

The Middle Class in Indonesia: The Shrinking Engine of Growth

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The middle class is the population group who are above the lower class (the poor) and below the upper class (the rich). The precise definition of the middle class differs in different contexts. Furthermore, the measure to rank the population also varies and can be based on income, consumption, wealth, education, occupation, etc. Therefore, there is no consensus on what threshold to use to distinguish the middle class from the lower and upper classes (Dartanto et al., 2020).

Nevertheless, the middle class usually consists of a significant number of population and plays an important role in a country's economic, political, and social aspects. Furthermore, an empowered middle class can expand individual rights and lead to a more accountable state (The Economist, 2024). Hence, the middle class often leads the critical thinking and becomes the driver of change in a country.

World Bank (2019) defines the middle class as those who enjoy economic security, meaning that they are free from risk of falling into poverty. Using the poverty line (PL) as the benchmark, the report classifies the socio-economic groups in Indonesia into five classes: (i) the poor ($<PL$), (ii) the vulnerable to poverty ($1-1.5*PL$), (iii) the pre-middle class ($1.5-3.5*PL$), (iv) the middle class ($3.5-17*PL$), and (v) the upper class ($>17*PL$).

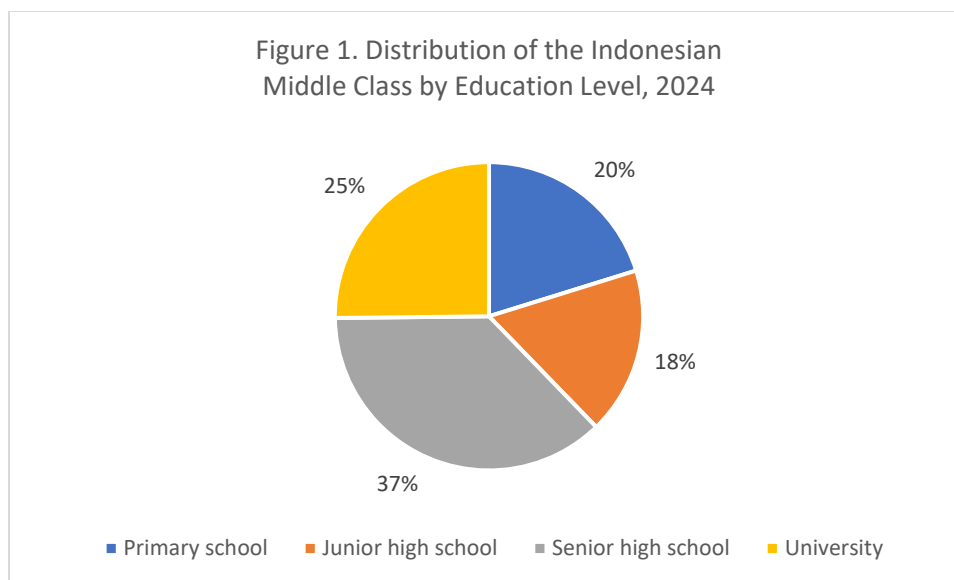
Using this definition, in 2024, the middle class in Indonesia is a group of population whose per capita household expenditure is around Rp 2 million (USD 133) to Rp 10 million (USD 667) per month. They consist of 47.85 million people or make up 17.13% of the total population. The government has targeted the middle class to reach 70% of the population by 2045, the 100th anniversary of the Indonesian independence.

The Role of the Middle Class and Its Recent Trends in Indonesia

The middle class is the backbone of the economy in many countries, including Indonesia. The reason is because they usually have high purchasing power and become the driving force of domestic consumption. The middle class usually allocates a larger part of their income for non-food consumption. This makes them the main market for health, education, and other services such as hotels, restaurants, amusement parks, and transportation providers, as well as durables such as cars, motorcycles, refrigerators, and air conditioners. According to World Bank (2019), about half of total household consumption in Indonesia is contributed by the middle class.

The Indonesian middle class is dominated by the productive age group. Hence, they are the main driver of the country's economic growth. Dartanto et al. (2020) find that the majority of middle class households live in urban areas and have higher levels of education, capital, and medical expenditure. Education is an important determinant of achieving the middle class status in Indonesia (see Figure 1).

Figure 1. Distribution of the Indonesian Middle Class by Education Level, 2024



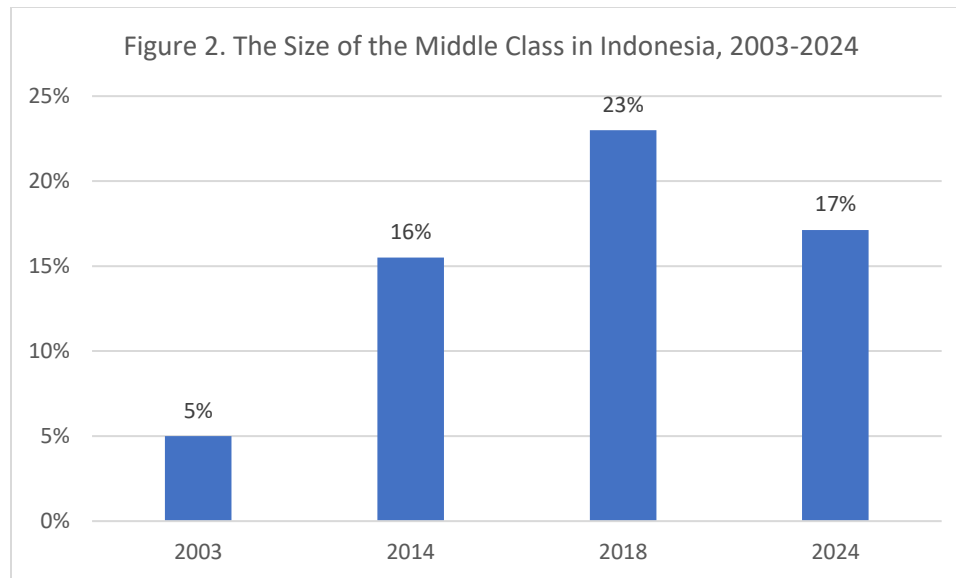
Source: https://assets.dataindonesia.id/2024/11/13/1731463008403-33-PPT-Report_Kumpulan-Data-Seputar-Kelas-Menengah-di-Indonesia-hingga-2024.pdf

The analysis by World Bank (2019) confirms that the expansion of the middle class has helped to sustain Indonesia's high economic growth. A growing middle class has led to higher domestic consumption because they have a higher marginal propensity to consume than the rich, and more income than the poor. In addition, the middle class also plays a very important role in state revenues, contributing about half of the tax revenues.

The middle class is also a source of entrepreneurship and job creation. Furthermore, the middle class supports growth by strengthening social cohesion and enhancing political stability. Finally, the process of growing the middle class supports human capital investments and faster poverty reduction.

To achieve the target to become a high-income country by 2045, Indonesia needs to sustain and accelerate economic growth and public investments. This requires Indonesia to substantially expand its middle class. Tax revenues from the growing middle class will be critical to fund the investments in health, education, infrastructure, and productivity necessary for Indonesia to keep developing (World Bank, 2019). The findings of Dartanto et al. (2020) suggest that investment in human and physical capital are the two main strategies to expand the middle class.

The size of the middle class in Indonesia has grown from just about 5% of the population in 2003 to 23% in 2018. Dartanto et al. (2023) find that the growth of the middle class in Indonesia can be attributed, in part, to upward trends in intergenerational mobility. However, since then the trend has reversed. The number and proportion of the middle class continues to decline in the period 2018-2024. In 2024, the size of the middle class has declined to 17.13% percent of the population (see Figure 2).



Source: <https://katadata.co.id/infografik/66cfdafdd198f/infografik-degradasi-jumlah-kelas-menengah-indonesia> and <https://databoks.katadata.co.id/infografik/2024/09/05/populasi-kelas-menengah-indonesia-kian-berkurang>

During the last five-year period, the size of the middle class decreased by about 6 percentage points or 9.5 million people. On the other hand, the size of the pre-middle class increased by 8.7 million people during the same period. This indicates that the reduction in the size of the middle class is due to many of them falling down to the pre-middle class. This confirms Dartanto et al. (2020) that middle class households are very economically vulnerable, as most are unable to retain their economic status over long period of time.

In other Asian countries, the trend of steady deceleration in the growth of the middle class is also observed. Between 1991 and 2014, the average annual growth rate in the number of Asian middle-class households was 6%, but in the following decade, it has slowed to just 2%. Similar to Indonesia, in some Asian countries, including China, the size of the middle class has shrunk (The Economist, 2024).

The Causes of Shrinking Middle Class in Indonesia

The decline of the middle class in Indonesia is caused by a combination of interacting economic, social, and policy factors. Among the economic factors, premature deindustrialization is considered one of the main causes of the shrinking middle class phenomenon (Anggina, 2024). This factor is related to declining foreign direct investment and exports (The Economist, 2024).

The decline of the manufacturing industry has triggered businesses to carry out massive workforce cuts. A consequence of these layoffs, the number of informal sector workers has increased. The share of informal sector workers increased from 38.29% of the total workforce in 2019 to 40.64% in 2024. Informal sector workers receive relatively lower wages than formal sector workers, have low or no labor protection, and hence, are more vulnerable to economic shocks.

The Covid-19 pandemic has exacerbated the decline in the middle class size. The effects of the pandemic in 2020, which hit the Indonesian economy hard, are still felt now on the economy. These problems are

made worse by government policies that burden the middle class, such as the increases in value-added tax (VAT) rates and various levies, which has suppressed people's purchasing power. The Economist (2024) also points to rising food prices as another factor that has hit the middle class.

In addition to these external factors, internally many of the people in the middle class face a high debt burden. The middle class often relies on credit and loans to finance housing, vehicles, education, and other consumption. When economic conditions worsen, interest rates rise, or incomes decline, this debt burden can become a heavy financial pressure. The Economist (2024) finds that high household debt has strangled middle class borrowers.

Added to this is the condition that the Indonesian middle class has minimal social safety nets. The government of Indonesia targets its social protection programs to the poor and vulnerable population, who are defined as the bottom 40% of the welfare ranking. When the Covid-19 hit, the government faced difficulty to target the social assistance programs to the middle class, who was hit hard by the pandemic (Suryahadi et al, 2021).

The Consequences of Shrinking Middle Class and the Policy Options for Its Revival

The decline in the middle class has a significant impact on the economy. Some of the immediate effects are a decline in the savings balance and consumption. In addition, economic pressures and reduced purchasing power make the middle class more careful in spending their money, causing spending on services and durable goods to decline.

As a result, for example, Indonesia has experienced deflation for five consecutive months during the period of May-September 2024. Furthermore, tax contributions will decrease further and potentially worsen Indonesia's already low tax-to-GDP ratio. All of this will ultimately lead to lower economic growth and adversely affect people's welfare and slower poverty reduction.

The difficult situation faced by the middle class in Indonesia needs to be addressed sooner than later as it also reflects the unfavorable condition of the Indonesian economy. If unresolved immediately, it can have an adverse effect on the government targets to achieve the high-income country status, 70% of middle class, and zero poverty by 2045.

To overcome this problem, the first step is for the government to evaluate various policies that have the potential to add burden to the middle class, such as the increases in VAT and other levies imposed on the middle class. The government also needs to strengthen the social safety nets and public services for the middle class. A strong social protection for all can help the middle class cope with economic uncertainty and other risks (World Bank, 2019). Expanding access to affordable health insurance and education for the middle class can reduce their financial burden. Social assistance programs should not only cover the poor and the vulnerable groups, but also the pre-middle class and the middle class who are facing economic hardship.

Furthermore, Indonesia needs to diversify its economy and innovate to reduce the dependence on certain vulnerable sectors, such as mining and crop estates. The government should encourage the development of new sectors that have high potential to absorb labor from the middle class, such as renewable energy, sustainable agriculture, creative industries, information technology, and tourism. In addition, the role of micro, small, and medium enterprises (MSMEs) needs to be strengthened through

better access to financing, training, and markets. MSMEs are the livelihood of a large proportion of the middle class people and, hence, need to be supported so they can grow.

Concluding Remarks

Indonesia experienced a rapid expansion of the middle class during the first two decades post-Asian Financial Crisis of 1997-1998. This is driven by a substantial increase in income per capita and the transformation of the Indonesian economy, making it possible for a large number of the poor to escape poverty and join the middle class. However, the trend has reversed since 2018, exacerbated by the Covid-19 pandemic in 2000-2001, which hit the middle class hard. On the other hand, there is a lack of social protection for the middle class.

This implies that strengthening social protection for the middle class is an important endeavor in the efforts to prevent the Indonesian middle class from shrinking further. In the longer term, access to and quality of education and skills training needs to be improved to increase the productivity of the middle class workers. Furthermore, the government needs to provide incentives to support the development of new sectors that can absorb middle class workers. Ultimately, this will increase the middle class's income and reduce their vulnerability to shocks.

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