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Regional Revenue Problems:
Is Fiscal Decentralization Really the Solution?

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Abstract

Fiscal decentralization is a policy strategy that aims to give regional governments greater authority in financial management, in order to increase efficiency, accountability and relevance of policies to the needs of local communities which is expected to be able to bridge prosperity in order to reduce the level of inequality between regions. This research uses a descriptive qualitative method with a literature study approach, namely data obtained from online observations from journals, websites and book sources. This article examines the benefits, challenges and impacts of fiscal decentralization on regional development. This policy provides an opportunity to increase autonomy and public services, regional readiness is a determining factor for success. In general, the results of the literature review show that fiscal decentralization is not necessarily an automatic solution to regional revenue problems; Its success depends greatly on the fiscal capacity, institutional readiness and quality of governance of each region. Therefore, a strategy to strengthen fiscal capacity and regional accountability is needed to ensure that fiscal decentralization can be a real solution, not an additional burden for regions.

Keywords: Fiscal decentralization, Public Welfare, Regional Inequality, Impact of Fiscal Policy

1. INTRODUCTION

At the global level, inequality is a problem underlying the development gap, high unemployment, and poverty hindering the economic growth process (Chroufa & Chtourou, 2023; Dluhopolskyi & Zhukovska, 2023; Vitkovics, 2023). This unequal distribution is reflected in the fact that 21 percent of income is allocated to the upper 1 percent of the population, while the lower 50 percent of the population only receives 14 percent of the total income, especially in South Asia and East Asia (Piketty et al., 2025). In Indonesia, almost 90 percent of national economic wealth is accumulated on the island of Java, including Sumatra and Kalimantan, with growth expansion in Maluku and Sulawesi due to downstream mining factors, and only 20 percent of regions have incomes above the national average (AMRO, 2025). These conditions underlie financial reform efforts with a focus on fiscal decentralization, including in Indonesia, with the aim of giving local governments more authority to manage their finances sensitive to local needs. In public finance, fiscal

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decentralization is considered capable of increasing the efficiency of resource allocation, transparency, and accountability of regional governments in responding to various challenges in governance.

Decentralized as financial devolution leading to transfers to the district level, especially the redistribution of taxation and the provision of public services that encourage local economic acceleration (Lewis, 2010, 2023), is carried out by the state as the implementation of state duties (Dudek, 2026). This policy is a reform of centralistic policies, where the central government has full control over resource management and budget distribution (Septiani et al., 2024). In the Indonesian context, fiscal decentralization began to be implemented more widely after the 1998 reforms referring to Law No. 22 of 1999 concerning Regional Government and Law No. 25 of 1999 concerning Financial Balance between the Central and Regional Governments which later became Law No. 1 of 2022 concerning Financial Relations between the Central Government and Regional Governments (JDIH BPK, 2022). This reform aims to reduce regional dependence on the central government, increase Regional Original Income (PAD), and address fiscal inequality between regions (Hardiana et al., 2020), encouraging regional governments to manage finances moderately, both increasing development and controlling risks (Dexu & Wenlong, 2022; Onofrei et al., 2022).

However, the implementation of fiscal decentralization in Indonesia faces various challenges. One of the main issues is the gap between fiscal needs and regional fiscal capacity, known as *the fiscal gap* . Referring to the Regional Economic and Fiscal Development Report (Kementrian Keuangan RI, 2025), the regions of Aceh, Bengkulu, West Kalimantan, Jambi, and Bangka Belitung with low levels of Regional Transfers (TKD) and unresponsiveness impacting Ecological-Based Performance Incentives (IKE) require increased fiscal capacity and governance, including structural reforms that encourage an escape from the low-growth trap. On the other hand, the regions of Yogyakarta, Banten, Riau Islands, West Java, and East Kalimantan have relatively high Transfers to Regions that can encourage regional resilience, downstreaming, and regional productivity. Therefore, a *rebalancing scheme is needed* by strengthening *the equity track* of TKD, in contrast to high TKD that encourages *investment-driven growth* . This difference can often be overcome by efforts to increase the transfer of General Allocation Funds (DAU) and Village Funds annually. As in Spain, fiscal interventions have narrowed the income gap between rural and urban areas (Loras-Gimeno et al., 2024), and strengthening the digital economy has moderated transparency and fiscal sustainability in China (Li & Yang, 2024). However, high dependence on central transfer funds can be an obstacle to regional fiscal autonomy, resulting in low levels of regional innovation in optimizing their own revenue potential (Mega Christia & Ispriyarso, 2019; Pabayo, 2025), while disincentives can worsen local democracy (Nemec et al., 2026).

This poses a crucial challenge to creating equity in Indonesia, with its diverse regional characteristics and heterogeneity requiring specific interventions across both underdeveloped and developed regions, as well as rural and urban areas, to prevent regional disparities from worsening. Studies show that the success of fiscal decentralization is influenced not only by regional financial capacity but also by the level of accountability and transparency in budget management. Corruption control, accountability, and transparency increase the effectiveness of fiscal transfers (Dinh Thanh et al., 2023), and proportional sharing encourages fiscal distribution that leads to endogenous and regional growth (Aritenang & Chandramidi, 2022). However, corruption cases in Indonesia are related to the effectiveness of government management (Siburian, 2024), and the level of regional independence affects central transfer funds in driving economic progress (Sofilda et al., 2023). Furthermore, fiscal allocations, particularly village funds, that fail to create inclusiveness and meet community needs have the potential to reduce the quality of public services (Hussain & Anis, 2022). A total of 508 districts/cities in Indonesia exhibit fiscal imbalances (Manto et al., 2025). Therefore, fiscal imbalances and regional financial management capacity still need to be addressed to ensure the success of this decentralization (Mega Christia & Ispriyarso, 2019).

2. METHODS

The research study refers to a qualitative approach based on literature studies (Hardani et al., 2020; Soesana et al., 2023; Wekke, 2019), while descriptively refers to the analysis of findings from previous publications that are reviewed and compared to obtain findings and conclusions on the observed phenomena, especially the context of regional income problems and fiscal decentralization in addressing disparities between regions in Indonesia. Literature study data utilizes secondary data by digging up data from several references that can be accessed online, especially ebooks, scientific journals, institutional reports and credible and valid websites without conducting field research, the same thing was done in the study (Febrianto et al., 2025; Febrianto & Nur Asiyah, 2025).

Meanwhile, the data analysis technique is carried out systematically with several stages that are passed: 1) researchers conduct literature searches related to the collection of scientific articles, policy documents, institutional reports including other digital sources, 2) researchers then map the problems and phenomena of the study to be studied, especially the context of decentralization policies by previous researchers in several local governments in Indonesia, 3) researchers conduct analysis and compare the findings and researchers conduct synthesis referring to the findings and tendencies of previous studies related to fiscal decentralization in various local governments. 4) After conducting in-depth literature analysis, qualitative research findings will be produced to answer the problem formulation, namely why fiscal policy decentralization is needed; the purpose of fiscal policy decentralization; regional financial problems before decentralization; regional readiness for fiscal policy decentralization and fiscal decentralization: a solution or a burden?. So that the findings are expected to be able to reflect the conditions of the implementation of fiscal decentralization that are being carried out, whether they are able to be used as a solution to overcome regional income disparities in Indonesia comprehensively and enrich the scientific literature presented in the points of research findings and analysis.

3. RESULTS AND DISCUSSIONS

Why Is Fiscal Policy Decentralization Needed?

Some important reasons why fiscal policy should be decentralized are as follows: (a) Decentralization allows local governments to better understand and address the needs and priorities of local communities, by giving them fiscal autonomy to design and implement programs that are more suited to the local context, thereby increasing the effectiveness of public services; (b) Local governments that are closer to their communities tend to be more efficient; and (c) Local governments that are closer to their communities have the ability to allocate budgets in a more appropriate and appropriate manner to local needs, as well as to identify and address problems directly (Mega Christia & Ispriyarso, 2019).

In general, fiscal policy decentralization increases the accountability of local governments to their citizens in terms of budget use and service provision, and increases economic stability by granting local governments fiscal autonomy (Mega Christia & Ispriyarso, 2019). Fiscal decentralization is considered capable of reducing the level of inequality and disparity between rich and poor regions. By giving local governments the authority to manage their own resources, it is hoped that less developed regions will have a greater capacity to develop local economies and improve community welfare (Sihombing et al., 2024). Decentralization also allows local governments to innovate in the provision of public services, resulting in improved quality of public services. With more freedom in budget management, regions can build more efficient and productive programs and improve public services. Overall, fiscal policy decentralization is considered an important step towards good governance, where the government can serve the community more responsively, accountably, and efficiently (LAN, 2020).

However, effectiveness depends on how fiscal transfers are managed in each region, which has varying levels of capacity. Comparisons between regions show that the impact of fiscal decentralization on welfare is not uniform. Studies in regencies and cities in West Java Province show that fiscal decentralization contributes to poverty alleviation efforts, although the level of success varies across regions depending on their respective fiscal capacities (Sihombing et al., 2024). Meanwhile, cross-sectional studies in developing countries find that the effect of fiscal decentralization on welfare is significantly moderated by institutional quality; the devolution of fiscal authority without good governance risks widening disparities, not reducing them (Digdowiseiso, 2022). As a comparison between regions, (Siburian, 2022)provides strong evidence that the implementation of fiscal decentralization in Indonesia during the 2001–2018 period contributed significantly to poverty reduction, although the extent of these benefits depends heavily on the capacity of local governments to manage public spending effectively. These findings are reinforced by a systematic literature review (Fadhlurrahman et al., 2026)of twenty-seven Scopus-indexed articles from Indonesia, India, and the Philippines, which shows that decentralization tends to improve the efficiency of public services and reduce poverty in regions with mature institutional quality, but risks triggering elite capture and corruption in regions with weak institutions. This comparison between studies confirms that the impact of fiscal decentralization on public welfare is conditional and heavily influenced by local government governance and accountability, rather than occurring automatically in every regional context.

Objective Decentralization of Fiscal Policy

Fiscal decentralization is implemented to achieve at least two main objectives: achieving a high level of fiscal equity or equality both vertically and horizontally. Vertical tax equity means equal taxation between the central and regional governments. Horizontal financial equity now refers to regional financial equity. Budget inequality arises from differences between budgetary capacity and household needs. The ability to pay taxes between regions affects the ability to raise revenue. Furthermore, budgetary needs are related to differences in public service performance, such as the composition of the school-age population through retirement, geographic and climatic conditions, and indicators of poverty and unemployment (Tupan & Setiorini, 2022). In general, high levels of equitable distribution depend heavily on two factors: fiscal capacity and fiscal equity. Therefore, a specific formula is needed to achieve tax equality between regions. This formula must be designed to ensure that regional rights are not neglected. An incorrect fiscal equalization formula can result in certain regional tax jurisdictions being neglected while others receive greater attention or benefits. A fiscal transfer system between levels of government or regions can be used to achieve fiscal equalization. Consequently, all formulas used must meet the standards of an effective fiscal transfer system. A sense of equity is one such criterion. Regional fiscal needs and regional capacity are negatively correlated with the amount of reserves (Lestari, 2023).

There are several ways to achieve a high level of fiscal equality, these methods include:

1. The allocation of funds is based on the considerations of organizational groups, namely political considerations that benefit the central government.
2. The central government can use the per capita fiscal equalization rule to provide funds to local governments that meet the requirements.
3. The central government can use a clearer and more complex formula (Tupan & Setiorini, 2022).

The division of authority between the central and regional governments is based on their respective budget management capacities. Regional governments with high unemployment rates, limited access to finance, and a lack of regional economic openness have relatively limited ability to influence prices. This occurs despite the central government's relatively unlimited authority regarding the budget's role in redistribution and stabilization. As a result, the central government has the ability to implement more equitable income policies, which include measures that influence the movement of household and business resources and stem economic shifts. Conversely, regional governments are responsible for determining the efficiency of public goods to maximize general welfare .

Regional Financial Problems Before Decentralization

Before decentralization, regional finances in Indonesia often faced challenges due to their dependence on the central government and their lack of autonomy to manage their own financial resources. While centralization created stability and uniform development, it also created disparities, innovation, and low local participation (Mareta et al., 2026). This centralized system resulted in overall government decisions and limited regional autonomy. This dissatisfaction led to the issuance of Law No. 22 of 1999, the foundation for decentralization and regional autonomy (Lathifah et al., 2024). As a result, when regions faced financial problems, they were unable to take swift and efficient action to resolve them. The issue of limited regional financial resources, which existed before decentralization, continues to pose structural challenges today, driven by the following weaknesses of the centralized system:

1. Resource Constraints: Because most regional revenues come from transfers from the central government, regions often experience limited revenue. This makes it difficult for regions to develop their local economic potential. (Hussain & Anis, 2022).
2. Community Dissatisfaction: Often, communities are dissatisfied with the inability of regions to manage their finances independently. They believe that because important decisions are made at the central level without considering the unique circumstances and needs of the regions, local needs and desires are not being met. (Mega Christia & Ispriyarso, 2019).
3. Delays in Development: Infrastructure development and public services in regions can be delayed due to persistent financial problems. Development projects are often halted or cannot be implemented properly due to lack of funding, impacting the quality of life of the community (Rizky, 2023) .
4. Inter-Regional Inequality: Before decentralization, there was a significant gap between rich and poor regions. Regions with abundant natural resources may have received greater attention and funding, while less fortunate regions remained in poverty and underdevelopment. With decentralization, it is hoped that regions will have more autonomy in managing their own finances (Rizky, 2023) .
5. Low Regional Original Revenue (PAD): Many regions had low PAD before decentralization. As a result, they were unable to independently finance development and government operations. Due to insufficient PAD, regions relied on transfer funds from the central government. (Mega Christia & Ispriyarso, 2019).

Regional Readiness For Fiscal Policy Decentralization

Fiscal decentralization, which began on January 1, 2001, significantly altered the relationship between the central government and the regions and required a rapid response in such a large country with challenging geographic conditions. Therefore, many observers considered this approach a bing-bang approach. Consequently, many regions had already prepared for this policy, primarily in an effort to prevent a continuing economic crisis. Pre-crisis economic growth (GRDP) averaged over 5% (five percent), but in 1998, the average increased slightly. However, before autonomy was implemented, several regions showed positive progress in 1999 and 2000 (Shulhan Naja et al., 2021). This initial overview shows that the fiscal potential of regional governments to address fiscal decentralization can vary significantly from region to region. These differences can generate different types of economic growth. To address these differences, the central government establishes a transfer allocation policy, also known as the general allocation fund (DAU), based on their fiscal capacity. Regions with greater fiscal capacity will receive larger allocations than regions with lower fiscal capacity. According to research, the proportional distribution of DAU allocations reduces the difference in per capita revenue. The coefficient of variation of the related variable decreased in 2002, dropping from 1.9 (one point nine) in 2001 to 1.18 (one point eighteen). However, it is important to remember that DAU is provided only to address the fiscal gap, or resource availability; in other words, DAU is provided only to address the input gap. The output gap, as indicated by economic growth, will depend heavily on the region's ability to manage resources efficiently, particularly in the productive sector (Surgawati, 2022).

Due to fiscal decentralization, there may be differences in economic policy approaches between the central and regional governments. Regional governments often face economic or financial constraints rather than financial constraints, which are the primary problem for the central government. As a result, regional governments will focus on allocation rather than (economic) stabilization. In other words, financial difficulties hinder efforts to achieve consistent and high economic growth. To address both issues simultaneously , regional governments must have experience and capabilities in financial management. Horizontal imbalances, or adverse effects, will arise as a result of differences in the level of economic progress between regions. This is due to the potential increase in the number of actors with market power, which in turn will increase inequality within the region. Income distribution tends to decline at the beginning of growth, indicating that the positive impact of development on growth takes a long time to develop (Rany et al., 2020).

In more detail, the four types of regions can be explained through a typology approach that compares the level of economic growth and fiscal capacity of a region, namely: (1) developed and fast-growing regions, which have above-average economic growth and fiscal capacity and are therefore most ready to implement decentralization; (2) developed but depressed regions, which have high fiscal capacity but slowing economic growth; (3) rapidly developing regions, which have high economic growth but still have limited fiscal capacity; and (4) relatively underdeveloped regions, which are low in terms of both economic growth and fiscal capacity and are therefore most vulnerable to facing the burden of decentralization. This classification is important because the appropriate strategy for strengthening fiscal decentralization will vary for each type of region. The latest data shows that of the 508 districts/cities in Indonesia, the majority are still in the low to medium fiscal capacity category, while only a small number are classified as very high, so strengthening the fiscal capacity of underdeveloped regions remains an urgent agenda (Manto et al., 2025). Developed and fast-growing regions have a greater chance of growth during decentralization compared to other regions. One characteristic of decentralization implementation that can be seen in Indonesia is (1) regional government units are formed by the government, and can even be abolished by the government through legal process; (2) decentralization forms provinces throughout Indonesia, and regencies and cities are formed as autonomous regions within those regions (Shulhan Naja et al., 2021).

Fiscal Decentralization: Solution or Burden?

Various references to fiscal decentralization indicate that it has had a positive impact on regional autonomy in Indonesia, although it has not been specifically regulated by law. Fiscal decentralization in Indonesia has had a positive impact on regional autonomy, although it has not been specifically regulated by law. Existing legal instruments play a role in encouraging regional economic growth and supporting local economic activity. Tax decentralization policies enable local governments to address various challenges by leveraging local economic potential, while ensuring decision-making is more aligned with community needs. From a positive perspective, decentralization is considered a strategy that can improve public sector efficiency, governance, and accountability. This occurs because local governments better understand the needs of their citizens in achieving prosperity. Furthermore, decentralization also has the potential to accelerate economic development, reduce poverty, and reduce inter-regional inequality (Supeno & Ansari, 2022).

Negatively, decentralization is not suitable for regions with weak local government institutions and limited budgets to meet community needs. Decentralization tends to increase costs and opportunities for corruption and abuse of authority, reduce the efficiency of government services, distort the economy, and possibly lead to macroeconomic instability and greater inter-regional inequality. In addition to its positive impacts, it has the potential to negatively impact regional economic growth. The greater the level of fiscal decentralization, the greater the regional economic growth. However, in the long term, fiscal decentralization at both the district/city and provincial levels tends to be beneficial (Wibowo & Oktivalerina, 2022). Negative impact on regional economic growth. The change in the inflation rate (INF), used as a control variable, also has a negative impact on regional economic growth. Some negative impacts of fiscal decentralization include the failure to achieve economies of scale, inefficient allocation, inefficient production, and corruption. This section discusses the possible negative impacts of tax decentralization that can hinder economic growth (Septiani et al., 2024). Since fiscal decentralization was implemented in 2001, it has had a minimal impact on regional development dynamics but has had a broad impact on politics (HILL & VIDYATTAMA, 2016). Case studies in MENA show that increasing inequality in wealth distribution, especially when accompanied by rapid tax reforms, is detrimental to economic growth (Chroufa & Chtourou, 2023). Although fiscal decentralization has been in place for more than two decades, its practice in various regions during the current administration has not been fully able to realize fiscal independence and equitable development between regions, so that it is necessary to strengthen the fiscal and institutional capacity of autonomous regions and improve the accountability and quality of regional spending so that the goals of regional autonomy can be optimally achieved (Pertiwi et al., 2026). This condition can occur if the national tax revenue ratio remains below the international standard of 15 percent (Siswantoro, 2024).

The Opportunity for Fiscal Decentralization as a Solution : Decentralized development is implemented through regional economic and financial policies. The fiscal decentralization approach is considered a solution to improve public welfare directly and through macroeconomic indicators such as economic growth, as well as creating more job and business opportunities for people in each region. Regional development policies, which are incorporated into regional financial policies through the Regional Budget (APBD), provide opportunities for local governments to more effectively utilize the welfare offered by federal policies. Fiscal decentralization is a political decision and government policy believed to be one solution to reducing inter-regional inequality (Hussain & Anis, 2022).

Regional inequality in Indonesia has increased due to budget decentralization. This finding certainly contradicts the goal of fiscal decentralization as a solution to inequality, as fiscal transfers between governments are intended to minimize vertical and horizontal imbalances. To address inequality, the government and community initiatives can implement various affirmative action policies. To address inequality, affirmative action policies involving both the government and the community are crucial. The importance of an asymmetric decentralization approach, particularly for border areas, is emphasized. They emphasize that the main problems in border areas are low welfare and a lack of infrastructure development. Therefore, socioeconomic development needs to be integrated with infrastructure development and a security- and welfare-based approach for the community (Nanga & Hudang, 2023).

CONCLUSION

The results of this study indicate that fiscal decentralization in Indonesia plays a significant role in accountability, regional economic stability, citizen participation, and improving the responsiveness of public services. However, its impact on overall welfare depends not only on the degree of fiscal decentralization but also largely on the quality and capacity of local governments. Achieving vertical and horizontal fiscal equity requires equitable transfer methods that take into account the capacities and needs of each region. At the same time, structural problems that existed before decentralization, such as reliance on centralized transfers and low per capita income in the regions, persist under the current administration, as evidenced by the share of national tax revenues that falls below international standards. Differences in regional readiness, categorized into four regional models based on economic growth and per capita income, will determine whether fiscal decentralization is a solution to improving welfare or risks creating inefficiency, elite dominance, and regional inequality, particularly in regions with weak institutions.

These findings highlight that the success of fiscal decentralization depends not only on the transfer of power from the central government to regional governments but also on strengthening the institutional capacity of regional governments. In practice, it is necessary to redesign fiscal transfer mechanisms to reduce the disparity in decentralization outcomes among regional governments by considering regional readiness classifications, increasing regional revenues, digitizing regional fiscal governance, and supporting policies in remote and border areas. Further research is recommended to evaluate the effectiveness of fiscal transfer mechanisms and strategies that encourage increased regional revenues in institutionally vulnerable regions, based on the latest data following the implementation of the Law on Fiscal Relations between the Central and Regional Governments. This will ensure that the resulting policy recommendations are relevant to the current governance situation.

Declaration of AI-Usage

This manuscript was developed based on the findings of my research and the relevant scholarly references consulted throughout the study. During the writing process, I occasionally used artificial intelligence (AI) tools solely as a language-assistance aid, particularly to improve grammar, enhance clarity, and refine sentence structure. AI was not used to generate, formulate, or substantively develop the research content. All data, analysis, interpretation, discussion, and conclusions presented in this manuscript are the original work and responsibility of the author.

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