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Economic Growth, Education, and the Islamic Finance Paradox: Evidence from Income Inequality in Indonesian Provinces

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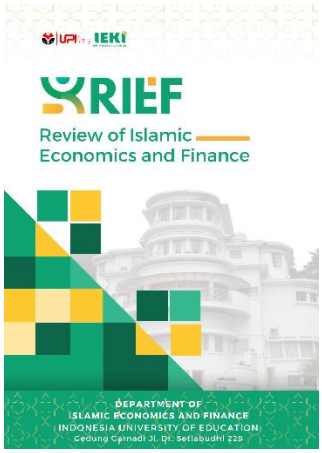

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Abstract

Purpose *– This study aims to examine the determinants of income inequality in Indonesia, with a particular focus on the roles of economic growth, education, and selected socio-economic factors across provinces.*

Methodology *- The study employs panel data from 34 provinces in Indonesia over the period 2010–2023. A panel regression approach is utilized to analyze the effects of economic growth, education, Islamic bank financing, poverty, female labor force participation, and unemployment on income inequality.*

Findings *- The results indicate that economic growth significantly increases income inequality, suggesting that the benefits of growth are not evenly distributed across income groups. In contrast, education plays a significant role in reducing inequality by enhancing human capital and promoting social mobility. Islamic bank financing is found to have no significant effect on inequality. Poverty exacerbates income inequality, while female labor force participation and unemployment do not show statistically significant impacts.*

Implication *- This study is limited to provincial-level data and may not capture micro-level disparities. Future research could incorporate household-level data and explore additional institutional variables.*

Keywords: *Income inequality; economic growth; Islamic bank financing; education*

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1. INTRODUCTION

Income inequality remains a crucial economic issue in Indonesia (Akita, 2002; Sulistyaningrum & Tjahjadi, 2022), despite significant progress in poverty reduction over the past two decades. The Gini coefficient, a widely used measure of income inequality, peaked at 0.41 in 2013 before declining to around 0.38 in recent years (BPS, 2023). While this suggests a slight improvement, disparities persist, particularly between urban and rural areas and across provinces. Economic growth has not been evenly distributed, with wealthier regions such as Jakarta, Bali, and East Java experiencing higher incomes compared to less-developed provinces like Papua and West Nusa Tenggara. These persistent inequalities raise concerns about economic mobility, social stability, and sustainable development in the country (Dorofeev, 2022; Le Caous & Huarng, 2020; Mishra & Kumar, 2018; Sari et al., 2025).

Understanding the factors driving income inequality is essential for designing effective policies to promote inclusive growth (Furceri & Ostry, 2019). Economic factors such as employment structure, industrial composition, and wage distribution play a significant role in shaping disparities (Ghosh et al., 2023; Hidayah et al., 2025; Kollmeyer, 2013). The transition from an agricultural-based economy to an industrial and service-based economy has created wage gaps, with urban areas benefiting more from structural changes. Additionally, globalization and technological advancements have contributed to skill-biased inequality, where high-skilled workers earn significantly more than low-skilled workers (Çelik & Basdas, 2010; Goyal & Aneja, 2020).

Education is another critical determinant of income inequality (Abdullah et al., 2015; Teulings & Van Rens, 2008; Yang & Qiu, 2016). Higher educational attainment is strongly correlated with better job opportunities and higher earnings. However, disparities in access to quality education, particularly between urban and rural areas, limit economic mobility for lower-income households. The Indonesian government has introduced various policies, including scholarship programs and curriculum improvements, to enhance education quality and accessibility. Despite these efforts, gaps in educational attainment remain a challenge, affecting long-term income distribution. Munir & Kanwal (2020) find unequal distribution of education among boys and girls at primary level increases income inequality and more recent research by Moyo et al. (2022) confirm that higher educational attainment leads to a decline in poverty levels.

Economic factors are widely recognized as important drivers of income inequality in literature. However, empirical studies yield inconclusive results, showing that economic growth can have mixed effects on inequality depending on how its benefits are distributed. Kuznets's (2019) inverted U-shaped hypothesis suggests that in the early stages of development, inequality increases as capital accumulation primarily benefits the wealthy, but in later stages, it declines as broader economic participation, and social policies enhance income distribution. Empirical findings vary; for instance, Dollar & Kraay (2002) find that economic growth tends to benefit the poorest 40% of the population proportionally, whereas Piketty (2014) argued that without redistribution, high growth can concentrate wealth among the rich. Likewise Berg & Ostry (2017) highlights that persistent inequality can, in turn, hinder long-term growth by restricting human capital development and undermining social stability. Thus, the relationship between economic growth and income inequality is complex and context dependent.

While numerous studies have explored income inequality in a global context, there remains a critical need for a comprehensive analysis at the national level, particularly in Indonesia. Examining income inequality using panel data across provinces allows for a deeper understanding

of the long-term effects of economic and educational factors, capturing regional variations and structural disparities. A key research question in this context is: How do economic and educational factors influence income inequality? Economic growth, financial development, labor market dynamics, and capital accumulation can either reduce or exacerbate inequality, depending on how wealth and opportunities are distributed. Similarly, education plays a fundamental role in shaping income mobility, as access to quality education enhances skills and employability.

This article is structured as follows: Section 2 outlines the literature review and hypotheses. Section 3 describes methodology. Section 4 presents empirical results and discussion. Section 5 concludes.

2. LITERATURE REVIEW

2.1. Islamic Finance and Income Inequality

Islamic finance is often conceptualized as a tool for promoting social justice and reducing income inequality, grounded in principles such as risk-sharing, prohibition of interest (*riba*), and the encouragement of ethical investments (Askari et al., 2012; Rama, 2015). Instruments such as *zakat*, *waqf*, and profit-and-loss sharing financing are theoretically designed to enhance wealth redistribution and support financially excluded groups. In this sense, Islamic finance should function as an inclusive financial system that mitigates inequality by channeling funds toward productive and socially beneficial activities. Empirical studies, however, provide mixed evidence. While some findings suggest that Islamic financial development can reduce inequality by improving access to finance (Barata, 2019), others indicate that its impact remains limited due to structural and institutional constraints.

This gives rise to a paradox: despite its normative emphasis on equity and redistribution, Islamic finance does not always translate into measurable reductions in income inequality. One explanation lies in the operational practices of Islamic financial institutions, which often mirror conventional banking models by prioritizing low-risk, profit-oriented financing such as *murabaha*, rather than equity-based contracts like *mudaraba* and *musharaka* (Alharbi, 2015; Rama & Kassim, 2013; Remali & Wilson, 2005). As a result, financing may disproportionately benefit established firms or higher-income groups with better collateral and creditworthiness, thereby limiting its inclusivity. Additionally, the relatively low penetration of Islamic finance in certain regions and the lack of integration with social finance instruments further constrain its redistributive potential.

2.2. Hypothesis Development

Omar & Inaba (2020a) examine the impact of financial inclusion on poverty and income inequality in developing countries. Using panel data regression analysis, the findings indicate that that financial inclusion contributes to macroeconomic growth, poverty reduction, and greater income equality in these nations. The study supports the notion that inclusive financial systems enhance economic opportunities by providing credit, savings, and insurance mechanisms that help individuals and small businesses accumulate wealth and mitigate financial shocks.

Similarly, Altunbaş & Thornton (2022) investigate the relationship between inflation targeting and income inequality, arguing that monetary stability plays a crucial role in reducing income disparities. The results confirm that effective inflation targeting helps stabilize purchasing power, maintain real wages, and reduce uncertainty in financial markets, benefiting lower-income groups who are most vulnerable to price fluctuations. This finding, however, contradicts Sima &

Hudson (2019) suggesting that inflation targeting may disproportionately benefit wealthier individuals by preserving the value of financial assets.

Berisha et al. (2020) investigate the effects of various macroeconomic factors on income inequality in BRICS countries, revealing a positive relationship between wage levels, inflation, and interest rates with income disparities. The findings suggest that higher wages do not necessarily lead to income equality if wage growth is concentrated among higher-income groups, while inflation and interest rates disproportionately burden lower-income populations, reducing their purchasing power and access to credit. Hailemariam et al. (2021) extend this discussion by emphasizing the role of non-economic factors such as innovation and education in shaping income disparities. The results highlight that while technological advancements can drive economic growth, they may also exacerbate inequality if access to innovation and education remains unequal, favoring skilled workers over low-skilled labor.

Meanwhile, Heshmati & Lee (2010) examine the broader impacts of economic growth and globalization on income inequality, finding that globalization has a negative effect on inequality, suggesting that global economic integration disproportionately benefits higher-income groups and multinational corporations. This aligns with concerns that trade liberalization and capital mobility can lead to wage suppression and job displacement for lower-skilled workers.

Based on these findings, our study argues that economic factors play a significant role in shaping income inequality. Thus, we propose the following hypothesis:

Hypothesis 1 (H1)*: Economic factors have a significant impact on income inequality*.

The role of education in shaping income inequality has been widely debated in the literature, with studies presenting mixed findings on its overall impact. Breen & Chung (2015) find that education has only a minor effect on income inequality, suggesting that while higher education may improve individual earnings, it does not necessarily lead to a more equal income distribution. This could be due to structural labor market factors, where high-income individuals continue to benefit from better access to prestigious institutions and lucrative job opportunities, reinforcing existing income disparities.

In contrast, Shahabadi et al. (2018) provide a more nuanced perspective, finding that primary and secondary school participation significantly reduces income inequality, while higher education participation increases it. The finding implies that basic education serves as an equalizer, giving individuals from lower-income backgrounds essential skills to compete in the job market. However, at the higher education level, disparities emerge as elite institutions and advanced degrees tend to be more accessible to wealthier students, leading to a concentration of high-paying jobs among privileged groups. This finding highlights the importance of policies that improve access to quality higher education for underprivileged populations, such as scholarships and affirmative action programs.

Yang & Qiu (2016a) further emphasize the importance of early childhood education investment, arguing that direct subsidies to low-income parents are the most efficient and effective policy to address financial constraints in early education. Their study suggests that early investment in human capital yields long-term benefits, as children from disadvantaged backgrounds who receive quality early education are more likely to succeed academically and professionally. A counterargument, however, is that while direct subsidies are effective, they must be complemented by broader structural reforms, including curriculum improvements, teacher quality enhancement, and job market alignment, to maximize their impact on reducing inequality (Abdullah et al., 2015).

Collectively, these findings suggest that education plays a crucial role in shaping income inequality. Building upon this argument, our study posits that educational factors significantly influence income inequality. Accordingly, we propose the following hypothesis:

***Hypothesis 2 (H1)**: Educational factors have a significant impact on income inequality*.

3. METHODOLOGY

3.1. Data and Source

This study utilizes a comprehensive panel dataset covering 34 provinces in Indonesia over a 14-year period, from January 2010 to December 2023. The primary data source is the monthly statistical reports published by the Financial Services Authority (OJK) and the Central Statistics Agency (BPS), which provide detailed and reliable information essential for this research. The dataset includes key variables such as *income inequality*, represented by the Gini ratio (*Y*), along with *economic factors*—including regional economic growth (*X1*) and Islamic bank financing (*X2*)—as the main independent variables. Additionally, the study incorporates educational factor, represented by the average years of schooling (*X3*), as well as control variables, including the number of people living in poverty (*X4*), female labor force participation (*X5*), and unemployment rate (*X6*). By leveraging this extensive dataset, the study explores how economic growth and education along relevant control variables influence income inequality across different regions in Indonesia.

3.2. Model Specification

To test the hypotheses, this study employs panel data regression analysis using the following basic equation model:

$$Y_{it} = \beta o_i + \beta_1 X_{1it} + \beta_2 X_{2it} + \beta_3 X_{3it} + \beta_4 X_{4it} + \beta_5 X_{5it} + \beta_6 X_{6it} + \epsilon_{it} \qquad (1)$$

Where:

- Y_{it} represents income inequality (Gini ration) for the *i-th* observation unit at time *t*.
- X_{1it} denotes regional economic growth.
- X_{2it} represents Islamic bank financing.
- X_{3it} refers to the average years of schooling.
- X_{4it} denotes to the amount of poverty.
- X_{5it} measures female labor force participation.
- X_{6it} denotes the unemployment rate.
- ϵ_{it} is the error term, and β_0 through β_6 are the parameters to be estimated.

The analysis employs panel data estimation techniques, including the Common, Fixed, and Random Effects models. Model selection is conducted using the Chow and Hausman tests, while hypothesis testing is performed through F-tests, t-tests, and R^2 analysis. Panel regression is chosen for its ability to minimize errors, enhance variable diversity, and improve efficiency by reducing issues related to classical assumption violations (Basuki & Prawoto, 2016; Gujarati, 2006). This approach provides robust insights into the dynamic relationships between economic, education, and income inequality in Indonesia.

4. RESULTS AND DISCUSSION

To determine the most appropriate model among the Common Effects Model (CEM), Fixed Effects Model (FEM), and Random Effects Model (REM), a series of statistical tests are conducted sequentially. *First*, the Chow Test is performed to compare the Common Effects and Fixed Effects models. If the *p*-value of the cross-section *F*-statistics is less than 0.05, the Fixed Effects Model is preferred; otherwise, the Common Effects Model is retained. Given that the Chow Test results in a probability value of 0.0000, which is below the 0.05 significance threshold, the null hypothesis (which assumes the Common Effects Model is appropriate) is rejected. Instead, the Fixed Effects Model is selected as its better accounts for unobserved heterogeneity across cross-sectional units, leading to a more accurate representation of the data.

Following this, the Hausman Test is conducted to compare the Fixed Effects and Random Effects models. If the Fixed Effects Model is chosen in the previous step, this test determines whether the Random Effects Model can provide consistent estimates. The Hausman Test results indicate a probability of 0.0004, which is also below the 0.05 threshold. This suggests that the Random Effects Model is inconsistent, as there is a significant correlation between the individual effects and explanatory variables. Consequently, the Fixed Effects Model is deemed the most suitable for this study, ensuring more reliable and consistent estimates.

Table 1: Panel Data Regression Model Selection

Test	Probability Value	Description
Chow Test	0.0000	The Fixed Effects Model (FEM) is preferred over the Common Effects Model (CEM)
Haussman Test	0.0004	The Fixed Effects Model (FEM) is preferred over the Random Effects Model (REM)

Table 2 presents the panel regression results for the Common Effects Model (CEM), Fixed Effects Model (FEM), and Random Effects Model (REM). Based on model selection tests, the FEM is identified as the most appropriate model for this study. Therefore, our analysis will primarily focus on the results obtained from the FEM, as it provides robust insights into the relationship between income inequality and various economic and educational factors across Indonesian provinces from 2010 to 2023. The adjusted R^2 value of 0.792 indicates that 79.2% of the variation in income inequality is explained by the independent variables, demonstrating a strong explanatory power. The *F*-statistics of 47.087 with a probability value of 0.000 confirm the overall significance of the model, suggesting that the independent variables collectively influence income inequality.

The panel data regression equation for the selected fixed effects model, as summarized in Table 2, is as follows:

$$Y = 0457450 + 4.58E\text{-}08X_1 + 0.005014X_2 - 0.0.027589X_3 + 0.049060X_4 - 0.000455X_5 - 0.000785X_6$$

Table 2: Estimation results

Variables	Common	Fixed	Random
Economic growth (X_1)	2.59E-08***	4.58E-08***	3.46E-08***
	(6.74E-09)	(1.16E-08)	(9.83E-09)
Islamic bank financing (X_2)	-0.013947***	0.005014	0.001634
	(0.003241)	(0.004038)	(0.003697)
Schooling years (X_3)	-0.002795	-0.027589***	-0.023781 ***
	(0.002278)	(0.002750)	(0.002558)
Number of poverty (X_4)	0.023340***	0.049060***	0.016671
	(0.005584)	(0.015411)	(0.010454)
Female labor participation (X_5)	-0.001387***	-0.000455	-0.000730*
	(0.000347)	(0.000452)	(0.000414)
Unemployment rate (X_6)	0.000139	-0.000785	-0.000198
	(0.000932)	(0.000787)	(0.000728)
Contant	0.419110***	0457450***	0.533933***
	(0.025985)	(0.049881)	(0.038067)
Obs.	473	473	473
Adj. R-squared	0.179720	0.792016	0.258291
F-statistic	18.23560	47.08728	28.39462
Prob(F-statistic)	0.00000	0.00000	0.00000
Durbin-Watson stat	0.279463	1.167849	1.044318

*Note: *, **, and *** denote significance levels of 10%, 5%, and 1%, respectively. Numbers in parentheses represent standard deviations.*

Economic growth has a significant positive effect on income inequality. A unit increase in regional economic growth increases income inequality, contradicting the notion that higher economic activity can help bridge income disparities. This finding contradicts with Kuznets' hypothesis (2019), which suggests that income inequality initially rises with economic growth but later declines as economies mature. Studies by Banerjee & Duflo (2003) and Dollar & Kraay (2002) similarly highlight that growth reduces inequality in the long run. However, Islamic bank financing does not show a statistically significant impact on income inequality in this model. This result contrasts with Abduh & Omar (2012) and Rama (2013) suggesting that Islamic finance plays a role in promoting financial inclusion and reducing poverty. However, it aligns with Widodo (2019) arguing that Islamic financing is often concentrated in corporate and commercial sectors, limiting its direct impact on income distribution. Overall, these findings support Hypothesis 1 (*H1*) that economic factors have a significant impact on income inequality.

Education demonstrates a strong negative relationship with income inequality, indicating that an increase in the average years of schooling contributes to a more equitable distribution of income. This finding supports Becker's (1964) human capital theory, which posits that investment in education enhances individual productivity, improves employability, and ultimately leads to greater income equality. By equipping individuals with better skills and knowledge, education enables access to higher-paying jobs and reduces the income gap between different socioeconomic groups. Furthermore, education fosters upward social mobility, allowing individuals from disadvantaged backgrounds to improve their economic standing over time. Empirical studies by

Barro (20000) and Castelló & Doménech (2002) further reinforce this argument, demonstrating that higher levels of education are consistently associated with lower income inequality across various countries and regions. Additionally, a well-educated workforce contributes to overall economic growth, which in turn helps narrow income disparities. The findings of this study strongly support Hypothesis 2 (*H2*) that educational factors have a significant impact on income inequality.

The results from the control variables provide valuable insights into the factors influencing income inequality. The analysis reveals that poverty has a significant positive effect on income inequality, suggesting that regions with a higher number of impoverished individuals tend to experience greater disparities in income distribution. This finding aligns with Bourguignon (2004) emphasizing the bidirectional relationship between poverty and inequality, where higher poverty levels exacerbate economic disparities, creating a cycle that is difficult to break. In regions with widespread poverty, access to economic opportunities, education, and financial resources is often limited, further reinforcing inequality (Bourguignon, 2004).

While female labor force participation exhibits a negative coefficient, indicating a potential reduction in income inequality, the effect is not statistically significant in the fixed effects model. This result contrasts with studies by Seguino (2000) and Kabeer (2021) finding d that increased female employment plays a crucial role in narrowing income gaps by enhancing household earnings and reducing economic dependency. Similarly, the unemployment rate does not show a significant impact on income inequality in this model. This finding is inconsistent with the theoretical framework proposed by Galor & Zeira (1993) arguing that higher unemployment rates tend to exacerbate income inequality by reducing earnings mobility and increasing economic disparities. One explanation for this result is the presence of labor market rigidities or the dominance of informal employment structures in Indonesia, where many workers engage in low-wage or temporary jobs that do not substantially affect measured income inequality. The insignificant effect may also suggest that social safety nets and household coping mechanisms, such as reliance on family support or informal sector employment, mitigate the direct impact of unemployment on inequality.

5. CONCLUSION

This study examines the impact of economic and educational factors on income inequality in Indonesia, highlighting the significant role of regional economic growth and education in shaping income distribution. The findings indicate that economic growth has a positive effect on income inequality, suggesting that as regions experience higher economic activity, income disparities tend to widen. This contradicts Kuznets' (2019) hypothesis suggesting that inequality should decline as economies develop. Instead, the findings align with studies that argue economic expansion initially benefits higher-income groups more than lower-income groups, leading to a rise in inequality. Additionally, Islamic bank financing does not show a statistically significant impact on income inequality, implying that while Islamic finance promotes financial inclusion, its benefits may be concentrated in corporate and commercial sectors rather than directly addressing income disparities. These results highlight the need for inclusive economic policies that ensure broader wealth distribution across different socioeconomic groups.

Education emerges as a crucial factor in mitigating income inequality, as greater access to schooling enhances individual productivity, employability, and social mobility. The results support human capital theory, demonstrating that increased educational attainment reduces income disparities by providing individuals with better skills and access to higher-paying jobs. Meanwhile,

control variables such as poverty show a significant positive effect on inequality, reinforcing the cycle where poverty exacerbates economic disparities. Although female labor force participation and unemployment do not show statistically significant effects in this model, previous research suggests that under certain labor market conditions, these factors can influence income inequality.

The implications of this study emphasize the need for policy interventions that foster inclusive economic growth and equitable access to education. Policymakers should ensure that economic expansion benefits all income groups by promoting policies that support small businesses, entrepreneurship, and job creation in lower-income sectors. Additionally, education policies should focus on improving access to quality schooling, particularly in underprivileged regions, to enhance skill development and reduce long-term inequality. Strengthening financial inclusion strategies-especially within the Islamic finance sector-can further contribute to narrowing income disparities by ensuring that financial services reach marginalized communities. Furthermore, targeted poverty alleviation programs should be reinforced to break the cycle of poverty and inequality, while labor market policies should promote gender-inclusive employment opportunities. By integrating these strategies, Indonesia can achieve more equitable and sustainable economic development.

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