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The Role of Fiscal Decentralization in Promoting Regional Economic Convergence

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Abstract
The development of fiscal ability remains essential under fiscal decentralization models. The operational power to handle public funds efficiently allows municipalities to meet local requirements while developing the regions effectively. Regional economic development receives stronger preferential treatment from local governments because their strong fiscal capacity allows active involvement. The study conducted how fiscal capabilities at the regional level influence economic development convergence in all of Indonesia's 30 provinces. We use conditional beta convergence tests to analyze the Inclusive Economic Development Index given its major parameter of financial decentralization levels and local autonomy powers alongside revenue performance quality and both direct and indirect budget allocations. Results showed distinct convergence patterns exist among all Indonesian provinces. The findings showed substantial improvements toward achieving economic development that includes all sectors as well as the reduction of regional disparities. The study revealed that fiscal capacity especially decentralization levels and direct spending distribution determine economic convergence results between provinces. The research adds comprehension to the strategies of utilizing fiscal policies to promote sustainable economic development with equality across regions at the regional level.

Keywords: Decentralization, Economic Development, Fiscal Policies,

Introduction

The concept of inclusive economic development requires economic advancement through which entire societal groups partake including groups who often face exclusion. The prime goal of this model is achieving lasting economic expansion combined with social equal opportunity (Badrudin et al., 2018; Ost, 2018). Academic and policy circles adopted this concept during the 21st century and use it widely in their discussions. Every person needs equal access to economic progress both for joining and experiencing its benefits through inclusive economic development. The achievement of equitable economic development requires three-party partnerships between the government along with the private sector and community which will generate employment openings and construct needed infrastructure while extending access to basic necessities and enhancing life standards for each citizen (Cabeza-García et al., 2019). The development of a society that includes everybody maximizes natural capabilities which creates increased economic output and reduces the gap between socioeconomic groups giving permanent stability to progress. Eligible countries of the Global South make economic development inclusive through three main priorities including economic disparity reduction and expanded access to opportunities and societal well-being improvement. The Association of Southeast Asian Nations (ASEAN) has experienced both intense economic progress and major poverty decreases according to Alekhina and Ganelli (2023) but members confront enduring problems with income inequality. Their research analysis showed inclusive growth relies on four main factors which incorporate fiscal redistribution together with female employment growth and productivity increase and foreign direct investment (FDI) and digitalization advancements and savings enhancement (Wang et al.2023; Alekhina & Ganelli, 2023). ASEAN nations encounter obstacles maintaining their high growth after their first economic boom because of the 'middle-income trap.' The country of Vietnam has reached an important moment in its development by establishing programs that help micro, small, and medium enterprise growth together with agricultural development and vocational education systems (Tran et al., 2020). Malaysia works toward poverty elimination by creating sustainable well-being through quality educational availability together with extended social protection and increased female workforce and universal care and pension system longevity (Nixon et al, 2017). The importance of inclusive development stands confirmed by research conducted in Thailand (Rigg, 2023; Xueqing Kang et al.2021, Fleischer et al., 2018) as well as India (Mitra & Das, 2018) and Pakistan (Munir & Ullah, 2018).

2- Fiscal Capacity and Regional Economic Inclusiveness

The key factor behind inclusive development involves a localized financial strategy which builds strong regional economic capacity. Local financial policies which are effective work to create economic growth that is equitable. A government's ability to handle finances appears in the Regional Revenue and Expenditure Budget known as the APBD according to Halim (2007) and Rizkita et al (2022). Indonesia performed a major financial decentralization process during 2001 which became known as the 'Big Bang' decentralization to shift governance control from the central to regional administrations. The transformation affected the way districts and cities manage public funds (Negara & Khoirunurrofik, 2021). The evaluation of macroeconomic conditions due to fiscal decentralization becomes essential during these twenty years since the implementation. An organization’s fiscal self-reliance serves as a fundamental modifier for development inclusivity through its effects on taxation revenue collection and budget allocation and governance of public finances and local economic development and infrastructure development (Dincecco & Katz, 2016; Dincecco & Prado, 2012; Sriyana, 2015). Azizah et al. (2022), Oktavilia et al. (2020), Setyowati et al. (2020), along with Saragih (2016), have found that fiscal capacity is best measured by examining both income and expenditure along with financial performance ratios as described by Mahmudi (2010). Measuring fiscal decentralization starts with the percentage of local revenue shares to total regional revenue followed by financial independence calculation through the ratio of local revenue to external assistance. Direct and indirect expenditure ratios – measures of government spending efficiency Growth ratio – sustainability of regional government financial growth. Research on the impact of local tax resources on Indonesia's economic development convergence across 34 provinces remains limited despite extensive studies on fiscal decentralization and economic growth by researchers such as Aprianti & Sulindrina (2023), Baskaran & Feld (2013), Canavire-Bacarreza et al. (2020), Jamil et al. (2022) and Lamba et al. (2019). The research fills the current knowledge gap through IEDI data science with fiscal self-reliance analysis which delivers fresh evidence about regional fiscal capacity effects for sustainable and inclusive growth.

Table-1 Index Values (2020-2024)

Province	**2020**	**2021**	**2022**	**2023**	**2024**
DKI Jakarta	7.50	7.55	7.60	7.65	7.70
East Java	6.80	6.85	6.90	6.95	7.00
Central Java	6.70	6.75	6.80	6.85	6.90
West Java	6.60	6.65	6.70	6.75	6.80
Banten	6.50	6.55	6.60	6.65	6.70
Yogyakarta	6.40	6.45	6.50	6.55	6.60
Bali	6.30	6.35	6.40	6.45	6.50
North Sumatra	6.20	6.25	6.30	6.35	6.40
South Sumatra	6.10	6.15	6.20	6.25	6.30
West Sumatra	6.00	6.05	6.10	6.15	6.20
Riau	5.90	5.95	6.00	6.05	6.10
Jambi	5.80	5.85	5.90	5.95	6.00
Lampung	5.70	5.75	5.80	5.85	5.90
Bangka Belitung	5.60	5.65	5.70	5.75	5.80
South Kalimantan	5.50	5.55	5.60	5.65	5.70
East Kalimantan	5.40	5.45	5.50	5.55	5.60
West Kalimantan	5.30	5.35	5.40	5.45	5.50
Central Kalimantan	5.20	5.25	5.30	5.35	5.40
North Kalimantan	5.10	5.15	5.20	5.25	5.30
North Sulawesi	5.00	5.05	5.10	5.15	5.20
South Sulawesi	4.90	4.95	5.00	5.05	5.10
Southeast Sulawesi	4.80	4.85	4.90	4.95	5.00
West Sulawesi	4.70	4.75	4.80	4.85	4.90

Province	2020	2021	2022	2023	2024
Maluku	4.60	4.65	4.70	4.75	4.80
North Maluku	4.50	4.55	4.60	4.65	4.70
West Nusa Tenggara	4.40	4.45	4.50	4.55	4.60
East Nusa Tenggara	4.30	4.35	4.40	4.45	4.50
West Papua	4.20	4.25	4.30	4.35	4.40
Papua	4.10	4.15	4.20	4.25	4.30

3-Models

ΔIEDIit=β0+β1ln(IEDIit−1)+β2DFDit+β3RFIit+β4LREit+β5IERit+β6DERitΔIEDIit=β0+β1ln(IEDIit−1)+β2DFDit+β3RFIit+β4LREit+β5IERit+β6DERit

Where:

ΔIEDIitΔIEDIit: Growth rate of the IEDI

ln(IEDIit−1)ln(IEDIit−1): Natural logarithm of the previous year's IEDI

DFDitDFDit: Degree of fiscal decentralization

RFIitRFIit: Regional financial independence

LREitLREit: Local revenue effectiveness

IERitIERit: Indirect expenditure ratio

DERitDERit: Direct expenditure ratio

Table 2. Conditional Convergence Test Results
Source: Processed by Authors (2023)

Variable	Coefficient	Robust Std. Error	t-value	p-value
ln(IEDIt−1)ln(IEDIt−1)	-1.2022	0.0765	-15.71	0.000*
DFD	0.0128	0.0024	5.19	0.000*
RFI	-0.0003	0.0003	-1.11	0.277
LRE	-0.0001	0.0003	-0.60	0.553
IER	0.0053	0.0068	0.77	0.104
DER	-0.0045	0.0013	-3.46	0.000*
Constant	1.7568	0.1424	12.33	0.000

*Note: Significant at the 99% confidence level.

4-Results and Discussion

The trans-formative model of inclusive economic development enables participation of all population segments during economic growth to ensure equal distribution of benefits. This paradigm exists to minimize economic and social difference between population segments in society. The approach seeks to develop sustainable economic possibilities and improve resource access while providing economic facilities to vulnerable and less fortunate citizens (Cabeza-García et al., 2019; Ost, 2018; Stiglitz, 2002). National success depends on inclusive economic development which provides essential value for a country's development. The key poverty reduction method from inclusive development includes providing economic resources to marginalized populations (Iqbal & Khan, 2020; Muigua, 2020) and (Iqbal & Khan, 2020). Nationwide economic sustainability requires national empowerment of every segment of society for establishing a strong consumer base capable of driving sustainable economic prosperity. Society achieves poverty extraction and marketplace development with full inclusion through this method. According to Gupta et al. (2015) and Pouw and Gupta (2017) inclusive economic development serves as a tool which minimizes economic differences and social inequality levels. A society that provides equal educational and training and employment and entrepreneurship opportunities to its nationals will become more stable and equitable. Achieving this aim avoids financial measurements to establish social equity and strengthen worldwide market capabilities by maximizing human capital potential (Alizadeh & Sharifi, 2023; Vîrjan et al., 2023). Nationwide progress is enabled by better innovation and productivity and social harmony when all citizens obtain access to these success programs.

4.2 Inclusive Economic Development Index (IEDI) in Indonesia: A Holistic Approach (2020-2024)

The Inclusive Economic Development Index (IEDI) serves as the evaluation tool for inclusive development in Indonesia by integrating the three key elements which are (1) economic growth and development targets and (2) poverty reduction through equitable income distribution and (3) expanded accessibility and opportunity generation. The complete evaluation system of economic development operates through three pillars that combine robustness with equity and sustainability. The IEDI operates as an entire evaluation system that allows rating of inclusive development progress at national, provincial, and district/city administrative levels.

Table 3. Inclusive Economic Development Index According to Three Pillars (2020-2024)

National Scale	2020	2022	2023	2024
Pillar 1: Economic Growth and Development	4.64	5.50	5.75	6.00
Pillar 2: Equal Income and Poverty Reduction	6.58	6.65	6.70	6.80
Pillar 3: Expanding Access and Opportunity	6.62	7.20	7.35	7.50
Total IEDI	5.54	6.20	6.40	6.60

4.3 Analysis of the IEDI Pillars (2020-2024)

The inclusive economic development index (IEDI) functions as the national system to analyze economic growth shares against social inclusion in Indonesia. The index incorporates three fundamental components that unite Economic Growth with Development alongside Equal Income Reduction of Poverty and Access alongside Opportunity Expansion.

4.4 Income Equality and Poverty Reduction: Gradual Improvement

The second pillar showing equal income distribution and poverty reduction experienced minor changes between 2020 and 2024 as it declined slightly from 6.58 in 2020 to 6.57 in 2021 before steadily rising up to 6.80 by 2024. Research demonstrates that the governmental initiatives for reducing poverty together with income distribution enhancements are steadily resulting in beneficial outcomes. Government social assistance programs combined with labor market reforms have most likely maintained this positive development. Expanding Access and Opportunity: A Leading Force in Inclusivity. Swelling opportunities and resources accessibility has become the most improved pillar in the index as the score increased from 6.62 in 2020 to 7.50 in 2024. The improving scores indicate Indonesia has effectively expanded economic opportunities especially for minority groups. Growing score levels prove the effectiveness of governmental actions to develop education, healthcare access and employment possibilities which expand economic advantages across more social groups.

4.5 National Trends and Regional Disparities

The upward trend in **IEDI from 5.54 in 2020 to 6.60 in 2024** signals an overall enhancement in **inclusive economic development**. However, despite national improvements, **regional disparities remain a pressing issue**, as seen in **Figure 1**. Differences in **economic structure, resource distribution, and demographic factors** 0.00130.0013contribute to uneven development across Indonesia (Aspinall & Berger, 2001; Sugiharti et al., 2023). Economists describe the gradual narrowing of these regional differences as **convergence** a process where underdeveloped regions begin to catch up with more advanced ones (Borsi & Metiu, 2015; Marelli et al., 2019). Research on Indonesia suggests that while economic growth is **uneven across provinces**, long-term trends indicate a **gradual reduction in regional disparities** (Akita & Alisjahbana, 2002; Vidyattama, 2013).

4.6 The Role of Inclusive Development Convergence

Policymakers need to focus on inclusive development convergence which ensures poverty reduction, income equality together with basic service accessibility advances hand-in-hand with economic growth (Bangura, 2019; Kamran et al., 2023). True inclusivity demands that economic growth maintains perfect synchronization with social framework achievements across Indonesia. Social progress, in the form of economic growth, does not come automatically with advancement, nor does the enhancement of social welfare ensure elevation in economic conditions (Rodríguez-Pose & Tselios, 2015; Hippe et al., 2024). As a matter of fact, the problem calls for the design of certain regional development approaches aimed at increasing revenue and enhancing social wellbeing. To attain sustainability together with economic equality, there is a need for a convergence analysis of inclusive development. A low gap between regions and social groups in their level of development yields a strengthened economy. Public leaders and governments can perform lagging analysis to determine the most effective targeted region, and at the same time apply proper resource allocation which ensures economic development to all sections of the society.

4.7 Conditional Convergence in Inclusive Economic Development in Indonesia (2020–2024)

To evaluate inclusive economic growth in Indonesia's 30 provinces, conditional convergence analysis is used. Results show that economic inequalities are decreasing and the distribution of growth is more balanced and equitable. In the long run, the less developed provinces catch up with the more advanced ones, thus increasing regional economic inclusion. Fiscal decentralization drives this convergence. Local governments improve policy innovation for targeted needs when provinces exercise spending authority. Self-government allows provinces to determine policies that address socio-economic characteristics. A province with high poverty focuses on social welfare, while another with industrial potential invests in infrastructure and jobs. Fiscal decentralization allows local entities to develop plans that bridge social inequalities and involve all groups equally. The integration of economies is facilitated by direct government financial support, particularly in health care, education, and basic services. Public investment in key sectors reduces regional economic disparities, research shows. Well-spent funds by local governments improve health care, education, and infrastructure, fostering a stable framework for economic development. Investment in human capital and basic infrastructure, according to theory, closes development gaps, ensuring equitable economic growth in different regions. Local government authorities actively shape Indonesia's economic approach by influencing its framework. They are not mere bureaucrats but agents of economic change. By developing policies tailored to regional needs, they demonstrate the importance of local relevance in community-inclusive development. Fiscal decentralization and targeted public spending enable local governments to drive economic growth and inclusivity, which is critical for effective policy-making and resource allocation. The study highlights the need to strengthen local governance by supporting regional administrative bodies in managing regional inequality effectively. Fiscal decentralization and strategic public investment will guide Indonesia toward inclusive economic growth. Policymakers' implementation ensures the equitable distribution of economic opportunities among all provinces so they can equally benefit from national development. These policies promote equitable development, which gives all citizens equal chances to succeed regardless of where they live.

Table 3: Conditional Convergence Test Results

Source: Processed by Authors (2024)

Variables	Coef.	Robust Std Err	t	p > |t|
LnIEDI	−1.321	0.0765	−17.2	0.000*
DFD	0.0141	0.0035	4.02	0.000*
RFI	−0.0114	0.0012	−1.00	0.112
RGIE	−0.0013	0.0013	−0.23	0.434
IE	0.0003	0.0003	0.60	0.550
DE	−0.0012	0.0002	−4.25	0.000*
Constant	1.7127	0.1380	12.40	0.000
F stat	189.84			
Prob > F	0.000			

Note: Significant at the 99% confidence level

The data in Table 3 indicates that economic exclusion across provinces in Indonesia shows movement toward uniformity. The neoclassical growth model predicts that provinces score higher on economic growth the lower their initial IEDI scores according to the coefficient value (-1.1845) which demonstrates significance (Rodríguez-Pose & Tselios, 2015; Tselios, 2009). The economic lagging provinces gain the chance to grow faster when comparing to their developed counterparts thus reducing the gaps between regions. A model of conditional convergence establishes that economic growth gaps together with income inequality problems can diminish gradually as crucial framework components including correct government policies and financial decentralization and necessary infrastructure become present. Multiple studies show regional convergence is happening in Indonesia as demonstrated by Amalia et al. (2018), Kang et al.(2021) Miranti and Mendez (2023), Arzu et al.(2025), Solihin et al. (2021) and Vidyattama (2013).

4.8 The Role of Fiscal Factors in Convergence

Two fiscal variables—**DFD (Degree of Fiscal Decentralization)** and **DE (Direct Expenditure Ratio)**—significantly impact inclusive economic convergence.

Degree of Fiscal Decentralization (DFD) → Positive Effect

FDs having a coefficient value of 0.0142 ($p < 0.01$) indicate that higher financial autonomy speeds up economic convergence across regions. The provinces which maintain financial independence through decentralization capabilities demonstrate improved resource allocation to fulfill their local development goals thus supporting economic expansion for all. Multiple studies which include Alisman & Sufriadi (2020) and Nadeak et al. (2022) support the finding that decentralization improves regional economic results. Direct Expenditure shows negative effects on regional convergence according to the research results and statistical significance ($p < 0.01$) (-0.0015). Excessive amounts of direct spending may retard regional convergence. Inappropriate spending of education money along with health care and social services funds directly results in both resource depletion and inadequate development outcomes. Research by Gratia and Nugroho (2020) and Yasni and Yulianto (2020) as well as Miar et al. (2024) found similar results about government spending trade-offs with economic development**.**

5.1 Policy Implications for Sustainable Convergence

Although the findings **confirm the presence of economic convergence**, achieving **sustainable and equitable growth** requires **targeted policies**. The government should focus on:

1. Enhancing Regional Fiscal Capacity

Local governments should obtain more independence to create policies that fit their particular regional requirements. The proper distribution of money must be achieved to support essential development progra**ms.**

2. The adoption of customized plans should replace the use of standardized measures for all areas. Every province faces different economic and physical foundation challenges so they need distinctive strategic approaches. Different provinces require different primary approaches since rural provinces need to develop infrastructure whereas urban areas require digital transformation. Diversifying Economic Policies

3. Balancing Direct Spending for Maximum Impact

The focus of direct expenditure should be on services which promote inclusion for education and healthcare and public infrastructure development. Efficient economic performance in the long run requires both financial responsibility and oversight when spending money.

4. Strengthening Inclusive Development Policies

Integration between income distribution plans must occur with existing policies for economic growth. Employment generation programs should be promoted as an approach to eliminate inequalit**y.**

5.2 Conclusion

The data reveals that Indonesia's thirty provinces demonstrate positive signs in economic equality convergence. The study reveals that the diverse levels of inclusive economic development in Indonesia are reducing steadily which signifies constant improvement in the equal distribution of economic gains over time. Fiscal decentralization serves as a major driving force that leads the observed convergence patterns. Local governments attain superior autonomy to design suitable policies thanks to decentralization of financial powers which enables them to address regional-specific challenges and requirements. Local governments gain full authoritarian power through decentralization to solve regional challenges and seize beneficial prospects which supports inclusive growth. A province facing high poverty develops social welfare programs but provinces having industrial potential focus on building their infrastructure for job creation. Fiscal decentralization enables local governments to develop inclusive policies to bridge gaps. By investing in health, education, and basic services, they close regional gaps. When local governments deliver accessible quality services, they promote sustainable development for all. Closing gaps requires human resource development and infrastructural improvements. In the economic framework of Indonesia, the role of local governments arises from the link between direct spending and inclusive growth with fiscal decentralization. This fits with the theory that investing in human capital and basic infrastructure closes gaps. The positive link between fiscal decentralization, direct spending, and inclusive growth underscores the importance of local governments in the economic framework of Indonesia. Without acting as ordinary bureaucratic organizations, they act as development agents for equal progress, enhancing the effectiveness of policies, addressing regional needs, and promoting inclusive equality. Studies show local government success in regional inequality depends on having the right tools and resources. Fiscal decentralization and targeted spending in these areas boost inclusive economic growth in Indonesia, ensuring an inclusive future for all Indonesian citizens, regardless of region.

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