



# Fiscal Decentralization in Economic Growth and Social Development in Indonesia

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## Abstract

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Fiscal decentralization in Indonesia has become an essential instrument to achieve regional independence, equitable development, and improvement in the quality of public services. This study aims to analyze the role of fiscal decentralization in relation to economic growth and social development in Indonesia by employing a library research method based on relevant academic literature. The review results indicate that fiscal decentralization contributes positively to the increase of Gross Regional Domestic Product, the Human Development Index (*Indeks Perkembangan Manusia* /IPM), as well as the quality of education and health, particularly in regions with strong institutional capacity. Nevertheless, several serious challenges remain, including fiscal disparities across regions, the dominance of bureaucratic expenditure, and the low level of accountability in budget management. Fiscal transfers have proven effective in reducing inequalities, but excessive dependence on transfers may weaken local innovation. The discussion further highlights that the success of fiscal decentralization is determined not only by the amount of transfers, but also by governance, transparency, and active public participation. Therefore, fiscal policy reform is required through optimizing productive expenditure, strengthening local fiscal capacity, and improving systems of oversight and public accountability.

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## 1. Introduction

Fiscal decentralization is one of the fundamental policies in modern governance that aims to provide greater financial autonomy to local governments. Since the implementation of decentralization reforms in Indonesia in 2001, local governments have been given the authority to manage budgets and public resources independently according to local needs. This policy is expected to accelerate regional development, improve the quality of public services, and reduce inter-regional inequality. In addition, fiscal decentralization opens up opportunities for regions to develop local economic potential, encourage policy innovation, and strengthen community participation in development. However, the implementation of fiscal decentralization in Indonesia faces various serious challenges. One of them is the fiscal gap, which reflects the difference between the fiscal needs of a region and its available financial capacity. Regions with a strong economic base tend to be more capable of financing development compared to regions that depend on central transfers.

Regional transfers (*Transfer Ke Daerah*/TKD) through schemes such as the General Allocation Fund (*Dana Alokasi Umum* /DAU), Special Allocation Fund (*Dana Alokasi Khusus* /DAK), Revenue Sharing Fund (*Dana Bagi Hasil* /DBH), and Village Fund are important instruments to close this fiscal gap. However, the dominance of personnel expenditure in regional budgets reduces fiscal space for productive sectors such as education, health, and infrastructure (Yusuf & Muhammad, 2020). The theory of fiscal decentralization emphasizes that local governments have a comparative advantage in information regarding local

community needs, allowing them to allocate budgets more efficiently. From the perspective of economic growth theory, fiscal decentralization is viewed as being able to increase productivity and encourage long-term growth through the provision of better public services. However, empirical findings in various countries show inconsistent results. Studies in developed countries generally find a positive relationship between fiscal decentralization and economic growth, while in developing countries the results tend to vary or even be negative. In the Indonesian context, fiscal decentralization has a dual impact. On one hand, it increases regional independence and accelerates the development of basic infrastructure. Data from the Central Statistics Agency (*Badan Pusat Statistik*/BPS) show that since the era of regional autonomy, per capita Gross Regional Domestic Product (*Produk Domestik Regional Bruto*/PDRB) has increased significantly, accompanied by an increase in the Human Development Index (*Indeks Perkembangan Manusia*/IPM) in most provinces. On the other hand, inter-regional fiscal inequality remains high, the quality of public services is still not evenly distributed, and most regional spending is still concentrated on bureaucratic needs (Ashkenazy et al., 2018).

Recent research findings also show that the effectiveness of fiscal decentralization depends not only on the amount of transfers to the regions, but also on the quality of governance, institutional capacity, and accountability in regional financial management. For example, a study by Aritenang (2020) found that regions with low fiscal capacity but transparent governance were able to utilize transfer funds more effectively than regions with high capacity but low accountability. Therefore, this research aims to examine the effect of fiscal decentralization on economic

growth and social development in Indonesia using a literature review approach. This research also seeks to fill a gap in the literature, namely the lack of a comprehensive study that links the fiscal dimension with social aspects, such as education and health. The urgency lies in the importance of formulating a more just, efficient, and welfare-oriented fiscal policy that is evenly distributed across society.

## **2. Literature Review**

### **2.1. Fiscal Decentralization and Economic Growth**

Empirical studies show that the relationship between fiscal decentralization and economic growth is essentially quite diverse and the results are not always uniform in various contexts. In Indonesia itself, the latest research conducted by Yusuf and Muhammad (2020) confirms that fiscal decentralization through the central-regional transfer mechanism generally contributes positively to economic growth. However, the effect produced by this policy is not evenly distributed among provinces, due to differences in fiscal capacity, quality of governance, and level of regional development. Therefore, it can be said that decentralization does not automatically produce equal results in all regions. The degree of fiscal decentralization is the level of a region's ability for fiscal independence. A region is said to be worthy of becoming an autonomous region if one of the conditions is that it has the ability to finance itself from its own potential. (Hanif et al., 2020)

Furthermore, Ashkenazy et al. (2018) emphasize that the efficiency of regional spending is a key factor that determines the magnitude of the fiscal impact on PDRB. In other words, even if transfer funds from the central government are quite large,

if regional spending is not managed effectively, the contribution to growth will tend to be low. This shows that the quality of regional budget management is no less important than the amount of funds transferred. On the other hand, another study in developing countries, as stated by Nanthalath et al. (2020), actually confirms that without strict supervision and clear accountability mechanisms, fiscal decentralization can widen inequality between regions. Therefore, the implementation of fiscal decentralization requires a combination of central fiscal support, regional institutional capacity, and an effective monitoring system so that the goals of equity and growth can be achieved in a balanced manner.

## **2.2. Fiscal Decentralization and Social Development**

Citation the social dimension in fiscal decentralization policies is now receiving more attention from researchers and policymakers. This is because decentralization is not only seen as an economic instrument, but also as a means to improve people's welfare more equitably. Nursini (2019), for example, shows through his research results that regional transfer funds are positively correlated with improvements in social indicators such as education and health. However, an important note is that inequality between regions still exists, so the benefits of decentralization have not been fully enjoyed equally by all provinces and districts/cities in Indonesia.

Furthermore, Siburian (2020) found that the quality of public services can increase significantly in regions that have strong institutional capacity. In other words, the success of fiscal decentralization in improving public services is strongly influenced by the ability of regional institutions to manage budgets, formulate

policies, and implement transparent and accountable governance. However, the results of research conducted by Farida et al. (2021) actually warn of a serious obstacle, namely the large dominance of bureaucratic spending, so that the contribution of decentralization to the increase in the national Human Development Index (HDI) is still limited. Therefore, the effectiveness of fiscal decentralization should be measured not only from the perspective of regional economic growth, but also from its contribution to the equitable development of human beings. With this approach, decentralization can become a more comprehensive instrument for achieving sustainable development goals.

### **3. Methods**

This research uses the library research method, which is an approach that focuses on reviewing and analyzing existing literature, so it does not directly collect field data. In the context of this research, this approach is considered relevant because the topics of fiscal decentralization, economic growth, and social development are issues that have been widely discussed in various academic literatures, both at national and international levels. By using the library research method, this research seeks to identify, compile, and analyze various findings that have been published to gain a comprehensive picture of the dynamics of decentralization policies in Indonesia. Research data sources include academic journal articles indexed in reputable databases, which are considered representative of the quality of research at the global and national levels.

In addition, this research also utilizes official reports from Indonesian government agencies, both ministries and technical institutions, as well as relevant international publications, such as reports from world development organizations. This diversity of sources aims to enrich the analytical perspective while increasing the validity of the study conducted. The research process is carried out through several systematic stages. First, a literature search is conducted using keywords such as “fiscal decentralization,” “economic growth,” and “social development in Indonesia.” Second, after obtaining the initial search results, a selection process is carried out for articles that meet the criteria, namely publications that are relevant, have tested academic quality, and are in accordance with the focus of the research. Third, a content analysis is carried out on the selected literature to find common patterns, similarities in findings, and differences in results between studies. This stage is important for formulating conclusions that are not only based on one source, but on a synthesis of various literatures.

This method was chosen because it is considered capable of providing a more comprehensive picture of the development of the theory, practice, and challenges of implementing fiscal decentralization in Indonesia. Thus, the research results are expected not only to enrich the academic discourse, but also to serve as a reference for policymakers in formulating a more effective, fair, and development-oriented decentralization strategy as well as improving the social welfare of the community.

## **4. Results**

The results of the literature review as a whole show that fiscal decentralization in Indonesia has a complex, layered, and multidimensional impact, both on economic growth and social development. This complexity arises because decentralization does not only involve technical fiscal aspects, but is also closely related to the quality of government governance, regional institutional capacity, and the social-economic conditions of the community in each region. Several studies highlight the success of decentralization in increasing regional fiscal capacity, especially through increased revenue from the DAU and the DAK. However, other studies actually found that the region's dependence on central transfers is still very high, and in many cases, the increase in these funds is not always accompanied by improvements in the quality of public services. This confirms that the impact of fiscal decentralization is not uniform, but is highly determined by variations in the regional context and the quality of management at the regional level.

The research conducted by Yusuf and Muhammad (2020) provides an important overview of the significant contribution of DAU and DAK to the growth of Gross Regional Domestic Product (PDRB), especially in the basic infrastructure sector. Infrastructure is considered one of the drivers of economic development, and through the allocation of transfer funds from the central government, many regions have been able to build road networks, transportation facilities, and basic services that support local economic growth. However, this finding also reveals a significant disparity, because the contribution to economic growth is more dominant in urban areas than in rural areas. This means that although fiscal transfers have had

a positive impact on development, the gap between regions remains high. This shows that fiscal decentralization, without a strong equity strategy, has the potential to widen the gap of inequality.

Furthermore, a different perspective by highlighting the role of Local Own-Source Revenue (*Pendapatan Asli Daerah*/PAD). They argue that increasing PAD is very important in strengthening regional fiscal independence. Fiscal independence means that the region does not completely depend on transfers from the central government, but is able to manage its own local resources. Unfortunately, the reality in the field shows that most regions in Indonesia still have relatively small PAD, so the fiscal space to finance independent development is still limited. This condition ultimately strengthens the phenomenon of fiscal dependence on the central government, which in the long term can reduce the effectiveness of decentralization itself.

Nanthalath et al. (2020), through a cross-country study, emphasized that the positive relationship between fiscal decentralization and economic growth can only be achieved if it is accompanied by transparent government governance and accountable regional financial management. Without good governance, decentralization is at risk of causing inefficiency, budget wastage, or even corruption. This condition is very relevant for Indonesia, where the variation in the quality of governance between regions is very diverse. There are regions that are able to manage transfer funds productively, while there are also other regions that are still constrained by institutional capacity and low accountability, so the effectiveness of using transfer funds is weak. Fiscal transfers from the center to the regions, for

example through the Revenue Sharing Fund (DBH) scheme, have basically been proven to help resource-rich regions increase their development capacity. DBH provides significant additional funds for regions with abundant natural resources, so they can allocate a larger budget for development. However, research conducted by Siburian (2020) emphasizes that this scheme has a serious weakness because it actually widens fiscal inequality between regions. Regions with abundant resources automatically get larger funds, while regions with poor resources get a smaller portion. This inequality creates an increasingly sharp development disparity. To overcome this, the government then implemented a needs-based Special Allocation Fund (DAK) mechanism. Unfortunately, the effectiveness of this DAK scheme is still limited, especially because the allocation often has not fully considered the structural disparities that exist between regions.

In the research by Nursini (2019), it was highlighted that fiscal inequality in Indonesia is not only caused by differences in fiscal capacity, but also by weak development planning at the regional level. Many regions still prepare budgets that are more oriented towards routine spending, such as personnel expenditure, rather than long-term investment that supports sustainable development. As a result, even though transfer funds increase, the impact on long-term development is not significant. This contributes to the occurrence of a fiscal gap, which is a condition where the fiscal needs of a region are much greater than the real fiscal capacity available. This fiscal gap is a serious challenge for the central and regional governments in realizing the goals of decentralization. The higher the fiscal decentralization, the lower the economic growth, and vice versa. In other words,

domestic growth from this sector can be used to estimate the amount of PAD that will be received and compare it with the total regional revenue as a description of the degree of fiscal decentralization (Hanif et al., 2020).

The impact of fiscal decentralization can also be seen from the social side, especially on the increase in the Human Development Index (IPM). The increase in HDI in most regions after decentralization reforms has shown a positive trend. A study conducted by Aritenang (2020) found that regions that were able to utilize fiscal transfers effectively experienced a significant increase in education and health indicators. The transfer of funds directed to the development of schools, hospitals, and basic health facilities was proven to encourage human development achievements. However, Farida et al. (2021) highlighted that the disparity between regions is still very sharp. Provinces in Java and Bali, for example, have a much higher IPM compared to Papua and Maluku, even though both receive fiscal transfers.

The factors that distinguish regions with high and low IPM achievements are apparently located in the quality of public spending. Regions that allocate a higher proportion of capital expenditure, for example for education and health infrastructure, generally have a better IPM. Conversely, regions whose budgets are concentrated on personnel expenditure tend to have a stagnant IPM. This indicates that the structure of the regional budget is the main determinant in linking fiscal decentralization with social development. Several other studies emphasize the importance of budget efficiency and accountability in the management of decentralization funds. A study by Fatoni (2020) shows that corruption and misuse

of transfer funds are still a serious obstacle in realizing equitable development. Audit reports from the Financial Audit Agency (*Badan Pemeriksa Keuangan* / BPK) have also repeatedly found that most of the regional financial problems are related to immature budget planning and weak supervision. In other words, even though funds are available, failure in the aspect of governance makes the benefits of fiscal decentralization suboptimal. However, there are also examples of good practices that can be learned from. Some regions have succeeded in implementing an e-budgeting system that allows the process of planning and managing the budget to be carried out transparently by utilizing information technology. In addition, public involvement in budget preparation is also able to reduce fiscal leaks while increasing the effectiveness of spending. This kind of governance innovation shows that the success of fiscal decentralization is not only determined by the amount of funds, but also by the extent to which the regions are able to develop effective accountability mechanisms.

When compared to the experiences of other countries, international literature provides valuable lessons. A study in China shows that fiscal decentralization did accelerate development in rich regions, but at the same time widened the gap with poor regions. This happened because the fund distribution mechanism was more in favor of regions with strong economic capacity. Conversely, India developed a needs-based fiscal transfer mechanism, which was proven to successfully reduce disparities between regions, although it still faces challenges from the side of the efficiency of fund use. In the ASEAN context, the Philippines faces a similar problem to Indonesia, namely the dominance of personnel expenditure in the

regional budget, so that the fiscal space for infrastructure development becomes limited. This cross-country learning shows that the success of fiscal decentralization is highly dependent on the design of the transfer policy, regional institutional capacity, and accountability mechanisms. Countries that successfully reduce inequality generally have a clear and measurable needs-based transfer formula, while countries that fail actually show weak planning and low supervision of fund use. The research results can be summarized into several important points. Fiscal decentralization encourages economic growth, but the effect is not evenly distributed among regions due to differences in fiscal capacity and quality of governance. Central transfers to regions are indeed important to close the fiscal gap, but have the potential to widen inequality if they are not truly based on proportional needs.

The positive impact on IPM is more visible in regions that have good budget governance, with a higher proportion of capital expenditure compared to routine expenditure. Fourth, accountability and governance innovation, including the use of technology and public participation, are key factors in the success of implementing fiscal decentralization. Thus, it can be concluded that fiscal decentralization in Indonesia is a process that brings both opportunities and major challenges. Opportunities arise because decentralization provides space for regions to be more independent in managing finances and determining development priorities. However, the challenge is how to ensure that fiscal transfers are truly effective, do not widen inequality, and are able to support equitable human development. Therefore, strengthening institutional capacity, transparency in financial

management, and improving the supervision and accountability system are key to realizing an inclusive and sustainable fiscal decentralization.

## **5. Discussion**

The research findings above confirm that fiscal decentralization in Indonesia presents both opportunities and challenges. From a theoretical perspective, decentralization should increase the efficiency of public services because local governments have better knowledge of local needs. However, in practice, there is a gap between theory and reality. One of the biggest challenges is the fiscal gap. Central transfers to regions often do not fully cover fiscal needs, so regions with low fiscal capacity still face limitations in providing public services. This problem is exacerbated by the dominance of personnel expenditure, which reduces the fiscal space for productive development. This situation is consistent with the findings of Farida et al. (2021) that the budget structure is more decisive for the impact of decentralization than the amount of transfers itself. Fiscal policy in developing countries like Indonesia often faces a dilemma between the need for development funding and the pressure to maintain economic stability.

The government needs to establish a tax policy that is able to increase revenue without burdening economic actors, especially the informal sector and MSMEs (Rita et al., 2021). In addition, the disparity in development between regions shows that fiscal decentralization has not been fully effective in creating equity. Regions rich in resources or with high PAD grow faster, while regions poor in resources remain dependent on transfers. This has the potential to strengthen fiscal

dependence and reduce the incentive for regions to increase PAD. Nevertheless, there is also positive evidence. Some regions have succeeded in using decentralization to innovate in public policy, for example through e-budgeting, public participation, and strengthening governance. Regions with these practices have been proven to be able to improve the quality of education and health services. This shows that the key to success is not only the amount of funds, but also the quality of fiscal management and institutional capacity.

Comparison with other countries shows that the problems faced by Indonesia are not unique cases. Other developing countries also face similar dilemmas: how to design a fiscal transfer system that can encourage equity while maintaining efficiency. From India's experience, for example, a needs-based formula is relatively more successful in reducing inequality than a fiscal capacity-based mechanism. Indonesia can learn by strengthening fiscal redistribution based on human development indicators. In the context of developing countries, efforts to redistribute income through fiscal policy are also influenced by economic and demographic conditions. Based on a study conducted by Indonesian Treasury Review, factors such as the level of Gross Domestic Product (GDP), demographics, and good governance have a significant influence on tax effort or tax collection efforts in the Asia Pacific region.

Countries with higher GDP tend to have a better capacity to collect taxes and make larger social expenditures. However, in countries with low GDP, tax collection efforts are more difficult to carry out, and social expenditures are often limited, so economic inequality remains a serious problem (Sidek, 2021). Thus, this discussion underlines that the effectiveness of fiscal decentralization is not just about financial

decentralization, but also institutional transformation. Increasing the capacity of local governments, strict supervision, and community participation in budget management are the main keys to realizing the goals of decentralization: equitable development and improving people's welfare.

## **6. Conclusion**

Fiscal decentralization in Indonesia has made a significant contribution to increasing regional development capacity, both in the economic and social dimensions. Central-regional transfers are a vital instrument for closing the fiscal gap, supporting infrastructure development, and improving public services. However, the effectiveness of this policy still faces serious challenges, such as the fiscal gap, the dominance of personnel expenditure, inter-regional disparities, and weak accountability in budget management. The research results show that the positive impact of fiscal decentralization on economic growth and social development is highly dependent on the quality of regional governance.

Regions with transparent, participatory, and productive-oriented budget management practices have been proven to be able to increase IPM and accelerate growth. Conversely, regions whose budgets are concentrated on routine expenditure tend to experience development stagnation. Therefore, future fiscal decentralization reforms must focus on increasing regional institutional capacity, implementing needs-based transfer mechanisms, and strengthening the supervision and accountability system. Thus, the main goal of fiscal decentralization, namely to

realize equitable development and improve people's welfare in accordance with the mandate of the 1945 Constitution, can be achieved more optimally.

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