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Empirical Study about The Interaction Between Equalization Funds, Regional Financial and Human Development Index in Regional Economic

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Abstract

This research aims to analyze the interaction between equalization funds, regional financial and human development index in East Java Province, Indonesia for 2008–2011. The method of analyze is *Partial Least Square* (PLS). The dependent variable used is equalization funds as a proxy for fiscal decentralization while the intervening variable used is fiscal capacity, fiscal independent and structure of regional government expenditure; the dependent variable used is human development index as proxy for social welfare live. The study revealed that equalization fund has a negative direct effect to fiscal capacity, fiscal capacity has a positive direct effect on financial independent, fiscal capacity has no negative direct effect on structure of regional government expenditure, financial dependent has positive direct effect on human development index, financial dependent has a positive direct effect on structure of regional government expenditure, and structure of regional government expenditure has negative direct effect on human development index. Based on this conclusion, regional government must focus on allocating the equalization fund to serve the public good provision.

Keywords: equalization funds, fiscal capacity, financial dependent and partial least square

1. Introduction

Different countries implement different financial policies in achieving the welfare of their society. Most countries in the world adopt decentralization system, although there is also some countries that run budget centralized under the constitution of each country. The choice between the two alternatives is much influenced by the combined effects of political choice and differences in the economic conditions of each country. The difference in the condition of each of these countries would require special handling. In countries which implement decentralization, fiscal decentralization, and the choice of each state in the country's financial management and budgeting. The realization of the decentralization policy is the provision of part of the authority's financial management and financial arrangements of the central government to the regional government. According to Oates (2006), in the traditional theory of public finance, it is described the role of fiscal decentralization spurs economic growth in the country. Specifically the role is reflected in the resource allocation functions in the public sector. The same thing is also described by Kee (2013), Fiscal decentralization is the devolution by the central government to regional governments (states, regions, municipalities) of specific functions with the administrative authority and fiscal revenue to perform Reviews those functions. Through the implementation of the fiscal decentralization policy, every country wants to improve the lives of its people.

In the context of national development in Indonesia, the mandate of the Constitution Act 1945, especially Article 33 gives special emphasis and importance related to the management of the economy and available resources for the greater welfare of the Indonesia people. This article is the basis of the democratic system that originates in the Indonesian economy, Indonesian state philosophy which adheres to the principle of kinship, cooperation, and self-reliance. Mainly about this independence, even, Bung Karno (1965) stated that the Republic of Indonesia is a sovereign, self-sufficient economy, fair, prosperous in economy and culture. In Indonesia, the political system and economic system in which the interrelated view of life and the basic philosophy of democracy prevailing in integrative perspective as opposed to individualistic. The relationship between society and the individual is integrative perspective, where the interests of society as a whole is preferred although the interest of individuals is not removed. Therefore, Indonesia's economy in a democratic system, the nature of the integrative perspective of state government is reflected in the objectives of economic democracy itself is not the preferred community prosperity of a people. State to promote the general welfare and implement social justice. Hence, it is also the earth and water and natural resources contained within the Earth Indonesia are the main points for the prosperity of the people, so it needs to be controlled by the state and utilized for the welfare of the people.

In line with this understanding, the state's financial management policy basically can be directed to the achievement of the welfare of the people living in these areas. In this case, the fiscal decentralization policy implemented in Indonesia in late 2000 which refers to the Law No. 25, 1999 should basically be interpreted as a return to economic identity that is based on the principle of kinship, cooperation and economic independence. In this case the fiscal decentralization is a policy of economic democracy in relation to the financial management of the central government and Regional governments. In this case, according to Tanzi (1995). Fiscal decentralization indicates a delegation of authority in the public finances and service delivery from central to Regional government. Delegation is associated with 4 terms, namely; expenditure decisions; taxing and revenue-raising power; subnational borrowings and intergovernmental fiscal transfers.

In its implementation, fiscal decentralization in the form of equalization fund allocation can lead to fiscal disparities (Allers & Ishemoi, 2011). These fiscal disparities may occur because regional governments are not able to produce comparable services at comparable tax rates. Fiscal disparities appear both on the revenue side and the expenditure side of the budget (Ladd, 1994). In this case the area with affluent population is usually better able to finance the provision of public goods in other areas. This is because the area of the affluent population can increase tax revenue more easily (Allers & Ishemoi, 2010).

These fiscal disparities can lead to the occurrence of inequality and inefficiency in resource allocation (Boadway, 2004). This happens because each region does not have the same ability in tapping the potential of its resources. Besides that inequality may occur due to factors of production that there can not be allocated efficiently. In this case the capital and labor that is more centrally located in areas with a high net fiscal benefit and not on the factor productivity areas with the highest production. As a result there are gaps in the budget allocation in the fulfillment of the needs of goods and services for society. The degree of this gap will get bigger when the posture in the budget area (budget) does not attend to the basic needs of life in the community. The implication of the fiscal disparities is a region where the population can receive services in public goods provision is better than a tax that has been paid. While residents of other areas have not received the service in the provision of public good is better than tax already pays (Allers & Ishemoi, 2010).

East Java is known as one of the provinces that has high levels of economic growth above the average growth rate of the national economy. The dynamics of a growing economy is also supported by the ability of the regional budget that is large enough. Ability substantial budget illustrates the ability of the region in achieving financial well-being of his life. However, based on the analysis suggests that the government's budget allocation to the district / town in East Java, most still much absorbed in the allocation routine to meet the needs of regional governments. While serving for the financing of capital / regional development that is still low. Even in a period of financial budgets are districts / cities that showed an average of about 70%–80% budget allocation largely from the balance funds from central government to regional governments absorbed depleted to meet the needs of Regional governments routinely. This raises a concern in an effort to accelerate the achievement of public welfare. When the portion of the regional government budget can not be developed dynamically in the fulfillment of capital financing / development, then the budget will be stuck on the political nature of waste and rigid. Meanwhile, in the modern era of regional development, regional governments are required to be proactive for financial empowerment in serving goods and services for the community (public goods provision).

Based on the explanation above, the study aims to analyze empirically about the existence and impact of fiscal decentralization on fiscal capacity, regional financial independence and structure of regional government spending and welfare of the people of East Java.

2. Review Literature

Economic development is a process in which a community creates an environment that affects the results of economic indicators such as employment opportunities and increase economic growth. Environment is meant as a resource planning that includes the physical environment, regulation, and behavior (Blakely, 1994). In the end, economic development can be directed at achieving the degree of well-being for regional people.

Regional economies today get more serious attention as the implementation of national development policies. It is expressly stipulated in Law No. 32 of 2004 and Law No. 33 Under of 2004 Act, given the greater authority in the empowering potential of the region's economy in order to achieve greater prosperity for Regional people. Greater authority is certainly can be an opportunity and a chance to explore the economic potential in the region and identify the problems of economic development in the region.

Implementation of Law No. 32 of 2004 and Law No. 33 of 2004 had repercussions on the region in implementing development programs. In this case, the region's readiness to respond to these two laws will greatly depend on the efforts of Regional governments in setting development strategy. This strategy is associated with a variety of efforts to explore the potential of economic and financial resources in order to finance the capital / development in subsistence societies. In this spirit to be built in the second implementation of the Act is the region's autonomy in doing development with discretion. Independence becomes increasingly important for the region in a bid to boost economic growth increasing. Independence is the essence implicit in regional autonomy laws when such laws provide discretion in determining the budget for the wider region in developing their budget capacity. Decentralization is expected to encourage the development of creative innovation of the community, so that the meaning of human development is the main building of Indonesia. Increasing self-reliance and Regional communities not only directly related to the declaration of independence but also meaningful participation of society as a whole family.

In view of independence is certainly derived from the constitution as a unitary state which is integrative where the interests of society as a whole (integral) are preferred and certainly different from the self-sufficiency in terms of free individuals. In this perspective of independence integrality, although public interest is preferred, but the interest of individual is not removed such as the freedom to associate, assembly and giving idea under the constitution. Society is prioritized based on collectivism but preferred the dignity of the individual human remains respected as intended principle of the family (Swasono, 1988). Thus, in the political context of regional budgets, regional fiscal autonomy still relies on the spirit of the interests of society as a whole in an effort sustained equitable equalization between regions. Balance transfer or grant funds from the central government therefore should pay attention as well as efforts to overcome the fiscal gap on one side and the other side pushing the region to continue to make efforts to increase the capacity of regional fiscal effort by increasing tax revenues that should have been received with regard to all the potential of the existing area.

Various studies have been conducted in order to analyze the effect of fiscal decentralization on public welfare. In this case the fiscal decentralization may impact the financial performance in the area of finance and public services development. Research conducted by Afonso et al. (2005) aimed to analyze the relationship between the quality of public finances and economic growth in OECD countries over the 1960 to the 2000 Research results show that the quality of public finances significant effect on the rate of economic growth in OECD countries. While the results of research by Yamoah (2007) in his research on US give conclusion that decentralization has a significant influence on the population and have no effect on the growth of employment opportunities in the United States.

The results of another study by Alexiou (2009) concluded that government spending on capital formation, development assistance, private investment and trade openness has a positive and significant impact on economic growth in many countries in South Eastern Europe (SEE) for the year 1995–2005. While the results of research by Matovu (2000) by using the method of dynamic general equilibrium analysis shows that government spending on the social sector could boost economic growth in the country of Uganda.

Another study conducted by Pose and Krøijer (2009) in the period from 1990 to 2004 in various European countries, especially in Central and Eastern Europe. Research results conclude that fiscal decentralization has a negative relationship with economic growth in various countries in Europe. In this case, the expenditure and transfers of funds from the center to the regions negatively correlated with the rate of economic growth. While taxes are charged to the area can have a significant positive correlation to the growth of the national economy. In relation to the financial management area, the results of research by Baskaran and Bigsten (2011) showed that the increase in fiscal capacity can improve government accountability in African countries over the years 1960–2008. While in relation to the implementation of fiscal decentralization in Indonesia, research by Simanjuntak and Mukhlis (2012) resulted in the conclusion of the influence of a positive and significant correlation between the allocation of funds from the central to the regional balance of regional government expenses districts / cities in East Java, Indonesia.

Results of conducted research by Faridli (2011) analyzed the impact of the implementation of fiscal decentralization on economic growth in Pakistan during the years 1972–2009. The results of his research gained the conclusion that the federal government should delegate their fiscal powers to the provincial governments and regional governments to increase economic growth and welfare of the people living in Pakistan. In this case the implementation of fiscal decentralization policy in Pakistan can reduce the dependence of regional governments to the central government.

In relation to the financial independence, research by Fattah and Irma (2013) demonstrated the persistence of the level of fiscal dependence of regional governments to the central government. As an illustration of the level of fiscal dependence of regional government in South Sulawesi against the central government in the era of regional autonomy is still high, ranging from 85.27% to 93.22%. Furthermore, in other studies, Sukanto and Mukhlis (2013) conclude that financial independence (fiscal independence) in the district / town in South Sumatra is very small / very low. In addition, the level of financial independence that area have a negative effect on the level of poverty and vice versa levels of regional financial autonomy has a positive effect on the welfare of living (measured by the Human Development Index) public districts / cities in South Sumatra.

Based on various studies, it show that empirical studies on the impact of fiscal decentralization policy implementation can be analyzed both in terms of mechanics and its impact on the welfare of society. In this case the fiscal decentralization and regional autonomy can be seen is an improvement in the financial management of state and regional finance. Through the decentralization of regional government fiscal policy can contribute even more in the area of financial management in order to meet the public good of society. Implementation of fiscal decentralization policy is expected to push for efficiency, competitiveness, reduction of disparities budget and welfare of society. Through this policy the central government provides a budget allocation as grants for regional governments.

3. Methodology

Object of this study is the 38 districts / cities in East Java, Indonesia in the period 2008–2011. The method of analysis used to examine the relationship between variables in this study is Partial Least Square (PLS). The data used in this study include primary and secondary data. Primary data is the type of data obtained directly from the relevant data sources. These data are such as; allocation fund balance, the level of welfare, financial capability and financial capacity of regional areas. The primary data can be obtained from; household groups, government officials, tax officials and businessmen. Primary data collection methods include; interviews, and field observations. Meanwhile, secondary data is the type of data obtained from the publication of the relevant agencies. These data are such as; fund balance, figures Human Development Index, economic growth, and regional districts / cities. Data obtained from the documentation relevant agencies, including: Central Bureau of Statistics, Directorate General of Taxation, and the Directorate General of Fiscal Balance of Regional Finance of the Republic of Indonesia (http://www.djpk.depkeu.go.id). The secondary data collection techniques can be carried out by the method of document analysis.

Based on its position in the structural model, the variables of this study can be grouped as follows:

- Exogenous - independent variables: Equalization Funds (X_1);
- Endogenous - intervening variables: Regional Fiscal Capacity (Y_1), Regional Financial Independence (Y_2) and Expenditure Structure of Regional Government (Y_3);
- Endogenous - Dependent Variable: Human Development Index (Y_4);

The operational definition of variables used in this study is:

- Equalization Fund is Fiscal Decentralization (X_1) which is a system of government financing within the framework of a unitary state, which includes the financial division between central and regional governments as well as inter-regional equalization proportionally, democratic, fair and transparent with regard to the potential, state, and Regional requirements in line with the obligations and distribution of authority and procedure for the organization of such authority, including management and financial oversight (Sidik, 2001: 9). Fiscal decentralization variable proxied by fund balance that has three main indicators : Tax Revenue (X_{11}), General Allocation Fund (X_{12}), Special Allocation Fund (X_{13}).
- Regional Fiscal Capacity (Y1) is the magnitude of the budget capacity owned by the regional government in the area of financial management in order to finance the implementation of regional development (Tennessee Advisory Commission on Intergovernmental Relations, 2005). The size of the fiscal capacity to assess this area using indicator (Besley and Persson, 2009a; Dinecco and Prado, 2010) : the ratio of Regional taxes to GDP.
- Regional Financial Independence (Y2) is the level of regional financial autonomy in the financing of development in the area. Yet, the degree of financial independence of a region can be calculated by the following formula (www.djpk.depkeu.go.id) : $KKD_i = PAD_i / TP_i$, in which KKD is a regional financial i, PAD is the original income i and TP is the total income of region i.

- Structure of Regional Government Expenditure (Y_3) is the magnitude of the budget allocations issued by regional governments to finance the implementation of its development. Government spending is limited to the budget, and hence productive spending (spending on public services, spending on education, spending on health expenditures for transportation and communication as well as expenditures for housing) will boost economic growth. Instead unproductive expenditure (spending on social security, spending for recreation as well as other consumer spending) does not increase economic growth (Kneller et al., 1999). In line with the Indonesia's budget after regional autonomy, the ratio of spending part of routine expenditure and development expenditure of the budget which is an indicator of the available budget ability in the regions. The indicators are: Routine Expenditures (Y_{31}) is the amount of personnel expenditure in the budget ; Capital Expenditures (Y_{32}) is the amount of capital expenditures and expenditures for goods and services in the budget.
- Society welfare (Y_4) is the level of success in human development. The indicator is: Human Development Index (Y_{41}).
- While the conceptual framework of the research can be described as follows :

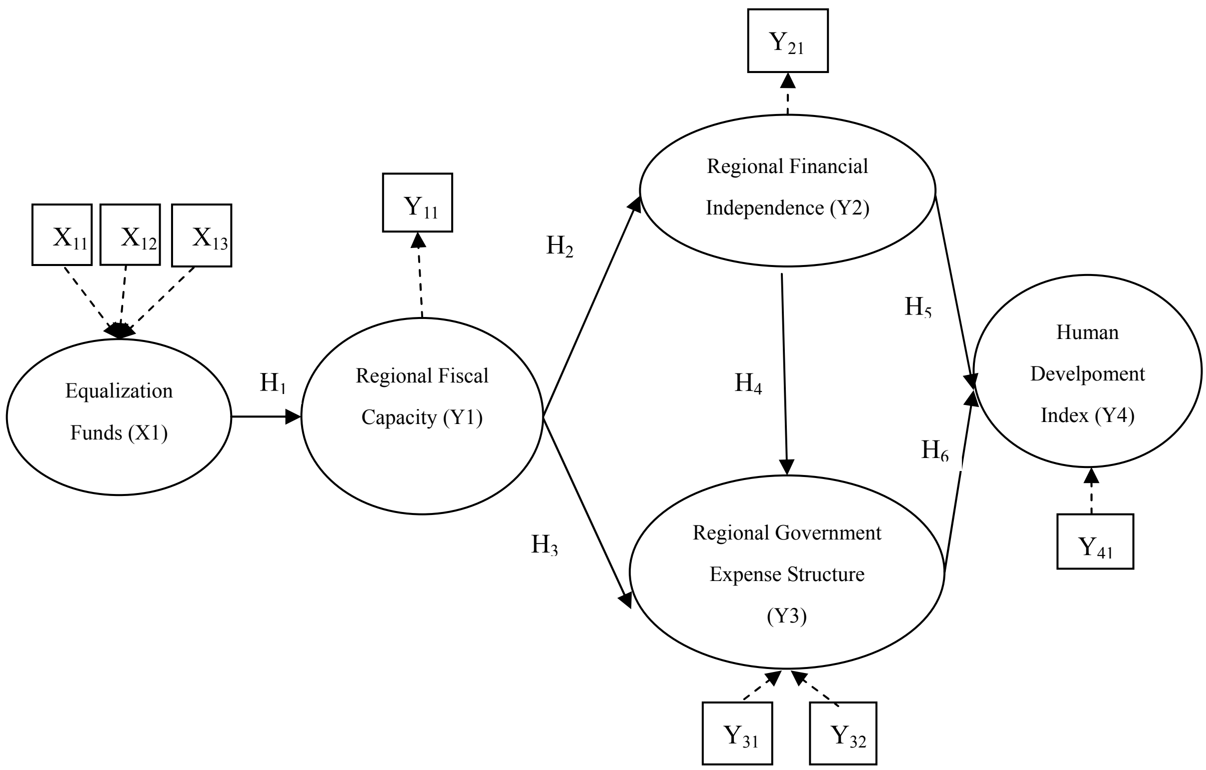

Figure 1. Conceptual research framework

Based on a literature review of existing research hypothesis, it can be formulated as follows:

H1: Equalization fund has significant positive effect on the regional fiscal capacity;

H2: Fiscal capacity has significant positive effect on regional financial independence;

H3: Fiscal capacity significant positive effect on the structure of regional government spending;

H4: Financial independence area significant positive effect on the structure of regional government spending;

H5: Self-reliance of regional finance has significant positive effect on the welfare of regional communities;

H6: The structure of regional government spending has significant positive effect on the development of human index.

4. Empirical Results and Interpretation

Goodness of Fit Testing uses predictive value-relevance (Q^2). R^2 value of each endogenous variable in this study are as follows: 1) for the Regional Fiscal Capacity (KFD) variable obtained R^2 of 0.1181; 2) for the human development index (HDI) variable obtained R^2 of 0.2227; 3) for Regional Financial Independence (KKD) variable obtained R^2 of 0.2949; and 4) for the Expenditure Structure of Regional Government (SPPD) variable obtained R^2 of 0.6683.

Predictive value-relevance is obtained by the formula:

$$Q^2 = 1 - (1 - R_1^2)\ (1 - R_2^2)\ (1 - R_3^2)\ \ldots\ (1 - R_p^2)$$

$$Q^2 = 1 - (1 - 0{,}1181)\ (1 - 0{,}2227)\ (1 - 0{,}2949)\ (1 - 0{,}6683)$$

$$Q^2 = 0{,}8397$$

The results of calculation showed predictive value-relevance of 0.8397 or 83.97%, so the model is said to have a decent relevant predictive value. Relevance predictive value of 83.97% indicates that the diversity of data can be explained by the model that is equal to 83.97%, or in other words, the information contained in the data 83.97% can be explained by the model. Meanwhile, the remaining 16.03% is explained by other variables (which is not contained in the model) and error.

In the PLS analysis, there is an assumption that must be met, namely the linearity assumption which requires the relationship between variables that is linear. The assumption of linearity uses the Curve Fit that is a linear relationship between variables declared if it meets one of the two following possibilities: (1) a significant linear model (linear model sig> 0.05), (2) significant non-linear models and all models may also be non-significant (linear model sig> 0.05 and sig models other than linear> 0.05). Test results are presented as follows:

Table 1. Linearity assumption test

Variable Relationship		Linearity Model Test	Conclusion
Equalization funds (EF)	Regional Fiscal Capacity (KFD)	Linear Model significant (Sig of Linier Model 0.000< 0.05)	Linier
Regional Fiscal Capacity (KFD)	Regional Financial Independence (KKD)	Linear Model significant (Sig of Linier Model 0.000< 0.05)	Linier
Regional Fiscal Capacity (KFD)	Regional Government Expence Structure (SPPD)	Linear Model significant (Sig of Linier Model 0.000< 0.05)	Linier
Regional Financial Independence (KKD)	Regional Government Expence Structure (SPPD)	Linear Model significant (Sig of Linier Model 0.000< 0.05)	Linier
Regional Financial Independence (KKD)	Human Development Index (IPM)	Linear Model significant (Sig of Linier Model 0.000< 0.05)	Linier
Regional Government Expence Structure (SPPD)	Human Development Index (IPM)	Linear Model significant (Sig of Linier Model 0.014< 0.05)	Linier

Based on the table above, it shows that sig linear model for the entire relationship has a value of less than 0.05 (significant linear model, so that the assumption of linearity is fulfilled. Based on the results of data analysis has been carried out resulted in some important information related to the influence of fiscal decentralization on the welfare of the people living in the district / city in East Java province, Indonesia. The data results if the data using quantitative methods conducted a test with the inner model (structural model). This inner model is mainly to test hypothesis in this study. Hypothesis testing is performed with the t test (T-Statistic) on each of the direct influence of the partial paths. The results of the complete analysis contained in the PLS analysis results, it can be seen in the following figure.

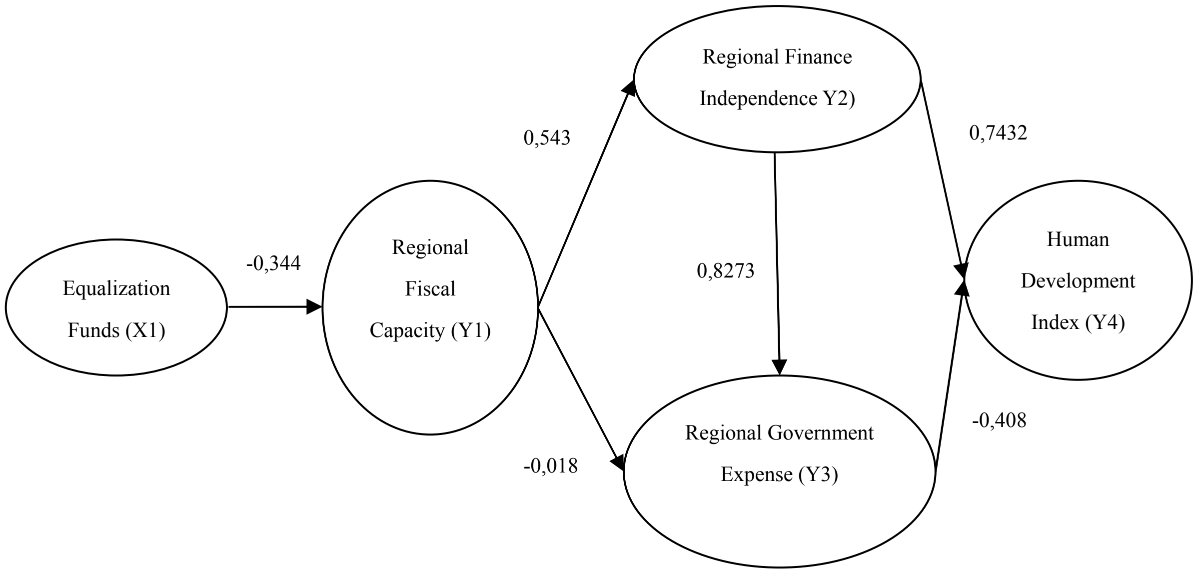

Figure 2.The result of hypothesis testing on *Inner model*: direct effect

Based on the picture above, it shows the negative and positive relationships between the various variables that exist. The above results can be summarized into the following table again.

Table 2. The result of hypothesis testing on inner model: direct effect

Correlation	Path Coefficient	T-Statistic	P-Value
Equalization funds → Regional Fiscal Capacity	-0,3437	2,0397	0,0414
Regional Fiscal Capacity → Regional Financial Independence	0,5430	6,6260	0,0000
Regional Fiscal Capacity → Regional Government Expense Structure	-0,0183	0,5338	0,5935*
Regional Financial Independence → Human Development Index	0,7432	9,1264	0,0000
Regional Financial Independence → Regional Government Expense Structure	0,8273	16,1801	0,0000
Regional Government Expense Structure → Human Development Index	-0,4089	5,5349	0,0000

Note. * Denotes that the coefficient is not significant at 5% level.

Among various exogenous and endogenous relationship above, it shows there is a relationship between endogenous variables, namely the relationship between the variables and the fiscal capacity of regional government expenditure structure variables are not significant. This happens because its p value below a certain confidence level (e.g 10% α). Management of non-current budget over the economic stake situations where the average almost every year, the regional government can not use the budget had received in full. Each year, the remaining budgets and not used according to a predefined plan. This indicates a serious problem because the number has a limited budget it was not used properly and worth. It is presumed that it happened as a result of the establishment of the no good coordination between the users and the central government budget which resulted not in accordance with the implementation plan in the area.

Besides that, there is a significant relationship between the variables, but have a negative direction of the relationship. The relationship of these variables includes the relationship between fiscal decentralization and regional fiscal capacity of the relationship between the structure of regional government expenditure by Human Development Index. Negative relationship between the variable direction of decentralization with fiscal capacity variable indicating increasing equalization funds from the regional government that condoned the resulting decline in the central government's fiscal capacity of regions. As it is known, the implementation of regional autonomy in Indonesia has been running for approximately 13 years. Throughout this period, there is regional expansion. One region could be 2 or 3 new autonomous region. Expansion of this area turned out in many areas that is not accompanied by an increase in the budget of fiscal capacity. In fact, the budget originally earmarked for 1 regent / city area should be divided into several autonomous regions without followed by the ability of new region to increase its budget capacities. The fact makes this area always depends on the budget of the center, one side due to differences in endowment between regions other side the limited ability to explore the sources of their budgets. This is in line with the direction of the negative relationship between the variable regions with variable expenses welfare society can be explained as a result most of the budget in the area is not used to improve the welfare of regional communities. It can be seen that the average regional budget (80%) is earmarked for personnel expenditure areas.

Yet, the relationship between the significant variables have a positive relationship towards covering; relationship between fiscal capacity of regions with regional financial independence, financial independence relations between regions with a Human Development Index, and the relationship between the structure of the financial independence of regional government spending. Relationships associated with an independent variable with a variable budget fiscal capacity, variable area and variable expenditures Human Development Index, indicating the importance of the independence of regional budgets to sustain the welfare of the people in the area.

The study provides results that are ambiguous regarding the relationship between fiscal decentralization with regional fiscal capacity. In this case the size of the budget in the area of financial management of the funds derived from the balance it gives a negative effect on the capacity of the region. This gives a signal will be very dependent on the financial budgets of central government funding. Equalization fund allocation from the central government can not increase the fiscal capacity of regional and regional contrary will increasingly depend on the central government. These results reinforce the findings of the study at the same time by Fattah and Irma (2013) about the government's dependence on the financial budget of South Sulawesi province of the national government that is between 85.27% to 93.22%.

The relationship between the fiscal capacities of regional financial independence has positive direction and significant relationship. This indicates that the region basically has the potential and opportunities in developing regional economy with reference to its financial resources. Financial resources can be naturally represented by the development of regional revenue (PAD) from time to time. In this case according to Barro (2002) fiscal capacity basically showed a relative ability of regional governments to generate funds sourced from revenues (revenue) itself. So with a great ability to increase Regional revenue, the fiscal capacity of regions will also be increased from time to time.

Furthermore, the financial independence has significantly positive relationship with the structure of regional government spending. Not only the region's financial independence but also has a positive and significant relationship with the welfare of society. It is indicated that the level of financial independence is basically an area of strong fundamentals for the district / city in East Java province, Indonesia. This result is consistent with the findings of research by Sukanto and Muhklis (2013) that the region's financial independence has a positive effect on the welfare of living (measured by the Human Development Index) public districts / cities in South Sumatra, Indonesia during 2006–2010.

In addition to testing the direct effect, the method of analysis using the PLS also recognized the existence of the indirect effect (indirect effect). The indirect effect is the result of multiplying two (2) indirect effect. Indirect effect was significant if both the direct influence that shape is significant. Here are presented the results of the indirect effect:

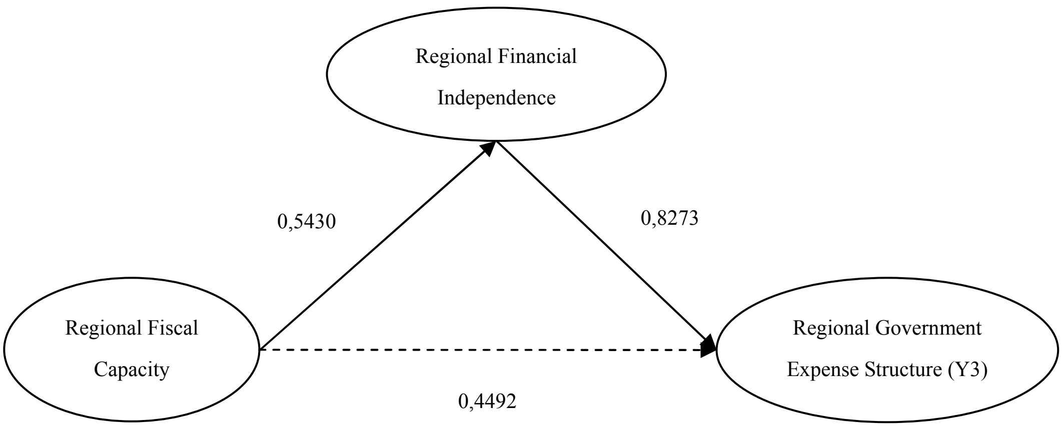

Figure 2. Hipothesis testing result on Inner model: indirect effect

Note. ⇢ Indirect effect.

The results of the analysis of the indirect relationship between existing variables using PLS method in addition to produce an image on the back which can also be summarized in the following table:

Table 3. Hipothesis testing result on Inner model: indirect effect

Indirect Effect	Direct Effect Coefficient	Coefficient Indirect Effect
Regional Fiscal Capacity → Regional Financial Independence → Regional Government Expense Structure	Regional Fiscal Capacity → Regional Financial Independence (0,5430*)	Regional Financial Independence → Regional Government Expense Structure (0,8273*)

Note. * Denotes that the coefficient is significant at 5% level.

Under the Table and Figure above, it was carried out tests on 1 indirect influence. The result of that is more indirect effect between Regional Fiscal Capacity on Regional Government Expenditures Structure through Regional Financial Independence, indirect effect coefficient of 0.4492. Due to the direct influence of Fiscal Capacity for Regions Regional Financial Independence Financial Independence Regional 0.5430 and towards 0.8273 Structure of Regional Government Expenditures both significant, it can be said that there is a significant indirect effect between Regional Fiscal Capacity of Regional Government Expenditures on Structures through Financial Independence areas. With the coefficient that is positive and indicating the direction of the relationship. The higher the Regional Fiscal Capacity, will have an impact on the higher structure of Regional Government Expenditures, if the higher Regional Financial Independence.

5. Conclusion and Recommendation

Based on the explanation of above results, it can be concluded that the implementation of fiscal decentralization on regional financial management performance has not yet showing maximum results. In this case, the implementation of fiscal decentralization policy in the form of allocation of fund balance (equalization funds) has a negative impact on the fiscal capacity at the district / city in East Java. In the context of fiscal decentralization policy in the form of allocation of financial balance increasing levels actually resulted in the decrease of the regional government fiscal capacity of the district / city in East Java. In other words, there is a significant negative direct effect and a negative between Fiscal Decentralization on Regional Fiscal Capacity. However, in relation to its capacity of existing fiscal immediate positive impact significantly on Regional Financial Independence. This means that the higher fiscal capacity, the higher the level of Regional Financial Independence. In this case, the higher level of Regional Financial Independence, it also further increases the degree of regional community welfare through higher Human Development Index.

Furthermore, the Financial Independence can also provide a positive direct effect and significant impact on Regional Government Expenditure Structure. However, the structure of regional government is actually providing a significant negative direct effect on public welfare regencies / cities in East Java. This occurs because the structure of expenditure in East Java, most of the portion of the budget is for recurrent expenditures in the form of expenditures for personnel expenditure, and small portion expenditures for capital expenditure, goods and services. This means that the greater the difference in budget allocation specifically for personnel expenditure, the level of welfare of the society will fall.

Based on these results, it is important for regional governments to focus on the areas of financial management in the financing of expenditures on the welfare of regional community life. The budget allocation is set such that the portion of the budget for capital expenditure and development expenditure is greater than the employee. This can be done by making the priority needs of the community and on other occasions the regional government can encourage an increase in regional revenues through regional taxes and retribution.

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