CHAPTER I

INTRODUCTION

1.1 Background

The economic development of a country is a process that must be carried out by a nation to fulfill a prosperous social standard in its country. However, building a country's economy is not an easy thing. In building the country's economy, it requires a lot of support for economic resources, both natural resources; human Resources; and capital resources, which are productive. While on the other hand, Indonesia's condition today still suffers from a lack of capital resources.

Indonesia is one of many developing countries. Not all developing countries or third world countries are poor countries, in the sense that they do not have good economic resources. Indonesia is a country that has abundant natural resources and human resources. Human resources that are not fully prepared are one of the obstacles to managing abundant natural resources. However, potential natural resource wealth cannot be maximally utilized.

In some developing countries, often found that economic growth is lower than growth expectations that can be achieved. In developing countries, the concept that is often used to measure state income is the concept of Gross domestic product. Gross domestic product is the value of goods and services are produced by a country within a certain period (Sukirno, 2000: 63).

Under these conditions, capital resources have a very important role to build a country's economy, Indonesia is no exception. One of the requirements to support the economy is the availability of sufficient capital to build the economy. There are many sources of income that can be used by Indonesia to fulfill the capital needs of economic development, including investment and taxes.

In general, investors are attracted to 3 types of investments in Indonesia, namely Plantation, Mining and Infrastructure. But investment growth in Indonesia has not been maximized. The Investment Coordinating Board (BKPM) recorded the realization of investment, both from domestic investment and foreign direct investment (FDI) throughout 2017 reaching Rp692.8 trillion or exceeding the target of Rp678.8 trillion. Despite an increase, investment realization growth in the past few years was relatively slower than growth in capital requirements (BKPM, 2018).

Meanwhile in the tax sector, the development has improved considerably. Reporting from APBN KITA January 2018 edition, the realization of tax revenue for 2017 reached Rp1,147.5 trillion or 89.4% of the target set. Realization of tax revenues in 2017 rise 3.8% from tax revenues in 2016. This is the highest compared to the realization in the previous two years in the range of 83% (Kemenkeu, 2018).

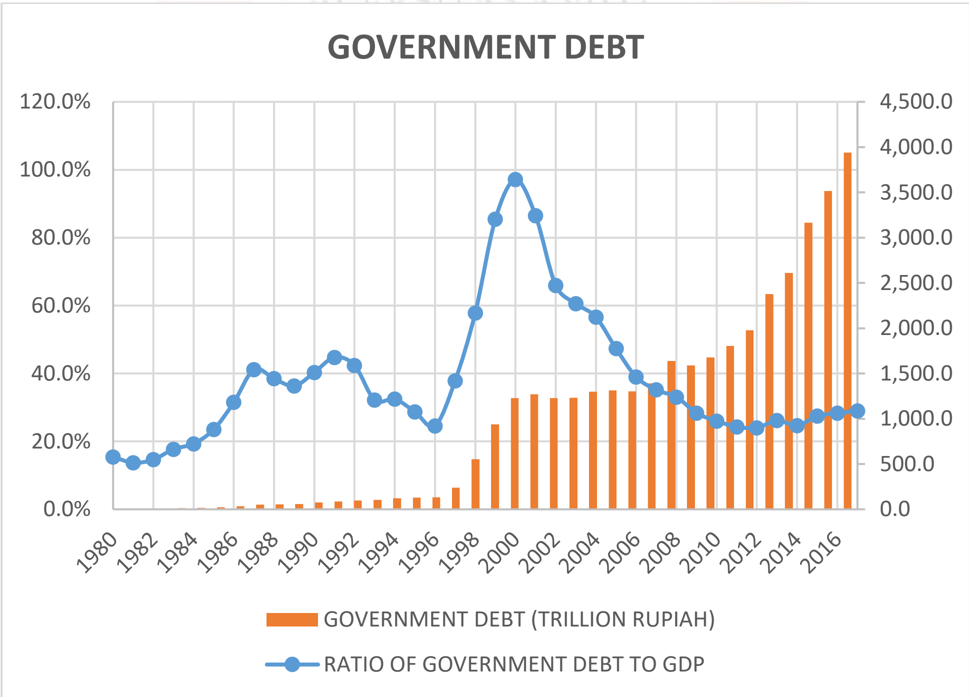
The policy of mobilizing funds through the tax sector often creates a dilemma. On the one hand, expansive taxation policies will enhance government revenues. Whereas on the other hand, the policy to collect more income from the tax sector will reduce the enthusiasm of the people to save and invest.

From this explanation shows that the government needs other sources of capital to improve the funding of the state budget and accelerate the process of economic development. An alternative step that must be taken by the government is to make loans from abroad.

Indonesia has been placing debt as one of the pillars of development, as a component to cover the lack of capital. When Indonesia lacks capital from the tax, oil and gas and non-oil and gas sectors, foreign debt remains a major component of income in the APBN.

Figure 1.1

Trend of Government Debt and The Ratio of Government Debt in Indonesia over 1980-2017



Sources: Ministry of Finance Indonesia (2018)

In recent years, the Indonesian government's debt has increased rapidly. Based on the Bank Indonesia report in 2018, as shown in the Figure 1.1, in 1980 the government debt of Indonesia reached Rp7.0 Trillion. The Indonesian government's debt continued to increase in the era of President Soeharto, and increase dramatically during the monetary crisis that hit Indonesia in 1998. At that time government debt reached Rp552.5 trillion or the percentage ratio of government debt to GDP reached 57.8%. Government debt in 1998 is two times greater than in 1997.

The increase in Indonesian government debt over the past few years has sparked public anxiety. Based on data from the Bank Indonesia, the highest ratio of government debt to GDP in Indonesia occurred in 2000 is 97.1%. Indonesia's debt in 2017 reached 3,983.5 trillion rupiah. When compared to government debt in 2013, in the era of Jokowi's government, Indonesia's debt increased by 46%. Some of the economic reasons underlying the current problem of government debt become important are:

a. The debt burden that must be paid in installments will increase even more. This is due to the pressure of currency exchange rates, such as the weakening of the rupiah today. As of August 2018, the average exchange rate of the rupiah is IDR 13,863 per US dollar (Bank Indonesia).
b. The ability to pay for it will decrease further if the value of the Debt Service ratio increases.
c. Large debt has the potential to cause an economic crisis. Like the conditions that occurred in 1997/1998.
d. There is an economic obligation to repay borrowed debt. This has the potential to slow down economic growth, because money that is supposed to be used to boost the economy must be used to pay off debts.
e. Theoretically the large amount of debt can affect public confidence in the economic prospects of Indonesia.

The government debt, which continues to increase is seen as a government depravity today. Reflecting on the events in Greece, excessive government debt brought Greece to the economic crisis and collapse in June 2015. This experience is a valuable lesson for other nations to evaluate the country's debt management strategy. Especially since 2014 the increase in government debt was not followed by an increase in Indonesia's GDP. This causes the ratio of government debt to GDP to continue to increase.

However, is it true that the large Indonesian government debt has a negative impact on the economy? There is debate among economists about the impact of the country's economy that will be generated, especially on economic growth. There are many empirical studies that have discussed the relationship between government debt and economic growth. Based on many previous empirical studies, there were two different results in the relationship between government debt and economic growth. Research has been conducted by Pattillo, Poirson, and Ricci, 2002; Reinhart & Rogoff, 2010; Kumar & Woo, 2010; Checherita & Rother, 2012; Debi & Badri, 2014 concluded that government debt has a negative relationship with economic growth. While the research that has been done by Jacobo & Jalile, 2017; Spilotti & Vamvoukas, 2015 concluded that government debt are able to encourage economic growth.

Meanwhile, some of economist suggest that a reasonable level of debt should help both developed and developing countries encourage their economic growth. Debt at a certain level that can be managed properly by the government for the productive sector will have a positive impact on economic growth. Jayaraman et al. (2009) studied six pacific Island major countries. This study concludes that there is a positive relationship between external debt and real GDP, but there is an inverse relationship between higher fiscal deficit and GDP growth.

Based on data and explanation before, this is precisely the motivation of this study to investigate the relationship between government debt and GDP growth in Indonesia over 38 years starting in 1980 until 2017 during the examined period, with a thesis entitled:

"Government Debt and Economic Growth: The Case of Indonesia"

1.2 Research Problem

Based on existing data, it shows that government debt of Indonesia is experiencing an increasing trend every year. This increase in debt is expected to have a significant positive impact on the growth of the Indonesian economy, because in the future there will be a debt burden that must be funded by the government.

Based on today's phenomenon, the main problems related to the correlation of government debt to Indonesia's economic growth can be formulated as follows:

1. What is the long-run relationship between government debt and economic growth in Indonesia?
2. What is the short-run dynamics relationship between government debt and economic growth in Indonesia?
3. What the relationship of another independent variable on economic growth in Indonesia?

1.3 Research Objective

Based on the research problem, the author's focus is to determine the relationship between the government debt and Indonesia economic growth, with the following objectives:

1. To examine long-run relationship between government debt and economic growth in Indonesia.
2. To examine the short-run dynamics relationship between government debt and economic growth in Indonesia.
3. To examine the relationship of another independent variable on economic growth in Indonesia.

1.4 Research Advantages

This study are expected to contribute for writer and the others parties that are:

1. Government

   For government, it will be recommended for the government to use and manage state finances, especially in implementing government debt management and in making decisions to add or not add new debt

2. Readers

   For readers, expected to be able to increase readers' insight and understanding of current Indonesian economic conditions, specifically the relationship between government debt and economic growth.

1.5 Scope of Research

The author focuses this research on the following:

1. Analyses the relationship between government debt and economic growth of Indonesia.
2. Economic growth defined as Growth rate of Gross Domestic Product (GDP)
3. Meanwhile, variables that influence or effect economic growth in this research are ratio of external debt to GDP, population growth rate, gross fixed capital formation, ratio of trade to GDP, inflation and human capital
4. The debt variables discussed in this study are limited to those included in government debt, not discussing the influence of private and central bank debt.

1.6 Writing Systematic

Systematic writing of this study is divided into six chapters. As for each chapter are briefly described as follows:

Chapter I: Introduction

This chapter consist of the background of the government debt and economic growth in Indonesia, research problem, research objectives, the research advantage, the scope of research, and writing systematic.

Chapter II: Theoretical Framework and Literature Review

This chapter will provide government debt theory and the relationship between economic growth and economic variables such as ratio of external debt to

GDP, population growth rate, gross fixed capital formation, ratio of trade to GDP, inflation and human capital. To support the literature review some explanation from empirical studies in the past, as proven.

Chapter III: Research Methodology

This chapter consist of the method of this study, research data such as sources of data and definition of variables, and method of data analysis such as unit root test, optimal lag test, cointegration test, ARDL test and classical assumption test.

Chapter IV: General Overview

This chapter describes the overview of research object, such as overview about trend of economic growth, ratio of external debt to GDP, population growth rate, gross fixed capital formation, ratio of trade to GDP, inflation and human capital in Indonesia.

Chapter V: Empirical Results and Analysis

This chapter consist the explanation of the results of the unit root test, optimal lag test, cointegration test, ARDL test and classical assumption test with the interpretation of the results obtained from the study.

Chapter VI: Conclusions and Recommendations

This chapter is the final part of the research that contains conclusions of the study and implication on the future research.