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Fostering Inclusive Growth in Indonesia: Evidence from Panel Regression Analysis

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ABSTRACT

An inclusive development does not only rely on economic growth but also on the creation of equitable access to growth outcomes. Government spending has an important role in promoting efficiency and economic growth as well as equity. Meanwhile, financial inclusion is believed to be able to expand opportunities to contribute to growth. Previous studies have proven the influence of both on inclusive growth with varying results. This study aims to analyze the impact of government spending in the fields of health, education, economy, and social protection, as well as financial inclusion on inclusive growth. Using panel data from 34 provinces in Indonesia in 2015-2019, this study applies a random effects model. The results show that education spending and the level of financial inclusion can foster inclusive growth. This finding confirms that public investment in education will expand access to education to increase human capital and labor productivity, as well as competitiveness and wages, while the inclusiveness of financial services increases access to more affordable credit. On the other hand, economic spending has a negative impact on inclusive growth due to the development gap. Meanwhile, health and social protection spending have no impact on inclusive growth. The implication is that health and economic spending policies must be directed at ensuring people's access to more equitable economic opportunities. Monitoring and provision of a more active social assistance also needs to be improved.

Keywords: Financial Inclusion, Government Spending, Inclusive Growth, Panel Regression

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INTRODUCTION

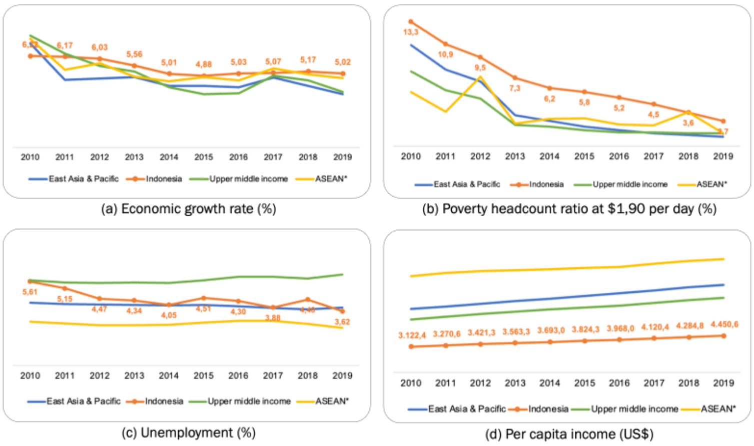
The concept of wise development for the community is inclusive and sustainable development. A development strategy based on inclusive growth will have two mutually reinforcing strategic focuses (ADB, 2008; Klasen, 2010). First, the expansion of access to economic opportunities will be realized through high and sustainable growth. Second, equal opportunity to contribute to growth will be created by expanding access to these economic opportunities.

A development paradigm with an inclusive character is needed because development that is only oriented towards growth will lead to social exclusion, poverty, inequality, and environmental damage (Brodjonegoro, 2019). Inequality is a bad condition for growth because it tends to weaken the growth base and reduce the speed and resilience of growth (Aoyagi & Ganelli, 2015; Lahouij, 2017; Zhuang et al., 2014). Increasing inequality can undermine the impact of economic growth on poverty reduction by reducing opportunities for the poor to accumulate human capital and access education and health and cause social, economic and political instability (ADB, 2011; Alekhina & Ganelli, 2020; Balakrishnan et al., 2013; Ostry et al., 2014).

Brodjonegoro (2019) defines inclusive growth as growth that is pro-poor, pro-job, pro-growth, and pro-equity. Inclusive growth can reach people at the lowest levels to reduce poverty levels, can reduce the unemployment rate through the creation and expansion of employment opportunities, can trigger an increase in economies of scale, and can encourage income distribution and reduce disparities between groups and between regions.

Indonesia's high economic growth rate indicates that economic activity is in a vibrant state (Figure 1(a)). However, this high growth has not been able to make a significant contribution to reducing poverty and unemployment rates and increasing per capita income in Indonesia. This can be seen from Indonesia's generally higher poverty and unemployment rates and lower per capita income compared to Asia Pacific countries, upper middle-income countries, and ASEAN (Figure 1(b) - 1(d)). This phenomenon indicates that economic growth in Indonesia is not yet fully inclusive. In other words, the benefits of Indonesia's economic growth have not reached the entire community and are mostly obtained by the richest segment of the population (ADB, 2014).

Figure 1. Inclusive growth indicators in Indonesia, 2010-2019



Source. World Bank (2021).

Government spending has an important role in affecting efficiency and economic growth as well as equity. Several literatures show that government spending on health, education, economy or infrastructure, and social protection can promote economic growth (Ambya, 2020; Johansson, 2016), reduce inequality (Balakrishnan et al., 2013; Hur, 2014; Johansson, 2016), reduce poverty (Misdawita & Sari, 2013; Taruno, 2019), and create more inclusive growth (Fitrianasari et al., 2022; Safitri et al., 2021). On the other hand, Arjona et al. (2003) found a negative impact of government spending on social protection on inclusive growth due to demotivation of the workforce, while Taruno (2019) found an insignificant impact. Misdawita & Sari (2013) conclude that the impact of poverty reduction does not apply to government spending on health and subsidies due to inappropriate targeting of subsidy users in the field. Prasetyia et al. (2011) revealed that government spending on infrastructure has a negative impact on inclusive growth due to the inadequate quality of budget management.

An inclusive financial system provides easy access to formal financial services that will encourage equal opportunities to participate in the economy. Financial inclusion has been widely recognized as important in promoting economic growth (Ratnawati, 2020; Zhou et al., 2018), reduce poverty and inequality (Alvarez-Gamboa et al., 2021; Park & Mercado, 2015; Ratnawati, 2020), and create inclusive growth (Alekhina & Ganelli, 2020; Balakrishnan et al., 2013; Sanjaya, 2014). However, various literatures show the opposite or insignificant effect of financial inclusion on inclusive growth. Neaime & Gaysset (2018), Schmied & Marr (2016), dan Seven & Coskun (2016) conclude that financial inclusion has no impact on poverty alleviation and inequality reduction. Although financial inclusion promotes economic growth, it does not necessarily benefit the poor and low-income people.

Due to the varied results of research, this study contributes to complementing previous research by analyzing the impact of government spending and financial inclusion on inclusive growth. The use of the Indonesian territory as a research locus is expected to contribute ideas in formulating inclusive growth strategies through government spending policies and financial inclusion in developing countries.

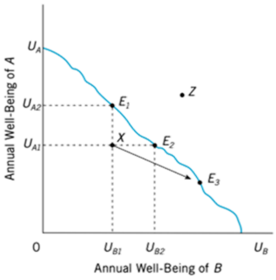
LITERATURE REVIEW

The Role of Government Spending in Inclusive Growth

In the growth process, the government allocates various available resources for the provision of public goods and services. The allocation of these resources is aimed at achieving efficiency and equity (Hyman, 2010). Efficiency refers to the optimal use of resources to increase output, while equity represents an increase in welfare evenly. The achievements of both reflect inclusive growth. However, efficiency and equity often face a trade-off between the two (Jalles & Mello, 2019). The trade-off between increasing efficiency and changing the welfare distribution is illustrated by Hyman (2010) with a utility-possibility curve (Figure 2).

Suppose the economic conditions are at point X which indicates inefficiency. The efficient condition is reached when the economy is at point E1, E2, or E3. While point Z cannot be reached due to limited resources. The government uses fiscal policy to encourage the economy to be efficient or full employment. When the government has the intensity to direct the economy at a certain point, equity will play its role. Moving point X to E3 will benefit certain groups and harm other groups (the utility of B increases, the utility of A decreases). Thus, growth is not inclusive.

Figure 2. Utility-possibility curve



Source. Hyman (2010).

Most of the impact of fiscal policy is achieved through the expenditure side (Bastagli et al., 2012; Bono, 2020; Hur, 2014). The allocation of resources through government spending aimed at addressing market failures and externalities can increase efficiency and promote growth. While government spending aimed at creating a social safety net, especially when the market fails to provide it or when the government is more efficient in providing it, as well as redistributive spending can increase equity.

Solow Growth Theory (Mankiw, 2010) describes that capital and labor are sources of growth. Government spending on the economy or infrastructure will encourage an increase in private investment and capital stock, while government spending on health and education will increase the capacity of human resources as labor capital (Estrada et al., 2014; Johansson, 2016). Meanwhile, government spending on social protection will encourage growth when it is able to provide funds for consumption and invest in human capital for households with limited liquidity (Arjona et al., 2003; Johansson, 2016).

Furthermore, government spending can help narrow the gap, especially between the rich and the poor. Equitable distribution of infrastructure, education and public health will increase access, especially for the poor, to markets and economic opportunities (Estrada et al., 2014; Fitrianasari et al., 2022; Hur, 2014; Johansson, 2016; Safitri et al., 2021). Meanwhile, spending on social protection has a bigger goal in terms of redistribution and risk sharing and creating a social safety net (Hur, 2014; Johansson, 2016; Long & Pasaribu, 2019).

Financial Sector Inclusiveness and Inclusive Growth

Various theories reveal important correlations between the rate of aggregate saving and the rate of economic growth, one of which is the Harrod-Domar Growth Theory. It states that growth is the effect of saving and capital accumulation. A higher saving rate will boost the economy and can help create self-sustaining economic growth. To sustain this mechanism, the financial infrastructure must be efficient to serve the entire economy, so that savings can actually create higher investment (Eriksson & Nilsson, 2020).

Fundamentally, financial inclusion is designed to realize the ability of economically and socially marginalized people to participate and contribute by creating equal opportunities (Alvarez-Gamboa et al., 2021; Khan, 2011). Inclusive financial systems can alter economic growth rates and labor demand with potentially major implications on poverty and income distribution (Demirguc-Kunt & Levine, 2009; Eriksson & Nilsson, 2020; Sarma & Pais, 2011). Thus, financial inclusion becomes very important for the economic growth and sustainable development of a country because of its role as an engine of growth (Bono, 2020; Claessens & Feijen, 2007).

Financial inclusion provides easy access to formal financial services that will encourage equal opportunities to participate in the economy. Alekhina & Ganelli (2020) and

Claessens & Feijen (2007) argue that inclusive financial system increases the amount of available funds and reduces borrowing costs, so that capital will increase. Access to and use of formal financial services, such as saving and credit, enables more efficient and secure financial transactions and helps the poor move out of poverty by enabling them to invest. By providing a mechanism for managing income shocks, financial inclusion can also prevent them from falling into poverty in the first place.

Bozkurt & Karakus (2020) states that the positive effect of financial inclusion on economic growth and poverty is supported in three basic theories. First, investment theory. Financial inclusion benefits the poor through reduced collateral requirements and borrowing costs that can unlock or improve entrepreneurial potential. Second, human capital theory explains that people need access to financial credit to invest in the human capital needed to find jobs and increase their income. Third, according to the theory of corporate behavior, financial inclusion has a positive external on decreasing the cost of capital which can lead to an increase in production.

RESEARCH METHOD

This study uses secondary panel data covering 34 provinces in Indonesia in 2015-2019. The data is sourced from the Statistics Indonesia (BPS), the Directorate General of Fiscal Balance (DJPK), Bank Indonesia (BI), and the Financial Services Authority (OJK). Inclusive growth index (IPI) is used as dependent variable. This index construction adopts McKinley (2010) which composed of four dimensions, namely the economic growth, labor, and economic infrastructure; poverty, income inequality, and gender equality; human resource capabilities; and social protection. The independent variables used are government spending on health (PPK), education (PPP), economic (PPE), and social protection (PPS), and financial inclusion (IIK). Construction of IIK adopts Sarma (2008) which composed of three dimensions, namely accessibility, availability, and use. The variables used are presented in Table 1.

Table 1. Research variables

Variable	Proxy	Definition
Inclusive growth	IPI	Inclusive growth index
Government spending	PPK	Regional government spending on health/GRDP
	PPP	Regional government spending on education/GRDP
	PPE	Regional government spending on economic/GRDP
	PPS	Regional government spending on sosial protection/GRDP
Financial inclusion	IIK	Financial inclusion index

The relationship between the variables in this study is arranged in equation 1.

$$IPI_{it} = \alpha + \beta_1 PPK_{it} + \beta_2 PPP_{it} + \beta_3 PPE_{it} + \beta_4 PPS_{it} + \beta_5 IIK_{it} + \varepsilon_{it} \quad (1)$$

where α: intercept, $\beta_1,...,\beta_8$: coefficient, ε: residual, i: region, and t: year.

The estimation method used is panel data regression. Parameter estimation in panel data regression can be done using three approaches, namely common effect (CE), fixed effect (FE), and random effect (RE). Determination of the best panel data regression model between the three was carried out with three types of tests, namely the Chow test to choose between CE and FE, the Breusch Pagan test to choose between CE and RE, and the Hausman test to choose between FE and RE.

RESULTS

Overview of Inclusive Growth and Its Determinants

The descriptive statistics of the research variables are shown in Table 2. Based on the IPI calculation, the inclusive growth rate of the Indonesian provinces shows satisfactory progress with an average of 5.07. The lowest IPI score is in Papua Province, which is 2.53 which shows unsatisfactory progress. In contrast, the category of superior inclusive growth progress was achieved by Central Java Province with the highest IPI of 7.07. The ratio of government spending to GRDP shows a value that is not large and tends to vary between provinces. Government spending on education has the lowest ratio of 0.0022 and the highest of 4.75 with an average of 1.13. In the health and economic functions, the ratio of government spending tends to be similar with a mean of 0.41 and a standard deviation of 0.30 and 0.33, respectively. Provincial government spending on social protection shows a very small value, i.e., an average of 0.056 with the lowest and highest values being 0.0005 and 0.20. In terms of financial inclusion, the average IIK is 0.39 which indicates a medium level of financial inclusion. The lowest IIK is 0.18 and the highest is 1 reflecting the diversity of levels of financial inclusion between provinces.

Table 2. Descriptive statistics (*N* =170)

Variable	Mean	Standard deviation	Minimum	Maximum
IPI	5,077846	0,8441273	2,531527	7,068809
PPK	0,4092994	0,3014155	0,003083	1,794063
PPP	1,134769	0,8784375	0,0022434	4,749205
PPE	0,4114726	0,3318545	0,0051822	1,407126
PPS	0,0555739	0,0432996	0,0005877	0,2038713
IIK	0,3933218	0,1390762	0,1785887	1

Source. Calculated by the authors.

Estimation Results

The results of the model selection are shown in Table 3. The results of the Chow test as well as the Breusch Pagan test show a probability value less than 5%. By that, the decision taken is to reject H_0 and the chosen model is FE dan RE, respectively. Finally, the results of the Hausman test are accept H_0 because the probability value is larger than 5% and conclude that the best model between FE and RE is the RE.

Table 3. Model selection results

Test	Hypothesis	Prob.	Conclusion
Chow test	H_0: CE, H_a: FE	0.0000	Reject H_0
Breusch-Pagan test	H_0: CE, H_a: RE	0.0000	Reject H_0
Hausman test	H_0: RE, H_a: FE	0.1550	Accept H_0

Source. Calculated by the authors.

The estimation results using the random effect model are shown in Table 4. It produces a probability value of Wald chi^2 test less than 5% and coefficient of determination (R^2) of 0.2681. It means, government spending in the fields of health, education, economy, and social protection as well as financial inclusion simultaneously affect about 27% of the diversity of inclusive growth.

Based on the results of the partial test, government spending on education and financial inclusion has a significant positive effect on inclusive growth, with a significance level of less than 10% and 1%, respectively. Meanwhile, government spending on the economy or infrastructure has a significant negative impact with a significance level of 1%. However, government spending on health and social protection does not have a significant impact on inclusive growth.

Table 4. Random effect regression results

IPI	Coefficient	z	P>|z|
PPK	0.2412929	0.94	0.345
PPP	0.0737258	1.87	0.061***
PPE	-0.8545495	-3.04	0.002*
PPS	0.4650364	0.28	0.779
IIK	2.89372	3.23	0.001*
Wald $chi^2(5)$	35.88		0.000*
R^2	0.2681		

Note. Significance level: *1%, **5%, ***10%.
Source. Calculated by the authors.

DISCUSSION

Impact of government spending on inclusive growth

During 2015-2019, government spending on education had a positive and significant effect on inclusive growth. From an efficiency perspective, increasing government spending on education will encourage economic growth through increasing human capital capacity (Ambya, 2020; Hur, 2014). These results are consistent with the Solow Growth Theory. Improving the quality of human capital in terms of education will increase the skills, expertise, and productivity of the workforce as a factor of production. This will increase production capacity and efficiency, thereby boosting economic growth.

In terms of achieving equality, public investment in education during 2015-2019 was able to expand access and educational opportunities for all communities, including the poor and marginalized groups, thereby creating inclusive growth (Fitrianasari et al., 2022; Safitri et al., 2021). Educated individuals are believed to have a better level of welfare (Ambya, 2020; Hur, 2014; Misdawita & Sari, 2013; Taruno, 2019). Financial factors are often become an obstacle for the poor and marginalized groups to access education. Government investment in education enables them to acquire and develop knowledge and skills that will increase competitiveness in the market. It will expand job opportunities and result in higher wages. In turn, their welfare condition will improve.

This success is supported by the Smart Indonesia Program (PIP) initiated by the government in the 2015-2019 RPJMN. Included in the program are 12-Year Compulsory Education, increasing access and quality of education and skills training services, increasing innovation and technology, and increasing the labor competitiveness. Therefore, an inclusive education system must continue to be promoted and strengthened to support more inclusive growth.

In contrast to education, during 2015-2019, government spending on the economy or infrastructure has a negative impact. This means that the development of public infrastructure to support the economy cannot promote efficiency and economic growth as well as equity. Inadequate quality of expenditure management can be one of the contributing factors (Prasetyia et al., 2011). Johansson (2016) mentions that the weak management of public finances causes public investment to not be fully translated into a growth effect. Better management of public investment will improve the quality of public infrastructure and economic growth, particularly in developing countries.

Besides, public infrastructure development can be counterproductive to growth because it causes limited funds and high costs for private expansion. Public investment can easily replace private investment, thereby lowering the rate of return on private investment and reducing business investment (Johansson, 2016). This is known as the crowding out effect. In addition, infrastructure development is a form of long-term investment (Safitri et al., 2021). Thus, government spending policies for the economic function should be directed at improving the quality of the allocation for spending on economic functions as well as strengthening infrastructure and connectivity between regions.

Government spending on health does not significantly affect inclusive growth. This means that public health investment has not been able to increase the accumulation of human capital to encourage growth and expand access to health for all levels of society. One of the reasons is thought to be the gap in health development (Suparmi et al., 2018). The gap can be seen from two sides. On the supply side, public health development has not been easily accessible to the poor. On the demand side, awareness of the health conditions and healthy behavior of the poor tends to be lower than that of the non-poor. The implication is that the government needs to distribute access and health infrastructure for all communities. Various health education programs can also be carried out to increase awareness and healthy living behavior, especially for the poor.

Social protection spending also does not have a significant effect on inclusive growth. Johansson (2016) mentions that social protection can demotivate individuals to work. This causes the labor supply decreased, thereby reducing the level of output and growth (Arjona et al., 2003). On the other hand, the social protection provided is more in the form of cash or non-cash social assistance compared to programs to increase people's real income (Habibullah, 2019). The inaccuracy of targeting social assistance recipients can also be a factor causing efforts to increase equity have not been achieved (Misdawita & Sari, 2013). The implication is that social protection policies need to be directed towards more active policies, so can motivate individuals to work and increase their income. For example, the make-work-pay policy (Immervoll, 2012; Matsaganisa & Figaric, 2016) that aims to increase the income of poor households by providing incentives for job seekers or for the workers themselves. Apart from that, it is also necessary to improve the database of target recipients of social assistance.

Impact of financial inclusion on inclusive growth

Financial inclusion has proven to have a positive impact on inclusive growth in Indonesia, especially during 2015-2019. Increasing financial inclusion is able to encourage economic growth (Alekhina & Ganelli, 2020; Ratnawati, 2020; Zhou et al., 2018). An inclusive financial system will create an efficient financial infrastructure to serve the entire economy. It spurs growth by enabling greater investment and a more productive allocation of capital, as in Harrod-Domar Theory of Growth.

Expanding access to formal financial services will increase equality of economic opportunity. One of the benefits of inclusive finance is the provision of affordable credit, especially for the poor. Affordable credit can help them cope with difficult times (illness or death) and facilitate consumption. In addition, human capital theory explains that people need access to financial credit to invest in the human capital needed to find work and increase their income (Alekhina & Ganelli, 2020; Alvarez-Gamboa et al., 2021; Bozkurt & Karakus, 2020; Park & Mercado, 2015; Ratnawati, 2020). Therefore, an inclusive financial system must continue to be promoted and strengthened to support more inclusive growth.

CONCLUSION

Throughout 2015-2019, inclusive growth in Indonesia was influenced by government spending and financial inclusion. Specifically, education spending and financial inclusion will significantly increase inclusive growth. On the other hand, economic spending has a negative impact on inclusive growth. Meanwhile, spending on health and social protection does not have a significant effect on inclusive growth. The policy implications that can be given are increasing the quality of expenditure allocation for economic functions as well as strengthening infrastructure and connectivity between regions, increasing equitable access and more affordable health service infrastructure, as well as increasing supervision and providing active social protection. Apart from that, inclusive education and financial system must continue to be promoted and strengthened to support more inclusive growth. Finally, research development can be done by incorporating elements of government quality, taxation, or digital financial inclusion.

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Authors have no potential conflict of interest.

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