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The Effect of Fiscal Decentralization and Foreign Direct Investment on Regional Income Inequality: Economic Growth as A Mediating Variable

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ABSTRACT
This research aims to analyze the effect of fiscal decentralization and foreign direct investment (FDI) on regional income inequality and examine the role of economic growth in mediating the effect of independent variables on income inequality in Indonesia. The analytical tool used was path analysis (Path Analysis). The sample data were taken from 34 provinces in Indonesia in the period of 2015-2019. The results show (1) fiscal decentralization has a significant negative effect on economic growth in Indonesia in the period of 2015-2019. (2) FDI has a significant positive effect on economic growth. (3) Fiscal decentralization has a significant positive effect on income inequality. (4) FDI does not affect income inequality. (5) Economic growth has a significant positive effect on income inequality. (6) Economic growth cannot mediate the effect of fiscal decentralization on regional income inequality. (7) Economic growth can mediate the effect of FDI on regional income inequality.

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INTRODUCTION

Urbanization is thought to be capable of increasing regional income inequality in Indonesia. One of the goals of developing countries is to achieve a more equitable distribution of income. Inequality of income distribution refers to the relative standard of living of the entire society. Economists have begun to investigate the issue of regional economic disparities. Esmara (1975) in Kuncoro (2006) concluded that from 1950 to 1960 Indonesia was a country with a low regional inequality category if the oil and gas sector was ignored. Since the 1997-1998 monetary crisis, Indonesia has struggled with the issue of inequality in people's welfare.

The government has implemented several solutions to address regional income inequality, one of which is to increase regional economic growth rates. Economic growth is a long-term issue in the economy. The difference in the real level of prosperity and the level of economy in various regions demonstrates the need for genuine efforts by regional leaders to generate economic growth. Sukirno (2002) argued that according to classical economists there are four factors that influence economic growth, namely the population, the amount of stock of capital goods, land area and natural wealth, and the level of technology used.

To overcome regional income inequality, the central government delegated authority to local governments to maximize the potential of their regions, which is commonly referred to as fiscal decentralization. According to Saragih (2003), fiscal decentralization is the process of distributing the budget from a higher level of government to a lower level of government to support the functions or tasks of government and public services in accordance with the many authorities delegated in the government sector. Sidiq (2018) revealed that fiscal decentralization has a significant effect on reducing the income inequality between regions in Indonesia. On contrary, Latifah Dewi (2019) argued that fiscal decentralization and economic growth have a significant impact on the rise in regional inequality.

Another solution to reduce regional income inequality and increase economic growth is to promote investment development in Indonesia. One of which is through the entry of foreign direct investment. The World Bank noted that Indonesia lags far behind other countries in terms of foreign direct investment (FDI). The entry of FDI is critical to international economic integration because it creates a stable relationship between the country's economic environment. In his research, Babatunde (2018) discovered that the entry of foreign direct investment can reduce income inequality. This is in contrast to the findings of Porfaraj and Megheran (2019), who discovered that FDI does not affect inequality.

Based on the aforementioned background, this research aims to determine the effect of fiscal decentralization and foreign direct investment on income inequality in Indonesia, with economic growth serving as a moderating variable.

LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

Kuznets Theory (Inverted U)

Kuznets (1995) with the concept of an inverted "U" curve explained that income distribution tends to deteriorate in the early stages of growth, but improves in the later stages. This concept illustrates how income will be more unequal in the beginning but will become more even after reaching a certain level of development. Several stages of increase and then decline are unavoidable; it all depends on each country's development process (Todaro, 2006).

Classical Economic Growth Theory

According to classical economists, four factors influence economic growth: population, the total stock of capital goods, land area and natural wealth, and technological level. They argue that the law of diminishing returns will have an impact on economic growth. This means that economic growth will come to a halt. Initially, if the population is small and natural wealth is abundant, the rate of return on capital from investment is high. Then entrepreneurs will generate high income and it will result in new investment and economic growth. This type of situation will not last indefinitely.

When the population is too large, the increase reduces the level of economic activity because the population's marginal productivity has become negative. As a result, societal prosperity declines, and the economy reaches a very low level of development. If this state happens, the economy is said to have come to a stationary state. In such a situation, the employee's income only reaches the subsistence level. The occurrence of this stationary state will be unavoidable for society. They can only postpone it (Sukirno, 2002:430).

Fiscal Decentralization

Bird & Vallaincort (1998) described fiscal decentralization as a way for each country to regulate the public sector, which in this case always reflects history, geography, political balance, goals, and other characteristics that differ greatly from one country to another.

Foreign Direct Investment/ FDI

Widjaya (2005) said FDI is foreign investment carried out in accordance with the provisions of the law and used to run businesses in Indonesia. Meanwhile, Noor (2007) in Ningsih (2017) categorized FDI as an investment in assets or sources of production factors made to run a business abroad.

Contingency Theory

Otley (1980) in Dewa Made, et al., (2016) suggested that the contingency approach is used to examine the relationship between various contextual variables. The contingency approach to accounting arose from the requirement for empirical research findings for its interpretation. One of the contextual variables in this research is the mediating variable. The mediating variable is a type of variable that establishes an indirect relationship between the independent and dependent variables. This means that the mediating variable can strengthen or weaken the relationship between variables that can be measured and observed. This approach can reveal the nature of the relationship between fiscal decentralization and FDI and income inequality, with economic growth serving as a moderating variable.

HYPOTHESIS

The Effect of Fiscal Decentralization on Economic Growth

Fiscal decentralization refers to the local government's authority to use existing resources for regional economic development. Economic development necessitates a high Gross Regional Domestic Product for economic growth to accelerate. According to Oates in Ridwan et al., (2017), fiscal decentralization can increase economic efficiency, which leads to increased local economic growth because local governments will be more efficient in the production and provision of public goods.

The efficiency of production and the provision of public goods will have an impact on the increase in GRDP, which will also have an impact on economic growth. This is consistent with the findings of research by Ridwan et al., (2017), Chygrn et al., (2018), and Hidayat et al., (2018), which show that fiscal decentralization increases economic growth. Based on theoretical review and results of previous research, the research hypothesis is as follows:

H1: Fiscal decentralization affects economic growth

The Effect of Foreign Direct Investment (FDI) on Economic Growth

FDI is critical to international economic integration because it creates a stable relationship between countries' economic environments. Foreign investment is required to finance the national development acceleration program. The inflow of funds can help to keep the wheels of a country's economy turning.

Incoming investment can absorb labor, facilitate technology transfer, and increase export industry, and market competitiveness, resulting in economic growth. This is consistent with Ali Malik (2016), Pratama et al., (2017), and Babatunde (2018), who found that increased foreign direct investment (FDI) has a positive effect on economic growth. Based on theoretical review and explanations of previous research, the research hypothesis is as follows.

H2: Foreign direct investment affects economic growth

The Effect of Fiscal Decentralization on Regional Income Inequality

Fiscal decentralization is the authority of local governments to manage the wealth of their respective regions. One aspect of justice in fiscal decentralization is the redistribution of income to achieve social justice. The government can take advantage of regional wealth and carry out redistribution activities through fiscal equity by transferring funds from richer regions to poorer regions. So that, each region has the same ability to

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provide a variety of public services as a concept of regional equity.

By optimizing regional wealth and transferring funds from the central government, it will reduce the income inequality between regions. This is in line with research by Bartolini, et al., (2016), Kyriacou, et al., (2016), Aritenang (2018), Bojanic (2018), Chygryn, et al., (2018), Dongjin (2018), and Sidiq (2018), which found that fiscal decentralization has a negative effect on income inequality. Based on literature review and results of previous research, the research hypothesis is as follows:

H3: Fiscal decentralization affects income inequality.

The Effect of Foreign Direct Investment (FDI) on Regional Income Inequality

Income inequality refers to the disparity in income between people living in developed and underdeveloped countries. A large number of investments in capital-intensive projects in a region is one of the causes of inequality. Foreign direct investment can be used as new capital to help fund various sectors that are underfunded.

Foreign investment is usually accompanied by the transfer of technology, which increases the community's knowledge and skills. The creation of new job opportunities can absorb labor, and it reduces Indonesia's unemployment rate, resulting in decreased inequality between regions. It commensurates with Babatunde (2018), Couto (2018), Ramadhan (2018), Porfaraj, and Mehregan (2019) who found that foreign direct investment can reduce income inequality. Based on literature review and results of previous research, the hypothesis is as follows:

H4: Foreign direct investment affects income inequality

The Effect of Economic Growth on Income Inequality

Income inequality is the difference in economic prosperity between the rich and the poor. One source of inequality is local governments' inability to manage natural resources, as well as an imbalance in the management of transfer funds from the central government. According to Schumpeter's theory, entrepreneurs play an important role in generating economic growth. This theory argues the role of the regional government is critical in generating economic growth in the region.

Regional governments can play a role in generating economic growth by allocating funds to sectors that can stimulate broad economic activity, resulting in increased production efficiency and a high supply of public goods. This will affect the increase in GDP. As a result, economic growth rises, which reduces the value of regional income inequality. This is in line with research by Liling et al., (2018) which stated that economic growth has a negative and significant effect on income inequality across regions. Based on this explanation, the hypothesis is as follows:

H5: Economic growth affects reducing income inequality.

The Effect of Fiscal Decentralization on Income Inequality through Economic Growth

Fiscal decentralization is one of the government's policy instruments for closing the fiscal gap between the central and local governments. This is accomplished, among other things, by providing several direct fund transfers to fulfill the decentralization principles.

It is expected that the fiscal decentralization program in Indonesia will be able to move the economy, which will increase economic growth and reduce income inequality in Indonesia. This is consistent with Bojanic's (2018) research, which found that fiscal decentralization and economic growth reduce regional inequality. Based on this explanation, the hypothesis is as follows:

H6: Fiscal decentralization has an effect on income inequality through economic growth.

The Effect of Foreign Direct Investment on Income Inequality through Economic Growth

Foreign direct investment (FDI) is an important point in the integration of a country's economy because it can create a more stable economic relationship between two countries. Foreign investment is one method of expanding a business, with the added benefit of being a tool for a country's economic development.

Investment in Indonesia is expected to raise economic growth, which will have an impact on reducing income inequality in the country. This is consistent with the findings of Dewa, I Nyoman

(2019), and Lorentino, et al., (2021), who found that FDI and economic growth have a significant impact on inequities. The hypothesis is as follows:

H7: Foreign Direct Investment has an effect on income inequality through economic growth.

RESEARCH METHOD

This research is a type of quantitative research that seeks to establish a causal relationship between two or more variables. The dependent variable was income inequality as measured by the Gini ratio, while the independent variables were fiscal decentralization and FDI. This research also included a moderating variable, which is economic growth as proxied by GRDP. The population was drawn from 34 provinces in Indonesia in 2015-2019. There were 170 samples collected. The sampling technique used was purposive sampling, which is the technique of determining the sample based on certain criteria. Data analysis techniques used in this research were multiple linear regression test, t-test, R^2 test, and Sobel test. The annual reports published by www.bps.go.id and www.bkpm.go.id were used as data sources in this research.

Variable	Measurement
Income inequality	GR= $1-\sum_{i=1}^{n}(fpi(Fci+Fci-1))$
Fiscal decentralization	$DF=\dfrac{Regional\ Contribution\ (SB)}{Total\ Regional\ Revenue\ (TPD)}$
FDI	$FDI=\dfrac{Foreign\ Direct\ Investment}{Regional\ Expenditure}$
Economic growth	$G=\dfrac{GRDP_1-GRDP_0}{GRDP_0}\times 100\%$

RESULTS AND DISCUSSION

This research used data from 2015 to 2019 from a sample of 34 Indonesian provinces. The provinces with extreme values were excluded in this research, so the total sample consisted of 161 observations.

Coefficient of Determination Test

Table 1. Results of Adjusted R Squared

Coefficient	Model 1	Model 2
R	,352	,466
R Squared	,124	,217
Adjusted R Square	,113	,202
Std. Error the Estimate	1,25384	0,03311

Source: processed data

According to the table above, the adjusted R Squared value in model 1 is 0.124. This demonstrates that fiscal decentralization and foreign direct investment can explain 12.4 percent of economic growth as measured by GRDP, while other variables outside of equation 1 explain the remaining 87.6 percent.

The adjusted R Squared value in model 2 is 0.217. This shows that fiscal decentralization, foreign direct investment, and GRDP can explain 21.7 percent of the income inequality variable as proxied by the Gini ratio. Variables other than equation 2 account for the remaining 78.3 percent.

F Statistic

Table 2. Results of F Statistic of Model 1

Source	Sum of Square	Df	Mean Square	F	Sig
Regression	35,053	2	17,527	11,149	.000[b]
Residual	248,392	158	1,572		
Total	283,446	160			

Source: processed data

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Table 3. Results of F Statistic of Model 2

Source	Sum of Square	Df	Mean Square	F	Sig
Regression	0,048	3	0,016	14,508	,000[b]
Residual	0,172	157	0,001		
Total	0,220	160			

Source: processed data

The results of the F statistic output in model 1 table 2 show that the F value is 11.149 with a significance value of 0.000, which is smaller than 0.005 (0.000<0.005). This indicates that the independent variables of fiscal decentralization and foreign direct investment have a simultaneous effect on the dependent variable of economic growth, as proxied by GRDP.

The results of the F statistic output in model 2 table 3 show the F value of 14,508with a significance value of 0,000, which is smaller than 0,005 (0,000<0,005). It shows that the independent variables of fiscal decentralization and foreign direct investment, as well as economic growth (GRDP) have a simultaneous effect on the dependent variable of income inequality (Gini ratio).

Partial Test (t-test)

Table 4. T-test Results of Model 1

	Unstandardized Coefficients		Standardized Coefficients		
Model	B	Std. Error	Beta	t	Sig.
Constant	6,160	0,266		23,188	,000
DF	-2,179	0,507	-,324	-4,298	,000
FDI	0,192	0,073	0,198	2,620	,010

Source: processed data

Table 5. T-test Results of Model 2

	Unstandardized Coefficients		Standardized Coefficients		
Model	B	Std. Error	Beta	T	Sig.
Constant	0,262	0,015		17,776	0,000
DF	0,067	0,014	0,356	4,705	0,000
FDI	-,003	0,002	-,110	-1,509	0,133
GRDP	0,012	0,002	0,445	5,895	0,000

Source: processed data

From table 4 and table 5, the results of the t statistical test output for the equation model 1 can be analyzed by the following regression equation model:

$$\mathbf{GRDP = -{,}324\ DF + 0{,}198\ FDI + e}$$

$$\mathbf{GR = 0{,}356\ DF - 0{,}110\ FDI + 0{,}445\ GRDP + e}$$

Equation 1 regression above shows a constant value of 6.160. This explains if the variables DF and FDI are considered constant, then GRDP increases by 6.160. Equation 2 shows a constant value of 0,262. It means, if the variables DF, FDI, and GRDP are constant, the income inequality distribution increases by 0,262.

Path Analysis

Table 6. Summary of Path Coefficient

Relation			Standardized coefficient	Standard Error	t count	Sig.	Description
Degree of DF	→	PDRB	-0,324	0,507	-4,298	0,000	Significant
FDI	→	PDRB	0,198	0,073	2,620	0,010	Significant
Degree of DF	→	GINI RATIO	0,356	0,014	4,705	0,000	Significant
FDI	→	GINI RATIO	-0,110	0,002	-1,509	0,133	Not Significant
GRDP	→	GINI RATIO	0,445	0,002	5,895	0,000	Significant

The e1, which is the effect of other variables on economic growth as proxied by GRDP, is calculated by e1= $\sqrt{1-R^2}$, where e1 = $\sqrt{1-0,124}$ = $\sqrt{0,876}$ = 0,935. While e2, as the effect of other variables on income inequality proxied by Gini ratio, is counted using this equation e2= $\sqrt{1-0,217}$ = $\sqrt{0,8848}$ = 0,9406.

Based on the summary table of the Path coefficient and the calculation of e1 and e2, the following equations are obtained:

$$GRDP = \beta_1 DF + \beta_2 FDI + e1$$

$$GR = \beta_1 DF + \beta_2 FDI + \beta_3 PDRB + e1$$

$$GRDP = (0,324)X_1 + 0,198X_2 + 0,935$$

$$GR = 0,356X_1 - 0,110X_2 + 0,445X_3 + 0,941$$

Results of Mediation Test (Sobel Test)

Table 7. Results of Sobel Test

Path	Relation			Standardized Coefficient		Standard Error	
1	Degree of DF	→	PDRB	-0,324	(a)	0,507	(sa)
	PDRB	→	GINI RATIO	0,445	(b)	0,002	(sb)
2	FDI	→	PDRB	0,198	(c)	0,073	(sc)
	PDRB	→	GINI RATIO	0,445	(d=b)	0,002	(sd)

DISCUSSION

The effect of fiscal decentralization on economic growth

This research showed that fiscal decentralization has a significant negative effect on economic growth. It is in line with research by Ahmad, Ayu (2018) who found that fiscal decentralization has a negative effect on economic growth. This is because the realization of regional expenditures from 2015 to 2017 was dominated by goods and services expenditures. Meanwhile, from 2017 to 2019, the realization of regional expenditure was dominated by personnel expenditure, which increased by 6.42 percent and 5.97 percent in 2019. The Director-General of DJPK, Ministry of Finance stated in Kompas.com that his party continues to encourage improvements in the management of the Regional Government Budget (APBD) and the imposition of sanctions for regions that do not realize the required expenditures. Capital expenditures, on the other hand, have continued to fall as a result of failed auctions and land issues. A portion of the capital budget is also used to construct official buildings and vehicles.

This demonstrates the significance of increasing capital expenditure allocations because they have a long-term useful life for local governments in providing services to the public and providing public goods. The increased supply of public goods will have an effect on the increase in the value of GRDP, resulting in even greater regional economic growth. However, the findings of this research contradict those of Chygryn et al., (2018) and Ridwan et al., (2017), who claimed that fiscal decentralization has an impact on economic growth as proxied by GRDP.

The effect of foreign direct investment (FDI) on economic growth

The results of data analysis in this research indicate that FDI has a positive and significant effect on economic growth. This is in line with Ali (2018), Pratama et al., (2017), and Putri, et al., (2018) who discovered that FDI has a significant positive effect on economic growth. This suggests that the flow of funds from FDI is beneficial in moving the wheels of a region's economy. Solow (2010) emphasized the importance of the government building the right institutions to ensure that the resources available in the regions are allocated as efficiently as possible in order to encourage regional economic growth.

Building the right institutions will increase investors' confidence in investing their capital. One of them is a country's legal certainty. This theory suggests that an ideal government acts as a helping hand in the market system, protecting property rights and combating crime. However, the findings of this research differ from those of Sophia, Sulasmiyati (2018), who claimed that FDI has an impact on economic growth.

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The effect of fiscal decentralization on income inequality

The results of the analysis show that fiscal decentralization has a significant positive effect on income inequality. This is in line with Liu, et al., (2016) who examined the impact of fiscal decentralization on inequality between provinces in China. The results suggested that fiscal decentralization leads to a greater increase in intra-provincial inequality. Fiscal decentralization can have an impact on high regional inequality because local governments have not focused on the realization of regional expenditures.

According to Finance Minister, Sri Mulyani, in Bisnis.com (11/14/2019), only 30 percent of the APBD had an impact on the people. This is because regional spending is still not focused, and local governments have not been innovative in using financing instruments to catch up with the infrastructure sector. Only developed regions want to use financing instruments. This is what contributes to the growing disparity between regions. However, this research finding differs from research by Bartolini et al., (2016), Kyricou et al., (2016), Aritenang et al., (2018), Soon (2018), Sidiq (2018), Bojanic (2018), and Dongjin (2018), which stated that fiscal decentralization is important in reducing income inequality.

The effect of Foreign Direct Investment on income inequality

Data analysis shows that FDI has no effect on income inequality. This is consistent with the findings of Ramadhan (2018) and Porfaraj and Mehregan (2019), who discovered that foreign direct investment does not affect income inequality. The findings of this research show that foreign investment into Indonesia has not had a significant effect on reducing the rate of income inequality that exists. This is due to economic, political, and legal factors that discourage foreign investors from investing their capital.

The causes of the low rate of return on capital are the small domestic market and a lack of basic facilities such as transportation, skilled labor, and technology. This, however, differs from Couto (2018) and Babatude (2018) who discovered FDI contributes to reducing income inequality.

The effect of economic growth on income inequality

The results show that economic growth has a significant positive effect on income inequality. This research supports the findings of Rekso, Nuryanto (2017), that economic growth increases the level of inequality in income distribution. High economic growth can increase regional inequality because many regions are still unable to optimize Government and Business Entities Partnership (KBPU). Sri Mulyani in her interview with Bisnis.com said that local governments have not been able to identify strategic projects and choose funding sources.

Only developed regions are interested in using financing instruments, whereas underdeveloped regions continue to use conventional APBD. As a result, economic growth occurs only in developed regions, while underdeveloped ones are unable to catch up. The findings of this research differ from those of Liling et al (2018), who discovered that economic growth has a significant negative effect on regional inequality.

The role of economic growth in mediating the effects of fiscal decentralization on income inequality

The results of this research indicate that economic growth cannot mediate the effect of fiscal decentralization on income inequality. This is consistent with Agus Salim's (2016) research, which found that fiscal decentralization has not been able to distribute economic growth in order to reduce income inequality. This occurs because local governments' regional spending is too low. Personnel expenditures and expenditure on goods/services continue to dominate, while capital expenditures remain low.

Many regions have been unable to identify strategic projects and funding sources. Only developed regions take advantage of financing sources. As a result, developed regions are becoming increasingly advanced, while underdeveloped regions are unable to catch up in development, resulting in an increasing regional income gap. To catch up with the infrastructure sector, local governments are expected to focus more on completing priority programs each year and to be more creative in their use of financing instruments.

The role of economic growth in mediating the effect of foreign direct investment on income inequality

The results of this research indicate that economic growth moderates the effect of FDI on income inequality. It is in line with Dewa, I Nyoman (2019) who stated that investment and economic growth have an effect on reducing regional inequality. This demonstrates the significance of the foreign investment for a country. The entry of investment into a country will have an impact on the addition of capital goods to increase production in the future. This development will encourage national production and create jobs.

The entry of investment into a country will be followed by advances in technology and new knowledge. The creation of new job opportunities can absorb unemployment while also having an impact on national and regional economic turnover, resulting in increased economic growth. In this way, regional income inequality can be reduced.

CONCLUSION AND SUGGESTION

The conclusions drawn from this research are: First, fiscal decentralization has a significant negative effect on economic growth in the period of 2015 – 2019. Second, FDI has a significant positive effect on economic growth in the period of 2015-2019. Third, fiscal decentralization has a significant positive effect on income inequality in the period of 2015 – 2019. Fourth, foreign direct investment has no effect on income inequality in the period of 2015 - 2019. Fifth, economic growth has a significant positive effect on income inequality in the period of 2015 - 2019. Sixth, economic growth as proxied by GRDP is not able to mediate the effect of fiscal decentralization on regional income inequality in the period of 2015 – 2019. Seventh, economic growth as proxied by GRDP can mediate the effect of FDI on income inequality in the period of 2015 - 2019.

Limitation

This research has some limitations that should be considered by future researchers to achieve better results. The limitations are that (1) the sample used in this research was only from 2015 to 2019, so the results only describe the situation in the year of the study, (2) researchers only used two independent variables that affect inequality, namely fiscal decentralization and FDI. There are several other variables that can explain and are likely to influence the dependent variable.

Suggestion

Further researchers can use sample data from a longer period, allowing the information conveyed to reflect actual conditions and reduce data source limitations. Future researchers can also use other independent variables to broaden the scope of their research findings.

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