Democracy and Financial Governance of Regional Economic Growth

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Abstract: The research focused on how the influence of democratic variables and regional financial governance on economic growth in Indonesia. The scope of the study uses data and information at the provincial level in Indonesia. A total of 34 provinces selected as study locations with observational periods ranging from 2010 to 2018. The results of panel data regression using the fixed-effect method, after going through the chow and haussmann tests. Variables of democracy and regional financial governance are significant influence the economic growth of provinces in Indonesia, where all variables (including control variables) have a positive influence on economic growth. The individual impacts in a cross-section shows that there are 13 provinces significant economic growth and 21 provinces are experiencing slowing economic growth.

1 INTRODUCTION

Economic growth determined by several factors such as natural resources, human resources, capital, and technology. It also can be supported by the presence of democracy and good government institutions. Hall (2010) in the research "Institutions, Capital and Growth", concluded that the allocation and productivity of capital in driving economic growth is highly dependent on state institutions. This research found that an increase in physical and human capital in economic growth only occurred in countries with good institutions.

Good institutions reflected in a fully functioning democracy. Kaldor and Vejvoda (2002) stated democracy as a set of formal institutions, redistribution of power, and life's grip. Dozens of developing countries in the world have fallen into poverty because there is no independence in democracy, and the transparency of government institutions in running the government (Goetzmann, 1999). On the other hand, democracy can cause the government to stalemate in policymaking. The same experience also occurred in China, which carried out market reforms but distortions occurred in its political regime (Batiz, 2002).

Proper regional financial management will be able to optimize local government spending so that it can encourage economic growth in a region. Regional financial management is carried out economically, efficiently, and effectively or meets principles the value of money and participation, transparency, accountability, and justice will be able to encourage economic growth (Arsa, 2015).

Decentralization is an alternative to centralized system which considered undemocratic. Decentralization is deemed to be capable of bringing development policies more in line with the needs, and able to increase community economic growth. Rondinelli and Cheema (1983) related decentralization with economics development that through decentralization and local government could run more effectively and efficiently.

The relationship of democracy, governance, and economic growth has become an exciting study theme that has long attracted the attention of intellectuals. This theme has become a standard issue in academic debate among political scientists and economists, which gave birth to a variety of views and conclusions (John Helliwell 1992, Robert Barro 1997, and Dani Rodrik 1997). Therefore, democracy is expected to be able to accelerate economic progress to achieve people's welfare.

The progress of democracy in Indonesia manifested in decentralized governance and regional financial autonomy has been running for more than 2 (two) decades. For this reason, it is fascinating to do a study of the influence of democracy and local financial governance in driving economic growth in Indonesia. Thus, the results of this study will provide a conclusion whether democracy and proper regional

financial governance have a positive influence on economic growth in Indonesia.

2 LITERATURE REVIEW

2.1 Economic Growth

Economic Growth is a process of changing a country's economic conditions on an ongoing basis towards better conditions for a specified period. Economic growth interpreted as a process of increasing the production capacity of an economy that increase in national income. The existence of economic growth is an indication of the success of economic development in people's lives.

Economic growth in a region interpreted as a process of increasing output per capita in the long run. In that sense, three aspects need to underlined, there are namely process, output per capita, and long term. Regional economic growth is related to per capita output, meaning that two things must be considered, namely total output (GDRP / GRDP) and population.

According of classical economists, four factors that influence economic growth there are the population, number stocks of capital goods, land area and natural wealth, and the level of technology used, even though they realize the economic growth depends on many factors. The classical economists focused their attention on the effect of population growth on economic growth (Sukirno, 2010). One of them is the classical theory put forward by Adam Smith. Adam Smith's argumen assumes that economic growth rests on population growth. With an increase in population, there will be an increase in output. Adam Smith's theory is in his book entitled "An Inquiry Into the Nature and Causes of the Wealth of Nations" (Simanjuntak 2013). Growth in output or results to be achieved is influenced by the following 3 (three) components including: (1) natural resources, (2) labor (population growth), and (3) total inventory

2.2 Democracy

Literally, democracy comes from the Greek language δημοκρατία (*dēmokratía*) means "people's power", which is formed from δῆμος (*Dêmos*) "people" and κράτος (*Kratos*) "power" or "authority" in the 5th century BC to refer to the Greek city-state political system, one of which was Athens. This word is an antonym of ἀριστοκρατία (*aristocratic*) "elit authority." According to Abraham Lincoln, "*Democracy is a government of the people, for the people, and by the people.*"

According to KBBI, Democracy has two meanings, namely: (1) Democracy is a form or system of government in which all people participate in governing, namely through the intermediaries of their elected representatives. (2) Democracy is an idea or view of life that prioritizes equal rights and obligations, and fair treatment for all citizens.

In general, there are two forms of democracy, namely:
1. Direct Democracy

Direct democracy is a form of democracy in which every citizen votes or opinions in determining a decision. In this system, each person represents himself in choosing a policy so that they have a direct influence on the political situation that occurs. The direct democratic system used in the formation of democracy in Athens were when there was a problem that to be solved, it cause the all to discuss it. In the modern era, this system becomes impractical because in general a country's population is quite large and gathering all people in one forum is difficult. Besides, this system requires high participation from the people while modern people tend not to have time to study all the country's political problems.

2. Representative Democracy

In representative democracy, all people elect representatives through general elections to express their opinions and make decisions for them. The principles and the prerequisites for the establishment of a democratic state have accommodated in the constitution the Republic of Indonesia. The principles of democracy, can be reviewed from the opinion of Almadudi who came to be known as the "pillar of democracy." According to him, the principles of democracy are :
a) People's sovereignty
b) Government based on approval from the governed
c) Majority power
d) Minority rights
e) Guarantee of human rights
f) Free, fair and honest elections
g) Equality before the law
h) Reasonable legal process
i) Constitutional government restrictions
j) Social, economic and political pluralism
k) Values of tolerance, pragmatism, cooperation, and consensus

The characteristics of democratic government has become an order that is accepted and used by almost all countries in the world. The aspects of a democratic government are as follows:
a) The involvement of citizens (people) in political decisions, both directly and indirectly (representative).

b) The existence of recognition, appreciation, and protection the fundamental rights of the people (citizens).

c) The existence of fair rights for all citizens.

d) The existence of an independent judiciary and judicial authority as a law enforcement tool

e) There is freedom and independence for all citizens.

f) The existence of a press (mass media) that is free to convey information and control government behavior and policies.

g) There is a general election to elect the people's representatives who sit in the people's representative institutions.

h) The existence of free, honest, fair elections to determine (elect) state, government leaders and members of people's to be representative the institutions.

i) Recognition differences in diversity (ethnicity, religion, class, etc.).

2.3 Conceptual Framework

Speaking of economic development and democracy, Immanuel Walerstain (1974) classifies countries in the world into three categories, namely core, semi-periphery, and periphery. Core countries are characterized by developed countries that have a democratic system and do industrialization to sustain the country's economy. Semi-periphery countries are in the middle position whose economic conditions are far better than periphery countries but are still below the core countries. Whereas periphery countries are a group of developing countries which are generally undemocratic. In global competition, the political system adopted by the core countries has always been an example of development for semi-periphery countries. Democracy is further said to have a positive correlation with improving the welfare of a country seeing the success of many core countries with the democratic system that it practices.

In connection with the explanation above, the writing of this article departs from doubts about the work of Lipset (1959) entitled Political Man. Lipset stated his hypothesis that democratization is directly proportional to a country's economic growth. The more democratic a country, is better the country's economic growth. Logically, within the framework of a democratic political system, each development stakeholder will be more free to voice his aspirations to improve development. The result of construction will be better because it takes the interests of the people as required by a democratic political system. Almond and Powell (1966) seemed to justify the Lipset hypothesis (1959). In his theory of capability of system politics then states that each political system has different abilities in handling inputs and outputs. But it can be said that democratic systems have a higher sensitivity to dealing with welfare issues. The critical question is, can democracy guarantee the welfare of a country? Considering today, many countries do not adhere to freedom or do not meet democratic criteria but can experience rapid economic improvement.

The argument of Lipset (1959) seems to be meaningless when many developing countries are separated from the occupation and stand as a new state, and generally follow the modernization, in the end, it is not as stated. Modernization gave birth to prosperity which led to democratization in Western Europe, North America and Australia, but this was not same case with Singapore, China, and South America countries which did not give to democracy but gave to authoritarianism. These countries have relatively fast economic development accompanied by reasonably even distribution of income. Lee Kuan Yew (former PM of Singapore) in his Thesis said that "Democracy will damage the economic growth and development of a country." This hypothesis is applied in Singapore and proven to have very high economic growth until now. Perdana (Iksan, 2015) explained Thesis Lee that to achieve higher welfare, the people must be willing to sacrifice a little civil liberties and political rights. Singapore, which maintains a very open market economy and attracts a lot of foreign investment, does not protect civil liberties such as freedom of speech and expression. If society has reached a high standard of living, independence and democracy are no longer a necessity. Furthermore, Asian values which form the essence of Lee's argument, believe that there is a cultural tendency to comply with higher authority and hard workers to enable East Asian countries to create liberal economic policies without democracy.

Unlike the case with North (1990) which says that theoretically, running an authoritarian government requires high costs and is very inefficient. Inefficiency results in weak economic performance. Also, democracy is considered more able to allocate resources efficiently. But Huntington (1968) says the opposite that democracy is inefficient. In a democracy, the decision-making process can seem slow. Democratic governance also has the potential to be subject to populist pressure while authoritarian governments can make decisions with a long-term orientation.

3 METHOD

This study uses panel data, namely a combination of cross-section and time-series data. Hsiao and Klevmarken (Baltagi, 2008) list several benefits from using panel data. These include the following:

a) Controlling for individual heterogeneity.
b) Give more informative data, more variability, less collinearity among the variables, more degrees of freedom, and more efficiency.
c) Better able to study the dynamics of adjustment.
d) Better able to identify and measure effects that are not detectable in pure cross-section or purely time-series data.
e) Allow us to construct and test more complicated behavioral models than purely cross-section or time-series data.
f) More accurately measured and unlike the problem of nonstandard distributions.

The data used from 34 provinces in Indonesia with a period of 2010-2018. The variables used in this study are gross regional domestic product at constant price 2010 as dependent variables. While the independent variables are index of democracy, BPK's opinion on financial statement, human development index, and percentage of labor to working. The data used in this research is secondary data. Data obtained from the Central Statistics Agency (BPS).

The method used is panel data regression with the following equation:

$$Y = \alpha + \beta_1 ID_{it} + \beta_2 Opinion_{it} + \beta_3 HDI_{it} + \beta_4 Labor_{it} + \varepsilon_{it} \qquad (1)$$

"Y" is gross regional domestic product at constant price 2010, "ID" an index of democracy, "Opinion" is BPK's opinion on financial statement, "HDI" is human development index, and "Labor" is a percentage of labor to working. Whereas "I" is the province in Indonesia (33 regions), and "j" is the time studied (2010-2018).

Equation (1) is estimated by the Chow Test and Hausman Test to get the appropriate model. Some of the models chosen to Pooled Least Square (Common-Effect), Fixed-Effect, or Random-Effect. It estimated by using Eviews 9.

4 RESULTS AND DISCUSSION

4.1 Choosing Appropriate Model

Choosing the appropriate model whether using Pooled Least Square/PLS (Common Effect) or Fixed

Effect Model (FEM) is by using the Chow Test. While choosing a model whether using the Fixed Effect Model (FEM) or Random Effect Model (REM) is by using the Hausman Test.

Table 1: Estimated Results of Chow Test and Hausman Test.

Test	Hypothesis	P-Value	Conclusion
Chow	H0: PLS H1: FEM	0.000	Reject H0 (Using FEM)
Hausman	H0: REM H1: FEM	0.015	Reject H0 (Using FEM)

From the estimation results, as shown in table 1, it can be concluded that the most appropriate model to use is the Fixed Effect Model. This study assumes that all variables change at a constant level over time.

4.2 FEM Estimated Results

Table 2 shows the specification effects of the Fixed Effect Model. R-squared value of 0.9997 means that variations of economic growth in Indonesia can be explained by index of democracy, BPK's opinion, human development index, and percentage of labor, while the rest are defined by other variables outside in model. In this case, the model used in this study is appropriate.

Table 2: Effects Specification of Fixed Effect Model.

Specification	Value
R-squared	0.999745
Prob. (F-statistic)	0.000000

Table 2 also shows that the probability of an F-statistic value of 0.00 is smaller than alpha 5%, rejecting Ho. That indicates an index of democracy, BPK's opinion, human development index, and percentage of labor variables simultaneously affect economic growth in Indonesia.

This study can prove that each variable, namely the index of democracy, BPK's opinion, HDI, and percentage of labor a significant effect on economic growth. The index of democracy coefficient of 0.00054 indicates that if the index of democracy increase for 1 %, it will be increasing economic growth for 0.00054 % (ceteris paribus). The BPK's opinion coefficient of 0.00847 indicates that every increase in BPK's opinion by 1 step, economic growth in Indonesia will rise by 0.00847 % (ceteris paribus).

Table 3: Output of Fixed Effect Model

Dependent Variable: Log PDRBHK	Parameter Estimates	
	Coefficient	SE
ID	0.00054*	0.00031
Opinion	0.00847**	0.00242
HDI	0.08563**	0.00118
Labor	0.00508**	0.00169
Constant	5.36895**	0.14085

Note: *Significant at 10%, **significant at 1%.

The HDI coefficient of 0.08563 indicates that every HDI increase by 1 point; growth economic in Indonesia will increase by 0.086 % (ceteris paribus). Meanwhile, the labor coefficient of 0.00508 indicates that each 1% increase in the labor, economic growth in Indonesia will increase by 0.0051 % (ceteris paribus).

Table 4: Cross Effect

Region	Effect	Region	Effect
Aceh	-0.172461	NTB	-0.156500
Sumatera Utara	1.123642	NTT	-0.345694
Sumatera Barat	-0.067954	Kalimantan Barat	0.115203
Riau	1.054282	Kalimantan Tengah	-0.542802
Jambi	-0.097909	Kalimantan Selatan	-0.156972
Sumatera Selatan	0.745299	Kalimantan Timur	0.796098
Bengkulu	-1.262410	Kalimantan Utara	-1.007072
Lampung	0.548355	Sulawesi Utara	-0.804149
Bangka Belitung	-1.092479	Sulawesi Tengah	-0.381732
Kepulauan Riau	-0.313477	Sulawesi Selatan	0.573158
Jakarta	1.502388	Sulawesi Tenggara	-0.645309
Jawa Barat	2.161116	Gorontalo	-1.579482
Jawa Tengah	1.750340	Sulawesi Barat	-1.194555
Yogyakarta	-1.266500	Maluku	-1.530172
Jawa Timur	2.279597	Malulu Utara	-1.629099
Banten	0.886296	PapuaBarat	-0.347699
Bali	-0.451687	Papua	0.950856

If we look at the effect of all variables, namely index of democracy, BPK's opinion, HDI, and labor on economic growth every province in Indonesia, there are 13 provinces where the democracy and financial management have a positive impact to economic growth. Where the biggest positive impacts were in the provinces of DKI Jakarta, West Java, and East Java. Meanwhile, there are 21 provinces in which the democracy and financial management guide on slowing economic growth for each province in Indonesia. Where the provinces of Maluku,

Gorontalo, and North Maluku are three provinces with the biggest impact of slowing economic growth.

5 CONCLUSIONS

This study proves that freedom of democracy and good financial management have a significant impact on economic growth in Indonesia. Where the impact has a positive influence on economic growth in each province, also affects slowing economic growth in several provinces in Indonesia. Good financial management has a greater impact than democratic freedom on economic growth in Indonesia. these conditions indicate that transparent financial governance will stimulate economic conditions for the better.

For this reason, both the central and regional governments must create a climate of information openness and open access so that they can have a domino effect on economic growth. Keep in mind, superior human resources also influence economic growth. This condition can achieved if the government can provide the best stimulation in the fields of education, health, and job creation, where it can have a significant impact on the economic growth of each region.

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