

Impact of Fiscal Decentralisation on Economic Growth and Poverty Reduction in Aceh Province, Indonesia

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ABSTRACT

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This study analyses the impact of fiscal decentralisation policy on economic development and poverty reduction. It focuses on the practice of intergovernmental fiscal transfer and on special autonomy policy in Aceh province, Indonesia, using data from 23 districts gathered from 2008 to 2018. Undertaking a panel data analysis, it will analyse the impact of intergovernmental fiscal transfer from central to local government on local government expenditure. The impact of local government expenditures and fiscal decentralisation practices on local gross domestic product (GDP) and poverty is also measured. The results show that several intergovernmental fiscal transfer policies in Aceh positively enhance the local expenditure. Further, the local government spending and fiscal decentralisation practices in Aceh improve the local GDP and reduce poverty levels in the region.

Keywords: Fiscal Decentralisation, Intergovernmental Fiscal Transfer, Special Autonomy, Government Expenditure

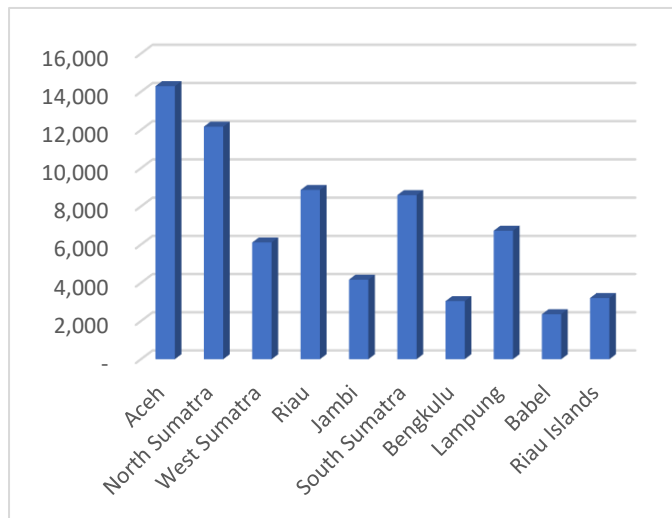
I. INTRODUCTION

To accelerate the achievement of national economic development goals, since 1999, the Indonesian Government has implemented a policy of fiscal decentralisation through the Indonesian Constitution No. 22 of 1999. By transferring part of its financial management authority to local governments, it aims to accelerate the progress of community welfare through improvement, services, empowerment and community participation, as well as by increasing

regional competitiveness. The policy of fiscal decentralisation aims to improve regional financial performance through the decisions of regional expenditure and regional income.

Fiscal decentralisation in Aceh province, Indonesia is quite different from in most other provinces in Indonesia. Besides the general transfer of funds from the Indonesian Government, the province of Aceh also receives special, autonomous funds, unlike other provinces. Aceh has been labelled as a 'special'

province which is mentioned in the Indonesian Constitution No. 18 of 2001 that Aceh was granted special autonomy (*otonomi khusus*). After a long rebellion era by the Free Aceh Movement (*Gerakan Aceh Merdeka*) and followed by military operation carried out by the Indonesian Government, a peace agreement was finally signed in August 2005. It is worth noting that the devastation caused by the 2004 Indian Ocean earthquake and tsunami in Aceh also helped to solidify this peace agreement. The authority of the special province of Aceh lies in the Constitution No. 11 of 2006, which specifically and broadly regulates the local governance of Aceh province and its regions, including in administrative, fiscal and policy decentralisation.

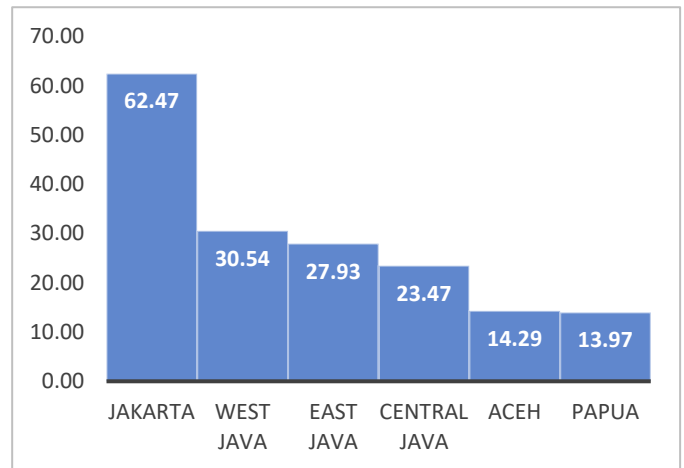


Source: Statistics Indonesia (BPS)

Figure 1 : Government Budgets for Sumatra Island, 2017 (Trillion Rupiah)

In 2017, Aceh had the highest local budget and was the largest fiscal transfer receiver in the Sumatra island. Aceh surpassed North Sumatra and Riau as the province with the most extensive budget. Figure 1 compares the local government budgets in the Sumatra region; it is evident that Aceh dominated the others with a budget of more than 14 trillion rupiah in 2017. Nationally, in the same year (2017), the total budget of Aceh province was in the fifth position. Figure 2 shows that Aceh was situated just below the

large provinces of Jakarta, West Java, East Java and Central Java.

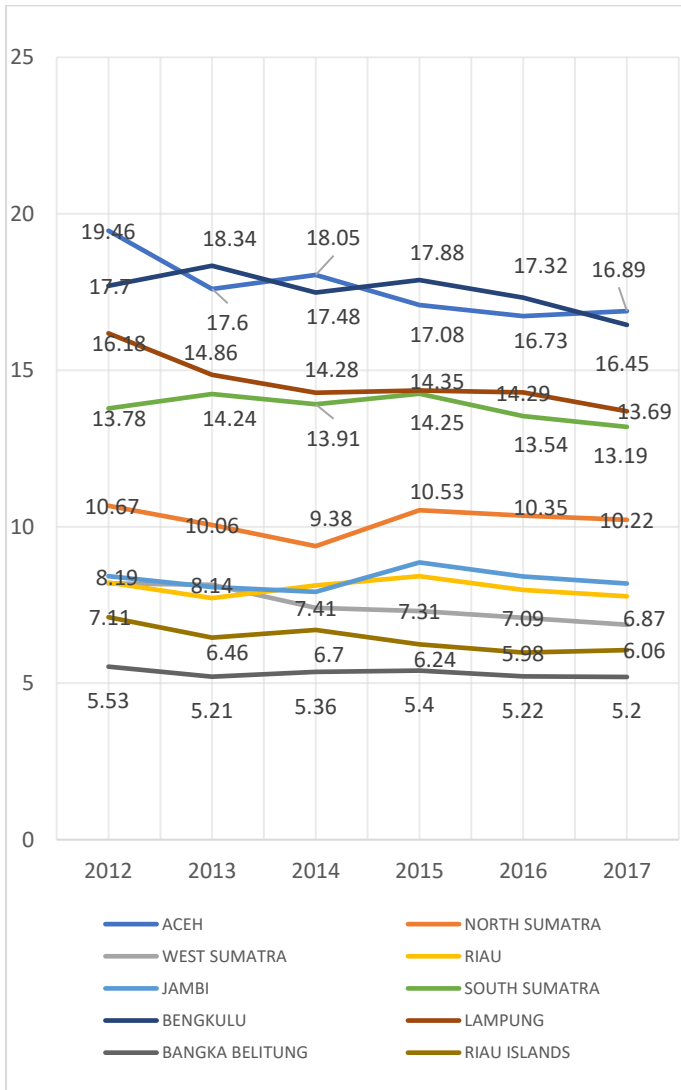


Source: Statistics Indonesia (BPS)

Figure 2 : Top Six Government Budgets in Indonesia, 2017 (Trillion Rupiah)

Ironically, with its huge budget for 2017, Aceh had the highest poverty level in the Sumatra region for that year, and the sixth highest in Indonesia. From 2012 to 2017 Aceh alternated with Bengkulu as the poorest province in the Sumatra region. Despite the initiation of special autonomy in 2008, the poverty rate in Aceh remains high. While there has been a slight decrease in poverty in Aceh, it has not been significant.

Figure 3 demonstrates that other provinces in the Sumatra region, such as Lampung and West Sumatra, have been better able to reduce poverty. Lampung decreased its poverty levels from 16.18% in 2012 to 13.69% in 2017, Riau Islands dropped its poverty percentages from 7.11% in 2012 to 6.06% in 2017 and West Sumatra reduced its percentage of people in poverty from 8.19% in 2012 to 6.87% in 2017. Meanwhile, Aceh lowered its poverty rate from 19.46% in 2012 to only 16.89% with a much larger government budget. Arguably, the purpose of special autonomy is to build a better Aceh; however, this trend does not show noteworthy success, but only a slight improvement.



Source: Statistics Indonesia (BPS)

Figure 3 : Poverty Levels in Sumatra Island, 2012–2017 (Percentages)

This paper analyses the impact of fiscal decentralisation through government revenues and spending policy on local economic growth and poverty reduction. It will examine the influence of local government spending via fiscal transfer funds in general and special autonomy funds in particular to ascertain their effect on economic development and poverty reduction in Aceh, Indonesia, from 2008 to 2018.

The rest of the paper is arranged as follows. Section II discusses the data and methodology while section III presents the result and discussion of the study. In the

next section, section IV provides conclusions and policy recommendations.

II. DATA & METHODOLOGY

The secondary data used in this study were collected from various sources such as Bureau of Statistics (BPS), annual reports published by the Ministry of Finances and Aceh’s provincial and local governments. This study utilises the data from 2008 to 2018, with 2008 marking the commencement of special autonomy in Aceh. Despite regulation by the Constitution in 2006, the fiscal transfer only began in 2008, the base year of this study. As data from 2019 are currently unavailable, 2018 marks the latest period considered in this study.

The operational definition of each variable used is as follows:

1. General allocation funds (DAU) originate from the national/state budget (APBN), which is allocated to regions with the aim of the equal distribution of inter-regional finances to facilitate expenditure needs in the context of implementing decentralisation.
2. The special allocation funds (DAK) are transferred from the central government to certain regions with the aim of funding special activities that are the affairs of the regional government but accord with national priorities.
3. Profit-sharing funds (DBH) are sourced from the APBN revenues and allocated to regions based on percentages of tax and natural resources to fund regional needs in the context of implementing decentralisation.
4. Locally generated revenues (PAD) are incomes obtained by the regions that are collected based on regional regulations in accordance with statutory rules in the context of implementing decentralisation.
5. The special autonomy funds (*Otsus*) are provided by the central government to regional

governments with special autonomy rights to finance their regional development in the context of implementing decentralisation and special autonomy.

6. Regional expenditures are made within a certain fiscal year. Local government goods and services expenditures (BBJ) are for operational needs to carry out routine government activities, including personnel expenditures, goods expenditures and other expenses. Local government capital expenditures (BBM) generate added value to assets, both physical and non-physical, and are made within a certain period.
7. The GRDP is value the value of the goods and services produced by all economic activities in the regions and is measured based on a certain period from the base year so that the value truly reflects the amount of production free from price effects.
8. The poverty rate is the percentage of poor people in a ratio with the total population of an area. It accounts for those who experience an average per capita expenditure per month below the poverty line in relation to the total population.
9. Gross fixed capital formation (PMTB), is defined as the acquisition of produced assets, including purchases of second-hand assets and the production of such assets by producers for their own use, minus disposals.

This study uses panel data regression for its quantitative analysis. Several regression models are presented. However, in general, this tool is used to determine the impact of intergovernmental fiscal transfer policy on government expenditure in all Aceh regions. Later, the impact of this government expenditure on goods and services and on the capital for economic growth and poverty reduction is measured.

Four panel regression models are analysed in this study:

1. The first analyses the impact of fiscal decentralisation in the form of the intergovernmental fiscal transfer of DBH, DAU, DAK and the special autonomy funds (*Otsus*) on local public goods and services expenditure.

$$\ln BBJ_{it} = \alpha_{it} + \ln DBH_{it} + \ln DAU_{it} + \ln DAK_{it} + \ln PAD_{it} + \ln OTSUS_{it} + \varepsilon_{it}$$

2. The second analyses the impact of fiscal decentralisation in the form of the intergovernmental fiscal transfer of DBH, DAU, DAK and the special autonomy funds (*Otsus*) on local public capital expenditure.

$$\ln BBM_{it} = \alpha_{it} + \ln DBH_{it} + \ln DAU_{it} + \ln DAK_{it} + \ln PAD_{it} + \ln OTSUS_{it} + \varepsilon_{it}$$

3. The third analyses the impact of local government spending (goods, services and capital), the fiscal decentralisation practice of locally generated revenue collection (PAD) and the special autonomy fund (*Otsus*) on regional GDP.

$$\ln GRDP_{it} = \alpha_{it} + \ln BBJ_{it} + \ln BBM_{it} + \ln PMTB_{it} + \ln PAD_{it} + \ln OTSUS_{it} + \varepsilon_{it}$$

4. The fourth analyses the impact of local government spending (goods, services and capital), the fiscal decentralisation practice of locally generated revenue collection (PAD) and the special autonomy fund (*Otsus*) on poverty reduction.

$$\ln POVR_{it} = \alpha_{it} + \ln BBJ_{it} + \ln BBM_{it} + \ln GRDP_{it} + \ln PAD_{it} + \ln OTSUS_{it} + \varepsilon_{it}$$

III. RESULTS AND DISCUSSION

Overall, the share of special autonomy fund (*Otsus*) in total Aceh budget is very substantial. The special autonomy fund has become a main source of revenue for the Aceh expenditure budget. Table 1 displays that over the years, from 2014 to 2018, the contribution of *Otsus* fund in Aceh province on average is more than 60% every year. In districts level, the figures also show positive trends in general. This *Otsus* fund has exceeded other fiscal transfer from central government (DAU, DAK, DBH) and locally generated revenue (PAD).

Table 1 : Shares of PAD and *Otsus* on Total Government of Aceh Budget

	2014	2015	2016	2017	2018
Otsus Fund	7,286,776	8,080,416	8,727,252	8,206,138	8,330,110
PAD	1,731,131	1,972,049	2,060,181	2,276,306	2,359,385
Total Budget	12,045,847	12,135,635	12,119,713	13,832,849	12,306,306
Otsus Fund Ratio	60.49	66.58	72.01	59.32	67.69
PAD Ratio	14.37	16.25	17.00	16.46	19.17

Source : Ministry of Finance and Aceh Local Government

However, there is two contrasting argument regarding the dominance of this *Otsus*. On the one hand, this is a good thing, because it shows that the central government is very concerned with the ongoing development of Aceh province. It also demonstrates that the central government follow an important point of the peace agreement of MoU Helsinki which is to build a better Aceh through national funds. On the other hand, this huge share of budget might also create dependency of Aceh government on *Otsus* fund, which is not good. As previously mentioned, this *Otsus* fund will only last for 20 years since the implementation of this policy, which is in 2008. Therefore, when *Otsus* fund is ending, this dependency might interfere with the ongoing development of Aceh in the future.

Hence, in terms of the fiscal decentralisation policy, the capability of local regions to collect locally generated revenue is worth reviewing. In general, the figures for own-source revenue collection (PAD) in all districts are increasing. The data indicates positive trends of local government revenue accumulation in Aceh province. The share of locally generated revenue (PAD) itself from Table 1 shows an increasing trend. Generally, the share of PAD to the total budget is approximately 15% every year on

average. For that reason, it can be said that, slowly all the districts in Aceh starting to improve their responsibility and authority to manage their regional financial resources to develop their regions. This PAD will be essential in the future for the Aceh government when *Otsus* fund will not be provided anymore by the central government.

Panel regression analysis will be explained into four models. The first model examines the impact of fiscal decentralisation on local government expenditure, particularly on goods and services. Fiscal decentralisation in entails intergovernmental transfers, such as DBH, DAU, DAK and also *Otsus* funds. Meanwhile, local regions have the capacity to collect their own revenue, which is another form of fiscal decentralisation measured by PAD.

The first model can be written as follows:

$$\ln BBJ_{it} = 7.503 - 0.219 \ln DBH_{it} + 0.072 \ln DAU_{it} + 0.138 \ln DAK_{it} + 0.392 \ln PAD_{it} - 0.014 \ln Otsus_{it} + \epsilon_{it}$$

The first model from the table shows that several elements of fiscal decentralisation policy significantly affect government expenditure in goods and services.

The variables DBH, is significant at $\alpha = 5\%$, DAK at

$\alpha = 1\%$ and PAD at $\alpha = 0.1\%$, whereas DAU and *Otsus* are not. Two fiscal decentralisation components, DAK and PAD, can be seen to positively increase local goods and services expenditure. The impact of PAD is greater than that of DAK, at 0.392% and 0.138%, respectively. Meanwhile, one significant other, DBH, negatively affects local government good and services expenditure, at 0.219%.

The second model analyses the impact of fiscal decentralisation on local government capital expenditures. All the independent variables are similar to those in the previous model, representing fiscal decentralisation practices.

The second model can be written as follows:

$$\ln\text{BBM}_{it} = 7.436 + 0.206\ln\text{DBH}_{it} - 0.555\ln\text{DAU}_{it} + 0.329\ln\text{DAK}_{it} + 0.489\ln\text{PAD}_{it} + 0.059\ln\text{Otsus}_{it} + \varepsilon_{it}$$

The result shows that all variables are significant at $\alpha = 5\%$. This means that all components of the fiscal decentralisation policy significantly affect local government capital expenditure. Four out of five intergovernmental fiscal transfer components positively affect local capital expenditure. The one with the greatest influence was the PAD variable at 0.489%, then DAK at 0.329%, DBH at 0.206% and, last, *Otsus* at 0.059%. However, the impact of the DAU variable on local government capital expenditure is negative. The increase in the DAU fiscal transfer reduces the local government capital expenditure by around 0.55%.

The third model investigates the impact of government expenditure and the special autonomy fund on economic development. The PMTB variable is used as control variable. Economic development is measured using GRDP. This model also examines the impact of special autonomy funds on economic development in terms of GDP improvement.

The third model can be written as follows:

$$\ln\text{GRDP}_{it} = 9.401 + 0.109\ln\text{BBJ}_{it} - 0.016\ln\text{BBM}_{it} + 0.314\ln\text{PMTB}_{it} + 0.012\ln\text{Otsus}_{it} + \varepsilon_{it}$$

The result shows that three out of four variables are significant at $\alpha = 5\%$ and have positive impacts on the economy. PMTB, as a control variable, has the largest positive impact on the economy at 0.314%. Local government expenditure on goods and services has a positive effect on GRDP development, but local spending via capital expenditure has no significant influence on GRDP improvement in this model. The special autonomy fund (*Otsus*) positively affects the escalation of local economy, albeit only to a small extent at 0.012%.

The fourth model studies the impact of government expenditure and the implementation of fiscal decentralisation on poverty reduction. The impact of local government expenditure is classified into goods and services expenditure and capital expenditure. Fiscal decentralisation was partially analysed in this model using the capabilities of local regions to collect their own revenue (PAD) when using special autonomy funds (*Otsus*).

The fourth model can be written as follows:

$$\text{PovRate}_{it} = 95.92 - 0.013\ln\text{BBJ}_{it} + 1.357\ln\text{BBM}_{it} - 4.621\ln\text{GRDP}_{it} - 1.739\ln\text{PAD}_{it} - 0.491\ln\text{Otsus}_{it} + \varepsilon_{it}$$

The result indicates that local spending on goods and services does not significantly affect poverty alleviation. However, local capital expenditure worsens the poverty rate, as its impact is positive at 1.357%. The negative impact of capital expenditure on poverty rate could happen if there is a large number of corruptions in local regions. The other three variables, GRDP, PAD and *Otsus*, each play significant roles in reducing the poverty rate. Local GDP has the most significant impact on lowering the figure of local poverty rate, followed by PAD. However, the impact of *Otsus* is only minor at 0.5%.

IV. CONCLUSION & RECOMMENDATIONS

Aceh is a special province with a special autonomy status. The decentralisation affecting Aceh is slightly

different than in other regions. In the past, provinces such as Aceh and Papua have sought to separate themselves from the Republic of Indonesia in response to central government policies. However, as an alternative, the central government granted special autonomy to the Aceh and Papua provinces. From 2008 until today, Aceh, as a special autonomy province, has received a special autonomy budget from the central government.

Until this year, the proportion of this *Otsus* fund has been essential for the Aceh province. The Aceh province's increasing budget on a national level over the past year results from the significant amount of special autonomy funds comprising the local Aceh budget (APBD) and transferred from the central government. The purpose of the special autonomy fund is to encourage regions with special autonomy status to increase their economic development. However, the local government should slowly introduce and improve its capacity to collect locally generated revenue (PAD) as an alternative to fiscal transfers from the central government.

Despite the high level of poverty in the Aceh province, the percentage of poor citizens is decreasing. In general, the figures across all regions are experiencing a drop in their poverty levels. This is also true for local GDPs, as all districts are generally increasing their GDP levels. However, the changes vary among districts and may need to be analysed separately at a district level.

The results from the data panel analysis show the positive impact of the fiscal decentralisation policy on government expenditure levels. Several elements of intergovernmental fiscal transfers, such as DBH and DAK, significantly affect local goods and services expenditure. In addition, PAD, as the capacity of local regions to collect their own revenue, is affecting local goods and services expenditure. Meanwhile, all variables significantly influence the local government capital expenditure. Only one variable, DBH, negatively affects the local capital expenditure while the rest of variables (DAU, DAK, PAD, *Otsus*) have positive impacts on local capital spending.

This study also finds an impact of fiscal decentralisation on economic development and poverty. The analysis shows a positive influence of fiscal decentralisation on economic development. The panel regression result indicates that local government spending in goods and services improves the local GDP. Two other variables, PMTB and the *Otsus* fund, also positively affect local GDP. In terms of the impact on poverty, the analysis shows that the *Otsus* fund reduces the poverty rate, but only to a small extent. Further, the improvement of local GDP (GRDP) and local government capabilities in terms of collecting own revenue (PAD) proven as a good instrument of lessen the poverty figures.

The special autonomy fund (*Otsus*) proven to be a good enough policy of fiscal decentralization in Aceh province. Overall, from panel data regression analysis, the *Otsus* fund positively enhance local government expenditure, escalate local GDP and more importantly reduce the poverty level. Nonetheless, the impact of this *Otsus* fund is not that big. For that reason, in the remaining years of special autonomy funds, the supervision of the use of the special autonomy funds need to be improved, either from central government or Aceh province in hoping that the impact of *Otsus* fund could become greater. This is important because the amount of *Otsus* fund received by Aceh over the year is massive. In addition, further analysis in all districts need to be investigate separately to get better insights and details of fiscal decentralisation impact in smaller regional levels.

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