is necessary for the accumulation of assets or market incentive for long-term growth investment, our research³ finds that increasing inequality will actually lead to adverse growth. Consumption inequality is usually closely related to other forms of inequality, such as inequality in access to education, health, and public services. This often manifests as *inequality of opportunity*. These dimensions of inequality have significant detrimental effects on economic growth, and even political and social stability. Thus, in turn, it also poses substantial risk to human development.

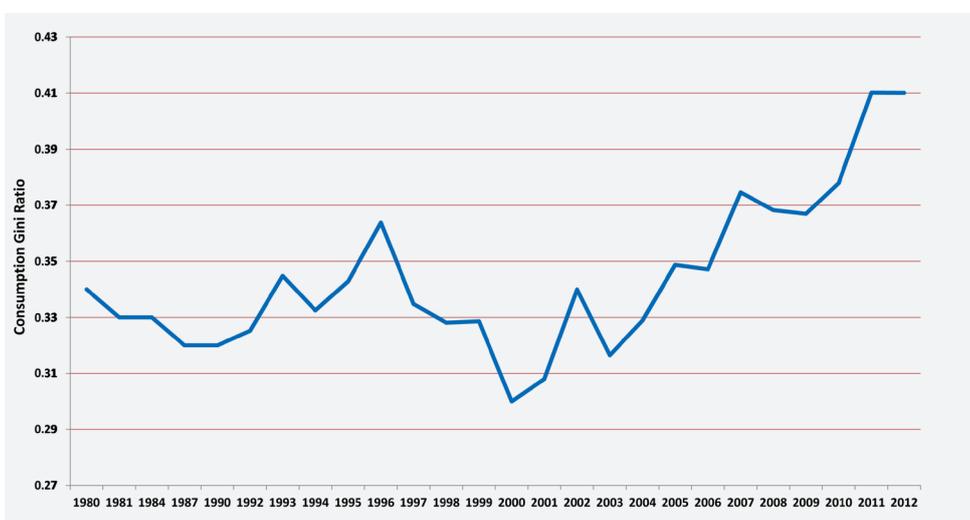


Figure 1. Trend of consumption inequality in Indonesia, 1980-2012

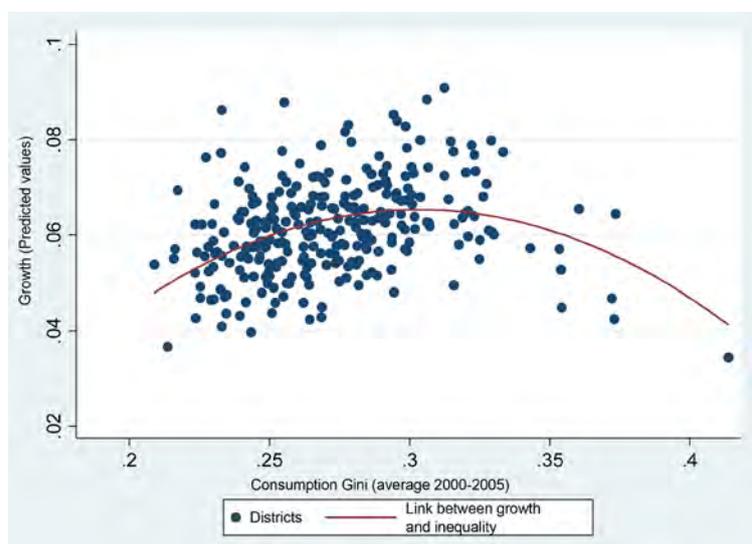


Figure 2. The impact of initial consumption Gini ratio on subsequent growth at district level

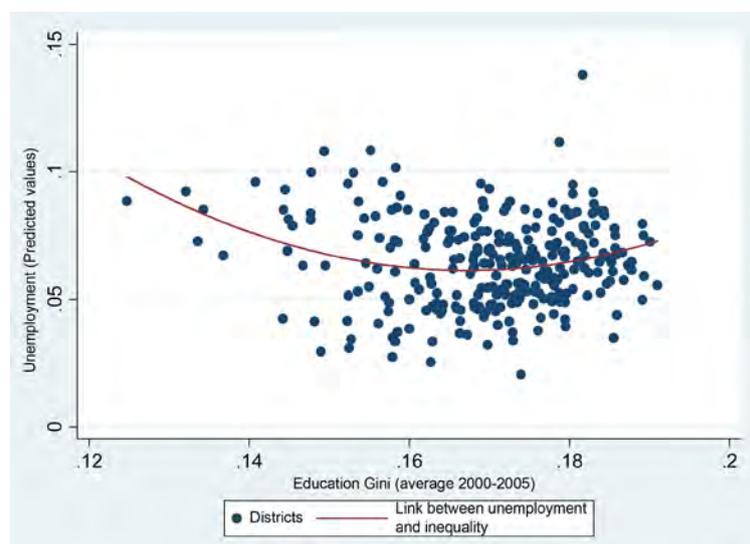


Figure 3. The impact of initial education Gini ratio on the subsequent unemployment rate at district level

The SMERU Research Institute

Authors: Athia Yumna & Asep Suryahadi

Editor: Liza Hadiz, Laura Simpson Reeves (Australian Volunteers International)

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Impact of Inequality on Economic Growth

SMERU's research finds that, initially, an increase in consumption inequality increases economic growth, but after reaching a certain point, further increases in inequality reduces economic growth. Based on the districts Gini ratios, we perceive that some districts in Indonesia have reached this peak point, and further increases in inequality will result in lower economic growth (see Figure 2).

Trends over the past decade indicate that increasing consumption inequality in urban districts, particularly in Java, Sumatra, and Kalimantan, will lead to a reduction in economic growth. Urban areas across Indonesia have generally developed more rapidly than rural areas and, consequently, consumption inequality has risen alongside other developments. Nonetheless, the data displayed in Figure 2 shows that negative impacts on growth will only be noticeable if increases in inequality are sustained over an extended period. Thus, any increases in consumption inequality should be addressed urgently and efficiently to ensure minimum negative impact on long term economic growth.

Impact of Inequality on Unemployment

While an analysis of inequality trends in Indonesia over the past decade indicates that there is no significant link between consumption inequality and unemployment, there is a strong relationship between education inequality and unemployment. As with consumption inequality and economic growth, past a certain point, increases in education inequality increases unemployment (see Figure 3).

As we can see from Figure 3, the majority of districts in Indonesia have already passed the threshold, indicating that any increases in education inequality will only increase unemployment. This will impact the unemployment rate in these districts both in the medium future and over the long term. The implication of increased education inequality on subsequent unemployment is even more serious than the previous condition on subsequent growth, suggesting concerns on education inequality should be raised and addressed urgently.

Policy Implications

Increasing inequality is a growing concern in many parts of the world, including Indonesia. The results of analyses in this study suggest that inequality does matter for economic growth and unemployment rate. Overall, the findings indicate that consumption inequality affects economic growth, while education inequality affects unemployment.

These findings suggest that we should treat inequality very cautiously. Initially inequality may not be harmful for growth and employment; however, after reaching a threshold, it will have an adverse impact. This implies that rising inequality poses a significant risk for both the economy and human development. Therefore, it is important to put in place policies to address increasing inequality to anticipate its harmful impact particularly for the districts that already passed the threshold. ■

¹ The value of 0 expresses perfect equality and a value of 1 maximal inequality.

² See, for example, the inequality report 'Divided We Stand' launched by OECD in 2011, the 'Inequality Matters' report published by the UN in 2013, and several research reports published by international institutions such as the IMF and ILO.

³ SMERU's research focused on district-level data with annual observations from 2000 to 2012. Because many new districts were established during this period, all districts are realigned to match the 2000 district borders.