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One Size Does Not Fit All: The Heterogenous Impact of Democracy on Economic Growth in Indonesia

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Abstract

Indonesia's democratic level has grown during the last decade. Unfortunately, economic growth is on the decline at the same time. Based on this phenomenon, this study investigates whether democracy has a causal impact on economic growth. The panel data used in this study spans 33 Indonesian provinces from 2009 to 2020. The fixed-effect analytical model was employed to capture the effects of changes in provincial characteristics. This study provides empirical evidence that democracy supports economic growth, even though human capital, infrastructure capital, and government and trade policies are considered in the analytical model. By splitting the sample, this study finds that democracy is a predictor of economic growth in provinces in Java and provinces in the Western Part of Indonesia. The findings in this study have implications for policymakers and researchers; "One Size Does Not Fit All" in democracy context. The democracy-based economic growth strategy in Java and Western Indonesia needs to be maintained. Strengthening political rights and improving the quality of democratic institutions, on the other hand, are required to ensure that the economic benefits of democracy can be noticed Outside of Java and Eastern Indonesia.

Keywords: Democracy; Economic Growth

Introduction

The debate over whether democracy accelerates economic growth and creates wealth has long attracted the attention of political economists. Historically, this debate was first raised by Plato and Aristotle; they questioned what form of government is most capable of providing economic benefits to society (Pozuelo et al., 2016; Papaioannou & Siourounis, 2008). Although empirical methods have developed rapidly over two centuries, recent systematic literature studies show that the relationship between democracy and economic growth is ambivalent (Colagrossi et al., 2020; Ghardallou & Sridi, 2020; Knutsen, 2012; Doucouliagos & Ulubaşoğlu, 2008).

The first generation of scholars in the 1960s found that democracy hinders economic growth (Krieckhaus, 2006). This opinion was pioneered by Samuel Huntington, who stated that demands tend to increase in newly democratized developing countries so that the level of government spending tends to be high. This then causes a disincentive for the private sector to carry out capital accumulation, and thus, the country's economic growth rate tends to be low (Krieckhaus, 2004). Rooted in the arguments of the first generation of scholars, the researchers found another mechanism that explains why democracy tends to hinder economic growth: the influence of elite capture. This is reflected in the special interest groups that influence economic policy excessively (Azis, 2011). This special interest group has lobbying power beyond the voice of most people. Unfortunately, not all democracies can resist rent-seeking pressure. Olson (1982) exemplifies that East Asian countries under non-democratic regimes are relatively capable of producing pro-growth policies compared to other democratic countries.

In contrast to the early generation, in the 1980s, the second generation of scholars found different results; democracy supports economic growth (Krieckhaus, 2006). Rich countries are characterized mainly by an established degree of democracy, such as progress in civil liberties, political rights, and democratic institutions. In contrast, developing countries are primarily inherited with poor levels of democracy. An increasingly democratic country is a conducive environment for citizens to work and invest in efficient allocation of resources in the market and private sector activities to maximize profits. All of which can be maintained in a climate of civil liberties, free-flowing information (reducing potential asymmetric information and principal-agent problems), and adequate protection of property rights. (Acemoglu et al., 2019; Gründler & Krieger, 2016; Alfonso-Gil et al., 2014; Persson & Tabellini, 2006; Rodrik & Wacziarg, 2005).

Indonesia has been the third-largest democracy in the world since Reform Era. Ananda (2018) noted that Indonesia's transition to democracy took place dramatically, from centralized governance in the New Order Era to decentralization in the Reform Era. Due to this transition, executive and legislative powers at the local level in Indonesia are determined through direct elections to channel people's political preferences (Surkati, 2012). The development of democracy that accommodates people's political preferences has resulted in social and political stability in Indonesia for two decades due to the relative distribution of political power in all regions.

Although the quality of democracy continues to improve, Indonesia's economic growth tends to decline from 2009 to 2020. Figure 1 shows the Indonesian Democracy Index (IDI) in 2009 was only 67.3 points, then increased to 73.66 points in 2020. Unfortunately, economic growth has gradually decreased from 6.20% in 2009 to 5.03% in 2019; even during the 2020 pandemic, it reached a low of -2.07%. In other words, the rapid improvement in the quality of democracy seems to have not been able to lift Indonesia's economic growth back to its highest level, as it was in 2010. This fact appears to bolster Jamil's (2017) concern in his study, which underscores lower economic growth in the Reform Era based on democratic government rather then the New Order Era based on authoritarian rule.

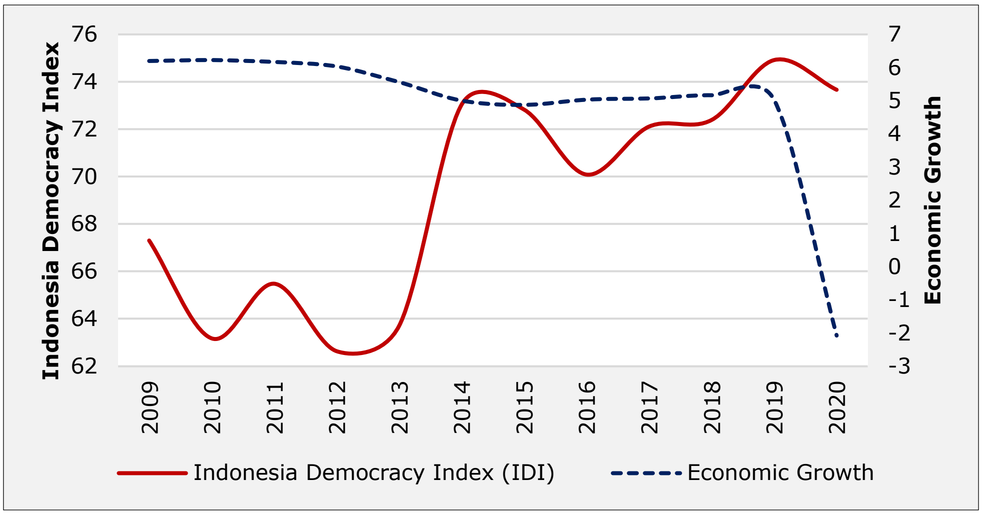

Figure 1: The Evolution of Democracy and Economic Growth in Indonesia, 2009-2020
Source: BPS Indonesia & World Development Indicators, various series.

The purpose of this study is to provide empirical evidence regarding the causal effect of democracy at the provincial level on economic growth in Indonesia, considering that the trend of data at the national level seems to be different from the findings of mainstream political economists in previous studies. In addition, this study checks the consistency of the effect of democracy on economic growth by splitting the sample into two characteristics: i) Java vs Outside Java; ii) Western

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and Eastern Regions of Indonesia. Borrowing from Krieckhaus's (2006) study at the global level, we also assume that democracy has different effects in Indonesia based on regional charateristics.

This research at least bridges two gaps in previous studies. First, this study fills the empirical gap by including institutional factors, particularly democracy, as a determinant of economic growth. Studies in the Indonesian context still rely heavily on physical capital (Vidyattama, 2010) and human capital (Affandi et al., 2019; Resosudarmo & Abdurohman, 2018) as factors that influence economic growth. So far, studies that include institutional factors do not explicitly use democracy variables but are limited to good governance variables as in McCulloch & Malesky (2011) and Duadji (2012) and corruption variables such as in Alfada (2019) and Kuncoro (2002). The democracy variable as a determinant of economic growth has been explicitly used by Acemoglu et al. (2019), Minier (1998), and Barro (1996) at the global scope.

Second, this research fills the empirical gap by using sub-national or provincial units of analysis. Research on the effects of dominant democracy has been carried out on the unit of analysis at the country level (Acemoglu et al., 2019; Redek & Sušjan, 2005; Rodrik & Wacziarg, 2005; Rodrik, 2000; Barro, 1996), which has yet to be explored at the sub-national level. Practically, There are only three studies that measure democracy at the sub-national level, namely the study by Harbers et al. (2019) on the case of India and Gervasoni (2010) on the case of Argentina, with a focus that is not directly on the effects of economic growth. Meanwhile, Knutsen et al. (2016) measure the impact of local democracy on national economic growth, but the unit of analysis is the country. This study is expected to enrich findings regarding the effects of democracy on economic growth at the sub-national level.

The rest of this paper will go over the fixed effect model that was used to estimate the impact of democracy on economic growth. The following paper highlights the discussion of why the economic benefits of democracy are limited to the provinces of Java Island and the Western Regions. The final section sums up the policy implications and efforts made to overcome this study's empirical drawbacks

Research Method

This study uses balanced panel data covering 33 provinces in Indonesia (excluding North Kalimantan Province) during the 2009-2020 period. Using panel data allows researchers to control the heterogeneity of the provinces. Not controlling for unobserved province-specific effects (μ_p) can result in biased estimates. In line with this thought, all models in this study were estimated using a fixed effect which considers the error to be a parameter that is estimated to be fixed (de Chaisemartin & D'Haultfœuille, 2020; Imai & Kim, 2021).

In general, the analytical model adopted to determine the effect of democracy on economic growth comes from the study of Barro (2015). The form of the equation can be written as follows:

$$\boldsymbol{G_{pt}} = \boldsymbol{log}\left(\frac{\boldsymbol{GRDP\_cap_{pt}}}{\boldsymbol{GRDP\_cap_{pt-1}}}\right) = \boldsymbol{\alpha_0} + \boldsymbol{\alpha_1}\, \boldsymbol{log(GRDP\_cap)_{pt-1}} + \boldsymbol{\beta_1}\, \Delta \boldsymbol{log(DEMO)_{pt}} + \boldsymbol{X'_{pt}\,\gamma} + \boldsymbol{\mu_p} + \boldsymbol{v_{pt}},$$

where, G_{pt} denotes the growth of GRDP per capita at province p in year t. $log(GRDP\_cap)_{pt-1}$ denotes one-year lagged per Capita GRDP in province p. DEMO shows the Indonesia Democracy Index as measured by three aspects: civil liberty, political right, and democratic institutions. X' is a set of covariates include mean years of schooling, life expectancy, electricity per capita, safe water per capita, trade openness (ratio export and import to GRDP), and government expenditures. The inclusion of control variables is meant to ensure that the estimation results hold true even when variables with the potential to affect growth are included in the model (Sala-i-Martin, 1997).

In addition, there are two coefficients of interest in this study. First, $\boldsymbol{\alpha_1}$ shows whether there is income equality between provinces in Indonesia. The value of $\boldsymbol{\alpha_1 < 1}$ reflects the convergence of income among provinces, where poor regions grow faster than rich regions, whereas the value of $\boldsymbol{\alpha_1 > 1}$ indicates that there is a divergence of income among provinces. Second, $\boldsymbol{\beta_1}$ shows the magnitude of the effect of democracy on the growth of GRDP per capita. The value of $\boldsymbol{\beta_1 > 1}$ reflects that democracy tends to increase the growth of GRDP per capita. The value of $\boldsymbol{\beta_1 < 1}$ indicates the opposite condition.

To ensure the consistency of the estimation results, robustness checks are carried out by dividing the sample into two sub-samples with different characteristics, namely: 1) Java Island and Outside Java Island. This sorting is also based on regional disparities, where the island of Java has contributed to the formation of a national GRDP of around 57-59% over the last ten years, which is much more dominant than regions outside Java. This sample sorting is in line with the argument of Manning & Purnagunawan (2011), which states that there are quite systematic differences in characteristics between the regional economy in Java and outside Java; 2) Eastern and Western Indonesia. This sort of disaggregation is based on the study of Miranti & Resosudarmo (2005), which found that there is a disparity between regions, where the Western Region of Indonesia is far more economically developed than the Eastern Region of Indonesia.

Results and Discussion

Table 1 shows all the results of the estimation of the impact of democracy on the growth of GRDP per capita in Indonesia in various specifications. Model 1 in Table 1 is intended to detect whether there is unconditional convergence in Indonesia. Model 2 in Table 1 is designed to see whether there is conditional convergence as well as the impact of democracy on economic growth. Meanwhile, Model 3 in Table 1 is intended to detect whether there is conditional convergence and the effect of democracy on economic growth, even if it includes variables such as human capital, infrastructure capital, or government spending and trade policies. The use of a model, either without or with a control variable, allows the researcher to determine how robust the estimates of the impact of democracy used in the study are. This form of model specification is commonly used in statistical inference procedures (Hanck, 2016; Sala-i-Martin, 1997).

Table 1
The Impact of Democracy on Economic Growth and Convergence

	Growth of GRDP *per* Capita					
VARIABLES	Model 1	Model 2	Model 3a	Model 3b	Model 3c	Model 3d
Log (Lagged *per* Capita GRDP)	-0.0807***	-0.0814***	-0.0745**	-0.0892***	-0.0807***	-0.102**
	(0.0141)	(0.0143)	(0.0352)	(0.0231)	(0.0122)	(0.0397)
Log (Change in Democracy)		0.0284**	0.0277**	0.0274**	0.0278*	0.0243*
		(0.0132)	(0.0132)	(0.0128)	(0.0138)	(0.0132)
Mean Year Schooling			-0.00532			-0.00464
			(0.00521)			(0.00480)
Life Expectancy			0.00267			0.00454
			(0.00202)			(0.00292)
Electricity				0.00774		0.0111
				(0.00710)		(0.00682)
Safe Water				-8.18e-05		-0.000144
				(0.000308)		(0.000285)
Trade Openness					0.0137***	0.0157***
					(0.00415)	(0.00442)
Government Expenditure					-0.123	-0.133
					(0.0855)	(0.0915)
Constant	0.617***	0.622***	0.428*	0.676***	0.620***	0.495**
	(0.105)	(0.106)	(0.229)	(0.168)	(0.0988)	(0.235)
Additional Controls	NO	NO	Human Capital	Infrastructure Capital	Government and Trade Policy	All Controls
Observations	396	396	396	396	396	396
Number of Provinces	33	33	33	33	33	33
R-squared	0.141	0.146	0.148	0.151	0.182	0.197
Provincial FE	YES	YES	YES	YES	YES	YES

*Robust standard errors in parentheses *** $p<0.01$, ** $p<0.05$, * $p<0.1$*

Model 1 in Table 1 shows that a one-year lagged GRDP per capita has a negative relationship with per capita GRDP growth at a significance level of 1%. This indicates that there is unconditional convergence between provinces in Indonesia. This means that provinces with low per capita income levels can grow faster than those with high per capita income levels.

Model 2 in Table shows that there is still a negative relationship between one-year lagged GRDP per capita and per capita GRDP growth at a significance level of 1%. Model 2 also shows a positive relationship between democracy and per capita GRDP growth at a significance level of 5%. These results indicate that democracy can increase economic growth and create a convergence of economic development between provinces in Indonesia. Compared to Models 1 and 2 in Table 1, Model 3a shows that the coefficient of one-year lagged GRDP per capita has increased in significance level from 1% to 5%. In comparison, the democracy coefficient has not changed at the 5% significance level. Unfortunately, the mean years of schooling and life expectancy coefficients are insignificant. This result is in line with the study of Krueger & Lindahl (2001), which did not find strong empirical evidence between human capital and economic growth. Thus, the impact of democracy on economic growth does not seem to

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be able to be explained through the human capital channel. Model 3B depicts the lagged GRDP coefficient per capita, and democracy has the same significance level as Models 1 and 2 in Table 1. Meanwhile, all proxies related to infrastructure capital are not significant. The results of this estimate prove that infrastructure, both electricity and water availability, has failed to change the company's production costs, so it does not encourage much output expansion. Thus, the impact of democracy on economic growth cannot be explained by means of infrastructure capital and human capital. Model 3C shows the value of the lagged GRDP coefficient per capita has the same significance level as Models 1 and 2 in Table 1, while the value of the democracy coefficient has decreased in significance. This decrease in significance occurred because, at the same time, the variable of trade openness influenced economic growth at a significance level of 1%. These findings indicate that democracy and trade openness are, coincidentally, the driving forces behind economic growth. Model 3D in Table 1 displays results that are not much different from the Model 3c in Table 1. Where democracy, one-year lagged GRDP per capita, and trade openness significantly affect economic growth. These results suggest that the impact of democracy on economic growth can be explained through the mechanism of increasing trade openness. However, this mechanism needs to be proven empirically, considering that control variables often contain measurement errors and small variations (Papaioannou & Siourounis, 2008).

Based on the estimation results in Table 1, democracy is a predictor of economic growth in Indonesia. There are two possible explanations for why democracy benefits local economies. To begin, democracy has an electoral mechanism in place to determine what is best for society. Increased political rights enable the community to choose the ideal regional heads who represent policy preferences related to efforts to increase economic activity through political contestation. An anecdotal study conducted in the Indonesian context by Pradhanawati et al. (2019) noticed that even low-income people can elect the best regional heads based on their voting conscience and are reluctant to take part in voter mobilization. Azis (2013) noticed that the economic benefits of democracy are generally enjoyed by regions with high community participation and quality local leaders, reducing the negative impact of local elites' interests.

Second, democracy has features of government effectiveness which are reflected in good governance. The existence of good governance will improve public services that can accelerate economic activity. This argument is supported by the research of Abeberese et al. (2021), who unearthed that improving governance in the era of decentralization in Indonesia, such as improving the quality of business regulations, has encouraged an increase in firm productivity, resulting in a faster local economy. Rezki (2022) brings that democracy, as reflected in political competition, has the opportunity to increase per capita income in line with the growing role of the modern sector with high added value. This is because political competition provides a check and balance mechanism that allows the best economic policy to be presented. However, it is necessary to prove whether these results do not change with various characteristics of the sub-sample in Indonesia. Therefore, the heterogeneous effect of democracy on economic growth is detected by separating two sub-sample characteristics: i) Java vs. Outside Java, and ii) Western vs. Eastern Part of Indonesia.

Table 2 shows that democracy positively impacts economic growth only in Java. This result is not surprising considering that the Provinces on Java Island have a much more established political economy institution than those outside Java Island. This can be seen in the study of Dell & Olken (2020), which proves that the prosperity of most areas on the island of Java is inseparable from the Dutch colonial heritage production system. On the other hand, political economy institutions developed outside Java are intended to exploit extractive commodities (Rinardi, 2020).

Table 2
Heterogeneous Impact of Democracy on Economic Growth and Convergence: Java vis-a-vis Outside Java

	Growth of GRDP *per* Capita	
VARIABLES	Java	Outside Java
Log (Lagged *per* Capita GRDP)	-0.0850**	-0.0806***
	(0.0272)	(0.0167)
Log (Change in Democracy)	0.0426*	0.0248
	(0.0186)	(0.0161)
Constant	0.656**	0.614***
	(0.205)	(0.124)
Observations	72	324
Number of Province	6	27
R-squared	0.239	0.132
Provincial FE	YES	YES

*Robust standard errors in parentheses and *** $p<0.01$, ** $p<0.05$, * $p<0.1$*

The non-dominant capture elite is responsible for the functioning of political economy institutions on Java Island, whereas the opposite occurs outside of Java Island. According to Berenschot's (2018) research, the majority of Java Island's regions have very low levels of clientelism, as evidenced by Surabaya, Jakarta, Bandung, and Tangerang. Other areas outside of Java, on the other hand, have a high level of clientelism, such as Kupang, Flores, and Jayawijaya. According to a similar study, low clientelism in Java allows for the provision of public services in accordance with good governance principles, as well as the implementation of a merit-based bureaucracy. The provision of such public services is extremely beneficial to the growth of economic activity. In contrast, in other regions outside of Java Island with high clientelism but an underdeveloped industrial base, most local actors (such as regional apparatus, contractors, and small business owners) are heavily reliant on the state (regional) budget. With a high reliance on the budget, these local actors frequently try to maintain the status quo in order to protect their privileges. This type of practice is actually detrimental to economic activity in other regions outside of Java (van Klinken & Berenschot, 2014).

Table 3
Heterogeneous Impact of Democracy on Economic Growth and Convergence: Western vis-a-vis Eastern Part of Indonesia

	Growth of GRDP *per* Capita	
VARIABLES	Western Indonesia	Eastern Indonesia
Log (Lagged *per* Capita GRDP)	-0.0783***	-0.0841***
	(0.0117)	(0.0257)
Log (Change in Democracy)	0.0293*	0.0267
	(0.0152)	(0.0258)
Constant	0.602***	0.636***
	(0.0879)	(0.189)
Observations	240	156
Number of Province	20	13
R-squared	0.190	0.124
Provincial FE	YES	YES

*Robust standard errors in parentheses and *** p<0.01, ** p<0.05, * p<0.1*

Furthermore, Table 3 shows that democracy tends to be accompanied by increased economic growth only in the Western Part of Indonesia. This is because most of the provinces in the Western Part of Indonesia have joined as part of Indonesia since the independence era. Compared to the Eastern Part of Indonesia, whose entire province only joined Indonesia in 1963, the Western Part of Indonesia has much more stable political institutions in supporting economic activity. This path dependency explains why democracy has disproportionate economic benefits

Overall, the positive effects of democracy on Java and Western Indonesia are consistent with empirical evidence on the quality of democracy in these two regions. Figure 2 depicts that provinces on Java Island and in Western Indonesia have consistently had a higher Indonesian Democracy Index (IDI) than other provinces over the last decade. This explains why democracy works relatively well in both regions in terms of promoting economic growth.

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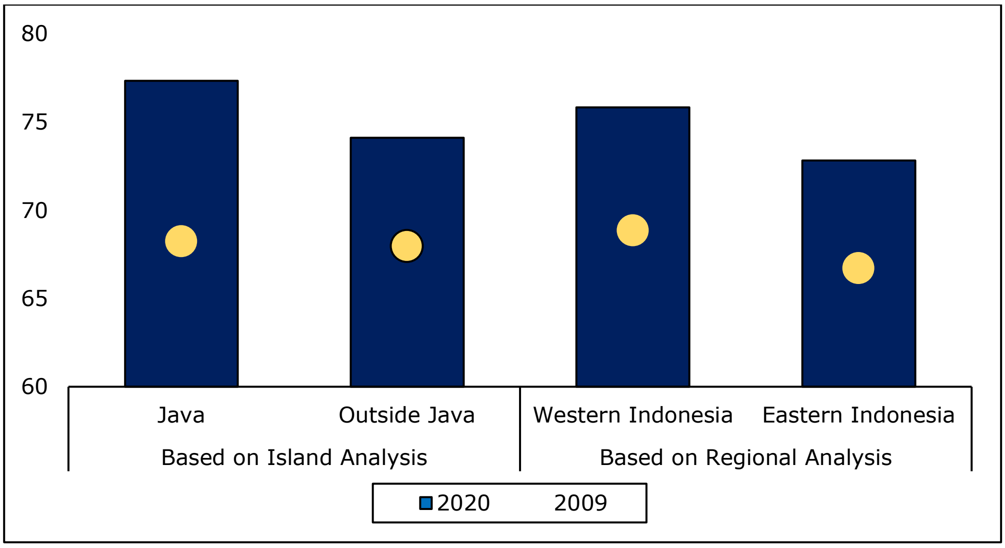

Figure 2: Heterogeneity of the Indonesian Democracy Index (IDI), 2009 and 2020
Source: BPS Indonesia, various series

Conclusions

This study aims to examine whether democracy has a causal impact on economic growth in Indonesia. By using the fixed-effect estimation method, this study proves that democracy supports economic growth, even though human capital, infrastructure capital, and government and trade policies are considered in the analysis model. However, the robustness of the estimation results depends on the disaggregation of the sub-samples. This study finds that democracy is a predictor of economic growth in provinces in Java and provinces in the Western Part of Indonesia.

The findings in this study have implications for policymakers and researchers; "One Size Does Not Fit All". For policymakers, Indonesia's future economic growth strategy needs to consider the heterogeneity of political economy institutions in each province. Policymakers on Java and in West Indonesia must maintain productive democratic performance in order to achieve economic growth. Increasing the function of democracy to spur economic growth in Outside Java and Eastern Indonesia, on the other hand, is a must, which can be accomplished by strengthening people's political rights and improving the quality of democratic institutions.

Political rights can be strengthened in provinces Outside of Java and Eastern Indonesia with or without a political contestation mechanism. Political rights are exercised in the form of people's political participation through political contestation by encouraging an increase in the distribution of voting rights to select the best regional heads and members of the regional legislature. Meanwhile, incentivising community involvement in the formulation of economic development policies through both formal and informal political channels can result in community political participation without the need for political contestation. Providing technical assistance in good governance can help to improve the quality of democratic institutions in provinces Outside of Java and Eastern Indonesia. At the sam time, political party financing must be reduced to free regional leaders and elected members of the legislature from negative elite capture in the process of developing economic development policies.

Despite the results of a study, there are two shortcomings that must be addressed in the future for a more comprehensive analysis of democracy. First, the Indonesian Democracy Index (IDI) continues to limit the concept of democracy to electoral, liberal, participatory, and majoritarian democracy. Meanwhile, the concept of deliberative and egalitarian democracy has been left out of this research. In fact, the Variety of Democracy (V-Dem) Institute conducted a study that measured these two democratic concepts (Coppedge et al., 2021). As a result, additional research on the impact of democracy on a broader scale is required.

Second, the scope of democracy examined remains constricted to the province. Meanwhile, the level of democracy in the district has not been deemed. In fact, as found in Rezki (2022), Abeberese et al. (2021), and Kis-Katos & Sjahrir (2017), political decentralization and the formulation of regional economic policies are predominantly determined at the district level in Indonesia. As a result, measuring the impact of democracy at the district level is critical in order to serve as a reference point when developing policies to improve the quality of democracy.

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