FISCAL DECENTRALIZATION, BASIC PUBLIC SERVICE SPENDING, AND POVERTY

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Abstract:
Fiscal decentralization has been widely promoted as a policy instrument to improve public welfare and reduce poverty by granting greater fiscal autonomy to local governments. However, empirical evidence on the relationship between fiscal decentralization and poverty remains inconclusive, and the mechanisms through which fiscal decentralization influences poverty outcomes are still insufficiently explored. This study investigates the direct effect of fiscal decentralization on poverty and examines the mediating role of expenditure allocation for basic services in Indonesia. Using provincial-level panel data covering 34 provinces from 2007 to 2024, this study employs Structural Equation Modeling (SEM) to analyze both direct and indirect relationships among the variables. Fiscal decentralization is measured by the ratio of local own-source revenue to total local expenditure, while expenditure allocation for basic services consists of spending on education, health, public works and housing, public order and safety, environmental protection, and social protection. The results indicate that fiscal decentralization significantly increases expenditure allocation for basic services and directly reduces poverty. In addition, expenditure allocation for basic services significantly contributes to poverty reduction and partially mediates the relationship between fiscal decentralization and poverty. These findings suggest that the effectiveness of fiscal decentralization in alleviating poverty depends not only on the degree of fiscal autonomy but also on how local governments allocate resources toward essential public services. This study contributes to the fiscal decentralization literature by providing empirical evidence on the expenditure channel through which fiscal decentralization influences poverty outcomes in Indonesia. The findings offer important policy implications for strengthening poverty reduction strategies through improved fiscal governance and more effective allocation of local government expenditures.
Keywords: Fiscal Decentralization; Poverty; Basic Service Expenditure; Public Welfare; Structural Equation Modeling; Indonesia

Abstrak:
Desentralisasi fiskal telah banyak dipromosikan sebagai instrumen kebijakan untuk meningkatkan kesejahteraan masyarakat dan mengurangi kemiskinan melalui pemberian otonomi fiskal yang lebih besar kepada pemerintah daerah. Namun, bukti empiris mengenai hubungan antara desentralisasi fiskal dan kemiskinan masih menunjukkan hasil yang beragam, serta mekanisme yang menjelaskan bagaimana desentralisasi fiskal memengaruhi tingkat kemiskinan masih belum banyak dieksplorasi. Penelitian ini bertujuan untuk menganalisis pengaruh langsung desentralisasi fiskal terhadap kemiskinan serta menguji peran mediasi alokasi belanja layanan dasar dalam konteks Indonesia. Dengan menggunakan data panel tingkat provinsi yang mencakup 34 provinsi selama periode 2007–2024, penelitian ini menerapkan metode Structural Equation Modeling (SEM) untuk menganalisis hubungan langsung maupun tidak langsung antarvariabel. Desentralisasi fiskal diukur menggunakan rasio Pendapatan Asli Daerah (PAD) terhadap total belanja daerah, sedangkan alokasi belanja layanan dasar mencakup pengeluaran pada fungsi pendidikan, kesehatan, pekerjaan umum dan perumahan, ketertiban dan keamanan, perlindungan lingkungan hidup, serta perlindungan sosial. Hasil penelitian menunjukkan bahwa desentralisasi fiskal secara signifikan meningkatkan alokasi belanja layanan dasar dan secara langsung menurunkan tingkat kemiskinan. Selain itu, alokasi belanja layanan dasar juga terbukti berkontribusi dalam menurunkan kemiskinan dan berperan sebagai mediator parsial dalam hubungan antara desentralisasi fiskal dan kemiskinan. Temuan ini menunjukkan bahwa efektivitas desentralisasi fiskal dalam mengurangi kemiskinan tidak hanya ditentukan oleh tingkat otonomi fiskal yang dimiliki daerah, tetapi juga oleh bagaimana pemerintah daerah mengalokasikan sumber daya pada layanan publik yang esensial. Penelitian ini memberikan kontribusi pada literatur desentralisasi fiskal dengan menyediakan bukti empiris mengenai peran alokasi belanja layanan dasar sebagai mekanisme transmisi yang

menghubungkan desentralisasi fiskal dan pengurangan kemiskinan di Indonesia. Temuan penelitian ini juga memberikan implikasi kebijakan yang penting bagi penguatan strategi pengentasan kemiskinan melalui tata kelola fiskal yang lebih baik dan alokasi belanja daerah yang lebih efektif.
Kata Kunci: Desentralisasi Fiskal; Kemiskinan; Alokasi Belanja Layanan Dasar; Kesejahteraan Masyarakat; Structural Equation Modeling; Indonesia

1. Introduction

Decentralization, the transfer of authority and responsibility from central to local levels of governance, is widely recognized as a critical strategy for improving governance, service delivery, and public participation. One of the key reasons why decentralization is considered important is its ability to improve governance and accountability, as decision-making becomes closer to the people and more transparent. Decentralization enhances government accountability and responsiveness by bringing decision-making closer to the governed. It fosters political competition, reduces political instability, and imposes limits on government power, which can lead to better governance outcomes (Faguet, 2014). It strengthens democratic structures by mobilizing political participation and enabling local governments to be more responsive to citizens' needs (Chattopadhyay, 2013). Decentralization addresses inefficiencies in centralized systems by tailoring public services to heterogeneous local needs. This leads to better resource allocation, improved service quality, and greater citizen satisfaction (Chattopadhyay, 2013). In sectors like education, decentralization has been shown to improve efficiency and the quality of services by allowing local authorities to adapt policies to specific regional contexts (Singh et al., 2024). And finally Decentralization is seen as a tool to spread the benefits of economic growth more equitably, ensuring that marginalized groups are included in the development process (Al-Teraifi, 2013), It can also promote territorial and social cohesion by managing diverse societal needs effectively (Ruano & Profiroiu, 2016).

The relationship between fiscal decentralization and poverty is complex and influenced by various factors, including institutional quality, governance, and local economic conditions. Empirical evidence from 53 developing countries (1990–2014) shows that both revenue and expenditure decentralization are significantly associated with poverty reduction, particularly in democratic contexts (Digdowiseiso, 2022). In Indonesia, fiscal decentralization from 2001 to 2018 contributed to poverty reduction, with robust evidence supporting its effectiveness (Siburian, 2022), In Côte d'Ivoire, increased local revenue autonomy improved access to public services and reduced poverty, particularly in urban areas and less ethnically diverse localities (Sanogo, 2019), In the Philippines, fiscal independence at the local level was associated with lower poverty, though the effect diminished at higher levels of decentralization (Canare, 2021). In Vietnam, fiscal decentralization linked to targeted transfers for poverty spending was effective in reducing poverty, especially when combined with fiscal accountability and autonomy at local levels (Bjornestad, 2009). But in practice The impact of fiscal decentralization on poverty is not always linear. For instance, in South Africa, fiscal decentralization had a short-term negative effect on household consumption, a proxy for poverty (Moche et al., 2014), While fiscal decentralization reduces poverty, it may exacerbate income inequality in certain contexts, as seen in India and China (Sepulveda & Martinez-Vazquez, 2011). The effectiveness of fiscal decentralization depends heavily on governance quality. In countries with high governance standards, decentralization is more likely to reduce poverty and social exclusion (Tselios & Rodríguez-Pose, 2024).

Fiscal decentralisation in Indonesia has become one of the key policies in supporting local autonomy and regional economic development. Fiscal decentralisation aims to reduce inter-regional inequalities and improve public welfare. However, the results vary. Some studies suggest that fiscal decentralisation can reduce regional income inequality (Siburian, 2020), whilst others find that general allocation funds and revenue-sharing funds are not always effective in reducing vertical and horizontal inequalities (Setiawan & Aritenang, 2019). Fiscal decentralisation has a positive impact on regional economic growth through increased local government spending and local investment (Zakaria et al., 2025). However, its impact on economic disparities between regions remains a challenge (Ananda et al., 2016). Reliance on Central Government Transfers: The majority of local government revenue comes from central government transfers, such as the General Allocation Fund (DAU) and the Special Allocation Fund (DAK). This reliance may reduce local governments' incentives to increase their own-source revenue (PAD) (Roy et al., 2019).

Fiscal decentralisation is also associated with an increase in corruption cases at the local level, primarily due to a lack of transparency and accountability in budget management (Alfada, 2019), decentralisation tends to increase spending on traditional infrastructure but reduces spending on human capital infrastructure, which may affect the competitiveness of Indonesia's workforce (Ghozali & Khoirunurrofik, 2020). The latest reforms introduced by Law No. 1 of 2022 aim to strengthen the central

government's control over the regions through performance-based incentives, revenue earmarking and spending mandates. However, the design of these policies is considered to have shortcomings and does not fully address underlying issues such as corruption and clientelism (Lewis, 2023). The implementation of fiscal decentralization in Indonesia has had a positive impact in several areas, such as economic growth and the reduction of inequality in certain regions. However, challenges such as dependence on central government transfers, corruption and infrastructure disparities still need to be addressed. More targeted policy reforms, increased transparency and the strengthening of local capacity are key to maximising the benefits of fiscal decentralisation.

Effective fiscal decentralization depends on the ability of local governments to generate and manage their own revenues. However, in many cases, local governments remain heavily dependent on central government transfers, limiting their autonomy. For instance, in Indonesia, local governments have limited fiscal power, with local revenue contributing only a small share to regional budgets, undermining their ability to mobilize resources effectively (Mbedzi & Gondo, 2010). Similarly, in Ethiopia, inefficiencies in revenue collection and expenditure management hinder local governments' financial capacity to deliver services (Mbedzi & Gondo, 2010). In Ukraine, fiscal decentralization has increased the share of local revenues in budgets, enhancing financial autonomy and enabling communities to address socio-economic challenges more effectively (Martynenko et al., 2025). Fiscal decentralization can enhance the efficiency of public service delivery by aligning expenditures with local needs. For example, in the Visegrad countries, fiscal decentralization positively impacted local government expenditures, improving public goods provision (Maličká, 2016). Similarly, in Romania, decentralization led to more responsible and efficient local spending, contributing to economic growth. In Nigeria, despite constitutional recognition of local government autonomy, limited fiscal control and political interference have impeded effective service delivery (Enuka et al., 2026). The success of fiscal decentralization is closely tied to the institutional capacity of local governments. In Sweden, strong fiscal autonomy and administrative competence have fostered accountability and responsive governance (Enuka et al., 2026). Conversely, in Iran, limited fiscal and legal autonomy has hindered local governments' ability to be responsive and accountable to voters (Tajbakhsh, 2021).

Although previous studies have extensively examined the relationship between fiscal decentralization and poverty reduction, the underlying mechanism through which fiscal decentralization affects poverty remains insufficiently explored. Fiscal decentralization does not directly improve welfare outcomes; rather, its effectiveness depends on how local governments allocate fiscal resources to sectors that are closely related to human development and poverty alleviation. Existing studies have largely focused on the direct effects of fiscal decentralization on poverty, inequality, or economic growth, while limited attention has been given to the mediating role of expenditure allocation in basic public services. Given that education, health, housing and public facilities, and social protection expenditures represent essential services that directly influence human well-being, examining these expenditure functions as transmission channels may provide a deeper understanding of how fiscal decentralization contributes to poverty reduction. Therefore, this study investigates whether local government expenditure allocation on basic service functions mediates the relationship between fiscal decentralization and poverty in Indonesia.

2. Literature Review

2.1 Desentralisasi Fiskal

Fiscal decentralization involves delegating revenue collection and expenditure responsibilities to regional or local governments, often guided by the principle of subsidiarity, which advocates for decision-making at the most localized level capable of addressing specific issues effectively (Krysovatyy et al., 2022; Madariaga, 2021). Core Goals of Fiscal Decentralization is Empowering local governments to manage their own resources, often through local taxation and budgetary control (Krysovatyy et al., 2022; Madariaga, 2021), the second is Enhancing the quality of public services and ensuring governments are more responsive to local needs (Agyemang-Duah et al., 2018), and then Promoting regional innovation, reducing inequalities, and fostering sustainable growth (Ren et al., 2025).

The concept of fiscal decentralization emerged in the mid-20th century, rooted in the theory of fiscal federalism. This theory posits that decentralization can improve government efficiency, reduce corruption, and align public spending with local preferences (Chygryn et al., 2018), Early models emphasized tax assignment, fiscal equivalence, and multilevel tax administration as key components (Madariaga, 2021). Over time, fiscal decentralization evolved from a normative theory to an evidence-based research field, driven by real-world transformations in governance systems worldwide (Madariaga, 2021). Empirical studies have explored its diverse impacts, including economic growth, environmental sustainability, and poverty reduction, revealing both positive and negative outcomes depending on the

context (Safi et al., 2022). Recent theories integrate fiscal decentralization with broader governance frameworks, such as administrative and political decentralization, to address complex challenges like climate change and technological advancements (Martínez-Vázquez et al., 2026).

Theories now emphasize balancing efficiency and equity, particularly in developing countries, where decentralization can reduce regional disparities but may also exacerbate corruption or inefficiencies if poorly implemented (Agyemang-Duah et al., 2018). Fiscal decentralization can enhance regional innovation, improve public service quality, and promote green economic development through mechanisms like environmental regulation and technological innovation (Wang et al., 2022), It can reduce within-region inequalities and foster accountability when local governments rely on self-raised revenues (Kyriacou et al., 2017). In developing countries, fiscal decentralization may increase corruption or inefficiencies if local governments lack capacity or accountability mechanisms (Agyemang-Duah et al., 2018). The relationship between decentralization and economic outcomes is often non-linear, with varying effects depending on national development levels and governance quality (Kwon, 2013)

2.2 Capability Approach

The Capability Approach is a normative framework developed primarily by Amartya Sen and Martha Nussbaum. It focuses on evaluating human well-being, social justice, and institutional arrangements by emphasizing individuals' substantive freedoms—referred to as "capabilities"—to achieve the lives they value. This approach contrasts with traditional development theories that prioritize aggregate economic measures like GDP, instead centering on what individuals are able to "do" and "be" in their lives (Cavalieri, 2016; Robeyns, 2024). The Capability Approach (CA), developed by Amartya Sen, provides a robust framework for policy-making by focusing on what individuals are able to do and be, emphasizing freedom, ethics, and well-being. The CA facilitates ex-ante evaluations of policies, particularly those with multiple goals, by enabling structured discussions on benefits, distributional impacts, and ethical considerations. For example, it has been applied to assess the impact of an EU proposal on organ donation, highlighting its utility in evaluating policy outcomes before implementation (Canoy et al., 2010; Veldhuis & van Dongen, 2025). The CA provides a theoretical framework for understanding and improving well-being through policy. It can be combined with methodologies like System Dynamics (SD) to model and simulate the complex interrelations of well-being components, offering practical tools for designing and evaluating well-being-oriented policies (Veldhuis & van Dongen, 2025).

2.3 Fiscal Decentralisation in Indonesia

Fiscal decentralization in Indonesia has been a significant policy shift aimed at promoting regional autonomy, economic growth, and public welfare. Since its implementation in 2001, the policy has transferred substantial financial resources and decision-making powers to local governments. However, its outcomes have been mixed, with both achievements and challenges. Fiscal decentralization has positively influenced regional economic growth and human development, particularly through increased public expenditure on education and health. However, its impact on reducing poverty and income inequality remains limited, as economic growth has not significantly alleviated poverty in autonomous regions (Roy et al., 2019; Soejoto & Subroto, 2015; Sofilda et al., 2023).

Despite efforts to reduce fiscal and economic disparities through equalization funds (e.g. General Allocation Funds, Special Allocation Funds), regional inequalities persist. Core regions benefit more from decentralization, while hinterlands face challenges due to limited resources and weaker institutional capacities (Aritenang & Chandramidi, 2023; Sirait et al., 2020). While fiscal decentralization in Indonesia has contributed to regional autonomy and economic growth, its effectiveness is constrained by persistent disparities, governance challenges, and limited local revenue mobilization. To maximize its benefits, policymakers must focus on improving governance, ensuring equitable resource distribution, and addressing regional disparities through tailored, place-based policies (Aritenang & Chandramidi, 2023; Sofilda et al., 2023)

2.4 Expenditure allocation by function

Expenditure allocation by function refers to the classification of government spending according to the objectives or sectors of public services provided to society. This classification is used to reflect government development priorities and to demonstrate how public resources are distributed across different sectors to meet societal needs. In the context of local government, expenditure allocation by function represents how fiscal resources are utilized to deliver public services and improve social welfare. Through fiscal decentralization, local governments are granted greater authority to determine spending priorities that align with local needs and regional characteristics.

This study focuses on six basic service functions: education, health, environmental protection, housing and public facilities, public order and safety, and social protection. These functions are closely associated with improvements in citizens' quality of life, as they contribute to human capital

development, the provision of basic infrastructure, the creation of a safe and healthy environment, and support for vulnerable groups. Therefore, expenditure allocation across these functions is considered an important mechanism through which fiscal decentralization may influence poverty reduction, as the effectiveness of public resources largely depends on how local governments prioritize spending on sectors that directly promote social welfare.

2.5 Poverty

Poverty is a multifaceted issue with profound implications across social, economic, and health domains. The abstracts provide a broad understanding of poverty, its causes, consequences, and potential interventions. Poverty is traditionally defined as a lack of economic resources, such as income, to meet basic human needs like food, water, shelter, clothing, healthcare, and education(Méndez & Villagrán, 2022; Tuli, 2013).

Absolute poverty refers to severe deprivation of these basic needs, while relative poverty is defined in relation to societal standards, often tied to median income levels (Jolliffe & Prydz, 2021)(Niemietz, 2010). Poverty is context-specific and shaped by social norms, cultural values, and historical conditions. For instance, relative poverty measures reflect societal standards of living, which vary across countries and over time (Niemietz, 2010). The concept of "social exclusion" has also gained prominence, highlighting how poverty can lead to marginalization and limited access to societal opportunities (Kolin, 2008).

Poverty is best understood as a multidimensional and context-dependent phenomenon that encompasses economic, social, and cultural dimensions. While traditional definitions focus on material deprivation, contemporary approaches emphasize the importance of addressing broader aspects of human well-being and social inclusion. However, the lack of a universally accepted definition and the challenges in measurement highlight the need for continued research and nuanced approaches to understanding and addressing poverty.

2.6 Previous Studies and Hypothesis Development

Previous studies examining the relationship between fiscal decentralization and poverty have produced mixed results. Several studies provide evidence that fiscal decentralization contributes to poverty reduction by improving local fiscal autonomy, strengthening public service delivery, and increasing government responsiveness to local needs (Digdowiseiso, 2022; Siburian, 2022; Sanogo, 2019; Bjornestad, 2009). However, other studies suggest that the effectiveness of fiscal decentralization depends on governance quality, institutional capacity, and local fiscal conditions, resulting in varying impacts on poverty across regions (Moche et al., 2014; Sepulveda & Martinez-Vazquez, 2011; Tselios & Rodríguez-Pose, 2024).

The literature also suggests that fiscal decentralization affects development outcomes through government spending decisions. Greater fiscal autonomy enables local governments to allocate resources according to local priorities and community needs, thereby improving the provision of public goods and basic services (Maličká, 2016; Martynenko et al., 2025). Expenditures on education, health, housing and public facilities, environmental protection, public order and safety, and social protection are expected to enhance individuals' capabilities and improve living standards. Consistent with the Capability Approach, improvements in access to basic services expand people's opportunities and well-being, which ultimately contribute to poverty reduction.

Based on the theoretical arguments and previous empirical findings, this study proposes that fiscal decentralization influences poverty both directly and indirectly through local government expenditure allocation across basic service functions.

Drawing on the theory of fiscal decentralization, greater fiscal autonomy enables local governments to allocate resources according to local needs and preferences, thereby improving the effectiveness of public service delivery and poverty alleviation efforts. Previous studies have shown that fiscal decentralization can reduce poverty through improved access to public services, enhanced fiscal responsiveness, and more efficient resource allocation (Digdowiseiso, 2022; Siburian, 2022; Sanogo, 2019). However, the mixed empirical evidence suggests that the relationship may not be entirely direct and could depend on how local governments utilize their fiscal authority.

In this regard, expenditure allocation for basic service functions represents a potential mechanism through which fiscal decentralization influences poverty outcomes. Fiscal autonomy allows local governments to prioritize spending on education, health, environmental protection, housing and public facilities, public order and safety, and social protection based on local development needs. Consistent with the Capability Approach, investments in these basic services enhance individuals' capabilities, improve living conditions, and expand opportunities to escape poverty. Therefore, this study argues that fiscal decentralization is expected to reduce poverty directly while also exerting an indirect effect through expenditure allocation across basic service functions. Consequently, expenditure allocation for basic

service functions is expected to mediate the relationship between fiscal decentralization and poverty.

3 Research Methods

3.1 Object, time and Place

This study focuses on Indonesia, with a population covering all provinces in the country from 2007 to 2024, in order to capture a long-term period relevant to the evaluation of the implementation of fiscal decentralisation. It refers to the mandatory budget for six basic government services, comprising education, health, public works, public housing, public order and conditional protection, and finally social services.

3.2 Data Collection Techniques

The data used in this study consists of secondary data sourced from relevant institutions or the official websites of the relevant government agencies, as well as official documents and publications from the Indonesian Central Statistics Agency (BPS) and the official website of the Ministry of Finance of the Republic of Indonesia (Kemenkeu RI).

3.3 Data Analysis Techniques

This study employs a Structural Equation Modelling (SEM) approach to analyse the direct relationship between fiscal decentralisation and community welfare at the provincial level in Indonesia, with expenditure allocation on basic services acting as a mediating factor.

The regression model used to demonstrate the relationship between fiscal decentralisation and social welfare is as follows:

$$Pj.i,t = \alpha + \alpha 1DF_{i,t} + \alpha 2BPD_{i,t} + \alpha 3TPT_{i,t} + \alpha 4KPKM_{i,t} + \alpha 5DumWili,t + \varepsilon_{i,t}$$

(1) Dimana :

Pj.i,t	:	Poverty is measured using the poverty rate published by Statistics
Indonesia FD$_{i,t}$	:	The ratio of local revenue to total local expenditure
BSE$_{i,t}$	:	The ratio of total expenditure on basic services to total local government
expenditure POP$_{,t}$	:	Population density per square kilometre.
UnEmpl$_{i,t}$	:	The open unemployment rate for each province
DumReg$_{i,t}$	:	A dummy variable for Java and non-Java regions, where 0 indicates a non-Java region and 1 indicates a province located on the island of Java.

Selanjutnya berkaitan dengan hubungan antara desentralisasi fiskal dengan alokasi belanja layanan dasar, model regresinya sebagai berikut :

$$BPD_{it} = \beta + \beta 1DF_{i,t} + \beta 2Lansia\ _{i,t} + \beta 3TPT_{i,t} + \beta 4\ KPKM_{i,t} + DumWil_{i,t} + \varepsilon_{it}$$

(2) Dimana:

BSE$_{i,t}$	:	The ratio of total expenditure on basic services to total local government
expenditure DF$_{i,t}$	:	The ratio of local revenue to total local expenditure
Old$_{i,t}$	:	Proportion of the elderly population
POP$_{,t}$	:	Population density per square kilometre.
UnEmpl$_{i,t}$	:	The open unemployment rate for each province
DumReg$_{i,t}$	:	A dummy variable for Java and non-Java regions, where 0 indicates a non-Java region and 1 indicates a province located on the island of Java.

The proposed structural models allow the examination of both direct and indirect relationships among the variables. The first model assesses the direct effect of fiscal decentralization on poverty while simultaneously examining the effect of expenditure allocation by function on poverty. The second model evaluates the relationship between fiscal decentralization and expenditure allocation by function, enabling the identification of potential mediation effects. Through these two structural relationships, the study investigates whether expenditure allocation by function serves as a transmission mechanism linking fiscal decentralization to poverty outcomes.

The data were analyzed using Stata statistical software. The analysis began with descriptive statistics and correlation analysis to provide an overview of the data and examine the preliminary relationships among variables (Gujarati & Porter, 2009). Subsequently, multicollinearity diagnostics were conducted using the Variance Inflation Factor (VIF). Following the recommendation of O'Brien (2007), VIF values below 10 indicate that multicollinearity is not a serious concern. The suitability of the structural model was then evaluated using several goodness-of-fit indicators, including the Root Mean Square Error of Approximation (RMSEA), Comparative Fit Index (CFI), and Tucker–Lewis Index (TLI), which are widely recommended for assessing model fit in structural equation modeling (Kline, 2023). After confirming an acceptable model fit, hypothesis testing was performed using Structural

Equation Modeling (SEM) to estimate both direct and indirect effects and to evaluate the mediating role of expenditure allocation by function in the relationship between fiscal decentralization and poverty.

4. Results and Discussion

The results and discussion sections should be presented systematically to explain the research findings and their meaning. Here is a general structure that can be used:

4.1 Research Results

Table 1. Tabel hasil Regresi

Variables	(1) BSE	(2) P	(3) /
BSE FD			
		-7.344***	
		(1.742)	
	0.119***	-26.80***	
	(0.0431)	(1.535)	
UnEmp	0.0688	-7.412	
	(0.311)	(11.52)	
Old	1.511***	-5.800	
	(0.252)	(10.40)	
ln_POP	-0.00125	0.236**	
DumReg var(e.BSE)	(0.00367)	(0.111)	
	0.0953***	-4.808***	
	(0.0205)	(0.700)	0.0160***
var(e.P) Constant			(0.00102)
			24.78***
	0.217***	29.22***	(1.501)
	(0.0419)	(2.103)	
Observations	577	577	577

The results show that fiscal decentralization has a positive and statistically significant effect on basic service expenditure allocation ($\beta = 0.119$; $p < 0.01$). This finding indicates that an increase in fiscal decentralization is associated with a higher proportion of local government expenditure allocated to basic services. The result supports Fiscal Federalism Theory, which argues that local governments possess better information regarding local needs and preferences than the central government. Consequently, greater fiscal autonomy allows local governments to allocate resources more efficiently toward sectors that are considered most important for local development.

The findings also reveal that basic service expenditure allocation has a negative and statistically significant effect on poverty ($\beta = -7.344$; $p < 0.01$). This coefficient suggests that increasing the share of expenditure allocated to basic services contributes to a reduction in poverty levels. From the perspective of the Capability Approach, expenditure on education, health, housing and public facilities, environmental protection, public order and safety, and social protection enhances individuals' capabilities by improving access to essential services. These improvements expand opportunities, increase productivity, and ultimately reduce deprivation and poverty.

Furthermore, fiscal decentralization directly reduces poverty, as indicated by the negative and significant coefficient ($\beta = -26.80$; $p < 0.01$). This result suggests that provinces with higher levels of fiscal decentralization tend to experience lower poverty rates. Greater fiscal autonomy enables local governments to design policies and allocate resources according to local socioeconomic conditions, thereby improving the effectiveness of poverty alleviation efforts.

The mediation analysis further demonstrates that fiscal decentralization indirectly affects poverty through basic service expenditure allocation. The indirect effect is calculated as the product of the coefficient linking fiscal decentralization to basic service expenditure allocation (0.119) and the coefficient linking basic service expenditure allocation to poverty (-7.344), resulting in an indirect effect of approximately -0.874. This finding indicates that fiscal decentralization reduces poverty not only directly but also indirectly through increased expenditure on basic public services. Since both the direct effect ($\beta = -26.80$; $p < 0.01$) and the indirect effect ($\beta = -0.874$) are statistically significant, basic service expenditure allocation can be classified as a partial mediator in the relationship between fiscal decentralization and poverty.

Comparing the magnitude of the effects reveals that the direct effect of fiscal decentralization on poverty (-26.80) is substantially larger than the indirect effect operating through basic service expenditure allocation (-0.874). This suggests that while expenditure allocation for basic services serves as an important transmission channel, other mechanisms may also explain how fiscal decentralization

contributes to poverty reduction. These mechanisms may include improvements in governance quality, local economic growth, employment creation, and administrative efficiency, which are not explicitly captured in the present model.

4.2 Discussion

The findings suggest that fiscal decentralization encourages local governments to allocate a greater share of their resources toward basic public services. This result supports the central argument of Fiscal Federalism Theory, which posits that local governments are better positioned than central authorities to identify local needs and priorities. As decision-making authority becomes more decentralized, governments can allocate resources more efficiently and tailor public spending to address specific regional challenges. Consequently, fiscal decentralization strengthens the capacity of local governments to improve the provision of essential services that directly affect citizens' well-being.

The study also indicates that expenditure allocation for basic services plays an important role in reducing poverty. This finding is consistent with the Capability Approach, which views poverty not merely as a shortage of income but as a limitation in individuals' opportunities and capabilities. Public investment in basic services such as education, health, housing, environmental quality, public safety, and social protection enhances individuals' access to essential resources and opportunities. As these services improve, people are better equipped to participate in economic and social activities, ultimately improving their quality of life and reducing poverty.

Furthermore, the results demonstrate that fiscal decentralization contributes to poverty reduction not only through expenditure allocation but also through broader governance mechanisms. Fiscal autonomy allows local governments to respond more effectively to local socioeconomic conditions, improve public service delivery, and implement policies that are more closely aligned with community needs. This finding reinforces the view that decentralization can enhance government responsiveness and accountability, which are important prerequisites for achieving welfare improvements.

An important implication of this study is that expenditure allocation for basic services serves as one of the channels through which fiscal decentralization influences poverty outcomes. However, the relationship is not explained entirely by expenditure allocation alone. This suggests that the effectiveness of fiscal decentralization may also depend on other factors, such as governance quality, institutional capacity, economic development, and labor market conditions. Therefore, maximizing the benefits of fiscal decentralization requires not only greater fiscal autonomy but also effective governance and strategic spending decisions that prioritize community welfare

4.3 Relevance to Research Objectives

The findings of this study demonstrate that all research objectives have been successfully addressed. First, the study confirms that fiscal decentralization significantly reduces poverty, indicating that greater fiscal autonomy contributes to improved welfare outcomes at the provincial level in Indonesia. Second, the results show that fiscal decentralization positively influences expenditure allocation for basic services, suggesting that local governments utilize increased fiscal authority to strengthen the provision of essential public services.

Third, the study finds that expenditure allocation for basic services significantly reduces poverty, highlighting the importance of public spending on education, health, environmental protection, housing and public facilities, public order and safety, and social protection in improving social welfare. Finally, the mediation analysis confirms that expenditure allocation for basic services serves as a significant transmission mechanism through which fiscal decentralization affects poverty. Although the mediation effect is partial, the findings provide evidence that the effectiveness of fiscal decentralization in reducing poverty depends not only on fiscal autonomy itself but also on how local governments allocate resources toward basic public services. Therefore, the study contributes to the literature by providing empirical evidence on the expenditure channel linking fiscal decentralization and poverty reduction in Indonesia.

5. Conclusion

This study examined the relationship between fiscal decentralization and poverty in Indonesia and investigated the mediating role of expenditure allocation for basic services. The findings demonstrate that fiscal decentralization contributes to poverty reduction both directly and indirectly through expenditure allocation for basic services. Greater fiscal autonomy enables local governments to allocate resources more effectively toward sectors that are closely related to community welfare, thereby supporting poverty alleviation efforts.

The results further indicate that expenditure allocation for basic services constitutes an important channel through which fiscal decentralization affects poverty outcomes. Consistent with Fiscal Federalism Theory, local governments are better positioned to identify local priorities and allocate

resources according to regional needs. Moreover, the findings support the Capability Approach by showing that public expenditure on essential services contributes to improving individuals' capabilities and opportunities, which are fundamental for reducing poverty.

However, the mediating role of expenditure allocation for basic services is only partial, suggesting that the impact of fiscal decentralization on poverty is not solely transmitted through public spending decisions. Other factors, such as governance quality, institutional capacity, economic development, and labor market conditions, may also influence the effectiveness of fiscal decentralization in improving welfare outcomes. Therefore, policies aimed at reducing poverty should focus not only on strengthening fiscal decentralization but also on ensuring that local governments allocate resources efficiently and prioritize expenditures that directly benefit society.

This study contributes to the fiscal decentralization literature by providing empirical evidence that expenditure allocation for basic services serves as a transmission mechanism linking fiscal decentralization and poverty reduction in Indonesia. The findings highlight the importance of aligning fiscal autonomy with strategic public spending to maximize the welfare benefits of decentralization.

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