Increasing the Fiscal Capacity and Human Development of East Java: What Should a Regional Government Do?

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ABSTRACT

This study aims to analyze the effect of economic growth on local government revenues and human development in East Java. The variables used in this study are economic growth (an exogenous variable), local government revenues (an intervening variable measured by fiscal capacity), and human development (an endogenous variable measured by the human development index). This study uses panel data of regencies and cities in East Java over the period of 2012 to 2016. Based on a path analysis, this study finds that economic growth has a significantly positive effect on fiscal capacity. Moreover, economic growth has a significantly positive indirect effect on the human development index, while its direct effect on the human development index is statistically insignificant.

Keywords: Economic growth; Fiscal capacity; Human development.

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1. INTRODUCTION

An implementation of fiscal decentralization is usually followed by an increase in the fiscal capacity of regional governments. Hence, it is reasonable to examine the implementation of regional autonomy from several indicators; one of which is the ability of the regions to increase their local own-source revenues (Nasution, 1999). The level of local revenues is typically used to illustrate the regional incomes generated by the region itself, and it is ideally the regional government's main source of funding for regional development (Khusaini, 2014; Kusreni and Suhab, 2009).

Theoretically, an increase in local own-source revenues is influenced by regional economic performance. Regions with a high economic growth generally experience increases in local revenues. Some research results indicate that the level of local revenues is rather sensitive to economic growth (Bappenas, 2013). Bappenas found that the GDP elasticity of the local own-source revenues of provincial governments is equal to or greater than 1. This indicates that a 1% change in GRDP

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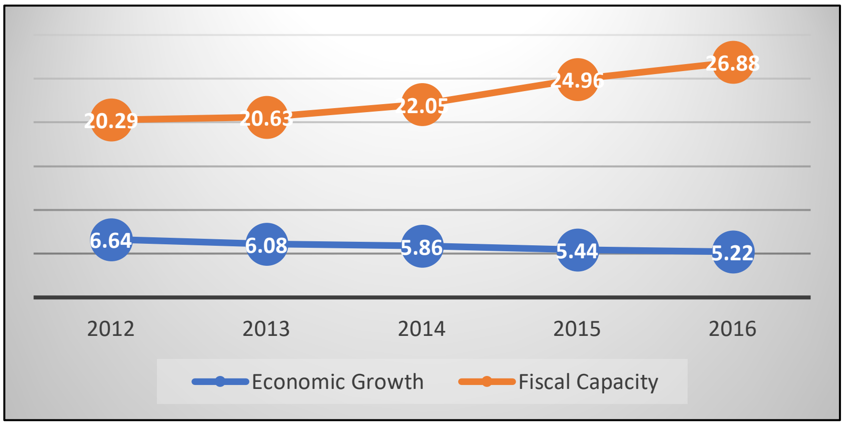
will increase the local revenues by more than 1%. Likewise, the relationship between economic growth and fiscal capacity is generally positive, but the results from past research in East Java show that a decline in economic growth is not followed by any decrease in fiscal capacity (Desmawati *et al*., 2015).

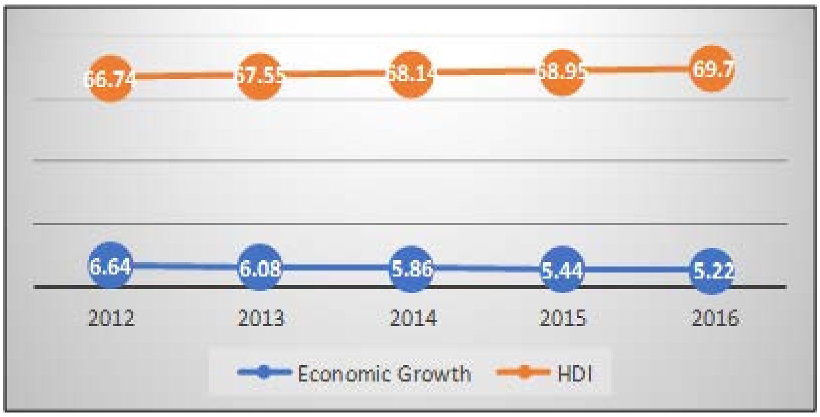
Figure 1: The Development of Economic Growth and Fiscal Capacity of East Java during 2012-2016



Source: Statistics Indonesia (2016)

In addition to increasing fiscal capacity, economic growth has an important role in effectuating human development. Although economic growth does not automatically reflect welfare, it remains to be an important indicator of development success (Todaro, 2000). However, the opposite occurred in East Java, where economic growth was declining while human development was increasing during 2012-2016 as shown in Figure 2.

Figure 2: The Economic Growth and HDI of East Java during 2012-2016



Source: Statistics Indonesia (2016)

In general, East Java's economic growth is still above the national average,

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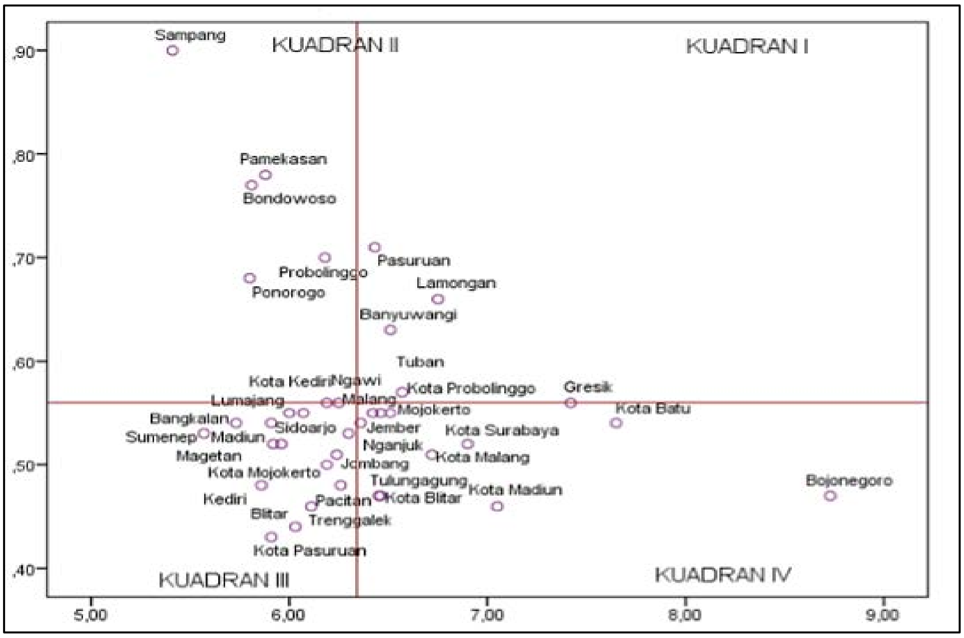
while its HDI is below the national level. This finding indicates that the outbound development of regencies and cities in East Java is still biased, in the sense that its economic development only improves the welfare of a certain part of the population, i.e., it is not evenly distributed in all regencies and cities. The impact of economic growth on the human development index can be seen in Figure 3.

Figure 3: The Effect of Economic Growth on HDI Increase in East Java during 2012-2015

Average increase in HDI during 2012 - 2015



Average economic growth during 20122015

Source: Statistics Indonesia (2017)

Quadrant I shows the regions where the average economic growth and HDI growth are above the provincial levels (i.e., pro-growth, pro-human development); these regions are Pasuruan Regency, Lamongan Regency, Banyuwangi Regency, Tuban Regency, and Probolinggo City. This finding implies that the economic growth is in line with the HDI growth. The challenge to the well-performing governments is about how to maintain the momentum of growth while increasing productivity and added value as well as maintaining the effectiveness and efficiency of public services in education and health.

Quadrant II shows the regions where economic growth is below the provincial average, but their HDI growth is above the average (i.e., low-growth, pro-human development); these regions are Sampang Regency, Pamekasan Regency, Bondowoso Regency, Probolinggo Regency, and Ponorogo Regency. This finding indicates that various policies and development programs that are directed to improve public services

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are able to increase HDI. The challenge to the governments is about how to accelerate economic development by increasing productivity and enhancing value-added sectors and economic activities, such as manufacturing, trade and services, agriculture, fisheries, and marine industries, that are using local resources.

Quadrant III shows the regions where economic growth is at the average level. Their HDI growth is generally below the provincial average (i.e., low growth, less pro-human development). Most regions, i.e. eighteen regencies and cities, are in quadrant III; they are Kediri Regency, Situbondo Regency, Magetan Regency, Bangkalan Regency, Sumenep Regency, Lumajang Regency, Sidoarjo Regency, Madiun Regency, Blitar Regency, Trenggalek Regency, Pacitan Regency, Jombang Regency, Malang Regency, Nganjuk Regency, Ngawi Regency, Pasuruan City, Mojokerto City, and Kediri City. This finding underscores the need for the local governments to improve public services in education and health. In addition, the regional governments must also encourage all SKPDs (local government work units) to spur economic development by increasing productivity and value added in the region's main economic sectors and activities.

Quadrant IV shows the regions where economic growth is well above the average level. However, their HDI growth is below average (i.e., high-growth, less-pro human development). There are ten municipal districts in this quadrant: Mojokerto Regency, Gresik Regency, Jember Regency, Tulungagung Regency, Bojonegoro Regency, Malang City, Batu City, Madiun City, Blitar City, and Surabaya City. The challenge to the local governments is about how to maintain a balance between economic development and public service quality improvement especially in education and health.

2. LITERATURE REVIEW

2.1 Fiscal Decentralization and Regional Economic Development

In general, decentralization covers the political (political decentralization), administrative (administrative decentralization), fiscal (fiscal decentralization), and economic aspects (economy of market decentralization) (Yani, 2002). One important aspect of the decentralization principle is fiscal decentralization – delegation of the authority in budgeting and finance that is previously administered, regulated, and carried out by the central government (Khusaini, 2006).

Several past studies mention that fiscal decentralization can have a positive impact on public services and regional economic growth (Khusaini, 2006). Economic growth is a process of increasing an economy's production capacity of goods and services in a comprehensive and sustainable manner so as to achieve a higher national incomes level (Todaro, 2000). Meanwhile, according to Suparmoko (1998), economic growth is one of the important goals of macroeconomic policies that is related to the physical size of

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the economy in the form of increased production of goods and services.

The role of economic growth can be considered as very important to the development processes. Todaro (2000) argued that, even though the economic growth rate does not provide answers to all welfare problems, it remains an important element of all development programs. Empirical studies in China concerning the role of economic growth in reducing poverty and realizing human development generally found that China has the highest economic growth rate in the world and that the country's economic growth is followed by poverty reduction. In the period of 1987-1998, China's population in poverty decreased from 303.4 million to 213.2 million. In addition to its reduced poverty, China's high economic growth was also followed by an increase in basic education and health services for the public, which serves as a strong basis for the long-term progress in realizing human development (Todaro and Smith, 2006).

Economic growth has a significant contribution in terms of increasing human development, especially through the household sector and government activities (Ranis *et al*., 2000). An empirical study on the relationship between economic growth and human development in 35 developing countries over the period of 1960-1992 found that economic and social policies that focus on economic stability are urgently needed as a prerequisite for economic growth. Furthermore, economic development (human development) in practice cannot be achieved without economic growth.

Economic growth and human development have a two-way relationship. Although they are not automatically related, their relationship can be strengthened by appropriate government policies. Such a relationship is influenced by two main channels, namely household activities vs. expenditure and government policies vs. expenditures.

In the era of fiscal decentralization, regions are also required to increase their fiscal capacity. As the regions are autonomous, they can develop and optimize their own policies, including policies for exploring the regions' potential areas to increase incomes (Sianturi *et al.* 2012). However, it is imperative that they do not compete in creating new taxes for increasing their fiscal capacity (Sebastiana and Cahyo, 2016)

According to Khusaini (2006), it is better for regions to focus on generating local own-source revenues and regional revenues-sharing funds because these financial resources are originally generated by the regions themselves. In addition, the regions are able to enhance their economic success by exploring their potentials to increase their fiscal capacities. However, if the regions are not managed properly, they can create economic distortions because poor policies can weaken people's purchasing power and reduce companies' ability in producing goods and services due to high costs and low demand (Kusreni and Suhab, 2009).

There are two alternative formulas for calculating a region's fiscal capacity. The

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first one is based on PMK Number 245/PMK.07/2010 as shown below.

$$KF = \frac{\text{PENDAPATAN ASLI DAERAH} + \text{DBH} + \text{DAU} + \text{LPDS} - \text{BP}}{\text{JPM}}$$

where:
KF = Fiscal Capacity
PAD = Local Own-source Revenues
DBH = Revenues Sharing Fund
DAU = General Allocation Fund
LPDS = Other Legal Regional Revenues
BP = Personnel Expenses
JPM = Population of Poor People

The second one is based on the Ministry of Finance's Directorate General of Fiscal Balance as shown below.

$$KF = \frac{\text{PENDAPATAN ASLI DAERAH} + \text{DBH Pajak} + \text{DBH SDA}}{\text{Total Belanja Daerah}}$$

where:
KF = Fiscal Capacity
Pendapatan Asli Daerah = Local Own-source Revenues
DBH Pajak = Revenues Sharing Fund of Tax
DBH SDA = Revenues Sharing Fund of Natural Resources
Total Belanja Daerah = Total Local Expenses

2.2 Human Development as a Development Focus

According to the concept of human development, development should be analyzed and understood from the perspective of human being, not only from the perspective of economic growth. As quoted from UNDP (Human Development Report, 1996), important premises of human development are:

- development should prioritize the population as the center of attention;
- development is intended to increase choices for residents, not only to increase their incomes;
- human development should pay attention to efforts and to optimally utilize human abilities, which are supported by four main pillars, namely, productivity, equity, harmony, and empowerment; and
- human development is the basis for determining development goals and analyzing the choices to achieve the goals.

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The United Nations Development Program (UNDP) publishes social welfare indicators annually for countries. One benchmark used to measure the quality of human life is the Human Development Index (HDI) complied by UNDP. This indicator is composed of measures in terms of the quality of education, health, and economy (purchasing power).

2.3 The Relationship between Economic Growth, Fiscal Capacity, and Human Development

The realization of human development that improves the community's welfare requires a process which is influenced by many factors. One of the factors that drives the realization of human development is economic growth which is proxied by the growth of Gross Domestic Product (GDP). Furthermore, economic growth improves human development through two main channels: household activities and government policies.

First, regarding household activities, economic growth increases household incomes and reduces poverty. The higher the incomes, the higher the tendency of household activities to be directed to spending on the goods, and services directly related to human development indicators. Ranis *et al*. (2000) also mentioned that economic growth provides direct benefits in terms of increasing human development through increasing incomes. For instance, higher incomes increase families' allocation of their incomes on nutritious food and better education.

The second channel is the government's role in allocating the economy's resources, as manifested in the government's expenditure allocations. Economic growth directly increases the revenues to the central and local governments. Furthermore, government revenues are the main financial source for all government activities aiming to realizing human development through spending on education and health.

3. RESEARCH METHOD

This study was designed to determine the effect of economic growth on human development, both directly and indirectly (through fiscal capacity), in regencies and cities in East Java during 2012-2016 through path analysis.

3.1 Operational Definitions of Variables

The operational definitions of the variables used in this study are as follows.

a. Exogenous Variables

Exogenous variables are stimulus variables which can cause changes in endogenous variables (Sugiyono, 2015). The exogenous variable in this study is the economic growth (PE) of regencies and cities in East Java during the period of 2012-2016.

b. Intervening variables

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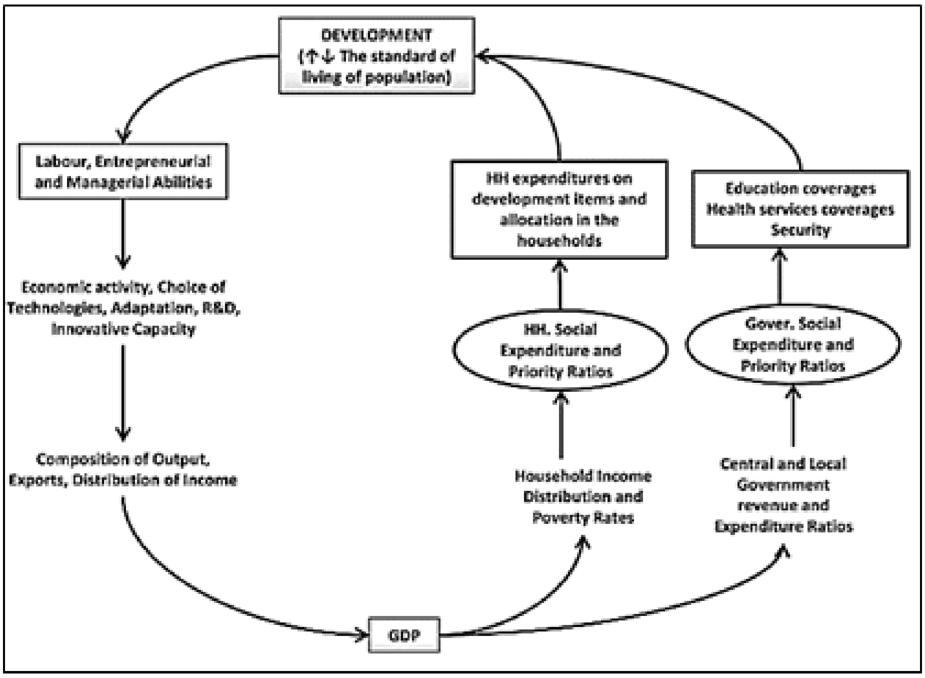
The intervening variable in this study is the fiscal capacity of regencies and cities in East Java during the period of 2012-2016. Fiscal capacity is a regional financial capacity that is reflected in the general revenues of the Regional Budget (excluding special allocation funds, emergency funds, loan funds, and other receipts whose use is limited to financing certain expenses) to finance government duties and services. Fiscal capacity (KF) is measured by the ratio of local own-source revenues (LOCAL OWN-SOURCE REVENUES) + regional revenues-sharing funds to the total regional expenditures. This ratio is expressed in percentage terms.

c. Endogenous Variables

The endogenous variable in this study is human development of regencies and cities in East Java in the period of 20012-2016. In this study human development is proxied by the Human Development Index (HDI).

Figure 5: Scheme for Realizing Human Development through Economic Growth



Source: Ranis *et al*, 2000

3.2 Data Types and Sources

This study is based on the following panel data:

- data on economic growth during the period of 2012-2016 taken from Indonesia Statistics of East Java;
- data on the local own-source revenues of regencies and cities in East Java during the period of 2012-2016 taken from the Directorate General of Fiscal Balance of the Ministry of Finance of the Republic of Indonesia; and
- data on Human Development Index (HDI) during the period of 2012-2016 taken

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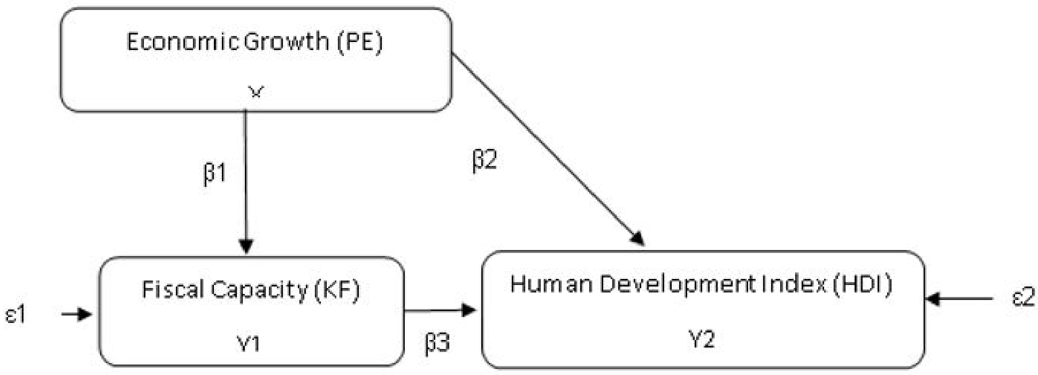
from Indonesia Statistics of East Java.

3.3 Data Analysis Technique

This study uses path analysis, which is used to describe and assess the causal relationship between variables without interactive and reciprocal relationships. Thus, in the relationship model between these variables, there is an independent variable, which in this case is called the exogenous variable, and a dependent variable, which is called the endogenous variable. In this path analysis, the most appropriate path can be estimated to represent the process by which the exogenous variable influences the endogenous variable. Kerllinger (2002) noted that path analysis can be carried out directly or indirectly between variables.

Figure 6: Path analysis diagram for the Effect of Economic Growth on Fiscal Capacity and Human Development



Source: Author, 2016

Based on Figure 6, the following structural equations can be formulated:

$$KF = \beta 1\ PE + \varepsilon 1 \quad (1)$$

$$IPM = \beta 2\ PE + \beta 3\ KF + \varepsilon 2 \quad (2)$$

3.4 Hypothesis Testing

- Economic growth has a positive and significant effect on the fiscal capacity.
- Economic growth has a positive and significant effect on the human development index.
- Fiscal capacity has a positive and significant effect on the human development index.

4. RESULTS AND DISCUSSIONS

4.1 The Direct Effect of the Research Variable

The results of the Ordinary Least Squares (OLS) analysis give the estimated path

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coefficients of economic growth, fiscal capacity, and human development, which are presented in Table 1.

Table 1. Summary of Path Coefficients

Regression	Standardized Coefficients Beta	$t_{statistics}$	Sig.	Decision
X → Y_1	0.287	4.115	0.000	Significant
X_1 → Y_2	0.058	0.904	0.367	Not significant
Y_1 → Y_2	0.524	8.177	0.000	Significant

Source: analysis Result

Information:

X : Economic Growth

Y1 : Fiscal Capacity

Y2 : Human Development Index

4.2 The Direct, Indirect, and Total Effect of the Research Variable

The results of data analysis regarding the calculation of the direct, indirect, and total effects of the variables are listed as Local Own-source Revenues in Table 2.

Table 2. Summary of Direct, Indirect, and Total Effect

	X			**Y_1**		
	Direct Influence	Effect of Indirect	Total Influence	Direct Influence	Effect of Indirect	Total Influence
Y1	0.287*	-	0.287*	-	-	-
Y2	0.058	0.150*	0.208	0.524*	-	0.524*

Description: * Significant

Table 2 suggests that the direct effect of economic growth on fiscal capacity is 0.287 and that the indirect effect of economic growth on human development through fiscal capacity is 0.150. Thus, the total effect of economic growth on human development is 0.208.

4.3 Model Accuracy

The accuracy of the model is measured by the coefficient of determination, i.e., 35.4%.

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Therefore, the contribution of the model in explaining the structural relationship between the three variables is 35.4%. The remaining 64.6% is explained by other variables not included in this model.

4.4 Discussion

4.4.1. The Effect of Economic Growth on Fiscal Capacity

The analysis shows that economic growth (PE) has a significantly positive effect on the fiscal capacity (KF) of regencies and cities in East Java. This confirms the scheme of human development through economic growth as designed by Ranis *et al*. (2000). The scheme emphasizes that economic growth directly increases the central and local government revenues. Our finding of a positive and significant relationship between economic growth and regional incomes (i.e., local government revenues) indicates that economic growth is effective in increasing regional incomes that indicates a region's fiscal capacity. In other words, economic growth can spread to economic sectors serving as the sources of regional incomes.

According to the data from the Regional Revenues Office (Dispenda) of East Java, the province's regional incomes in 2015 reached 12.5 trillion IDR, exceeding the target by 101.74 percent, where Motor vehicle tax (PKB) contributed 4.911 trillion IDR, transfer fee for motorized vehicles (BBNKB) contributed 3,534 trillion IDR, and motor vehicle fuel tax (PBBKB) contributed 2,202 trillion IDR. Aside from tax revenues, the regional revenues of East Java are also contributed by Local-Owned Enterprises (BUMD) such as PT East Java Regional Development Bank (2.53 trillion IDR), PT BPR Jatim (56.6 billion IDR), and Panca Wira Usaha Jatim, a construction, property, and industrial service enterprise (35.9 billion IDR).

This study finds a positive and significant relationship between economic growth and regional incomes that indicates fiscal capacity, which confirms the results of Indonesia's National Planning Agency (Bappenas). The estimated elasticity of local revenues with respect to GRDP with a value ≥ 1 is consistent with the estimate given by Bappenas (2003). This indicates that every 1% change in GDP (economic growth) positively and significantly changes local revenues by more than 1%. The results of this study are parallel with those of Desmawati *et al*. (2015) in the sense that there is a significant and positive relationship between economic growth and regional incomes. Hence, it can be concluded that increasing economic growth is an effective way to increase regional incomes (as proxied by fiscal capacity) that can be ideally used as the main funding source for the local government to finance regional development.

4.4.2 The Effect of Economic Growth on Human Development Index

The analysis results indicate that economic growth (PE) has a positive but insignificant

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effect on the human development index (HDI) of regencies and cities in East Java. The higher the incomes, the higher the tendency of household activities to be directed to spending on factors that are directly related to human development indicators. Poveda (2011) and Suri *et al* (2011) found that economic growth has a positive effect on human development index (HDI). In addition, higher human development has a positive and significant correlation with economic growth.

The insignificant influence of economic growth on human development in East Java indicates that the outbound development of regencies and cities in East Java is still biased – economic development only improve the welfare of a certain part of the population. This is indicated by the increasing incomes and wealth inequality among people in East Java, as indicated by the annual increase of the Gini ratio. In addition, economic growth in East Java is still uneven, resulting in high inter-city and inter-regency disparities. Inequality in East Java is considered to be high. One of the main causes of the high inequality is the different economic structures among regions. The economic gap between regions in East Java can be seen from the inequality in terms of a large gap in per capita GRDP between regions. Regencies and cities in East Java that have higher per capita incomes are Sidoarjo Regency, Gresik Regency, Madiun City, and Surabaya City, where there is a high concentration of industrial activities. In addition, the gap is also relatively large between regions with abundant natural resources and support from upstream-to-downstream processing industries and those regions without these advantages.

4.4.3 The Effect of Fiscal capacity on Human Development Index

The third finding of this study is that fiscal capacity (KF) has a significantly positive effect on the human development index (HDI) of regencies and cities in East Java. The positive relationship indicates that the sources of regional incomes and revenues sharing funds (tax and non-tax) are not distorted to the improvement of public welfare. The significant influence indicates that the regional fiscal capacity has been managed carefully and appropriately. This implies that the local governments through their policies of regional autonomy and fiscal decentralization have succeeded in managing the budget aiming to improve human development.

The data from East Java Provincial Health Office signifies that the health budget sourced from municipal and provincial budget in 2014 is 12,072,926,904,359 IDR, i.e., 96.75% of the overall health budget. This percentage has increased considerably from the same budg*et* allocation in 2013. The health budget from the municipal and provincial budget has significantly increased in the last three years.

In addition to the increased budget in health, East Java is also fully committed to improving education. This is evidenced by the 2013-2015 education budget, which was

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sourced from the local budget and continued to increase. In 2013, East Java's education budget was 413,058,763,000 IDR, and it continued to increase to 427,101,260,800 IDR in 2015.

The results of this study indicate that the level of regional incomes has a positive and significant relationship with the improvement of human development. Supporting the research of Ranis *et al*. (2000), our findings imply that economic growth significantly contributes to human development especially through the household sector and government activities. The results of this study also confirm the results from Dincecco and Prado (2010) and Suhab (2009) that there is a positive and significant relationship between fiscal capacity and human development index. Therefore, it can be concluded that fiscal capacity is an effective means to increase the human development index.

4.4.4 Direct, Indirect, and Total Effect of Economic Growth (PE) on Human Development Index (HDI)

Based on the analysis of the intervening variable, the effect of economic growth on the human development index through fiscal capacity is both direct and indirect. The direct influence of economic growth on the human development index is 0.058, which is not statistically significant. The indirect influence of economic growth on the human development index through fiscal capacity is 0.150. It can be concluded that fiscal capacity is a perfect intervening variable because it has an important role in connecting economic growth to the human development index. This is evidenced by the insignificant direct effect as well as the much larger value of indirect effect over the direct effect (0.150> 0.058). Hence, fiscal capacity performs as the driving factor or stimulus for the human development index. Furthermore, the total effect of economic growth on the human development index obtained from the sum of the direct and indirect effect is 0.208.

5. CONCLUSIONS AND IMPLICATIONS

Based on the results from the analysis and discussions regarding the effect of economic growth on fiscal capacity and human development in East Java, the following conclusions can be drawn.

- Economic growth is effective in increasing regional fiscal capacity. In other words, economic growth can spread into economic sectors serving as the sources of regional incomes.
- The economic growth of regencies and cities in East Java is still biased. The economic development is not evenly distributed among the regions and improves the welfare of only a certain part of the population. However, economic growth

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is effective in indirectly increasing the human development index through fiscal capacity. This indicates that regional fiscal capacity has been managed carefully and properly. As such, local governments are considered successful in managing their budget to improve human development in East Java through their regional autonomy policies and fiscal decentralization.

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