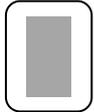


ESSAYS ON FISCAL DECENTRALIZATION: EVIDENCE FROM DEVELOPING COUNTRIES WITH SPECIAL FOCUS ON INDONESIA

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ABSTRACT

This thesis aims to examine the determinants of regional proliferation in Indonesia and fiscal decentralization in developing countries. Additionally, it explains the mediating effect of institutional quality on the relationship between fiscal decentralization, growth, and inequality in developing countries.

In general, my thesis is divided into three parts. The first part contains the analysis of the drivers of regional proliferation (known as *pemekaran*) as a consequence of the implementation of decentralization in Indonesia. Here, a qualitative analysis of the motivation behind *pemekaran* in Indonesia is expected to complement the econometric results at cross-province level. Upon observation of the years between 2007 and 2014, I have found that institutional-quality indicators, proxied by the level of administrative approvals and social capital, are positively and significantly correlated with the number of regional-proliferation events. I have also discovered that intergovernmental fiscal transfers and income per capita cannot be a motive for regions in Indonesia to proliferate. In addition, there is a significant and positive association between ethnic fractionalization and the occurrence of regional proliferation in Indonesia. Meanwhile, the qualitative findings in West Java and Banten show that territorial coalitions do matter and that there are political, economic, and bureaucratic rent-seeking motives behind *pemekaran*.

While the first part focuses on several metrics of fiscal decentralization at the national level, the successive parts stress the macro dimension of the revenue and expenditure share, and the fiscal authority of sub-national governments at cross-country level. Drawing from the Government Financial Statistics (GFS) dataset and the Regional Authority Index (RAI), the second part explains the determinants of fiscal decentralization in developing countries. I argue that the different institutional settings of fiscal decentralization observed in developing

countries depends on the quality of institutions. Specifically, policy-makers may have other incentives (e.g. political resistance and challenges) to alter the degrees of fiscal powers. My observation is based on a five-year average of periods between 1990 and 2014 in 56 developing countries. The findings show strong evidence of a nonlinear relationship between institutional quality and some metrics of fiscal decentralization. In this context, as democracy (polity), law and order, as well as fiscal decentralization are all evolving from low levels of development, a further surge in the magnitude of these institutional quality variables will further abate the degrees of fiscal autonomy and expenditure decentralization, respectively.

Based on the results from the second part, the third part will discuss how fiscal decentralization affects growth and inequality in developing countries. In the former case (i.e. growth equation), based on observations in 46 developing countries from 1990 to 2014, findings show that growth depends on the level of fiscal authority and its interaction with institutions. Decentralization of revenue leads to higher economic growth through stronger law and order. Decentralization of expenditure has a positive effect on growth when coupled with high democracy and low corruption. The effect on growth of a shared-rule of fiscal powers is likely to be affected by democracy and quality of governance. Meanwhile, in the latter case (i.e. inequality equation), based on observations across 56 developing countries in the period 1990 to 2014, findings show that the kind of fiscal authority has a significant effect on distribution of income and ethnic inequality. This depends on whether developing countries reach the optimum level of institution and defence spending.

To sum up, this thesis shows that institutional quality plays a significant role as a driver of regional proliferation in Indonesia and fiscal decentralization in developing countries. Additionally, at the very least, process-based and outcome-based measures of institutional quality are very effective to reduce inequality and to enhance economic growth in developing countries. Hence, one may expect that such metrics can also be applied in other countries.