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Regional Financial Performance and Inclusive Economic Development

Empirical Evidence From Provinces in Indonesia

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Abstract: This study aims to analyze the relationship between regional financial performance and inclusive economic development in Indonesia using secondary data from 34 provinces in Indonesia from 2011-2021. The data sources for this study were collected from the National Development Planning Agency, Directorate General of Fiscal Balance, and Statistics Indonesia. This study uses panel data regression analysis with a fixed effect model because it can reduce bias compared to other panel data models, especially those caused by unobservable time-invariant variables. The results showed that regional financial performance, as measured by the fiscal decentralization ratio, fiscal independence ratio, capital expenditure ratio, and social assistance expenditure ratio, significantly influenced inclusive economic development in Indonesia. Fiscal decentralization and social assistance spending have a positive relationship with inclusive economic development. Meanwhile, fiscal independence and capital expenditure have a negative relationship with inclusive economic growth.

Keywords: regional financial performance; inclusive economic development; Indonesia.

1. Introduction

Economic growth is very important for developing countries, while developed countries rely on it to maintain their leadership position in the global economy (Popkova et al., 2018). A country's development is successful if it has high and stable economic growth (Arkum & Amar, 2022), increasing per capita income employment opportunities, and reducing poverty and unemployment (Ismail, 2015). Economic development in Indonesia is quite good, but it has not been able to reduce inequality (OXFAM, 2017). In March 2022, several regions in Indonesia, such as DKI Jakarta, Special Region of Yogyakarta, West Java, Gorontalo, and Papua had quite high inequality with an inequality index (gini ratio) value of more than 0.4 percent.

The percentage of expenditure for the bottom 40% of society is one of the Gini ratio measures used by the World Bank (Sri Hartati, 2022). The World Bank divides inequality into three levels: high, medium, and low. The percentage of expenditure from the bottom 40% of society and below 12% is included in the high inequality category, a figure between 12-17% is included in the moderate inequality category, and a figure above 17% is included in the low inequality category. In March 2022, Statistics Indonesia reported that the expenditure distribution value for the bottom 40% of society was 18.06%. This means that public expenditure is at a low level of inequality. If divided by region, those in urban areas have a figure of 17.07 percent, and rural areas have a figure of 21.01 percent. This means it is classified as low inequality.

Economic studies generally state that reducing poverty levels is closely related to economic growth (Delen et al., 2019). Increasing poverty and inequality, along with high economic growth, shows that economic growth is only based on Gross Domestic Product (GDP) and is enjoyed by only some groups of society. This causes the amount of poverty and levels of inequality to increase (Renie, 2019). Economic growth is said to be inclusive growth if it can improve welfare for society as a whole (Brys et al., 2016). Therefore, this requires a new policy direction from the government so that it not only focuses on pursuing economic growth rates but can also reduce levels of inequality and poverty. This is known as inclusive economic growth, which can be an alternative approach to overcoming inequality (Widianingsih & Paskarina, 2019).

Inclusive growth was born from the debate around sustainable poverty alleviation (Stuart, 2011). Since 2000, the term inclusive has been used to characterize pro-poverty growth as participatory growth (Kakwani & Pernia, 2000). Economic growth is said to be pro-poor growth if the poor gain benefits (Ravallion & Chen, 2003), and has two main sub-concepts, namely relative and absolute concepts (Ngepah, 2017). Kakwani and Pernia (2000) emphasize the relative concept where the income of poor people, on average, is expected to rise faster than that of people who are not poor. Otherwise, Ravallion and Chen (2003) suggests an absolute concept that only requires an increase in the absolute income of the poor as economic growth, regardless of changes in inequality.

Several research results have shown the positive benefits of inclusive economic growth (A. F. Anwar et al., 2021; Aoyagi & Ganelli, 2015; Cichowicz & Rollnik-Sadowska, 2018; Jiang et al., 2022; Lee & Sissons, 2016; Sholihah et al., 2013; Sitorus & Arsani, 2018). Aoyagi and Ganelli (2015) found that economic growth in Asia was increasingly rapid and could reduce poverty, but inequality worsened from 1992-2011. These results are supported by research by Lee and Sissons (2016) who found that inclusive economic growth reduced poverty in British cities. Apart from that, several studies in Indonesia stated different results. Economic growth in

Indonesia has not been inclusive enough to reduce levels of poverty and inequality (Azwar, 2016; Kusumaningrum & Yuhan, 2019).

Several studies have found that good regional financial performance has a positive relationship with economic growth (Hu et al., 2019; Kumpangpune et al., 2019; Lin & Sun, 2017; Mao & Ma, 2021; Nurulita et al., 2018; Putra et al., 2015; Putri & Junaidi, 2020; Yasin, 2019; Yasin & Hardi, 2022). Good regional financial performance also has a positive impact on reducing inequality (S. Anwar et al., 2016; Prastowo & Putriani, 2022; Yasin & Hardi, 2022). Apart from that, there is also research that explains the relationship between regional financial performance and reducing poverty and unemployment (Arafah, 2022; Fahd & Rasyid, 2017; Hafan, 2019; Rarun et al., 2018). Regional financial performance is measured through several things, including growth ratio, efficiency, effectiveness, harmony, fiscal independence, fiscal decentralization, capital expenditure, and social assistance expenditure.

Even though good regional financial performance has been proven to increase economic growth, there is still very little research looking at the relationship between regional financial performance and inclusive economic development. Current research in various countries is still limited in looking at the relationship between regional financial performance and inclusive economic growth. With the same topic in Indonesia, the relationship is still under debate and is only limited to certain provinces, namely Sudiarta and Utama (2019) in Bali; Prasetyia (2021) in East Java; and Mafaza (2022) in Central Java. Sudiarta and Utama (2019) and Prasetyia (2021) states that good regional financial performance is able to accelerate the inclusiveness of regional economic growth. In contrast, Mafaza (2022) states that regional financial performance has no impact on the inclusiveness of economic growth. Therefore, based on existing research gaps and data availability, this research will try to fill the literature gap to see the relationship between regional financial performance and the inclusiveness of economic growth in one country as a whole, namely Indonesia.

2. Methods

This study uses secondary data in panel data from 34 provinces in Indonesia in 2011-2021. The year of observation in this research is based on the availability of data collected from The Ministry of National Development Planning, Directorate General of Fiscal Balance and Statistics Indonesia. Detailed data can be seen in Table 1.

Table 1. Data Types and Sources

No.	Data Type	Year	Source
1.	Inclusive Economic Development Index (IPEI)	2011-2021	The Ministry of National Development Planning
2.	Fiscal Decentralization Ratio (RDF)	2011-2021	Directorate General of Fiscal Balance, processed
3.	Fiscal Independence Ratio (RKF)	2011-2021	Directorate General of Fiscal Balance, processed
4.	Capital Expenditure Ratio (RBM)	2011-2021	Directorate General of Fiscal Balance, processed
5.	Social Assistance Expenditure Ratio (RBS)	2011-2021	Directorate General of Fiscal Balance, processed
6.	Primary Sector (SP)	2011-2021	Statistics Indonesia, processed
7.	Secondary Sector (SS)	2011-2021	Statistics Indonesia, processed
8.	Population Density (KP)	2011-2021	Statistics Indonesia, processed
9.	Road Length (PJ)	2011-2021	Statistics Indonesia, processed
10.	Open Unemployment Rate (TPT)	2011-2021	Statistics Indonesia, processed
11.	Electrical Capacity (KL)	2011-2021	Statistics Indonesia, processed

The analysis method in this study uses panel data regression, a combination of cross-section and time-series data. The panel data model used was the fixed effect model because it can reduce bias compared to other panel data models, especially bias caused by unobservable time-invariant variables from each observation unit. Specifically, the model in this study can be described in the following equation.

$$LnIPEI_{it} = \beta_0 + \beta_1 LnRDF_{it} + \beta_2 LnRKF_{it} + \beta_3 LnRBM_{it} + \beta_4 LnRBS_{it} + \beta_5 LnRSPit + \beta_6 LnSS_{it} + \beta_7 LnTPT_{it} + \beta_8 LnKP_{it} + \beta_9 LnPJ_{it} + \beta_{10} LnKL_{it} + \delta_t + \alpha_i + \varepsilon_{it}$$

This study uses eleven variables, as shown in the equation above. The Inclusive Economic Growth Index (IPEI) is the dependent variable. In contrast, the independent variables are divided into two variables: regional financial performance conditions (RDF, RKF, RBM, and RBS) and control variables (SP, SS, TPT, KP, PJ, and KL). The control variables used are relevant, based on theory and previous research, to overcome bias caused by endogeneity problems due to omitted variable bias (OVB), which can influence the variable of interest. Information regarding the variables used can be seen in Table 2.

Table 2. Variable Description

No.	Variable	Unit	Description
1	IPEI	Scale	Describes the level of inclusive economic development as measured by three scales.
2	RDF	Percent	The ratio of local to overall original income.
3	RKF	Percent	The ratio of local original income to all funds obtained from external parties.
4	RBM	Percent	The ratio of capital expenditure to total regional expenditure.
5	RBS	Percent	The ratio of social assistance spending to total regional spending.
6	SP	Percent	The ratio of primary sector (agriculture, forestry, fisheries, mining and quarrying) to GRDP.
7	SS	Percent	The ratio of secondary sector (processing and construction industry) to GRDP.
8	TPT	Percent	The ratio of the number of unemployed to the total workforce.
9	KP	Percent	The ratio of population per area.
10	PJ	Km	The total length of provincial roads.
11	KL	Mega Watt	Total installed capacity of power plants

3. Results and Discussion

There are several points regarding the general description of the condition of regional financial performance and inclusive economic development in Indonesia, as shown in Table 3.

Table 3. Descriptive Statistics

Variable	Observation	Mean	Std. Dev.	Min.	Max
Year	374	2016	3.17	2011	2021
Province	374	17.5	9.82	1	34
Ln_IPEI	374	1.68	0.16	0.76	2.07
Ln_Pilar 1	374	1.58	0.18	0.58	2.11
Ln_Pilar 2	374	1.78	0.22	0.64	2.12
Ln_Pilar 3	374	1.78	0.21	0.97	2.24
Ln_RDF	374	2.74	0.61	1.04	4.33
Ln_RKF	374	2.97	0.79	1.07	5.77
Ln_RBM	374	3.02	0.27	1.81	3.87
Ln_RBS	374	-0.61	1.10	-3.30	2.36

Variable	Observation	Mean	Std. Dev.	Min.	Max
Ln_SP	374	3.24	0.94	-1.53	4.08
Ln_SS	374	3.15	0.44	2.35	4.10
Ln_TPT	374	1.62	0.38	0.34	2.62
Ln_KP	374	4.84	1.60	2.08	9.68
Ln_PJ	374	9.45	0.65	8.07	10.73
Ln_KL	374	5.83	2.12	-1.71	9.59

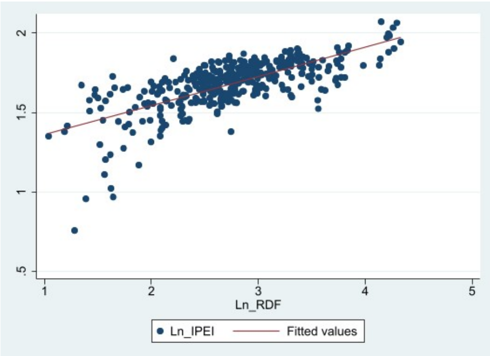
First, the condition of regional financial performance can be described from the variables fiscal decentralization ratio (RDF), fiscal independence ratio (RKF), capital expenditure ratio (RBM), and social assistance expenditure ratio (RBS). Fiscal decentralization aims to create a sense of independence in the regions (Sandjaja et al., 2020), requires local governments to play a role in managing their financial aspects independently (Haryanto, 2018), and provide a positive impact on local government performance (Baidhowah, 2022). The fiscal decentralization ratio (RDF) describes the total local original income percentage. The lowest RDF value of 1.04 was owned by West Papua Province in 2011, and the highest value was 4.33, owned by DKI Jakarta Province in 2015. The average value of the fiscal decentralization ratio in all provinces in Indonesia was 2.74.

Then, the condition of regional financial performance can also be measured from the regional fiscal independence ratio (RKF). Fiscal independence explains the regional ability to finance its authority to create economic growth, regional development, and community welfare (Haryanto, 2017). West Papua Province also owned the lowest RKF value of 1.07 in 2011, and the highest, with a value of 5.77, was owned by DKI Jakarta Province in 2015. The average RKF value for all provinces in Indonesia was 2.97.

Furthermore, regional spending can improve infrastructure development, education, health, and other public services (Wirawan, 2018). Capital expenditure and social assistance expenditure, which are types of regional expenditure, can have a positive impact on community welfare. Capital Expenditure Ratio (RBM) to total regional expenditure is used to determine the extent to which regional government policies in setting budgets are profit or investment-oriented in the long term (Temenggung et al., 2020). The lowest Capital Expenditure Ratio value of 1.81 was owned by DKI Jakarta Province in 2020, and the highest value was 3.87 in North Kalimantan Province in 2013. The average RBM value for all provinces in Indonesia was 3.02. Meanwhile, social assistance spending, as measured by the RBS, illustrates the allocations issued by regional governments to provide money, goods, or services to the community to prevent possible social risks that cause the emergence of social vulnerability. Examples include spending on social security, social empowerment, social rehabilitation, etc. The lowest RBS value of -3.30 was owned by Southeast Sulawesi Province in 2015, and the highest with a value of 2.36 in DKI Jakarta Province in 2021. The average RBS value for all Provinces in Indonesia was -0.61.

Second, the condition of regional inclusive economic development can be seen from the inclusive economic development index (IPEI) variable. Papua Province owned the lowest IPEI value of 0.76 in 2011. Meanwhile, the highest IPEI value of 2.07 in 2021 belongs to the DKI Jakarta Province. The average IPEI value for all provinces in Indonesia is 1.68. Furthermore, IPEI has three pillars, eight sub-pillars, and 21 indicators. The lowest pillar one value of 0.58 was owned by Papua Province in 2011, and the highest was 2.11, owned by DKI Jakarta Province in 2019. Then the lowest pillar two value of 0.64 was also owned by Papua Province in 2013, and the highest was 2.12, owned by Bangka Belitung Province in 2021. Furthermore, the lowest pillar three value of 0.97 was owned by Papua Province in 2011, and the highest was 2.24, owned by DIY Province in 2021.

Next, a scatterplot graphic technique was used to see and determine the linear relationship between each regional financial performance variable and inclusive economic development. The scatterplot results of the relationship between each of these variables can be seen in the following picture.



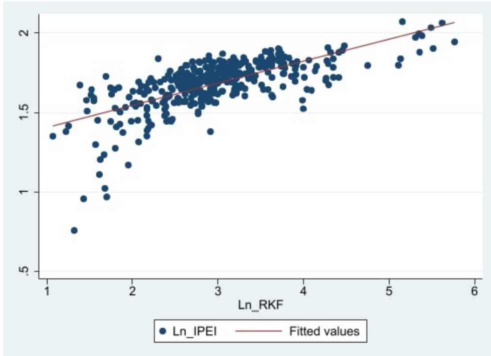
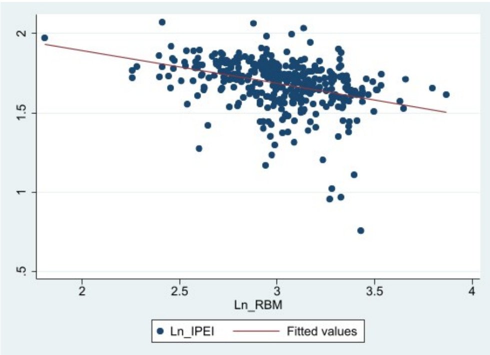


Figure 1. Relationship Between RDF and IPEI

Figure 2. Relationship Between RKF and IPEI



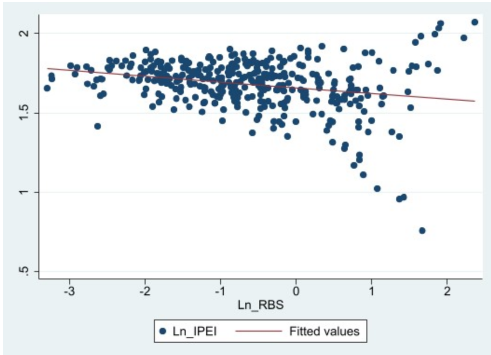


Figure 3. Relationship Between RBM and IPEI

Figure 4. Relationship Between RBS and IPEI

The scatterplot results show that regional financial performance, which has a linear and positive relationship to the inclusive economic development index (IPEI), is the fiscal decentralization ratio (RDF) and fiscal independence ratio (RKF) variables. This means that the higher the RDF and RKF values, the higher the IPEI value. Meanwhile, the variables capital expenditure ratio (RBM) and social assistance expenditure ratio (RBS) have a linear and negative relationship with IPEI. This means that the lower the RBM and RBS values, the IPEI value will increase.

Next, data analysis was carried out using panel data with a fixed effect model to see the relationship between regional financial performance and inclusive economic development. The results of this data analysis can be seen in Table 4.

Based on the results of data analysis in Table 4, it can be generally seen that the IPEI model in column 8 is the best compared to other IPEI models because it has a more stable significance level and includes all control variables. The results of this analysis show that regional financial performance significantly influences the inclusiveness of economic development in Indonesia. This is shown by the variables RDF, RKF, RBM, and RBS, which have a fairly stable significance level. The RDF variable has a positive coefficient, indicating that if regional decentralization increases, the inclusiveness of economic growth will also increase. This is in

Table 4. Data Analysis Results

Variable	1	2	3	4	5	6	7	8
	Ln_IPEI	Ln_IPEI	Ln_IPEI	Ln_IPEI	Ln_IPEI	Ln_IPEI	Ln_IPEI	Ln_IPEI
Ln_RDF	0.034	0.223**	0.179*	0.236**	0.198**	0.172*	0.153*	0.211***
	(0.122)	(0.106)	(0.106)	(0.101)	(0.094)	(0.091)	(0.091)	(0.061)
Ln_RKF	0.228**	-0.014	0.021	-0.044	-0.060	-0.041	-0.029	-0.156***
	(0.102)	(0.090)	(0.089)	(0.086)	(0.080)	(0.077)	(0.077)	(0.052)
Ln_RBM	-0.094***	-0.029*	-0.031*	-0.051***	-0.015	-0.017	-0.010	-0.028**
	(0.019)	(0.017)	(0.017)	(0.017)	(0.016)	(0.016)	(0.016)	(0.013)
Ln_RBS	-0.016***	-0.013***	-0.013***	-0.013***	-0.004	-0.004	-0.002	0.011***
	(0.004)	(0.004)	(0.004)	(0.004)	(0.004)	(0.003)	(0.003)	(0.003)
Ln_SP		-0.610***	-0.563***	-0.516***	-0.403***	-0.370***	-0.332***	0.098**
		(0.055)	(0.057)	(0.055)	(0.053)	(0.052)	(0.053)	(0.044)
Ln_SS			0.119***	0.125***	0.107***	0.116***	0.108***	0.147***
			(0.041)	(0.039)	(0.036)	(0.035)	(0.035)	(0.023)
Ln_TPT				-0.096***	-0.084***	-0.088***	-0.083***	-0.072***
				(0.016)	(0.015)	(0.015)	(0.015)	(0.011)
Ln_KP					0.458***	0.392***	0.378***	0.061
					(0.063)	(0.062)	(0.061)	(0.046)
Ln_PJ						0.176***	0.167***	0.071***
						(0.034)	(0.034)	(0.023)
Ln_KL							0.012**	-0.004
							(0.005)	(0.004)
Year = 2011								0.000
								(.)
Year = 2012								0.002
								(0.009)
Year = 2013								0.054***
								(0.009)
Year = 2014								0.077***
								(0.010)
Year = 2015								0.134***
								(0.011)
Year = 2016								0.163***
								(0.012)
Year = 2017								0.169***
								(0.013)
Year = 2018								0.168***
								(0.014)
Year = 2019								0.205***
								(0.014)
Year = 2020								0.150***
								(0.014)

Variable	1	2	3	4	5	6	7	8
	Ln_IPEI	Ln_IPEI	Ln_IPEI	Ln_IPEI	Ln_IPEI	Ln_IPEI	Ln_IPEI	Ln_IPEI
Year = 2021								0.232***
								(0.016)
Constant	1.184***	3.162***	2.659***	2.738***	0.249	-1.200**	-1.235**	-0.063
	(0.110)	(0.202)	(0.263)	(0.252)	(0.413)	(0.487)	(0.484)	(0.330)
Observations	374.000	374.000	374.000	374.000	374.000	374.000	374.000	374.000
R Square	0.475	0.616	0.626	0.661	0.708	0.729	0.734	0.886

Standard errors in parentheses
** p < 0.1, ** p < 0.05, *** p < 0.01*

accordance with the findings of Sudiarta and Utama (2019) and Prasetyia (2021). Meanwhile, the RKF variable has a negative coefficient, indicating that regional fiscal independence is still low and has not been able to encourage inclusive economic growth. This indicates that there is still a high level of regional dependence on funds from outside local original income, such as transfers to regions and village funds (TKDD) and other income. However, these results are different from the findings by Nurhemi & Suryani (2015); Sudiarta and Utama (2019); and Prasetyia (2021) which states that the regional fiscal independence ratio has a positive influence on the inclusiveness of economic growth. On the other hand, Mafaza (2022) found that fiscal decentralization and regional fiscal independence do not have a significant influence on the inclusiveness of economic development.

Meanwhile, capital expenditure, as measured by the Capital Expenditure Ratio (RBM) variable, also has a negative coefficient, which means that capital expenditure has not had a positive impact on the inclusiveness of economic development. When capital expenditure issued by regional governments is higher, the inclusiveness of economic growth in that region tends to be lower. This is in line with the findings by Prasetyia (2021) which stated that capital expenditure had a negative impact on the inclusiveness of economic growth in East Java Province. These findings indicate that economic growth in Indonesia is still exclusive because capital expenditure management is still less than optimal. In the concept of inclusive economic growth in Indonesia, economic growth should not be ignored so capital expenditure should have a positive influence on the inclusiveness of economic growth. However, this is different from the findings of Fajri (2016) and Waryanto (2017). Fajri (2016) stated that capital expenditure did not have a significant impact on economic growth. While Waryanto (2017) states that capital expenditure has a positive coefficient and a significant influence on economic growth in Indonesia.

Furthermore, as measured by the RBS variable, social assistance spending has a positive coefficient and a significant influence on inclusive economic growth. This means that the higher the spending allocation by local governments for social assistance, the more inclusiveness of economic growth will also increase. This is in line with the findings by Putra et al. (2015), which state that social assistance spending has a positive coefficient and a significant influence on economic growth in underdeveloped regions in Indonesia. Therefore, social assistance spending should be increased to encourage inclusive economic growth and directly impact community welfare. Increasing social assistance spending can also reduce poverty levels (Rarun et al., 2018). However, this is different from the findings of Sendouw et al. (2017) and Melati et al. (2021) which states that social assistance spending does not have a significant effect on reducing poverty levels.

In terms of control variables, the primary sector (agriculture, forestry, fisheries, mining, and quarrying) and the secondary sector (processing and construction industry), which are the leading sectors represented by the SP and SS variables, have a positive and significant coefficient on the inclusiveness of economic development. This means that the primary and secondary sectors are superior sectors that can encourage increased inclusiveness of economic growth in Indonesia. This also means that if the GRDP value in the primary and secondary sectors is low, inclusive economic growth will also decrease. Therefore, the contribution of GRDP to the primary sector and secondary sectors such as agriculture, forestry, fisheries, mining, industry, and construction must be increased by regional governments so that they can encourage increased inclusive economic growth. These results are in line with the findings of Nalle (2022), which states that the development of superior sectors can realize inclusive economic development, where the agricultural sector has the most dominant contribution in contributing to GRDP value.

Then, the open unemployment rate, as seen from the TPT variable, has a negative coefficient and a significant influence on the inclusiveness of economic development. This means that the higher the number of open unemployed people, the lower the level of inclusiveness of economic growth. This is in line with the findings by Mafaza (2022), which states that the open unemployment rate has a negative coefficient and a significant influence on the inclusiveness of economic development. However, this is different from the findings by Purwanti and Rahmawati (2021) and Prasetyia (2021), who found that the TPT variable did not have a significant influence on the inclusiveness of economic growth. Furthermore, the length of the road represented by the PJ variable also has a significant and positive impact on the inclusiveness of economic growth. This means that when road infrastructure development increases, the inclusiveness of economic growth in the area will also increase. This is in accordance with the findings by Panjaitan et al. (2019), which stated that improving road infrastructure can reduce income inequality so that inclusive economic growth can be achieved.

Furthermore, as measured by the KP variable, population density does not show a significance level at the 1%, 5%, or 10% levels. This is in line with the findings by Hunaifi (2022), which stated that the KP variable does not have a significant influence on the inclusiveness of economic growth. Judging from the direction of the relationship, the KP variable has a positive coefficient, which means that when the population is higher, the inclusiveness of inclusive economic growth in the region is also higher. The electrical capacity variable measured by KL also does not showed a level of significance at the 1%, 5%, or 10% level. This is different from the findings by Yuni (2022) which states that electricity infrastructure has a positive coefficient and a significant influence on the inclusiveness of economic development in Indonesia.

4. Conclusion

Based on the results of the analysis that has been carried out regarding the relationship between regional financial performance and inclusive economic development in Indonesia using fixed effect model panel data, it can be seen that regional financial performance, as seen from the level of fiscal decentralization, fiscal independence, capital expenditure, and social assistance expenditure has a significant influence towards inclusive economic development in Indonesia. Measures that have a positive coefficient on inclusive economic development are fiscal decentralization and social assistance spending. This shows that this aspect is very important in increasing regional inclusive economic development. On the other hand, regional fiscal independence is still low, and the level of regional dependence on funds from outside the local original income, such as transfers to regions and village funds (TKDD) and other income, is still quite high. Management of regional expenditure, especially capital expenditure, is also indicated to be less than optimal because it has not had a positive impact on inclusive economic development. In terms of control variables, factors that have an influence on inclusive economic development are the primary sector, secondary sector, open unemployment rate, and road length.

Policy recommendations related to the results of these findings are that regional governments must be able to maximize regional income sources that are currently still less than optimal, especially local original income, namely through intensification, extensification, and optimization of the role of the Regional Budget (BUMD). This is done in order to increase independence and reduce regional dependence on the central government in financing all government activities. Apart from that, regional governments also need to improve the quality of optimal management of regional expenditure, especially capital expenditure, so that it has a positive impact on inclusive economic development.

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