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Factor Affecting in Economic Growth and Regional Inequity in Indonesia

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Abstract: Purpose: Examine the Factor Affecting in Economic Growth and Regional Inequity in Indonesia. Factor affecting in this study are decentralization of autonomy power, decentralization of authority power, mobility factor, construction cost index, and inflation rate.

Originality: Several studies suggest that the central government was failed in realizing the expected level of economic growth, poverty reduction, income distribution, and preparation of appropriate public services (Oates, 1972). Although district are main providers of public services of the region, very few studies had been done on district's growing burden in decentralization era. The main reason of the lack of study in district level is due to the lack of data on district government which eventually encourages the writers to conduct the study of the relationship newly decentralized administration in regional level and how these changes affect the economic growth, and the imbalance among regions which is also a very important issue.

Methods: Population in this study is region/ Regency development area in Indonesia. Total population is 127 regions/regencies. This study takes all regions which are 127 regencies. Primary data is needed as supporting data to help further enrich the discussion of this research. This data is sourced from direct interviews or questionnaires several local governments with regard to the fiscal management of the area. Particularly with regard to financial management and a number of indicators that have been achieved. Secondary data is key data used in the model analysis of this study and sourced from multiple data sources, such as the Central Bureau of Statistics (BPS), the Ministry of Finance, Bank Indonesia reports and other sources. Analysis tools using cluster and cross-tabulation.

Findings: Based on the result and discussion, the conclusion of this research are follow. Decentralization with autonomy and authority power has positive and significant effect to economic growth, the higher value of decentralization with autonomy and authority power, will be lead the higher value of of economic growth. Economic growth has positive and significant effect to regional inequity, the higher value of economic growth, will be lead the lower value of regional inequity. Economic growth as mediation effect in relationship between decentralization of autonomy power and authority power toward regional inequity. It means that the lower

the autonomy and authority power in the region, the lower the economic growth of the regencies, and will affect the higher the regional inequity of the regencies. In other hand, mobility factors, construction cost index, and inflation rate does not effect to economic growth and regional inequity.

Keywords: Economic Growth, Regional Inequity, Indonesia

1. INTRODUCTION

The decentralized system, generally, assures every possible autonomy for local governments in exploring sources of income and its allocation to the good of the people. The notion of decentralization it self should be interpreted and brought into practice carefully so then maintaining the harmony of politic, economy, and fiscal decentralization. Political decentralization essentially grants authority to the local government to carry out a policy, while the administrative decentralization or decentralized managerial provide clues to how the implementation of the transfer of authority of these functions. Fiscal decentralization then provide financing for the transfer of authority. Thus, fiscal decentralization is part of a larger design that consists of political decentralization, administrative decentralization, and fiscal decentralization which leads to the welfare of the people (economic decentralization).

Thiessen (2001) describes fiscal decentralization as something that requires a shift of responsibility with regard to accountability at lower levels governments. It can be defined that the lower government should be able to increase tax revenue and allocate it into policies with given criterions. Moreover, Bird and Wallich (1993) state that fiscal decentralization is frequently interpreted as a package of changes aimed in improving efficiency in public sector in order to create a competitive atmosphere among regional governments in term of public service and to stimulate economic growth.

Fiscal decentralization, positively, encourages larger regional revenue by the transference of fund from the central government to regional government, i.e. the General Allocation Fund (DAU), Special Allocation Fund (DAK) and DBH (natural resources and taxes), and ultimately increase the economic growth of the region and, eventually, provide flexibility for local governments to forge policies purposed to stimulate the economic growth. Yet, negatively, fiscal decentralization may also increase the impact on the fiscal imbalances between regions, because of differences in potential and capacity.

The budget allocation for investment region will increase the capital stock of the region and opportunities for employment, thereby increasing the capacity of regional economies which eventually boosts economic growth. Moreover, increased economic growth impacts consumption and savings (investment) of the community and leads to the increased local tax base. Subsequently, the increased tax revenue and levies result in higher regional revenue. Therefore, it is assumed confidently that fiscal decentralization can encourage economic growth in spite of the consequences of redistribution of resources. (Martinez-Vazquez and McNab, 2001).

Regional districts and cities are today's main focus in term of increasing and encouraging their economic growth. Regions have resources that should be developed in a sustainable manner in which various possibilities can be done to encourage regional economic growth and equity by the local community.

Local governments pursues high economic growth by opening and providing opportunities for development by opening various businesses or developing existing businesses. To do so, local government can initiate more development to industrial areas, hire professionals, or seek investors from other regions.

Moreover, various incentive policies may be practiced to attract investment. Thus, generally, the local government aims to provide an enticing region for investors and a comforting region for staying.

Several studies suggest that the central government was failed in realizing the expected level of economic growth, poverty reduction, income distribution, and preparation of appropriate public services (Oates, 1972). Although district are main providers of public services of the region, very few studies had been done on district's growing burden in decentralization era. The main reason of the lack of study in district level is due to the lack of data on district government which eventually encourages the writers to conduct the study of the relationship newly decentralized administration in regional level and how these changes affect the economic growth, and the imbalance among regions which is also a very important issue.

Based on the background of the problems stated above, this research is aimed at studying the Factor Affecting in Economic Growth and Regional Inequity in Indonesia. Factor affecting in this study are decentralization of autonomy power, decentralization of authority power, mobility factor, construction cost index, and inflation rate.

2. LITERATURE REVIEW

Fiscal decentralization is a process by which local governments are given the region's economical authority. It covers fiscal responsibility at various levels of administrations. It also relates to fiscal instruments and procedures in order to assist the implementation of public services (Bird et al., 1995). Fiscal decentralization allows regional governments to provide varieties of different combinations of goods and public services since regional governments have more understanding toward the needs of its people compared to the central government. Proponents of decentralization believe that economic efficiency can be achieved in a decentralized government because they can provide multiple outputs (goods and services) at its best and reflects the priority needs of the regional people (Oates, 1972).

A centralized government tend to provide a homogenous goods and public services for regions with different needs in the country. Assume that people from different regions needs different goods and public servies, different needs, then a centralized government that offer homogenous goods and services is not efficient. Moreover, Oates (1999) states that a form of decentralized state offer an increased efficiency of the economy by providing various outputs of public goods which is relevant with the needs of the differences between communities. The provision of public goods and services can also be associated with a lower administrative costs because the cost of implementation and supervision will be cheaper. Further, Oates (1999) also states that the benefits of economic efficiency, fiscal decentralization is the increasing accountability of local officials, especially when they have been elected. Moreover, government officials who are closer to their voters are more likely to allocate resources efficiently, and they do their best to optimize the level of economic development and public services as the only way to re-elected. In addition, each region is obliged to pay what they provide, so then they will attempt to achieve the efficient cost in which the marginal benefit grows simultaneously with mersginal cost, compared to those services conducted by the central government (Tanzi, 1996).

Community in a region of fiscal decentralization acts as a "research laboratory" for the entire population of the country (Osborne, 1988). Decentralization allows experimentation and innovation in

the production process of public goods (Tanzi, 1996) and for the next, the experiment may lead to a more developed technology and producing better public goods and services and public policy (Oates, 1999). When local communities grow and develop models of economic development in a decentralized system, the first program implemented is that a relatively small scale. If the program is successful, it will developed in all parts of the country. Yet, even if the trial program is failed, only a small proportion of the people who suffered losses. Therefore, the transference of responsibilities to those represent the country illustrates the failure of the existing program and efforts of making the country as an experiment to find the program that suits all.

Economic growth is no longer a major concern in the theory of fiscal decentralization in generals since the principal concern is now on economic efficiency. Actually, growth theory does not provide a specific framework to explain or analyze the relationship between fiscal decentralization and economic growth (Martinez-Vazquez and McNab 1997). However, in the last two decades, fiscal decentralization policy has been massively applied in industrial countries as well as in developing countries, in which the goals or objectives of the fiscal decentralization policy making is to encourage better economic growth.

Akai and Sakata (2002 and 2005) have examined the relationship of fiscal decentralization and economic growth and regional imbalances in states of the United States during the period 1992 to 1999. They found that the positive effect of fiscal decentralization on economic growth even tough fiscal decentralization did not have a significant effect on regional imbalances if fiscal decentralization measured by revenue contribution or contribution in the area of local government expenditure. While the attainment of autonomy by fiscal decentralization has a negative influence on regional inequality.

Zhang, Xiaobo (2006) examines the impact of fiscal decentralization and political decentralization on economic growth and inequality in China and it was found that due to the large differences in economic structure beginning with a basic revenue of each region, so that the tax rate and the fiscal burden to support the role and functions of local government are significantly varies across the regions, where the regions are already from the beginning to have a basic a large tax is not sourced from the farm need not rely on the companies existing or new companies to finance public goods or services, and eventually create a healthy investment environment for non-agricultural sector to grow. In contrast, regions with agriculture as the main economic activity have resources left relatively small for public investment since all expenditures incurred to finance the bureaucracy. As a result, differences in economic structure and the fiscal burden could lead to regional deepened disparities.

Cheng and Li Sung-ko (2006) examines the inequality of revenue and efficiency by using a decomposition approach and its application in China. This study suggests a new interpretation on the decomposition of the Theil inequality index if the income can be described as a multiplicative component. By applying these methods in China, they found that the impact of technical inefficiency in inequality between regions shows a trend of diminishing.

Kikuchi, Tadashi (2007) introduces some relevant policy-oriented approach, which measures the economic impact of the development of social inequality. Gini inequality is frequently used because it is highly flexible and both individuals and groups of data are taken into account to describe a clear influence on the change of the Gini inequality. First, the estimation of the Lorenz curve is described as a concept that is very closely related to the Gini inequality. Next, using individual data from the 5938 household

consumption expenditure in Vietnam, Kikuchi draw the conclusions of the factors that influence the inequality.

Liang Pinghan (2005) says that the changes in the structure of public expenditure is usually followed by economic development, and her study emphasizes the effect of certain development programs in the structure of public expenditure provincial governments. By using multivariate statistical analysis, the study analyzes the calculation system of public expenditure, compared to public expenditure priorities before and after the execution of the development program of Western China (Western China Development Programme). There are two ways of analysis of the main component, the first one is based on a calculation system of the ordinary and the another one is based on the system of the new calculation, in which it is established through the analysis of the grouping variable, and considering the wholefully of Western China, the research study the changes of spending priorities. The main conclusion of the study is, after the execution of the development program of Western China (Western China Development Programme), there is a significant change in public expenditure priorities. The government has made change to prioritize the infrastructure provision and administrative maintenance, and transform community's stabilization policies.

Thornton, John (2006) examines the relationship between fiscal decentralization and economic growth using cross-section data from 19 OECD member countries. He reveals that limiting the size of fiscal decentralization to the revenue side of the regions that obtain full autonomy, then the impact of fiscal decentralization on economic growth is not statistically significant. Thus, the significance of fiscal decentralization and economic growth relationship cannot be explained due to independent tax power among the regions which in turn represents the effectiveness of decentralization.

3. METHODOLOGY

This study employs survey method. According to Mc Millan and Schumacher (2006), survey is used to study about attitude, belief, values, demography, behavior, opinion, habit, willingness, ideas, and other types of information. This study is located in Indonesia, distributed in 26 Provinces in Indonesia starting from Aceh to Papua. Population in this study is region/ Regency development area in Indonesia. Total population is 127 regions/regencies. This study takes all regions which are 127 regencies. Primary data is needed as supporting data to help further enrich the discussion of this research. This data is sourced from direct interviews or questionnaires several local governments with regard to the fiscal management of the area. Particularly with regard to financial management and a number of indicators that have been achieved. Secondary data is key data used in the model analysis of this study and sourced from multiple data sources, such as the Central Bureau of Statistics (BPS), the Ministry of Finance, Bank Indonesia reports and other sources. All data used in this study is a cross section data for all districts and cities in Indonesia area for each variable of research in 2008.

4. ANALYSIS RESULT

Cluster analysis in this study is used to classify regencies' regional inequity into two levels, namely low, and high regional inequity, also in economic growth in two leavess, low, and high growth. Also the factor affecting such as decentralization with autonomy power, decentralization with authority power, mobility factor, construction cost index, and inflation rate in two levels (low, and high level). The result of cluster

analysis by Non-Hierarchical Cluster with Euclidean Distance showing 68 regencies classified in low regional inequity, and 59 regencies classified in high regional inequity. In other hands, the result of cluster analysis by Non-Hierarchical Cluster with Euclidean Distance showing 58 regencies classified in low economic growth, 38 regencies classified in moderate economic growth, and 31 regencies classified in high economic growth.

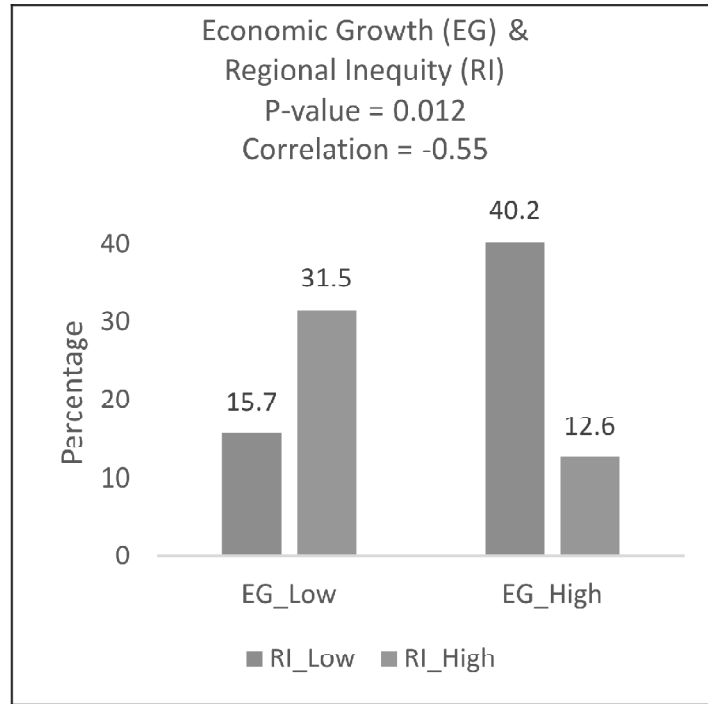


Figure 1: Economic Growth and Regional Inequity

The results of the analysis of cross-tabulation in Figure 1 shows that of the 127 regencies, 15.7% to the level of economic growth is low, have regional inequity is low; while 31.5% more to the level of regional inequity is high (more dominant regions with levels of economic growth is low, then it will lead the regional inequity that is high). On the other hand, at a high growth level of economic, are more likely to have a 40.2% regional inequity regions is low, although there are regencies that have a 12.6% regional inequity is high. From the test results showed that the economic growth has a significant and negative relationship to the regional inequity (P-value of <0.05 , and the value of negative correlation). It can be concluded that the higher the economic growth in the region, the lower the regional inequity of the regencies.

The results of the analysis of cross-tabulation in Figure 2 shows that of the 127 regencies, 32.3% to the level of autonomy power is low, have economic growth is low; while 16.5% more to the level of economic growth is high (more dominant regions with levels of autonomy power is low, then it will lead the economic growth that is also low). On the other hand, at a high power level of autonomy, are more likely to also have a 29.9% economic growth regions is also high, although there are regencies that have a 21.3% economic growth is low. From the test results showed that the autonomy power has a significant and positive relationship to the economic growth (P-value of <0.05 , and the value of positive correlation).

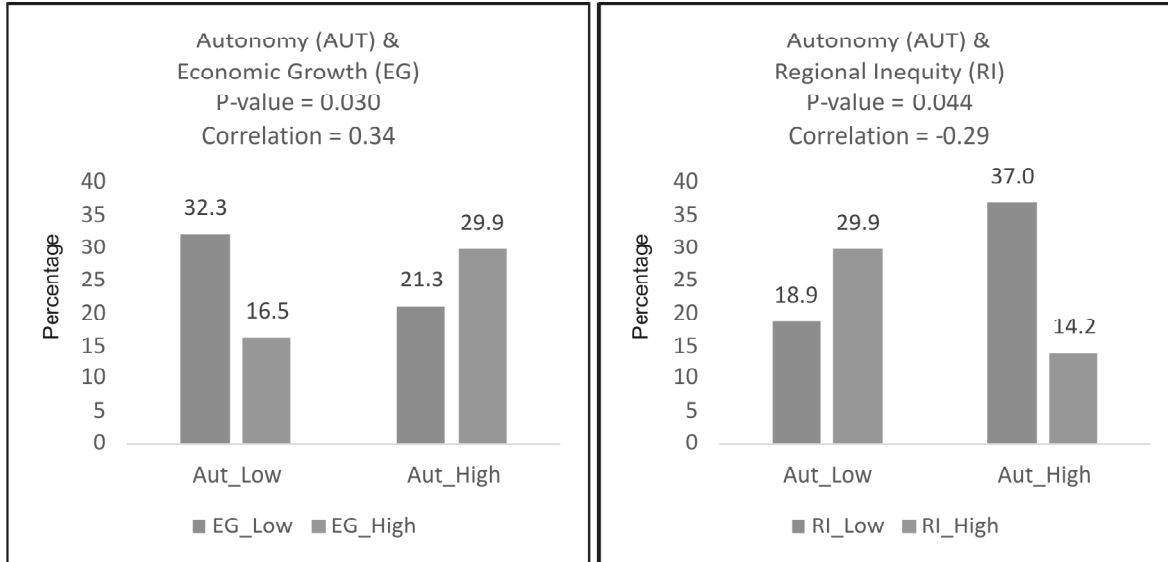


Figure 2: Autonomy Power and Economic Growth-Regional Inequity

It can be concluded that the higher the autonomy power in the region, the higher the economic growth of the regencies. Based on the right figure (relationship between autonomy power and regional inequity), 18.9% to the level of autonomy power is low, have regional inequity is low; while 29.9% more to the level of regional inequity is high (more dominant regions with levels of autonomy power is low, then it will lead the regional inequity that is high). On the other hand, at a high power level of autonomy, are more likely to have a 37.0% regional inequity regions is low, although there are regencies that have a 14.2% regional inequity is high. From the test results showed that the autonomy power has a significant and negative relationship to the regional inequity (P-value of <0.05, and the value of negative correlation). It can be concluded that the higher the autonomy power in the region, the lower the regional inequity of the regencies. The result on Figure 1 and Figure 2 conclude that Economic Growth as mediation effect in relationship between Autonomy Power toward Regional Inequity, with negative correlation. It means that, the higher the autonomy power in the region, the higher the economic growth of the regencies, and will affect the lower the regional inequity of the regencies. In other hand, the lower the autonomy power in the region, the lower the economic growth of the regencies, and will affect the higher the regional inequity of the regencies.

The results of the analysis of cross-tabulation in Figure three shows that of the 127 regencies, 30.7% to the level of authority power is low, have economic growth is low; while 14.2% more to the level of economic growth is high (more dominant regions with levels of authority power is low, then it will lead the economic growth that is also low). On the other hand, at a high power level of authority, are more likely to also have a 30.7% economic growth regions is also high, although there are regencies that have a 24.4% economic growth is low. From the test results showed that the authority power has a significant and positive relationship to the economic growth (P-value of <0.05, and the value of positive correlation). It can be concluded that the higher the authority power in the region, the higher the economic growth of the regencies. Based on the right figure (relationship between authority power and regional inequity), 14.2% to the level of authority power is low, have regional inequity is low; while 30.7% more to the level of regional inequity is high (more dominant regions with levels of authority power is low,

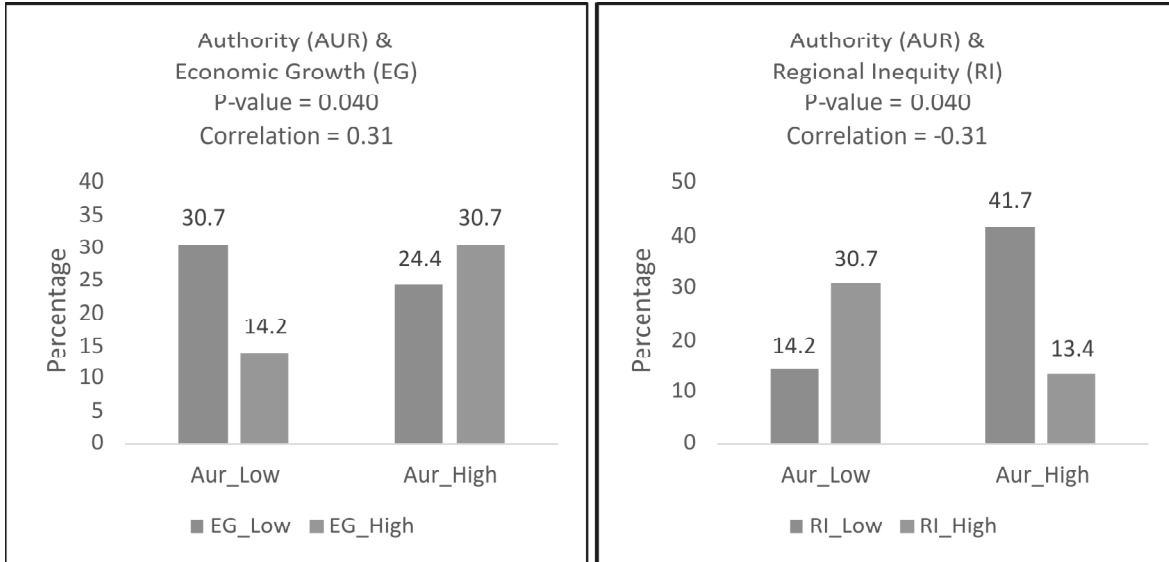


Figure 3: Authority Power and Economic Growth-Regional Inequity

then it will lead the regional inequity that is high). On the other hand, at a high power level of authority, are more likely to have a 41.7% regional inequity regions is low, although there are regencies that have a 13.4% regional inequity is high. From the test results showed that the authority power has a significant and negative relationship to the regional inequity (P-value of <0.05, and the value of negative correlation). It can be concluded that the higher the authority power in the region, the lower the regional inequity of the regencies. The result on Figure 1 and Figure 3 conclude that Economic Growth as mediation effect in relationship between Authority Power toward Regional Inequity, with negative correlation. It means that, the higher the authority power in the region, the higher the economic growth of the regencies, and will affect the lower the regional inequity of the regencies. In other hand, the lower the authority power in the region, the lower the economic growth of the regencies, and will affect the higher the regional inequity of the regencies.

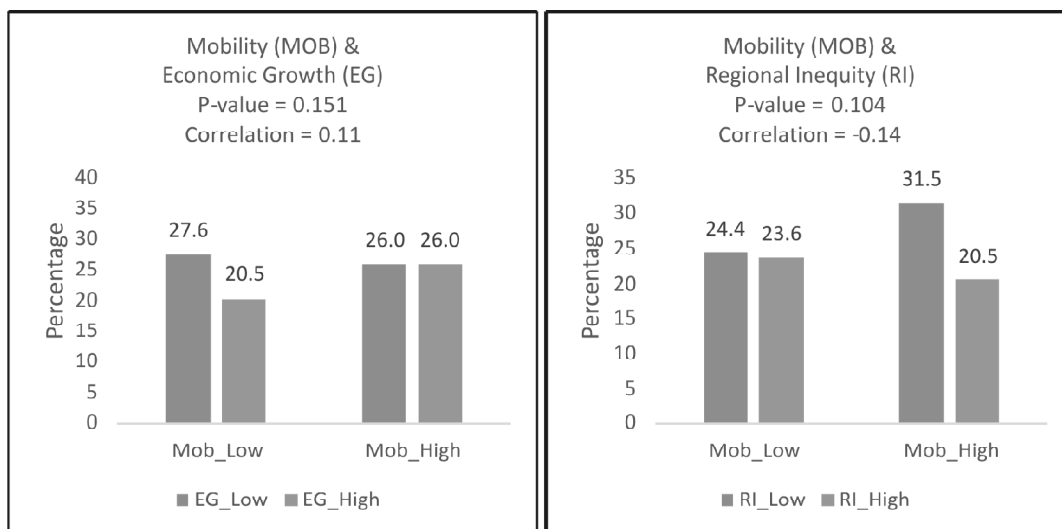


Figure 4: Mobility Factor and Economic Growth-Regional Inequity

The results of the analysis of cross-tabulation in Figure 4 shows that of the 127 regencies, 27.6% to the level of mobility factor is low, have economic growth is low; while 20.5% more to the level of economic growth is high (two level approximately equal). On the other hand, at a high factor level of mobility, have equal response in level of low economic growth and high economic growth. From the test results showed that the mobility factor has a insignificant relationship to the economic growth (P-value of > 0.05). It can be concluded that economic growth does not depend on mobility factor. Based on the right figure (relationship between mobility factor and regional inequity), 31.5% to the level of mobility factor is high, have regional inequity is low; while 20.5% more to the level of regional inequity is high (two level approximately equal). On the other hand, at a high factor level of mobility, have equal response in level of low regional inequity and high regional inequity. From the test results showed that the mobility factor has a insignificant relationship to the regional inequity (P-value of > 0.05). It can be concluded that regional inequity does not depend on mobility factor. The result on Figure 1 and Figure 4 conclude that Economic Growth is not mediation in relationship between Mobility Factor toward Regional Inequity, because the relationship is insignificant.

The results of the analysis of cross-tabulation in Figure five shows that of the 127 regencies, 28.3% to the level of construction cost index is low, have economic growth is low; while 19.7% more to the level of economic growth is high (two level approximately equal). On the other hand, at a high index level of cost, have equal response in level of low economic growth and high economic growth. From the test results showed that the construction cost index has a insignificant relationship to the economic growth (P-value of > 0.05). It can be concluded that economic growth does not depend on construction cost index. Based on the right figure (relationship between construction cost index and regional inequity), 30.7% to the level of construction cost index is high, have regional inequity is low; while 21.3% more to the level of regional inequity is high (two level approximately equal). On the other hand, at a high index level of cost, have equal response in level of low regional inequity and high regional inequity. From the test results showed that the construction cost index has a insignificant relationship to the regional inequity

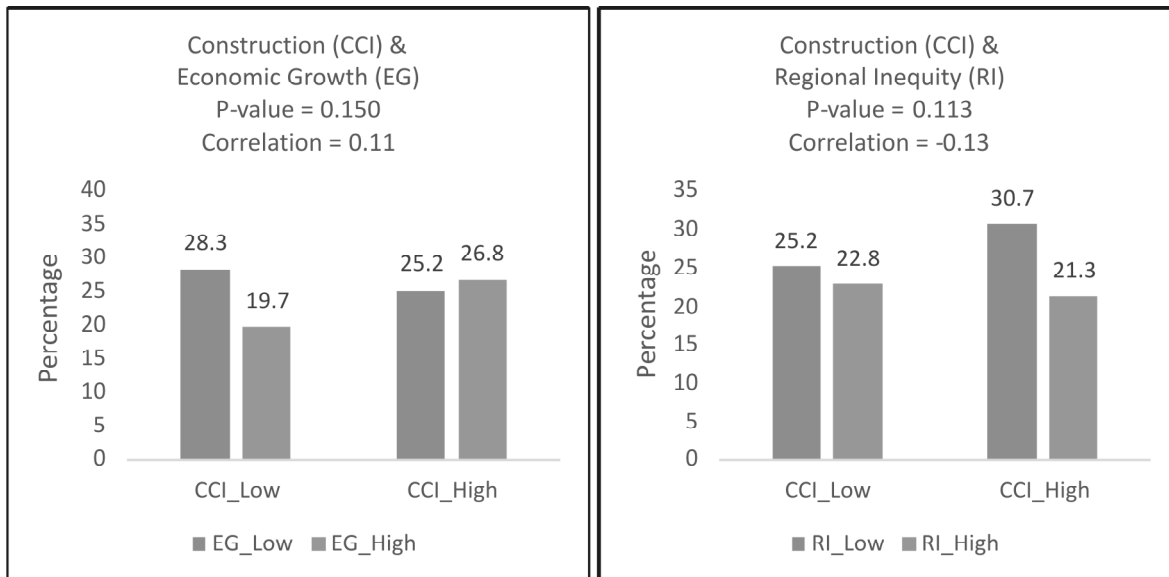


Figure 5: Construction Cost Index and Economic Growth-Regional Inequity

(P-value of > 0.05). It can be concluded that regional inequity does not depend on construction cost index. The result on Figure 1 and Figure 5 conclude that Economic Growth is not mediation in relationship between Construction cost index toward Regional Inequity, because the relationship is insignificant.

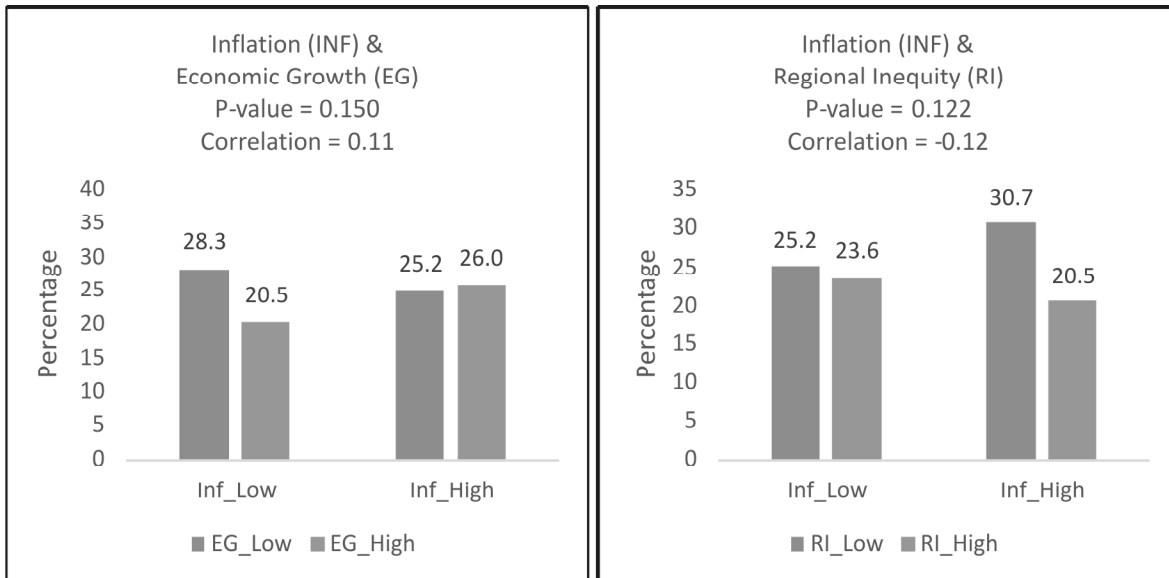


Figure 6: Inflation Rate and Economic Growth-Regional Inequity

The results of the analysis of cross-tabulation in Figure 6 shows that of the 127 regencies, 28.3% to the level of inflation rate is low, have economic growth is low; while 20.5% more to the level of economic growth is high (two level approximately equal). On the other hand, at a high rate level of inflation, have equal response in level of low economic growth and high economic growth. From the test results showed that the inflation rate has a insignificant relationship to the economic growth (P-value of > 0.05). It can be concluded that economic growth does not depend on inflation rate. Based on the right figure (relationship between inflation rate and regional inequity), 30.7% to the level of inflation rate is high, have regional inequity is low; while 20.5% more to the level of regional inequity is high (two level approximately equal). On the other hand, at a high rate level of inflation, have equal response in level of low regional inequity and high regional inequity. From the test results showed that the inflation rate has a insignificant relationship to the regional inequity (P-value of > 0.05). It can be concluded that regional inequity does not depend on inflation rate. The result on Figure 1 and Figure 6 conclude that Economic Growth is not mediation in relationship between Inflation rate toward Regional Inequity, because the relationship is insignificant.

5. DISCUSSION

The study concludes that, after observations and the results of the quantitative analysis that has been done, and examines the fiscal decentralization model that is likely more appropriate and more effective in developing countries like Indonesia. If the economic and political pressures on fiscal decentralization is getting stronger and at the same time the encouragement of democratic development continues to grow, many countries, including Indonesia, the demand for fiscal decentralization is increasing. However,

despite the increased support and desire, fiscal reform for regional governments is likely to remain slow and the process is also depressing due to the serious constraints on the decentralization still unresolved, such as overlapping authority, excessive burdens of the officials, and insufficient regional infrastructure.

Based on the analysis of the effects of decentralization with autonomy power, the correlation to economic growth rate is not significant. It gives an indication that the fiscal decentralization run at the provincial level conducted by strengthening revenue through increased taxes and levies, do not grant any significant effect toward the rate of economic growth in the provinces.

Overall, it can be concluded that the fiscal decentralization does not provides optimum benefits to Indonesia, both on the level of employment, economic growth rate and the rate of regional inequality. It is caused by the difference reaction in each region to the implementation of fiscal decentralization as a result of different resource reserves in each region. In addition, large apparatus expenditure paid by the APBD results in highly limited fiscal space.

The analysis of long road reveals no significant effect on the rate of economic growth, and regional disparity levels directly or indirectly. The analysis of the effect of construction cost index reveals no significant effect on the rate of economic growth, directly or indirectly, but there is a direct positive influence on the level of regional inequality. The analysis of the effect of inflation reveals no significant effect on the rate of economic growth rates, and regional disparity levels directly or indirectly.

The analysis of the effect of fiscal decentralization with the power authority (power authority) reveals no significant effect on the rate of economic growth which indicates that the remaining regional expenditures is too small to support the rate of regional economical growth. Fiscal decentralization has not provided optimum benefit to the regions of Indonesia, both on the level of economic growth and the level of regional inequality. It is caused by various obstacles such as the lack of resource, or limited regional expenditures.

Thus, it can be argued that the variable of economic growth has not proved as bridging variable (mediate) the effect between decentralization with autonomy power, decentralization with authority power, mobility factors, construction cost index and inflation rate toward regional inequality. Thereby, it shows that the variable of economic growth is not serving as a mediate variable in the effect of decentralization with autonomy power, decentralization with authority power, mobility factors, construction cost index, inflation rate toward the rate of regional inequality.

6. CONCLUSION AND RECCOMENDATION

Based on the result and discussion, the conclusion of this research are follow. Decentralization with autonomy and authority power has positive and significant effect to economic growth, the higher value of decentralization with autonomy and authority power, will be lead the higher value of of economic growth. Economic growth has positive and significant effect to regional inequity, the higher value of economic growth, will be lead the lower value of regional inequity. Economic growth as mediation effect in relationship between decentralization of autonomy power and authority power toward regional inequity. It means that the lower the autonomy and authority power in the region, the lower the economic growth of the regencies, and will affect the higher the regional inequity of the regencies. In other hand, mobility factors, construction cost index, and inflation rate does not effect to economic growth and regional inequity.

Based on the conclusions of the research, then put forward some suggestions into the implications of the results of this study include (1) The results of this dissertation study reveals that there exists any space that enables fiscal decentralization to improve economic growth and repair regional inequality. Yet, local governments should be steadily alerted to the positive/negative effect for it only occurs in some cases. Thus, to achieve the optimum level, the appropriate economic environment is highly needed, which gives the researcher to suggest the revitalization of monetary competence of the region. (2) Fiscal decentralization, despite giving impetus to economic growth area, but still has the potential to create imbalances between regions if the funds transfer policy experiencing distortion. It is advisable to use a standard formula without being distracted by the basic allocation and policy adjustments.

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