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Fiscal Decentralization and Regional Economic Growth

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Abstract

Fiscal decentralization in Indonesia initiated in 2001 has proven to be effective and efficient; although, its implementation still need to be evaluated. The aim of the study was to analyze the implementation of fiscal decentralization on economic growth in Central Java. Tools multiple regression analysis using the method Fixed Effect Model (FEM).The period of the research was 9 years (2009-2017), and the subject of the was 35 districts/cities in Central Java Province. The dependent variable was economic growth, the independent variable was fiscal decentralization, and the control variables were investment and labor. The results showed that fiscal decentralization has a positive effect on economic growth in the district/city in Central Java. Other findings, private investment and the amount of labor encourage economic growth in Central Java. Based on findings, to reduce the fiscal gap, local governments should be able to increase their fiscal capacity through the development of commodity-based economic activity in their regions.
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INTRODUCTION

The implementation of regional autonomy and fiscal decentralization in Indonesia which was effective on January 1, 2001 by the issuance of Law No. 22 of 1999 on Regional Government and Law No. 25 of 1999 on Financial Balance between Central and Local Government bring significant changes. Among the changes is that fiscal decentralization will be able to accelerate the realization of public welfare in local regions because local governments will be more flexibility in managing resources and responding to environmental changes based on community needs. Therefore, fiscal decentralization plays an important role in promoting sustainably economic growth at regional level through budget allocations in real sectors. Zang and Zou (1998) stated that the decentralization of expenditure and revenueis an approach to improve efficiency in public sector, decrease budget deficit, and promote economic growth. In this case, economic growth is used as an indicator to assess economic performance, particularly in increasing the production of goods and services,at regional level. Furthermore, the increased production of goods and services is expected to have trickle-down effect that could improve people's welfare.

The consequence of the implementation of the regional autonomy is that regional governmentshave to achieve high economic growth and sustainable development in order to overcome various problems such as unemployment, poverty, and inequality. Table 1 shows the economic growth in Central Java and Indonesia, as well as budget transfer from central government to regional government.

Table 1. Economic Growth in Central Java, Economic Growth in Indonesia,and Realization of Budget Transfer to Regional Government in 2011-2017

	2011	2012	2013	2014	2015	2016	2017
Economic Growth in Central Java (%)	5,3	5,4	5,1	5,3	5,5	5,3	5,3
Economic Growth in Indonesia (%)	6,2	6,0	5,6	5,0	4,9	5,03	5,07
Budget Transfer from Central to Regional (trilyun rupiah)	403,7	480,6	513,3	573,7	623,0	776,3	764,9

Source: Central Bureau of Statistic (BPS) (analyzed) and the Directorate General of Fiscal Balance (DJPK) Ministry of Finance, a number of years

The economic growth in Central Java and national level fluctuates and tends to be stagnant caused by the weakening price of commodity in the world, the declining purchasing power ofthe consumers, and the Chinese slowing-economy. As a result, the transfer of funds from central government to regional administration is increasing every year.

Economic growth is influenced by several factors such as government spending, investment, and labor.The government spending on real sectors such as infrastructure can improve the efficiency of production and distribution as well as to encourage economic growth in a region. Wyatt (2005) argued that the scale composition government expenditure on consumption affect the level and rate of growth of productivity at all levels of industries. Meanwhile, Gonzalo et al. (2017) pointed out that government should be disciplined in its fiscal and reduce the debt to avoid a crisis. In addition to government spending, participation of private sectors in the form of investment is needed as investment will speed up economic growth. In Pakistan, investment (private and public investment) is sources of funds to improve productivity of a company and has a direct impact on national income and therefore increase the economic growth (Aurangzeb, 2012). In addition to a direct impact on the increase in national income of Pakistan, investments can also be directly perceived by the

public which is reflected in the instability inpolitic, economy, and law. To encourage economic growth in provincial level, sufficient quantity and quality labors are needed. Neo Classical theory (in Todaro, 2015) stated that economic growth is determined by the development of production factors, such as capital, labor, and technology. Many economists believe that the quality of labor input that are skillful, knowledgeable, and discipline is the most important element in economic growth. For example, Samuelson and Nordhaus (2002) stated that human resource inputs consist of quantity and quality of labors; while, Ritzen (2013) argued that higher educated workers with good knowledge and skills will encourage productivity of a country to increase, and has a direct impact on economic growth. On the contrary, a nation having poor quality of workers will be borne by a high unemployment rate. Given this background, this study aims to analyze the effect of the implementation of fiscal decentralization to economic growth in district/city in Central Java province of Indonesia, and the control variable is investment and labor.

According to Law No. 32 of 2004, decentralization is the devolution of government power from central government to autonomous regions within the framework of the Unitary Republic of Indonesia. Meanwhile, fiscal decentralization is the transfer of functions and fiscal responsibility from central government to local governments in order to improve the welfare of the community. The goal of fiscal decentralization is to provide opportunities to regional administration to explore various sources of funding and allocation of expenditures appropriate to regional needs.

According to Ivar and Odd-Helge (2006), fiscal decentralization is authorizing expenditure and maintaining resources of revenue to local governments. The benefits are that local government might adjust the needs of the community with the budget allocations, efficiency through competition might occur,and financial capability might increase.

However, the drawback is that the decentralization may not be efficient in term of policy decisions and the use of resources if there are positive and negative externalities among regions. Ebel and Yilmaz (2002) explains the fiscal decentralization-related issues: The division of roles and responsibilities of governmental structures, Transfers among governmental structures, Strengthening the system of revenue andof local public services, Privatization of government-owned company that sometimes includes the responsibility of local governments, and the provision of social safety nets. Fiscal decentralization has a very important role in economic growth since local governments have great authority to invest and spend more on productive sectors. Lin and Liu (2000) argued that economic growth may occur in two ways; by increasing capital investment and doing efficiency on the available resources. In addition, Parash study (2015) showed that developing countries have significant factors affecting the economic growth, namely:

Export volume of and natural resources production. Developing countries are supplier of raw materials to countries that produce goods. Therefore, exporting natural resources are essential to sustain their income. Investment, Investment is essentialin improving productivity of developing country. If the value of an investment increases, jobs availability will increase, productivity of companies will also increase, which result in reducing unemployment and increasing national income. Labor. Human resource is the most important factor in the development process. The acceleration of the development depends on the extent to which the human resources as the subject of development have sufficient competence to carry out the process of the development.

According to growth theory of neo classic, the growth of the output is obtained from one or more of three factors, namely the increase in the quantity and quality of labor, capital improvement (through saving and investment), and the advances in technology (Todaro, 2015). In the economic growth model of Neo Cassic, standard aggregate production function is as follows:

$$Y = Ae^{\mu t}. K^{\alpha}.L^{1-\alpha} \quad (1)$$

Where Y = gross domestic product; K = stock of physical and human capital; L = labor; A = a constant that reflects the level of basic technology; $e^{\mu t}$=progress rate of technology; α = output elasticity to the model; the percentage growth of GDP that comes from a 1% increase in physical and human capital.

The role of investment is very important in fostering economy as in the long-term investment has a dual effect. In one side, the investment affects demand aggregate, on the side, the investment affects the capacity of national production by adding available stock of capital. The national economy must always be in steady-state growth, because the demand arising from the increased investment must always be balanced by the effect of offering. According to Haming and Basalamah (2010), investment is a spending at present time to buy real assets (land, house, car, etc.) or financial assets in order to get higher return in the future. Investing is a business activity related to resources (funds) accumulation used to hold capital goods at the present time with which new products will be produced in the future.

Meanwhile, according to Samuel (2013), investment has important policy implications as the government should be concerned with the importance of the investment contribution to economic growth. Economic development of a country can be achieved by encouraging investment (foreign, public, and private investment) to create more jobs. In addition, the use of technology in production will train more skilled labor force, increase productivity, and fulfill the demand and satisfaction of the consumers.

However, investment has a negative effect to domestic manufacturers for they will lose their market power as foreign investors become serious competitors in the market. In this situation, the domestic manufacturers will indirectly face difficulties to survive in the long term because foreign company economically achieve its scale by using technological advances. Therefore, the government should enact relevant policies such as joint ventures to provide opportunities for domestic manufacturers to become part and enjoy the benefits together with foreign investors such as transferring and adopting high technology.

The availability of skilled workers might attract investors to come into a region and provide work opportunities that expected to reduce unemployment and poor people. Todaro (2015) stated that the higher the labor force, the higher the labor productivity, and the higher the domestic market. From this perspective, population growth and the increase of the labor force is a positive factor for economic growth. A big number of labor force growth means more productive workers, and a big population will expand the size of the domestic market. So, it can be concluded that the workforce has a significant impact on economic growth of a region. One of the objectives of economic development is the provision of greater employment opportunities to workforce as especially in developing countries,the growth of workforce is faster than that of economy growth.

RESEARCH METHODS

The purpose of this study was to analyze the effect of the implementation fiscal decentralization on economic growth in the district/city in Central Java Province of Indonesia. The dependent variable was economic growth that is the continuous process of increasing output of an area for a certain period of time expressed in units of percent.

The independent variable was fiscal decentralization, and the control variables were investment and labor. Fiscal decentralization is the ratio of expenditures of every local government at district/city level to the realization of the total expenditure spent by central government. Investment is the realization of private investment consisting of foreign investment (FDI) and Domestic Investment (DI). Labor force is the population aged 15 to 65 years working in various business fields.

The data used this study were secondary data from panel data obtained from Central Bureau of Statistics, Board of Investment, and Ministry of Finance. The period of the research was 9 years (2009-2017), and the subject of the was 35 districts/cities in Central Java Province. The tool used to analyze the data was multiple regression using Fixed Effects Model (FEM). The research model is formulated in the following equation:

EG= f (DF,INV, L) ....(2)

$EG_{it}= \beta_0+\beta_1 DF_{it}+\beta_2\ INV_{it}+\beta_3 L_{it}+\mu_{it}$...............(3)

Where EG is economic growth; DF is fiscal decentralization; INV is investment; L is labor; μ is error term; β_0 is constant; $\beta 1$...... $\beta 3$ is regression coefficient; i is cross-section data (35 regions); t is the time-series data. In this study using nine-year time series data, during the period 2009 - 2017. In this study, the regions that will be the object of research are all districts/cities in Central Java Province, namely 29 Regencies and 6 Cities with a period of time from 2009 to 2017.

RESULTS AND DISCUSSION

There are two levels of local government in Indonesia; provincial and district/city. In the autonomy and fiscal decentralization era, the spending of local government increased sharply compared to the previous one as the authority delegated from central government to the local government was getting bigger, and the principle of money follow function was inherent. The total spending of the government constantly increase every year. The problem was that there was still a widely vertical gap between central and local government in term of financial sector resulted in a very high dependency of local to central government. Theoretically,fiscal decentralization variables have a functional relationship with macroeconomic performance in the regional level. The estimation results of the independent variable on the dependent variable using FEM is shown in the steps: The first step is Chow test to choose the common effect model or with the fixed effect model. The Chow test results in Table 2 below:

Table 2. Chow Test

Effects Test	Statistic	d.f.	Prob.
Cross-section F	3.630355	(34,277)	0.0000
Cross-section Chi-square	116.085885	34	0.0000

Chow test results prob. value Chi-square cross-section <0.05, the fixed effect model is chosen instead of the common effect model. Next is the Hausman test, the results are shown in Table 3 below:

Table 3. Hausman Test

Test Summary	Chi-Sq. Statistic	Chi-Sq. d.f.	Prob.
Cross-section random	4.863134	3	0.1821

Hausman test results with prob.value greater than 5%, it can be concluded that the fixed effect model is better than the random-effect model. The estimation results of the independent variable on the dependent variable using FEM is shown in Table 4. Based on the results of the estimated panel data in Table 4, the regression equation obtained is as follows:

$EG = 5.132831 + 0.579377\ DF + 6.45E\text{-}15 Inv + 7.56E\text{-}07L$

(6.714818) (7.165883) (7.312656)

Collectively, fiscal decentralization, private investment, and manpower significantly and positively affected economic growth of districts/cities in Central Java.

According to Medina and Marcela (2002) decentralization is the delegation of power, functions and resources from higher levels of government (national level) to lower levels (sub-national level). The aim is to strengthen regional government autonomy and encourage citizen participation at the local level in public affairs. There are three things that are submitted by the central government to local governments, namely: Authority to carry out decision making quickly and accurately to respond to problems and public affairs that are being faced by communities in the area, Carry out the main functions of the government as already stated in the law for the community at the regional level, so that the presence of the government can be felt more real, Delegation of resources, so that local governments are able to provide public goods and carry out the implementation of public services for local communities.

Table 4. Estimation Result of Fixed Effects Model (FEM) on Dependent Variable of Economic Growth

Var.Independen	Coef.	Std. Error	t-Statistic	Prob.	Conclusion
Cons	5.132831	0.032090	159.9510	0.0000	
DF	0.579377	0.086283	6.714818	0.0000	Significance
Inv	6.45E-15	1.01E-14	7.165883	0.0117	Significance
L	7.56E-07	1.03E-07	7.312656	0.0000	Significance
R-squared	0.627222				
Adj. R-square	0.577429				
F-statistic	12.59648				
Prob(F-statistic)	0.000000				

Significance at α=5%

Fiscal decentralization significantly and positively affected the economic growth in thedistricts/cities in Central Java province. If fiscal decentralization increases through the increased government spending, economic growth will also increase. The delegated authority and budget to local governments created a flexibility of regional administration to perform its functions to appropriately allocated budget based on local potencies and public needs. Public investment would have a direct impact on the productivity of the economic development. Thus, local governments proved to be more sensitive to local economic conditions after the enactment of the fiscal decentralization. The local governments were more independent and creative in managing as well as exploring potential resources to improve the economic growth of their regions.

In the context of decentralization funding, a very crucial problem is the effectiveness of budget use. Larger budgets rolling into the regions and spent by the regions must have a positive impact on improving people's welfare. The success of a region in improving people's welfare is influenced by the expenditure policies of each local government. The regional government expenditure policy can be reflected in the amount of expenditure allocation for each function and type of expenditure. This findings corroborated the one of Hammond (2009) that an increase in the value of decentralization in the metropolitan cities of the United States positively and significantly affect their economic growth. Every 10% increases in decentralization resulted in the increase of economic growth by 0.28%. The increased decentralization directly influenced the revenue of a city or region; as a result,this region might use the available funds for productive projects to increase revenue and economic growth. Attari et al. (2013) found that both in the short and long-term, government spending has a positive effect on economic growth. The local government that deeply understood the needs of its region had the authority to regulate the allocation of expenditures embodied through development projects planned to boost economic growth.

In addition, government spending in infrastructure development could also help facilitate economic activity. Whenever goods were easily distributed with acceptable price due to the improvement of infrastructure, the profits of the companies would increase and the economic growth in the region would also increase. The findings of Akai and Sakata (2002), Desai et al. (2003), and Thiessen (2003) also showed that fiscal decentralization has a positive effect on economic growth. Meanwhile the Sasana and SBM study (2018) concerning the implementation of decentralization in Indonesia found that fiscal decentralization was able to reduce poverty in Central Java Province. Sasana (2018) also found that economic growth increased the budget deficit of regional governments in Indonesia. So that local governments must be effective and efficient in allocating budgets to sectors that drive the economy.

On the contrary, a study of Thornton (2007) by comparing 19 countries of OECD and using OLS analysis concluded that the fiscal decentralization revenue through the transfer does not affect economic growth at the regional level. Fiscal decentralization does not significantly affect economic growth, because OECD countries has had a very high economic independence. Moreover, Davoodi and Zou (1998) also identified that fiscal decentralization does not have a significant impact on economic growth in developing countries. Meanwhile, Nukman (2013) argued that although fiscal decentralization policy positively and significantly affect economic growth in underdeveloped areas, but the value of the resulting growth is relatively very small that the average of GDP per capita in underdeveloped areas is still far below the average of the national GDP per capita. Furthermore, the finding of Woller and Phillips (1998) as well as Baskaran and Feld (2009) showed that fiscal decentralization fail to push economic growth; although, Breuss and Eller (2004) stated that an ambivalent effect in the relationship between fiscal decentralization and economic growth takes place, making it difficult to draw a clear recommendation concerning the optimal decentralization. There was no clear relationship between fiscal decentralization and economic growth.

As fiscal decentralization in Indonesia was more focused on the expenditure side, the essence of regions' fiscal management was the freedom to use/allocate the budget according to priorities and needs of each regions. The influence of local government expenditures on the performance of the regional economy depended on the allocation and composition of regionals' spending. The more the decentralized public expenditure spent to productive sectors,the more positive influencesthe economic growth at the regional area would be. Miskhin (2008) explains that the increase in aggregate demand caused by the transfer of funds from the central government to the regions, is a decrease in inventory (inventors) from unplanned economic actors. If the economy is very close to its potential output (when the economy is in a part of a steep aggregate supply curve), then the economy cannot increase output on a large scale

The other result of this study showed that investment significantly and positively affected economic growth of districts/cities in Central Java. If an investment in creases, economic growth will also increase. Central Java Investment Board (2016) reported that the realization of private investments (domestic and foreign) in Central Java tends to increase from year to year. In 2014, the realization of private investments in Central Java was Rp 18.7 trillion, and increased to Rp 26.04 trillion (39.25%) in 2015. The economic performance showed a similar pattern, but the growth rate was relatively slow.

This result was consistent with the finding of Kongphet (2012) that public and private domestic investment has a positive effect on economic growth in 15 developing countries in Asia. The problem was that the value of public investment in developing countries continued to decline from year to year and was distributed to private investment; so that,the private investment exceeded the threshold of investment.

This result was also consistent with the findings of Antwi (2013) that foreign direct investment (FDI) significantly affect economic growth, and FDI plays an important role in the economy of Ghana as there is a positive relationship between FDI and economic growth. Economic development could be achieved by encouraging FDI to create more jobs in a country. In addition, the investment should introduce an advanced technology to increase production and economic growth. The research finding of Afzalur (2014) revealed that the investment has a positive effect on economic growth in developing countries as the demand for capital formation in developing countries can be provided by investment. Through investing the resource gaps in many developing countries would be filled. For example, investment has allowed economic growth in South and East Asia by raising capital. Investment was useful for building physical infrastructure such as roads, factories as well as transfer of knowledge, technology, managerial skills, and ideas that can contribute to the economic development of the country.

Investment as capital formation was very important to encourage regions' economy, especially in Central Java, because regional development required huge funds, while local governments had limited budgets.Therefore, the private sector, both foreign and domestic investors, should closely get involved, and the government should provide conducive policies, good public services, and law to accommodate investors'security. The increased investment to regional areas might encourage increased production volumes and create employment opportunities that can boost economic growth, income per capita, and the welfare of society. While the study of Sasana et al. (2018) regarding investment (FDI and domestic investment) in the era of fiscal decentralization in Indonesia found that investment is able to improve the welfare of the people in Central Java Province.

Investment will encourage capital accumulation, increase the potential output of a region and stimulate economic growth for a long period of time. Therefore, in the macroeconomic context the role of investment is very important, so that the economy can run well, so that we can reduce poverty and unemployment. This is in accordance with Harrod-Domar's theory (Todaro, 2015) that economic growth requires investment, and economic growth is part of economic development. Economic development will also have an impact on human development as measured by the Human Development Index (HDI).

Alvarado, et al. (2017) stated that FDI has a negative effect on economic growth in poor and low-income countries, with uneven effects. Whereas in Sunde's research, (2017) investment has not been proven to influence economic growth. In a study conducted by Pegkas (2015), it was stated that FDI was a significant factor that had a positive impact on economic growth in several European countries. Meanwhile the research of Anthony et al. (2015) states that domestic investment has a positive relationship with economic growth in Nigeria.

The result of the estimated regression indicated that labor positively and significantly affected economic growth. If the number of labor increases, the economic growth will also increase. This result was in line with the opinion of Solow (in Jones, 2014) stated that economic growth depends on the provision of production factors (population, labor, and capital accumulation). If the amount of labor increases, the level of productivity of a region will also increase rapidly so as to boost economic growth. Therefore, productive workforce was important to push economic activities of a region. The findings of Emsina (2014) stated that labor positively affects economic growth, especially in times of economic crisis. In the pre-crisis period in Latvia, Lithuania and Estonia, the relationship between labor and the economic growth was relatively weak. However, when the economic crisis occurred, manpower significantly affected the economic growth.

The availability of labors and increased labors productivity encouraged company increased production and therefore contributed to increased global competitiveness and economic growth. Shahid (2014) showed that labor force has positive influence on a country's economic growth in Pakistan. Factors affecting labor positive effect on economic growth are establishing a new educational institution to improve labors'skills, and promote economic growth in Pakistan. There is a need to build a new training institute that provides trained manpower to increase the economic growth of Pakistan. There is a need of promoting government gross fixed capital formation through monetary policy. The increase in interest rates encourages savings to be converted to investment and promotes economic growth.

Ratan (2016) stated that labors have significant and positive effect on economic growth. A study in India proved that OLS regression with a correlation coefficient of 0.65 is considered good enough to explain the relationship between employment and economic growth.

The increase of the number of labor force would increase nation productivities, so that state revenues would also increase that might boost economic growth. The output of each economic activity depended on human resources activities; therefore, human resources was the main resource in accelerating the development. Contributions of workers working in various business fields influenced the economic growth. The increase number of labors and skilled experts in a region will encourage economic growth.

Labor affects of poor people from the perspective of economic growth impact. Todaro, (2015), stated that economic growth is influenced by capital, labor, and technology. The availability of qualified workforces can attract investment into a region and absorb unemployment. Therefore, the availability of a qualified workforce is needed to address the socio-economic problems such as poverty. Furthermore, Samuelson and Nordhaus (2010), argued that labor input consists of quantity and skills of the work force. Many economists believe that the quality of labor input is an important element in economic growth that late affect poverty reduction.

Labor is an important input to drive the economy of a region. The output of economic activity depends on the productivity of its human resources. Human resources are the main factor to drive economic growth. The contribution of labor in various sectors is very important for economic growth. The large number of qualified workers in each region will encourage economic growth in the region The study of Folawewo & Adeboje (2017) using a sample of West Africa shows that the GDP growth rate can reduce the unemployment rate in West Africa, but not significantly, which is indicated because the growth of labor elasticity in the area is low. The results of this study are in accordance with the research of Astra Auzina & Emsina (2014), finding that the relationship between labor productivity and economic growth is significantly different and this is not a constant or stable relationship over time. The finding argues that there is a weak relationship or there is no relationship between labor productivity and economic growth in the period before the crisis and the first post-crisis period. However, increasing labor productivity during the crisis is a significant economic driver after a certain period of time.

CONCLUSION

The relationship between regional autonomy and fiscal decentralization is an embodiment of the principle of money follows function, funding follows the function of government. In its implementation, the transfer of authority to the regional government, the central government provides funding sources to carry out this authority.

The various results of the study of fiscal decentralization often do not produce the same conclusions among researchers and those interested in decentralization. There are cross opinions on each party that has a logical argument and has proven it empirically. The results of the study of Vazquez Martinez and McNab M Robert (2006) prove that fiscal decentralization will lead to macroeconomic instability through inflation which will then reduce regional economic growth. Feltenstein Andrew and Shigeru Iwata (2005) found negative results and did not even have a significant relationship between fiscal decentralization on macroeconomic stability through price stability.

Referring to the results and discussion of the previous section,it can be concluded that the implementation of fiscal decentralization in Indonesia has a positive effect on economic growth in the districts/cities in Central Java

Province. This condition indicates that the implementation of fiscal decentralization in Indonesia has been increasing the regional economy. Moreover, the increasing realization of private investment (domestic and foreign) and of the number of workers also has a positive and significant relationship on the economic growth in the districts/city in Central Java Province.

To reduce the fiscal gap, local governments should be able to increase their fiscal capacity through the development of commodity-based economic activity in their regions. The local governments must perform the allocation function effectively and efficiently to develop real sector within their area.

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