

THE IMPACT OF GOVERNMENT'S TRANSFER FUND TO THE LOCAL OWN-SOURCE REVENUE

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Abstract

Despite more than two decades of fiscal decentralization, most local governments in Indonesia remain highly dependent on intergovernmental fiscal transfers. This condition raises concerns regarding the effectiveness of transfer mechanisms in strengthening local fiscal capacity and promoting revenue mobilization. This study examines the effects of four major transfer instruments—General Allocation Funds (DAU), Special Allocation Funds (DAK), Revenue Sharing Funds (DBH), and Village Funds (DD)—on local own-source revenue, specifically local tax and local retribution revenues, across Indonesian regencies and municipalities. Using a balanced panel dataset of 412 regencies and municipalities during the 2015–2022 period, this study employs a Fixed Effects Model (FEM) with Panel-Corrected Standard Errors (PCSE) to address heteroskedasticity and autocorrelation issues. The analysis investigates whether fiscal transfers generate a crowding-in effect by enhancing local revenue collection or a crowding-out effect by reducing local fiscal effort. The results reveal heterogeneous impacts across transfer types. DAU has no significant effect on local tax revenue but positively affects local retribution revenue. DAK consistently exhibits positive and significant effects on both local tax and retribution revenues, indicating that conditional transfers can strengthen local revenue-generating capacity. In contrast, DBH negatively affects both local tax and retribution revenues, suggesting the presence of a crowding-out effect and potential dependence on transfer revenues, particularly in resource-rich regions. Village Funds do not significantly affect local tax revenue but negatively affect local retribution revenue.

Keyword: intergovernmental transfers, local taxes, local retributions, local own-source revenue

Introduction

Crowding out refers to a phenomenon in which expansionary government policies influence market conditions. One manifestation of this phenomenon occurs when an increase in the government budget deficit suppresses private-sector investment expenditures. In the context of intergovernmental fiscal transfers, crowding-out effects may arise when substantial transfer funds are allocated to local governments, potentially affecting the amount of own-source revenue collected by subnational governments. However, this theory remains subject to debate, particularly in developing countries, where fiscal transfers may instead enhance local revenue generation.

Most local governments in Indonesia have not yet achieved sufficient financial capacity to independently finance regional governance. An assessment conducted by the Audit Board of Indonesia (BPK, 2021) revealed that, in 2020, 443 out of 503 local governments, or approximately 88.07%, had not attained fiscal independence. Regional fiscal autonomy is largely determined by the realization of Local Own-Source Revenue (Pendapatan Asli Daerah/PAD), as stipulated in Law No. 1 of 2022 concerning Financial Relations between the Central Government and Regional Governments. The issue of regional fiscal dependence requires immediate policy attention.

Fiscal decentralization is expected to support the achievement of regional financial independence (Haryanto, 2018). Nevertheless, despite the implementation of fiscal decentralization since 2001, most regions continue to rely heavily on transfers from the central government. According to the Law on Financial Relations between the Central and Regional Governments, intergovernmental transfers consist of several components, namely the General Allocation Fund (DAU), Revenue-Sharing Fund (DBH), Special Allocation Fund (DAK), Special Autonomy Fund, Privileged Region Fund, and Village Fund.

Although each transfer mechanism serves a distinct function, they share a common objective: reducing fiscal disparities and strengthening regional fiscal capacity. These transfers are expected not only to generate tangible outputs such as buildings, roads, and other physical infrastructure, but also to create

broader economic outcomes through the utilization of such infrastructure. Regional economic performance can be measured through Gross Regional Domestic Product (GRDP).

According to Nadhiroh (2018), economic growth as reflected in GRDP indicates a region's ability to generate value added over a specific period. Similarly, Patra (2022) argues that economic growth represents an increase in a region's capacity to produce goods and services and serves as a key indicator of the economy's ability to generate additional income over time. Economic growth indirectly increases monetary circulation within a region, thereby expanding the potential tax and user-charge base. As this potential increases, local governments can optimize PAD collection through regional taxes and service charges.

However, Boschmann (2009) argues that fiscal transfers from the central government may reduce local governments' incentives to maximize local revenue mobilization. Boschmann's argument is supported by several empirical studies demonstrating the existence of a crowding-out effect, whereby increases in fiscal transfers lead to declines in local revenue collection. Evidence of this phenomenon has been documented by Liu and Zhao (2011), Mogues and Benin (2012), Bravo (2013), and Tradinatama and Solikin (2023). Therefore, this study aims to examine whether crowding-out effects occur within Indonesia's intergovernmental fiscal transfer system

Theoretical Framework

The implementation of fiscal decentralization in Indonesia since 2001 has been characterized by a continuous increase in the amount of intergovernmental transfers allocated to regional governments. In 2001, total transfers amounted to only IDR 81.05 trillion, whereas by 2020 the figure had increased substantially to IDR 762.54 trillion. The World Bank Institute (1999) demonstrated that local governments in most developing countries are granted taxing authority based on relatively weak tax bases. Consequently, local governments remain highly dependent on fiscal transfers from the central government. A similar condition exists in Indonesia, where the limited local tax base stems from the fact that a substantial portion of revenue sources remains under the control of the central government. This arrangement is intended to preserve national unity and maintain the integrity of the state (Fiscal Policy Agency, 2021).

According to Nashshar and Mulyana (2022), decentralization provides local governments with greater autonomy in managing governmental affairs because they possess a better understanding of regional characteristics and development potential than the central government. As a result, regional development policies can be designed and implemented more effectively and accurately. Hastuti (2018) argues that fiscal decentralization was originally intended to foster regional self-reliance. However, achieving such independence remains challenging due to the tendency of local governments to rely heavily on transfers from the central government. This phenomenon is supported by the theory that local governments tend to finance expenditures using transfer revenues rather than utilizing their own-source revenues (Pratiwi & Paramita, 2016).

The General Allocation Fund (Dana Alokasi Umum/DAU) is intended to finance regional government operations and reduce disparities among local governments (or horizontal fiscal imbalance). In contrast, the Revenue-Sharing Fund (Dana Bagi Hasil/DBH), which is allocated based on a region's contribution to national revenue, is designed to address fiscal disparities between the central and regional governments (or vertical fiscal imbalance). The utilization of both transfer instruments is largely left to the discretion of local governments in accordance with their respective priorities and development needs.

Another kind of fiscal transfer is the Special Allocation Fund (Dana Alokasi Khusus/DAK), which is allocated to finance specific programs, activities, and policy initiatives, including those aimed at promoting regional economic growth. Juanda and Handra (2017) describe DAK as a specific grant operating under a top-down approach, whereby local governments are prohibited from using the funds for purposes other than those predetermined by the central government. DAK is categorized into two types: Physical DAK and Non-Physical DAK. Physical DAK is intended to finance the development and provision of public-service infrastructure and facilities, whereas Non-Physical DAK supports the operational costs of public services.

In addition, the Village Fund (Dana Desa/DD) constitutes a major source of revenue for villages to support village governance and development activities. This fund is expected to serve as a catalyst for development in rural and peripheral regions of Indonesia. Financed through the State Budget (APBN), the Village Fund is intended to support local governance, development implementation, community development, and community empowerment initiatives (Riyadi & Sutarto, 2017). Wibowo et al. (2019) found that the Village Fund has contributed to improvements in infrastructure services, educational and health services, and various indicators of social welfare.

The second-generation theory of fiscal federalism, developed by Musgrave and Musgrave (1959) and Oates (1972), emphasizes the importance of allocating fiscal responsibilities across different levels of government in managing public revenues and expenditures. Under this framework, a reduction in the role

of the central government grants local governments greater authority to manage regional economic affairs. Oates further argues that fiscal federalism represents a decision-making process distributed among various levels of government to provide public services in accordance with citizens' preferences and demands.

Furthermore, Hayek (1945) and Musgrave and Musgrave (1959) contend that regional development can be supported through transfer instruments, particularly conditional grants. In Indonesia, the Special Allocation Fund (DAK), as one of the key instruments of fiscal decentralization, has the potential to stimulate regional economic development and strengthen local revenue generation.

Several studies have investigated the effects of intergovernmental transfers on local government revenue in Indonesia. Lewis and Smoke (2017) found that central government transfers, particularly the General Allocation Fund (DAU) and Revenue-Sharing Fund (DBH), significantly affected local own-source revenue (PAD), regional expenditures, and savings. Their findings indicate that DAU positively influences PAD, whereas DAK has no significant effect. In addition, tax-sharing transfers under DBH positively and significantly affect PAD, while natural resource revenue-sharing transfers do not exhibit a significant effect.

Wawan (2017), examining the effects of Village Funds, population size, and land area on Rural and Urban Land and Building Tax (PBB-P2) revenue in Sigi Regency, found that Village Funds did not significantly affect PBB-P2 collections. Tradinatama and Solikin (2023) concluded that DAU negatively affects regional tax revenue but positively affects regional user-charge revenue. Meanwhile, DAK has no significant impact on regional tax revenue but negatively affects user-charge revenue. In contrast, DBH positively influences tax revenue while exerting a negative effect on regional user charges.

Mogues and Benin (2012), in their study of Ghana covering the period 1994–2004, found that larger transfer allocations received in previous years failed to increase local tax revenues. Instead, transfers generated a negative effect on local revenue mobilization. The authors argue that this outcome is attributable to limited fiscal accountability at the local government level, as local budgets are heavily dependent on central government transfers.

Liu and Zhao (2012), examining the effects of transfer policies on tax collection efforts in China, found that poorly designed transfer systems create disincentives for provincial tax collection. Likewise, Taiwo (2022) reported that increased fiscal transfers in Nigeria reduced local revenue generation. This outcome was attributed to corruption in tax administration, weak local revenue management, and the misuse of transfer funds.

Dash and Raja (2013), studying India, reinforced these findings by demonstrating that larger transfer allocations reduce local tax revenues. They argue that local governments may be reluctant to impose direct taxes because such measures could diminish political support among voters. But, Troland (2014) found evidence of a crowding-in effect in the Philippines. Rather than discouraging local revenue mobilization, transfers significantly increased local tax revenues. Troland argues that transfer funds help finance the fixed costs associated with tax administration, including the identification and monitoring of taxable entities such as unregistered businesses and buildings. Furthermore, transfers provide fiscal stimulus that encourages the establishment of new businesses and expands local economic activity, thereby broadening the tax base.

Caldeira and Rota-Graziosi (2014), studying Benin in West Africa, concluded that central government transfers positively affect local government revenues. Similar findings were reported by Masaki (2018) in Tanzania, where fiscal transfers were found to increase local own-source revenues, particularly in rural areas. Masaki argues that transfers enable local governments to improve public service delivery and strengthen institutional capacity for tax collection.

Likewise, Porto and Puig (2021) found that fiscal transfers significantly enhance local revenue generation in Argentina. Their study suggests that transfers improve both tax enforcement and the quality of public services, thereby encouraging greater local revenue mobilization. Bravo (2013) demonstrated that unconditional grants exert a negative effect on local revenue generation. When local governments are responsible for tax collection, the amount of revenue generated depends largely on their tax collection efforts. Although intergovernmental transfers may increase total local government revenues, the effectiveness of local own-source revenue (PAD) collection may decline because the costs associated with revenue mobilization can exceed the additional benefits obtained from tax collection activities.

Methods

This study employs panel data regression analysis to examine the correlation between intergovernmental transfers and local revenue generation. The analysis covers the implementation of fiscal transfers to local governments during the period 2015–2022 and includes all regencies and municipalities in Indonesia, comprising a total population of 434 local governments.

To determine the most appropriate panel data estimation model, several specification tests were conducted. First, the Chow Test was employed to select between the Common Effects Model (CEM) and the Fixed Effects Model (FEM). Second, the Hausman Test was performed to determine whether the Fixed Effects Model or the Random Effects Model (REM) was more appropriate. Finally, the Lagrange Multiplier (LM) Test was conducted to choose between the Common Effects Model and the Random Effects Model.

The empirical analysis utilizes multiple regression techniques to investigate the effects of the independent variables on the dependent variables. To assess the existence of a crowding-out effect, two separate regression models were estimated. The first model employs regional tax revenue as the dependent variable, while the second model uses regional user-charge revenue (retribusi daerah) as the dependent variable.

The models used to test the research hypotheses are specified as follows:

Model 1

$$\text{LnPD}_{i,t} = \beta_0 + \beta_1 \text{LnDAU}_1 X_{1i,t} + \beta_2 \text{LnDAK}_2 X_{2i,t} + \beta_3 \text{LnDBH}_3 X_{3i,t} + \beta_4 \text{LnDD}_4 X_{4i,t} + \beta_5 \text{LnPDRB}_5 X_{5i,t} + \varepsilon_{i,t}$$

Model 2

$$\text{LnRD}_{i,t} = \beta_0 + \beta_1 \text{LnDAU}_1 X_{1i,t} + \beta_2 \text{LnDAK}_2 X_{2i,t} + \beta_3 \text{LnDBH}_3 X_{3i,t} + \beta_4 \text{LnDD}_4 X_{4i,t} + \beta_5 \text{LnPDRB}_5 X_{5i,t} + \varepsilon_{i,t}$$

Variable Definitions

PD : Local Tax Revenue

RD : Local Retribution Revenue

DAU : General Allocation Fund

DAK : Special Allocation Fund

DBH : Revenue Sharing Fund

DD : Village Fund

GRDP : Gross Regional Domestic Product

i : Cross-sectional unit index (regencies and municipalities)

t : Time-period index (year)

β_0 : Constant term (intercept)

β_1 – β_5 : Regression coefficients of the explanatory variables

ε_{it} : Error term

Results and Discussions,

To examine the effects of the independent variables on local tax and retribution revenues, three panel data regression models were considered: the Common Effect Model (CEM), Fixed Effect Model (FEM), and Random Effect Model (REM) (Gujarati & Porter, 2009). The results of the Chow test, Hausman test, and Breusch–Pagan Lagrange Multiplier test consistently indicated that the Fixed Effect Model was the most appropriate specification for the data.

Since the Fixed Effect Model is estimated using the Ordinary Least Squares (OLS) approach, diagnostic tests were conducted to assess compliance with the classical linear regression assumptions. Specifically, tests for autocorrelation, multicollinearity, and heteroskedasticity were performed. A normality test was not conducted because, according to the Central Limit Theorem, datasets with more than 30 observations are generally assumed to approximate a normal distribution. Given that this study consists of 412 observations, the normality assumption was considered satisfied.

The diagnostic tests revealed the presence of autocorrelation and heteroskedasticity problems. To address these issues and obtain efficient estimators that satisfy the Best Linear Unbiased Estimator (BLUE) criteria, the Panel Corrected Standard Errors (PCSE) approach was employed, following the recommendation of Sihombing (2021). Accordingly, the Fixed Effect Model was re-estimated using PCSE-adjusted standard errors.

Model 1: Local Tax Revenue

The estimated regression equation for Model 1 is as follows:

$$\text{Tax} = -9.849 + 0.078\text{DAU} + 0.110\text{DAK} - 0.138\text{DBH} - 0.085\text{DD} + 1.157\text{GRDP} + \varepsilon$$

The estimated coefficients indicate that DAU and DAK have positive relationships with local tax revenue. A one-unit increase in DAU is associated with an increase of 0.078 units in local tax revenue, while a one-unit increase in DAK increases local tax revenue by 0.110 units. In contrast, DBH and Village Funds (DD) exhibit negative relationships with local tax revenue, with coefficients of –0.138 and –0.085, respectively. Furthermore, GRDP has a positive coefficient of 1.157, suggesting that regions with larger economic output tend to generate higher local tax revenues.

The coefficient of determination (R^2) for Model 1 is 0.756, indicating that 75.6% of the variation in local tax revenue can be explained by the independent variables included in the model. The remaining 24.4% is attributable to factors not captured in the analysis.

Model 2: Local Retribution Revenue

The estimated regression equation for Model 2 is:

$$\text{Retribution} = -9.147 + 0.600\text{DAU} + 0.337\text{DAK} - 0.210\text{DBH} - 0.271\text{DD} + 0.629\text{GRDP} + \varepsilon$$

The results indicate that DAU, DAK, and GRDP positively influence local retribution revenue. Specifically, a one-unit increase in DAU is associated with a 0.600-unit increase in retribution revenue, while DAK and GRDP increase retribution revenue by 0.337 and 0.629 units, respectively. Conversely, DBH and Village Funds exhibit negative coefficients of -0.210 and -0.271 , suggesting that increases in these transfers are associated with lower levels of local retribution revenue.

The R^2 value of Model 2 is 0.409, implying that the explanatory variables account for 40.9% of the variation in local retribution revenue, while 59.1% is explained by factors outside the model.

The empirical results indicate that the General Allocation Fund (DAU) does not significantly affect local tax revenue. Although the estimated coefficient is positive, the relationship is statistically insignificant, suggesting that increases in DAU transfers do not necessarily translate into higher local tax collections in subsequent years. This finding implies that unconditional transfers alone are insufficient to incentivize local governments to expand their tax base or improve tax administration.

The absence of a significant effect may be explained by the spending composition of DAU. Previous studies have shown that a substantial proportion of DAU is allocated to personnel expenditures and routine administrative costs rather than productive investments that could stimulate local economic activity. Consequently, DAU may generate limited multiplier effects on local tax revenues because relatively little of the transfer is directed toward infrastructure development, public service improvements, or economic empowerment programs.

This result differs from the findings of Tradinatama and Solikin (2023), who documented a negative relationship between DAU and local tax revenue, but also contrasts with Lewis and Smoke (2017), who found a positive effect. These differences may reflect changes in intergovernmental fiscal arrangements and local government spending behavior over time. In contrast, DAU exhibits a positive and statistically significant effect on local retribution revenue. This finding suggests that unconditional transfers may provide fiscal space that enables local governments to improve public services and infrastructure, thereby increasing the demand for government-provided services that generate retribution revenues. The result is consistent with previous studies by Lewis and Smoke (2017) and Tradinatama and Solikin (2023), which similarly reported a positive association between DAU and retribution collections.

From the perspective of fiscal federalism, unconditional grants can enhance local fiscal capacity by allowing governments to allocate resources according to local priorities. Since 2017, the requirement to allocate a portion of DAU toward capital expenditure and infrastructure development may have strengthened the ability of local governments to stimulate economic activity and expand sources of retribution revenue.

The results reveal that the Special Allocation Fund (DAK) positively and significantly affects both local tax and retribution revenues. This finding suggests that conditional transfers targeted at specific sectors and development priorities can enhance local revenue-generating capacity.

The positive effect of DAK on local tax revenue differs from earlier findings reported by Lewis and Smoke (2017) and Tradinatama and Solikin (2023), who found no significant relationship. One possible explanation is the reform of the DAK allocation mechanism introduced in 2016. Prior to the reform, DAK allocation followed a predominantly top-down approach. Subsequently, the allocation process incorporated local government proposals, allowing funding priorities to better reflect regional development needs while remaining aligned with national strategic objectives.

In addition, DAK has increasingly focused on infrastructure development, support for small and medium enterprises, labor market development, and other productive sectors. Such investments are likely to stimulate regional economic activity, broaden the tax base, and increase local governments' ability to generate tax revenues. Similarly, the positive relationship between DAK and local retribution revenue indicates that infrastructure and public service improvements financed through DAK may increase demand for government services requiring permits, licenses, and user charges. As economic activity expands, businesses and households interact more frequently with public services, thereby increasing retribution collections.

These findings are consistent with the fiscal federalism framework proposed by Hayek (1945) and Musgrave (1959), which argues that conditional grants can be effective instruments for promoting regional

development and improving public service provision. In this context, DAK appears to function not only as a fiscal transfer mechanism but also as a catalyst for strengthening local revenue capacity.

The analysis demonstrates that Revenue Sharing Funds (DBH) have a significant negative effect on both local tax and retribution revenues. This finding suggests the presence of a crowding-out effect, whereby higher transfers from natural resource and tax revenue-sharing schemes reduce local governments' incentives to mobilize their own-source revenues.

A possible explanation is that local governments receiving substantial DBH transfers may become less reliant on local revenue collection efforts. As argued by Taiwo (2020), intergovernmental transfer systems may create dependency and weaken incentives for fiscal effort when local governments perceive transfers as a more accessible source of funding than locally generated revenues.

The negative relationship is particularly relevant for resource-rich regions, where DBH revenues are largely derived from extractive industries such as oil, natural gas, mining, and plantation commodities. While these transfers increase local fiscal resources, they may simultaneously reduce incentives to diversify revenue sources and improve tax administration.

This finding is also consistent with the natural resource curse hypothesis, which suggests that regions endowed with abundant natural resources often experience weaker institutional development and lower incentives for economic diversification. As noted by Badeeb et al. (2017), dependence on resource revenues may undermine long-term economic development through governance challenges, commodity price volatility, and reduced fiscal discipline.

The results therefore indicate that although DBH strengthens local fiscal capacity in the short term, excessive dependence on revenue-sharing transfers may discourage local governments from developing sustainable sources of local revenue, thereby weakening fiscal independence over time.

The empirical findings show that Village Funds (DD) do not significantly affect local tax revenue but have a significant negative effect on local retribution revenue. The insignificant relationship between Village Funds and local tax revenue suggests that increased transfers to villages do not automatically translate into greater taxable economic activity at the regency or municipal level.

Although Village Funds are intended to support rural development and community empowerment, their implementation may not yet be sufficiently effective to generate measurable improvements in local tax capacity. This finding is consistent with studies suggesting that Village Fund management remains constrained by limited administrative capacity, fragmented planning processes, and insufficient integration between village development programs and broader regional economic strategies. Consequently, improvements achieved at the village level may not produce substantial spillover effects on local government tax revenues.

More importantly, the negative effect of Village Funds on retribution revenue raises concerns regarding the effectiveness of fund utilization. Several studies have identified challenges related to targeting accuracy, planning quality, and accountability in Village Fund management. Weak governance mechanisms may reduce the developmental impact of these transfers and limit their contribution to local economic expansion.

In addition, governance issues, including corruption and inefficiencies in fund management, may further constrain the ability of Village Funds to stimulate productive economic activities. When transfers are not utilized effectively, the expected improvements in public services, local business development, and economic opportunities may fail to materialize, thereby reducing their potential contribution to local revenue generation.

Overall, the findings suggest that while Village Funds have played an important role in expanding fiscal resources at the village level, their effectiveness in strengthening local own-source revenue remains limited. Improving governance quality, accountability mechanisms, and the alignment of village development programs with broader regional economic objectives may be necessary to maximize the long-term fiscal benefits of these transfers.

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