

Does Economic Openness Contribute to The Increase of Income Inequality in Indonesia

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ABSTRACT: Two decades since the economic crisis in 1997, the household income inequality measured by gini ratio tended to increase. Many efforts have been done by the local government to increase people's income and to reduce inequality. One of these efforts is done by increasing economic openness. The objectives of this study are investigating the effect of economic openness on the income inequality in Indonesia. Two main variables used to measure economic openness are trade openness and investment openness. Trade openness is calculated as the ratio of province's total trade, the sum of exports plus imports, to the province's gross domestic product. Investment openness is measured as the ratio of FDI to the province's gross domestic product. In addition, this study also involves domestic variable that is useful as control variables. The fixed effect method is chosen to estimate the model with panel data set comprising 33 provinces for six years period, 2010-2015. The fixed effect panel data analysis revealed that the increase in trade openness potentially reduces income inequality while the increase in investment openness actually widen inequality.

KEY WORD: income inequality, trade openness, gini ratio, FDI

Date of acceptance: 19-12-2018

I. INTRODUCTION

As the income inequality in national and regional levels tends to increase, it has become the attention of the policy maker that it will potentially hamper the development process and lead to social problems. According to Sunarto (1993), inequality will make government facing social problems such as the increase of crime rate and the emergence of disharmony between groups of the community. In addition, income inequality will also lead to an increase in poverty due to the inherent pattern of resource ownership (Todaro and Smith, 2006).

Since the last decade (2006-2015), the Indonesian income inequality has shown a positive trend. This fact appears from one of the measurement tools of income inequality called a Gini ratio. In 2006, the Gini ratio was 0.36 and continued to increase until reached 0.41 in 2015. When compared to the previous decade (1996-2005), the Gini ratio was relatively low, which only fluctuated at 0.31 to 0.36. According to Arsyad (2010), high-income inequality in developing countries can be caused by high population growth, inflation, inequality of development and capital-intensive investments.



Source: BPS - Statistics Indonesia, processed

The widening of income inequality over the last decade has been in line with the high of annual average economic growth of 5.3%. The 10-year economic growth has not been able to decrease income

inequality. The obstacles to reduce income inequality increase in line with the economic openness both in the region and international scope. On a regional scope, the running of the ASEAN Economic Community (MEA) since December 2015 will trigger greater economic openness in Southeast Asia, potentially expanding international trade, increasing foreign investment and allowing foreign workers to enter Indonesia for economic activity.

In the context of regional autonomy, each region is given a freedom to export products directly to the world and to receive foreign investment and imported goods from abroad. Through the openness of the economy in the form of international trade is expected to create new jobs due to the increase in demand for export products. The community will be involved in the production process through their contribution of the production factors, such as labor, capital, and entrepreneurship. Furthermore, the community will get an income in the form of the remuneration of production factor. Such remuneration will be an income for the community so that the income distribution depends on the community participation in economic activity.

According to the neo-classical economist approach based on Heckscher-Ohlin and Samuelson theory, international trade will cause developing countries to specialize in the labor-intensive product. This is due to the abundance of low-skilled labor with low prices. Increased production through such specialization will increase labor demand so that the wage rates will also be pushed up. Finally, income will be gradually distributed both within and between regions (Oktaviani, 2014). However, the empirical study in some countries show the opposite result which economic openness actually widened the income inequality. A recent study by Kremer and Maskin (2006) suggested that the more open a country's economy, the more diminished the recruitment of uneducated labor would be and replaced by an educated labor. It would trigger the income inequality among the citizen of a country.

In Indonesia, it is not known whether economic openness could reduce regional income inequality in accordance with Heckscher-Ohlin's theory or enlarge inequality in accordance with empirical study conducted by Kremer and Maskin (2006). By looking at the provincial data level, high inequality occurs in the provinces of the center of the economy on the Java Island. In fact, these provinces have a high economic growth and access to international trade. The opposite condition occurs in provinces with low economic openness such as North Maluku Province whose the income distribution tends to be evenly distributed with a gini ratio only 0.28. The uncertainty of the relationship between economic openness and income inequality at the regional level is interesting to be examined as a consideration for the government to address the era of free trade. So the objective of this research is to investigate the effect of economic globalization on the income inequality in Indonesia.

II. LITERATURE REVIEW

Economic openness

Economic openness is an increase of economic integration and economic interdependence in national, regional and local coverage through intensification of goods movement, services, technology, and capital (Joshi, 2009). Economic openness is measured by trade flows, foreign direct investment and portfolio investment, as well as trade barriers by the government. In an empirical study, the economic openness is divided into trade openness and financial openness. Trade openness is measured from the ratio of trade (the sum of export and import) to Gross Domestic Product (GDP). Financial openness is measured by FDI (Foreign Direct Investment) and portfolio investment (Jaumotte et al., 2008). Kant in Rajan (2001) argued that financial openness should be measured from FDI flows as it shows the flow of permanent capital investment, while portfolio investment is dominated by speculative decisions. Financial openness or investment openness is usually measured as the ratio of FDI to GDP.

Income Inequality

Todaro and Smith (2006) distinguished two main dimensions of income distribution namely functional income distribution and personal income distribution. The functional income distribution describes the proportion of income received by each production factor in accordance with its contribution to national production. While the personal income distribution directly calculates the amount of income received by each person or household regardless of where the source is. One measure of the personal income distribution is the gini ratio.

Trade Openness - Income Inequality Relationship

The effect of trade openness on income inequality has been explained in some economic theories. Ehrhart (2005) illustrated how neo-classical economists explain the process of income distributed under the Heckscher-Ohlin theorem. Developing countries with abundant labour rather than capital will specialize in the production of labour-intensive goods. When trade occurs, the labour-intensive developing countries will

experience an increase in the price of labor and a decrease in the income of capital owner. So it can be concluded that international trade tends to reduce income inequality.

However, neo-classical theory is criticized by economists who believe that international trade will widen the income inequality. Kremer and Maskin (2006) argued that trade will benefit to the developed regions and make a loss to the developing regions. The less educated workers of developing countries often become the obstacles to the absorption of labour in international trade markets.

Investment Openness – Income Inequality Relationship

Krugman and Obstfeld (2000) define FDI as an international capital flows from a country to establish or expand business in another country, accompanied by transferring resources and controlling over company decision. The neo-classical trade theory pioneered by Heckscher-Ohlin model can be used to provide a simple explanation for the relationship between the investment openness (the ratio of FDI to GDP) to income inequality in developing countries. This theory assumes that educated and uneducated labor as the abundant production factors in developing countries. Developed countries have an advantage in the ownership of capital production factors. Capital flows in the form of direct investment from developed countries to developing countries will increase the demand for labour both educated and uneducated labour so that the level of wages will be evenly distributed gradually.

On the other hand, Faustino and Vali (2012) stated that dependency theory has a different way from neo-classical theory in explaining the influence of FDI on inequality. This theory reveals that in the long term, the economic dependence of developing countries on developed country have a harmful impact on the socio-economic condition in developing countries. The economists argued that FDI penetration in developing countries will hamper economic growth and lead to income inequality. Multinational companies that investing capital-intensive goods in developing countries will bring benefits and prosperity to their home countries.

Domestic Variables - Income Inequality Relationship

The study of Simon Kuznets (1955) became a reference for income inequality analysis, especially in developing countries. It concluded that high-income growth to inequality has a positive relationship in the short term. The higher income per capita, the greater the difference between the poor and the rich. This phenomenon is known as the Kuznets Inverted U-curve. The opposite condition happened in the long run, income per capita will be able to reduce income inequality.

In addition, a high-income growth is usually followed by inflation. The relationship between inflation to income inequality begins by first looking at the impact of inflation on the firm performance. Inflation will lower the firm's profit because it leads to an increase in production costs and a decrease in people's purchasing power. Furthermore, the company will also reduce the number of employees for efficiency and reduce production due to the decreased of consumers demand (Crowe, 2006). The final impact of the inflation is the rise in unemployment resulting in widening the gap between the poor and the rich.

Inflation also provoked the labor unions to insist the increase of wage, where the government responds it by raising the minimum wage. Neoclassical economists argued that in perfectly competitive markets, the minimum wage will increase the income gap. The increase of minimum wage makes more people offer to work in the economy while employment is in declining condition. It causes an increase in unemployment which will increase income inequality. (Montgomery, 2014).

To increase the production capacity due to the inflation, a company also needs capital in the form of bank credit. According to Simorangkir (2000), credit is useful as a source of capital for companies to expand the business. The impact of this expansion is the increase in employment that encourages the equity of income. Pamungkas et al. (2016) in his study concluded that the credit provided by banks in Indonesia has a significant effect on income inequality. However, the large-scale enterprises and consumption credits actually increased inequality.

Other domestic variables that determine the income inequality are government spending allocated for remote areas and mean years of schooling. Cheong and Wu (2013) used the government spending allocated for remote areas in China as one of the factors affecting income inequality. In the case of Indonesia, those variable could be proxied by the local government spending for community and village empowerment. Mubyarto in Hatu (2010) stated that community empowerment is a process aimed at developing human resources for the creation of business opportunities in accordance with the wishes of the community.

Mean years of schooling is the average number of years spent by adults aged 15 years and over for all types of formal education. It was used by Wahyuni and Monika (2016) to see the effect of education on income inequality in Indonesia using the National Labor Force Survey (Sakernas) data in 2013. This study concluded that the effect of education on income differs on various income distributions, in another word it raises income inequality.

Empirical study of literature

The study that addresses the effects of economic openness to income inequality often makes different conclusions. Jaumotte et al. (2008) studied the effect of globalization to income inequality in developed and developing countries. Globalization variable is measured by technology, trade, and financial openness. Technological openness is measured by the ratio of capital-ICT (information and Communication Technology) to total physical investment, trade openness is measured by the ratio of exports and imports to GDP and financial openness is measured by the ratio of FDI-GDP and the ratio of portfolio investment-GDP. The study concluded that technology gives the greatest influence among the three determinants of inequality. Trade openness significantly reduces inequality whereas financial openness increases inequality.

A similar study was conducted by Cheong and Wu (2013) using provincial data in China. However, the economic openness is only measured by trade openness and financial openness without involving technology. The conclusions obtained by Cheong and Wu (2013) contradicted with the results resulted by Jaumotte et al. (2008). According to this study, trade openness in China actually increases inequality while the investment openness reduces inequality. Cheong and Wu (2013) and Jaumotte et al. (2008) also include several control variables to measure the effects of economic openness.

III. RESEARCH METHOD

Types and Source of Data

Two main variables used to measure economic openness are trade openness and investment openness. The first step of the analysis is descriptive techniques with spatial thematic map applied to give the illustration about the characteristic of provincial income inequality, trade openness and investment openness in the recent year. Then, we use a static panel estimation techniques to measure the effect of economic openness on the income inequality in Indonesia. In addition, this research also involves domestic variable that is useful as control variables such as income per capita, minimum wage, bank lending, mean years of schooling, inflation, local government expenditure allocated to empowering community and villages. Data used in this study is panel data set, comprising 33 provinces for six-year period, (2010-2015) which is obtained from BPS-Statistics Indonesia, and Indonesian Ministry of Finance (Kemenkeu).

Panel Regression Analysis

The linear regression model of panel data can be written as follows

$$y_{it} = \alpha_{it} + X_{it}\beta + u_{it} ; \quad \text{for } i = 1, \dots, N; \quad t = 1, \dots, T \quad (1)$$

where N is the number of individuals (cross-sectional units) and T is the number of time periods. In the X_{it} there are k slopes (excluding intercepts) indicating the number of independent variables used in the model. While α_i is an individual effect that can be constant over the period t or even vary across the individual i . The panel data analysis has three independent approaches: independently pooled panels; random effects models and fixed effects models (Baltagi, 2008)). The selection between these methods depends upon the objective of our analysis, and the problems concerning the exogeneity of the explanatory variables. The static panel regression model used in this study can be formulated

$$GINI_{it} = \alpha_i + \beta_1 TO_{it} + \beta_2 FDI_{it} + \beta_3 GRDPPC_{it} + \beta_4 INF_{it} + \beta_5 MWAGE_{it} + \beta_6 LOAN_{it} + \beta_8 MYS_{it} + \beta_{11} GOVEX_{it} + \varepsilon_{it} \quad (2)$$

where $GINI_{it}$ is the Gini ratio, TO_{it} is trade openness measured by the ratio of trade (export + import) to nominal GRDP (Gross Regional Domestic Product), FDI_{it} is investment openness measured by the ratio of FDI to nominal GRDP, $GRDPPC_{it}$ is income per capita measured by the nominal GRDP divided by population expressed in million rupiah, INF_{it} is inflation rate, $MWAGE_{it}$ is minimum wage measured by the provincial minimum wage (UMP) in million rupiah, $LOAN_{it}$ is bank credit measured by the ratio of bank credit to nominal GRDP, MYS_{it} is mean year of school and $GOVEX_{it}$ is the ratio of government expenditure for community and village empowerment to total GRDP.

IV. RESULTS AND DISCUSSION

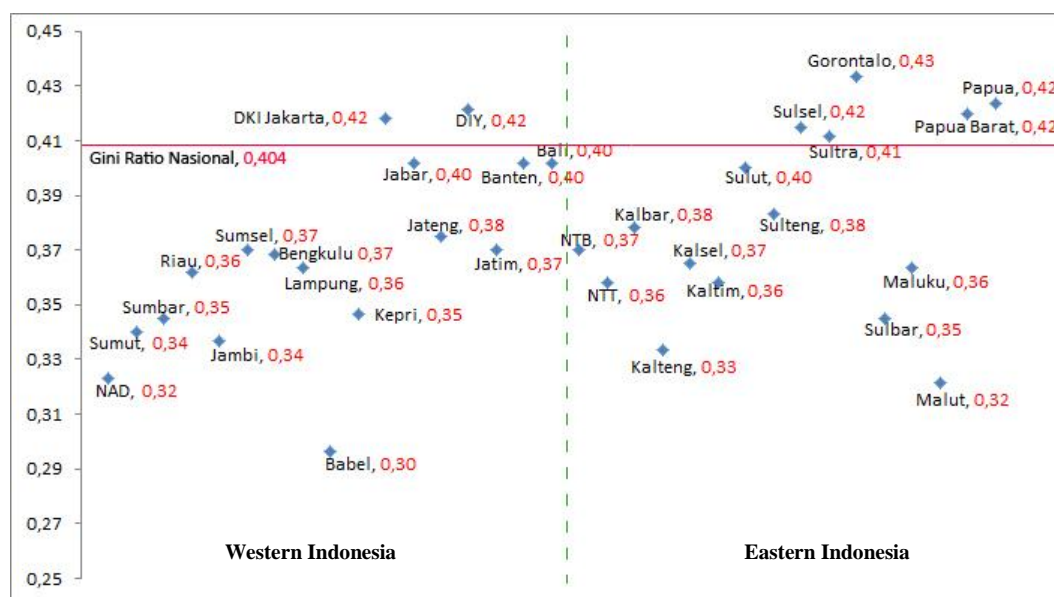
An Overview of Provincial Income Inequality in Indonesia 2010-2015

Since 2000, the Indonesia's Gini ratio has been increasing gradually. Even, the inequality started to enter the moderate stage (Gini ratio 0,4-0,5) in 2011. It was difficult to escape from that stage for several years. If we look at the regional context, there is a high variety in inequality across province. The provinces in western region, especially in Java Island-like DKI Jakarta, DI Yogyakarta, West Java, Banten, and Bali, reach the moderate level of inequality. The rising of inequality in Java Island is associated with the quality of economic growth. The economic sector that absorbs dominant labor like agriculture and manufacturing sector grows slower. On the other hand, the growth of services sector has been accelerating since 2000, while the

characteristics of these sectors are capital intensive that generates relatively few jobs. This condition makes the income of the richest household segment increases in huge rate but the income of the poorest segment increases in low rate.

The high inequality not only happens in Java Island - the Indonesia's highest concentrations of economic activities but also happens outside the Java Island region with less concentration of economic activities. Figure 2 shows that the provinces outside the Java Island have a high gini ratio of around 0,4 to 0,5 as same as the Java Island. Even in several provinces, especially in eastern region, reached the level of inequality above the national average-like Gorontalo, Papua, and West Papua. The problems faced by these provinces are related to the economic condition of lower class society. According to the Susenas (Indonesia-National Socio-Economic Survey) data, it could be seen that the poverty rate in Papua and West Papua are quite high, around at 30% in 2010-2015. It implied that the expenditure of the 40% poorest of the households becomes low. Meanwhile, the income and expenditure of the 20% richest households increases due to the existence of the modern multinational mining firms.

Figure 2. Average of Provincial Gini Ratio by Region, 2010-2015



Source: BPS - Statistics Indonesia, processed

Plotting of Provincial Characteristics about Trade Openness, Investment Openness and Income Inequality in 2015

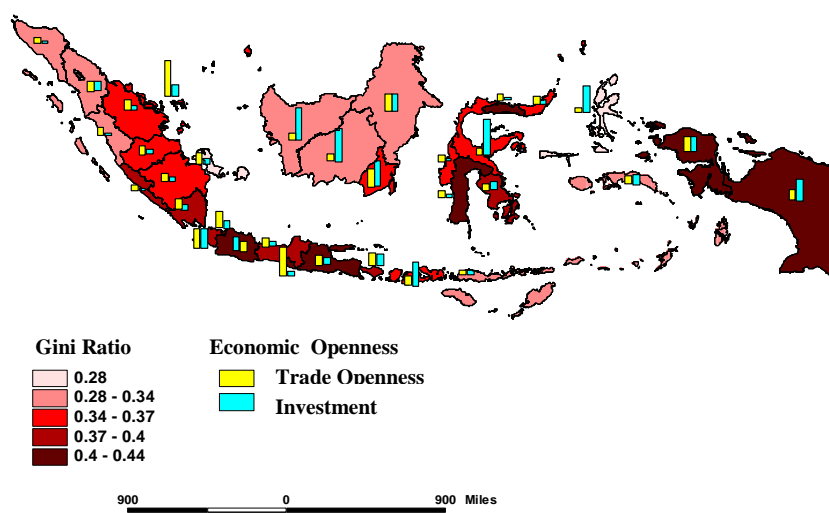
Trade openness that determined by the value of exports, imports and GRDP is varied across province. There are provinces that have heavily interactions on international trade but others tend to be closed. By province, the high trade openness in Indonesia is concentrated in western Indonesia. The highest trade openness in Indonesia has occurred in Riau Islands - one of the industrial center in Java Island. The economy of Riau Islands heavily depends on international trade which is indicated by the value of trade openness near 1. In addition, the location of this island which is located in the middle of the Malacca Strait also gives strong supports to international trade activities.

The allocation of Indonesia's FDI is still concentrated in the provinces as the center of economy located in western region. Java Island dominates the realization of investment in Indonesia with West Java Province as the largest, followed by Jakarta and East Java Province. According to Lall (1997) in Kurniati (2012), the determinants of investment inflow in host country are the availability of raw materials, location, availability of infrastructure, labor conditions, industry integration and access to markets. Some factors of those investor attractions are owned by the provinces in western region of Indonesia, especially the Java Island.

If the value of FDI is divided by GRDP, we obtain the investment openness. The province investment openness in Java Island is relatively small, which is less than 10%. The top three provinces with the highest investment openness are located outside the Java Island, such as Central Sulawesi, Central Kalimantan, and West Kalimantan Provinces. Meanwhile, the provinces with small investment openness are Aceh and West Sulawesi.

If trade openness, investment openness, and income inequality are plotted in a thematic map, we can see the characteristics of each region based on the three variables. Provinces with high inequality such as Papua and West Papua also have high investment openness. However, the provinces of Sulawesi Island and parts of Java Island that have relatively high inequality tend to have low investment openness. Trade openness also shows an indeterminate pattern, the provinces in Java Island with high inequality is relatively open to international trade. Meanwhile, the provinces in Sulawesi Island which also have high inequality are relatively closed to international trade. Quantitative analysis with panel regression will clarify the relationship between economic openness and income inequality by considering the influence of some control variables.

Figure 3. Gini Ratio, Trade Openness and Investment Openness of 33 Provinces in Indonesia, 2015



Source: BPS - Statistics Indonesia, processed

The Estimation of Income Inequality-Panel Regression Model

The quantitative analysis begins with the selection of the best models in the study. From Chow test, it can be concluded that the fixed effects regression is better than common effects. Similar results are also obtained from the Hausman test, which concludes the fixed effects model is better than random effects. From the results of the two tests, the best regression model is fixed effects. Meanwhile, from the classical assumption test, it is detected that there is non-homogenous residual variance. To overcome such heteroscedasticity, the regression model will be estimated using the EGLS (Estimated Generalized Least Square) method with cross-sectional weights.

Table 1. Panel Regression Model Estimate – Determinant of Inequality in Indonesia

Variabel Independen	Koefisien	Prob.
C	0,44168**	0,0001
TO	-0,08992**	0,0309
FDI	0.14659***	0.0024
LOAN	0.00096*	0.0410
GRDPPC	0.00258**	0.0067
INF	-0.00161	0.0506
MWAGE	-0.00409	0.6789
MYS	-0.02153	0.1490
GOVEX	0.00452	0.9844
Jumlah Observasi		198
R-squared		0.882025
Adjusted R-squared		0.851968
F-Statistic		29.34483
Prob (F-Statistic)		0.000000

***Signifikan pada 1%, **signifikan pada 5%, *signifikan pada 10%

By looking at the significance of F-test, it can be concluded that simultaneously variables of trade openness, investment openness, per capita income, inflation, minimum wage, bank credit, mean year of schooling and government expenditure for community and village empowerment have a significant effect on

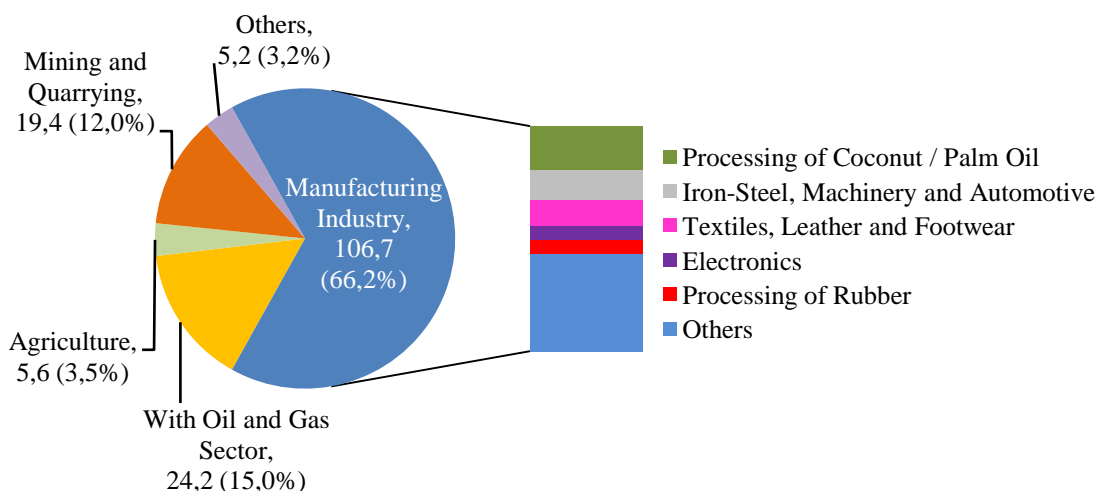
income inequality at alpha 5%. The results of the data processing also obtained adjusted R-squared of 0.85 which means that the change in income inequality can be explained by 85% of independent variables, while 15% explained by other variables.

The Effect of Trade Openness on Income Inequality

Table 1 shows that trade openness significantly affects income inequality with 95% significance. If the trade openness increased by 1 unit then the gini ratio decreased 0.08992 units with the assumption that all other variables remain constant. The influence of trade openness in Indonesia that is capable of reducing income inequality is in line with the neo-classical economists approach based on the Heckscher-Ohlin theorem. Developing countries tend to specialize and export labor-intensive products. This is due to the abundance of low-skilled labor with low prices. Increased production will increase labor demand so that the level of wages will also be pushed up. Eventually, income will be equally distributed within a region.

Study about the impact of economic openness on income inequality in Indonesia has also been done by Muradi (2014) where exports could reduce income inequality while FDI widened the income distribution. Using data at the country level, similar study has also been conducted by Ehrhart (2005) in the American developing countries and eastern Asian countries including Indonesia. The study concluded that trade openness reduces income inequality whereas FDI inflows increases inequality.

Figure 4. The Exports Value by Sector and Industry in Indonesia, 2015 (Billion USD)



Source: BPS - Statistics Indonesia, processed

In order to obtain a clarity of the relationship between trade openness and inequality, we need to look at the profile of international trade by the components. The composition of Indonesian exports is generally dominated by non-oil and gas commodities obtained from the manufacturing sector. In 2015, Indonesia's processing industry sector dominated Indonesia's export value of 106.7 billion USD (66.2%) followed by oil and gas sector which contributed 24.2 billion USD (15.0%). The largest value of exports in the industrial sector is found in processed agricultural products, especially palm oil. The top three industrial groups that produce the highest exports are the coconut/palm oil processing industry; iron, steel, machinery and automotive industries; and industrial textile products, leather goods, and footwear.

Another component of trade openness is the import of goods and services. If we look at the composition, Indonesia's imports are dominated by raw materials. The import value of raw materials, capital goods, and consumer goods in 2015 amounted to 21.35%, 15.56% and 14.16%, respectively. Indonesia's imports will have a positive impact in reducing inequality if imported raw materials are able to encourage the development of domestic industries so that the labor force will be absorbed.

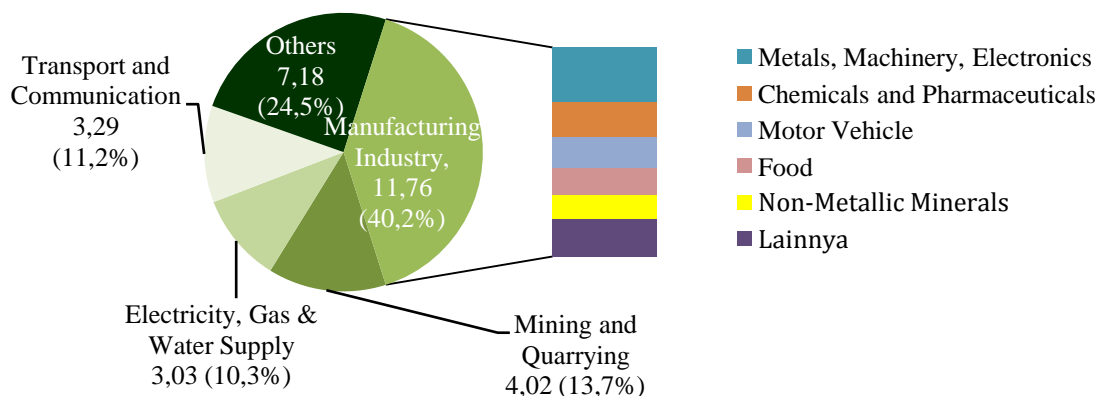
The Effect of Investment Openness on Income Inequality

From Table 1, it can be concluded that the investment openness has a significant effect on increasing income inequality with 99% significance with the assumption that other variables remain constant. The effect of investment openness that widening income inequality is dominantly due to the structure of FDI. In recent years, the composition of FDI inflow in Indonesia is dominated by capital-intensive investments. This result is also consistent with Velde's (2004) study which concludes that not all types of workers have a positive effect on investment openness. Investment openness that carries high technology will lead to an increase in the bargaining value of skilled workers. This could happen because the factory machinery cannot be operated by unskilled

workers. This will indirectly increase income inequality because the bargaining power of uneducated labor does not increase. Besides, the composition of the labor force in Indonesia is still dominated by uneducated workers.

By looking at FDI by sector, the top three which foreign investors are targeted in 2015 is the manufacturing sector with 11.76 billion USD (40.2%); mining and quarrying 4.02 billion USD (13.7%); and transportation, warehousing and communications 3.29 billion USD (11.2%). Since 2011, FDI inflow has always been dominated by manufacturing sector. However, the manufacturing sector targeted by investors is still capital-intensive, such as metal and machinery; chemical and pharmaceutical; and motor vehicle and other transportation industries.

Figure 6. The Realization of FDI by Sector and Industry in Indonesia, 2015 (Billion USD)



Source: Indonesia Investment Coordinating Board (BKPM), processed

During 2010-2015, capital-intensive investments are strongly dominated FDI inflow. In 2015, the realization of labor-intensive investment was only 55.5 trillion rupiahs far below the capital-intensive investments whose reached 489.9 trillion rupiahs. The high realization of capital-intensive investment makes the demand for labor not large and more focused on skilled and educated worker. This condition tends to widen the income inequality.

The Effect of Domestic Control Variable on Income Inequality

Among the six domestic variables used as control variables in this study, only two variables significantly affect inequality under the 95% confidence interval. These variables are credit distributed by banks and income per capita. Both variables have an effect to increase income inequality.

From Table 1, we can interpret that with a 95% confidence level, the increase of one unit ratio of credit-GRDP will increase the gini ratio by 0.00096 units. The effect of credit that widened the income inequality in Indonesia are related to the small allocation of bank credit for Micro Small Medium Enterprises (MSMEs) (Pamungkas et al., 2016). In 2015, the credit distributed by banks for MSMEs was only about 830.7 trillion rupiah (19.9%) of 4,176.4 trillion rupiahs total credit. From the amount of credits for MSMEs, only 64.2 trillion rupiahs (7.7%) is allocated to the agriculture sector, which is a population base with low income.

The effect of income per capita on inequality shows a positive relationship with a 99% confidence level. Any increase of 1 million rupiahs of income per capita will increase the Gini ratio by 0.00258 units given the other variables remain constant. This condition is in line with the Kuznets Inverted U-curve theory where developing countries will have high income growth per capita and begin the growth with inequality, but at a given level of income per capita, the distribution will show improvement towards equity.

In addition, the structural transformation that does not work properly in Indonesia could also be another cause. The Indonesia’s economy which is initially dominated by the agriculture sector is slowly being shifted to manufacturing sector. However, the shift in economic share is not followed by the shift in labor absorption. The largest employer is still dominated by the agriculture sector. The increase of income in manufacturing sector has potentially widened the income inequality as the percentage of employment in this sector is relatively small. Most of Indonesian is still working in agriculture sector which the share declines.

V. CONCLUSION AND RECOMMENDATION

Conclusion

1. The panel data revealed that the increase in trade openness potentially reduces income inequality while the increase in investment openness actually widen inequality. The bad effect of FDI on income distribution in Indonesia can be seen from the structure of FDI that more concentrated in capital-intensive sectors. The

domestic control variables that significantly affect inequality are bank lending and income per capita. The bank lending gives a negative effect on income equality the same as income per capita.

Recommendation

1. Foreign direct investment with capital-intensive tends to increase inequality. The government can facilitate the arrival of foreign investors that are more labor intensive to reduce inequality. Textile, leather, and footwear industries are some of the most labor-intensive industries that has to be developed in Indonesia.
2. Local governments need to issue policies that are able to encourage exports of regional products.
3. Future research may consider dividing the quantitative analysis by region in order to get more in-depth conclusions.

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