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Examining the Effects of Fiscal Decentralization and Income Inequality on the Economic Performance of West Sumatra Province, Indonesia

ABSTRACT

Purpose: The issue of income inequality in various regions of Indonesia is a significant national concern that requires immediate attention. Despite the government's efforts through fiscal decentralization policies, inequality persists. This study decisively explores the impact of fiscal decentralization and regional income inequality on regional financial performance.

Design/methodology/approach: The research sample comprises 19 districts/cities in West Sumatra province, with data from 2018 to 2020 sourced from the Ministry of Finance and the Central Statistics Agency of West Sumatra Province. The analytical approach utilized in this study is the SmartPLS ver 3.2 model.

Findings: The first research finding indicates that fiscal decentralization has a positive and substantial impact on regional financial performance. A second finding suggests that regional income inequality also positively and significantly affects regional economic performance.

Research limitations/implications: These results enrich the perspective of Rostow's stages of economic growth model from a different standpoint.

Originality/value: This study contributes to a deeper comprehension of the fields of economics, politics, and social sciences, particularly within the specific context of the province of West Sumatra in Indonesia.

Keywords Fiscal Decentralization, Income Inequality, Rostow Model, West Sumatera

I. Introduction

Income inequality, typically measured using the Gini Ratio, has decreased over the past decade in Indonesia. However, the COVID-19 pandemic has exacerbated the level of income inequality in West Sumatra due to the country's economic downturn resulting in decreased national revenue and regional expenditure fell significantly. These disparities, rooted in variations in financial potential and management across regions (F. D. P. Santoso & Mukhlis, 2021). Income inequality can cause social injustice, tension, and increase disparities between groups in society. It can also impact social mobility, social stability, and economic growth in the long term (Bhagaskara, 2023). One of the main factors that determine poverty is income distribution, because poverty is determined by the average per capita expenditure of the population that is below the poverty line, it can be concluded that an increase in income inequality caused by a decrease in the level of labor income indirectly attracts population groups that initially have average expenditure above the poverty line to average expenditure below the poverty line (Maskur et al., 2023). Basically, the percentage level of the poor in Indonesia is influenced by income inequality, open unemployment, government spending, or the human development index. Conversely, increasing economic growth requires poverty reduction efforts that depend on the effects of income inequality (Suparman, 2021).

Indonesia's economic growth before COVID-19 from 2010 to 2019 tended to decline. In 2020, the COVID-19 pandemic entered Indonesia, causing economic growth to fall even further to -2.07%, indicating that the COVID-19 pandemic has affected Indonesia's economic growth and national development (Widiastuti & Silfiana, 2021).

Each of development opportunities can be more evenly utilized across regions, thus impacting the development process in developed areas. This approach will help reduce economic disparities between regions, address income inequality within economic sectors, tackle low incomes among individuals or groups, combat unemployment, address isolated areas, improve the quality of human resources (HR), and address environmental challenges. These are significant challenges for stakeholders, including local and central governments, the private sector, and the community, who must work together in synergy to find solutions. The evident disparity in per capita income between districts and cities signals unequal development and investment policies or an imbalance that requires equitable distribution of development to ensure more even increases in per capita income. Studies by Damanik et al (2018) and Matondang (2018) found that economic growth and population size can impact income inequality.

Policies aimed at fostering economic development have inadvertently worsened regional economic disparities. Various factors contribute to unequal welfare across different regions, as evidenced by the Human Development Index (HDI). The disparities result from regional differences, development issues in West Sumatra, and particularly challenges in the health and infrastructure sectors (Ramadhani & Utomo, 2023). The core feature of regional autonomy is its ability to demonstrate financial potential, decentralization, and effective financial management. The distribution of income and fiscal decentralization significantly impact regional financial performance. Income inequality in developing countries often does not adequately consider its regional dimensions. This is crucial because efforts to reduce income inequality nationally will only succeed in contexts where highly unequal regions coexist with economically relatively equal regions (Savoia, 2020).

The expanded authority of regional autonomy allows Regional Governments to independently manage their finances by decentralizing funding to the regions. It is crucial for local governments to transparently and accountably manage these funds to ensure proper allocation and utilization. Fiscal decentralization is vital for enhancing societal welfare by effectively managing regional finances (Rahman & Saputra, 2022).

In 2022, the realization of Local Own Source Revenue (PAD) for West Sumatra Province reached 2,848,207,032,876 IDR, marking an increase of 11.6% or approximately 296 billion IDR compared to the previous year. PAD in that year contributed the largest share to regional income, amounting to 46.52%. Local taxes were the largest contributor, comprising 79.86%, followed by Other Legitimate Local Revenues at 16.19%, Income from the Management of Separated Regional Wealth at 3.53%, and Local Levies at 0.42%.

The Indonesian government has implemented a performance-based budget system to improve regional financial management's effectiveness, efficiency, transparency, and accountability (Khan, 2024).

The research is particularly timely given the high disparity in income distribution between urban and rural areas in West Sumatra, Indonesia, a trend mirrored in other Indonesian cities. This study aims to assess how fiscal decentralization and regional income inequality impact the financial performance of the District Governments of West Sumatra Province.

A. Literature Review and Hypothesis Development

1.Rostow's Model of Development

Rostow (1960) proposed a development theory outlining a five-stage process for a developing country to achieve developed status. These stages are (1) traditional society, characterized by a limited community structure and low per capita income; (2) the preconditions for take-off, marked by the transition of the middle class towards a more modern society with an advanced economic system; (3) the take-off stage, representing an era of economic development where obstacles to growth give way to forces of progress, leading to a significant increase in investment; (4) the drive to maturity, defined by continuous and regular economic growth utilizing modern technology; and (5) the age of high mass consumption, where the leading sectors of society shift towards durable consumer goods and services. According to this theory, this economic development transition is driven by economic, political, and social orientation changes and shifts in people's attitudes and customs towards economic development.

2.Fiscal Decentralization

To implement fiscal decentralization, sources of local government funding are designed more equitably. It reduces political conflict between the central and local governments and provides local government operational funds consisting of local taxes and levies, as well as central and local government balancing funds from the APBN (Sinaga, 2023). This shift in government authority has significant implications for budget administration and fiscal decentralization, particularly regarding the responsibilities of district, city, and provincial government bureaucracies in Indonesia. The sentence Fiscal decentralization is characterized by the autonomy of local governments in managing regional finances, granting them discretion to allocate funds based on regional priorities. Regional autonomy refers to self-governing regions' rights, authority, and obligations to serve local communities in line with statutory regulations. This autonomy is recommended to enhance the efficiency, effectiveness, and accountability of financial management in local government, as highlighted by Hasthoro & Sunardi (2016) to enhance Indonesia government policy. As local government undertake fiscal decentralization, they are expected to have the independence to finance regional expenditures and pursue development separate from the central government (Iskandar et al., 2021).

3.Regional Income Inequality

Hakim & Rosini (2022) explained that income inequality refers to the difference in income levels among individuals, specifically between high and low incomes. Furthermore, the inception of the problem of regional disparity indicates differences in welfare levels, so it can be said that rapid growth occurs in some regions while slow growth in others, both of which are caused by the unique characteristics of each region (Asrahmaulyana, 2023). corruption can reduce government spending on education, health, and final consumption, as this leaves fewer resources available for social spending. Thus, it can be concluded that, increased corruption has worsened the position of the poorest. increased corruption will increase income inequality (Sari & Qibthiyyah, 2022). San (1983) identifies three aspects on which regional income inequalities can be based: regional income disparity, urban-rural income disparity, and size distribution of income.

Inequality is a major problem of almost every country, especially developing countries. Inequality in distribution can lead to disparities throughout society. Providing equal opportunities to each community to utilize the available social facilities and providing equal opportunities to each community to develop and improve its economy are the main keys in efforts to overcome socioeconomic disparities (Silpia, 2023).

4.Regional Financial Performance

All local governments in the cities of Sumatra Island demonstrates a significant level of financial dependency on funds received from the central government, provincial government, and other districts. This high dependency reflects a strong reliance on external assistance to support regional governance and development activities. This is evidenced by the fact that the contribution of transfer income exceeds 50% of the total revenue of each district or city in the region (Abdullah & Mardatillah, 2017).

Various factors, including government policies, the economic situation, and regulations governing regional financial management, affect regional financial performance. Improving efficiency, independence, decentralization, effectiveness, and regional dependence can help regional financial performance (Sartika, 2019). Furthermore, By using predetermined financial indicators, regional financial performance can be defined as the level of achievement of regional work results that aim to determine how well and effectively the region manages finances (SAIFRIZAL, 2022).

5.Fiscal Decentralization and Regional Financial Performance

In Indonesia, fiscal decentralization plays a crucial role in implementing the principles of regional autonomy aimed at improving community welfare based on local potentials, despite facing various challenges. Initially, fiscal decentralization in Indonesia aimed to promote economic independence at the local level. As a result, regions were granted broad authority in various sectors except for foreign affairs, defense, security, justice, finance, and religion. In the context of regional autonomy, fiscal decentralization is considered a significant second step. The package of State Finance Laws, which includes three state finance regulations, has implemented reforms in national financial policy to support this process (Christia & Ispriyarso, 2019).

Fiscal decentralization involves transferring financial responsibilities from the central government to regional or local governments, which is known to impact overall financial performance significantly. This can be observed through the level of autonomy of the central government in handling regional finances and the reduced reliance on the central government. With less dependence on the central government, local administrations can independently manage financial operations, oversee, and exploit financial opportunities, and handle budgeting and allocation. To improve local financial capability, local governments must have the ability to support the financing of government, development, and community activities. In addition, they must encourage the community to participate in regional development and manage local revenue effectively and efficiently (R. T. Santoso et al., 2021). Therefore, building upon existing theory and research, the initial hypothesis presented in this study is:

H1: Fiscal Decentralization has a positive effect on regional financial performance.

6.Regional Income Inequality and Regional Financial Performance

Income inequality measures how income is distributed among people in a specific area or region during a specific time. This trend of increasing income inequality is observed at various levels in Indonesia, including rural, urban, national, and provincial levels. In urban areas, income inequality is more pronounced than in rural areas, which has implications for regional economic performance and public trust in the government. Income inequality is closely linked to poverty, and reducing income distribution inequality or income level gaps will inevitably be a top priority in economic development (Wuladari et al., 2022). Hanum & Muda (2019) The elevated poverty rate in the region is attributed to restricted access to education, wage disparities, and the modest incomes of agricultural workers.

. By reallocating regional expenditures more effectively, it is possible to promote stronger and more equitable economic growth, thereby addressing the issue of income inequality. Hence, in line with existing theories and previous research, the second hypothesis posited in this study is:

H2: Regional income inequality exerts a positive impact on regional financial performance.

7.The Effect of Fiscal Decentralization and Regional Income Inequality on Regional Financial Performance

Fiscal decentralization has the potential to enhance efficiency in public and production services. However, the implementation of decentralization varies across different regions, leading to diverse effects due to variations in characteristics and institutions. Fiscal decentralization is crucial in improving regional financial performance and reducing income inequality. According to Galbraith (2012), unequal distribution of development results in income inequality within each region, which, in turn, hinders economic growth and exacerbates income inequality .

There exists a correlation between financial performance and regional income inequality. Unequal economic growth contributes to decreased regional income inequality. Regional authorities can proactively and innovatively manage regional finances to foster growth. Efriza (2014) examined income inequality among districts, cities in East Java Province and found that the Williamson index indicates significant income inequality, particularly in Kediri and Surabaya.

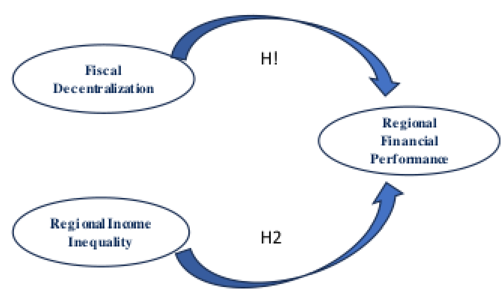
The Theil Entropy Index also confirms a very high-income inequality in East Java province. Moreover, the inflation rate positively and significantly impacts regional income inequality. Greater local revenue will make a region more independent in financial management (Sarumaha & Annisa, 2023). Therefore, based on existing theory and previous studies, this study proposes the third hypothesis:

H3: Fiscal Decentralization and Regional Income Inequality have a positive effect on regional financial performance.

II. Methodology

This research is a quantitative study that examines and evaluates the effect of fiscal decentralization and regional income inequality on regional financial performance. Secondary data from government institutions such as the Central Bureau of Statistics (BPS) of the relevant regions is the source of this research. The required data are Gross Regional Domestic Product (GRDP), APBD, and population. Revenue reports of regional own-source revenues (PAD), central taxes for regions, general allocation funds (DAU, and other data relevant to the research used from the APBD besides secondary data also collected through literature research to support this research. This research uses data from 12 districts and 7 cities in West Sumatra. This research uses the smart pls 3.2.2 analysis tool**,**

Figure 1. Conceptual Framework



A. Data Analysis Method

Descriptive statistics offer an overview of the data profile within a research sample. In this study, descriptive statistics are employed to provide descriptions of the respondents. These statistics are computed using Microsoft Excel to facilitate the analysis. The study utilizes the SEM technique and employs the SmartPLS 3.2.2 analysis tool to evaluate two models, namely the outer and inner models.

1. The Evaluation of Measurement Model (*Outer Model*)

The outer model is assessed to determine the relationship between the latent construct and its indicators. This model serves to establish the validity and reliability of the research instruments. The validity test encompasses convergent and discriminant validity. In assessing convergent validity, this study employs the loading factor (Solling Hamid & M Anwar, 2019).

It stated that a loading factor value > 0.50 is practically significant. Additionally, the cross-loading value for each indicator within a variable differs from the indicator in other variables, with a loading value > 0.5. Furthermore, this study utilizes Cronbach's alpha and composite reliability for reliability testing. The Rule of thumb dictates that the values for Cronbach's alpha and composite reliability must exceed 0.7 for the construct or variable to pass the reliability test (Chua, 2023).

2. The Evaluation of Structural Model (*Inner Model*)

In this study, the aim of evaluating the inner model is to scrutinize the research hypothesis. According to Hartono et al (2020), the evaluation of the inner model can be elucidated by the R^2 value for the dependent variable, path coefficient value, or t-value for a significant test between constructs in the inner model. A high R^2 value indicates a strong prediction model for this study. The path coefficient value is explicated by t-statistics and then compared with the t-table value in hypothesis testing. For the one-tailed hypothesis with an alpha of 5%, the t-table value is 1.64 in the case of the mediation effect. The significance test parameter output is derived from the total effect table rather than the path coefficient table. This is because the mediation effect tests the independent variable's direct impact on the dependent variable and examines the indirect relationship between the independent and dependent variables through the mediating variable (indirect effect).

The R^2 value is 0.67 (strong) 0.33 (moderate) and 0.19 (weak) testing the path coefficient individually can be used t test or f test from the regression output. The primary objective of this research is to analyze the effects of fiscal decentralization and regional income inequality on the financial performance of the West Sumatra Province. This study seeks to delve into the relationship between these factors and their influence on the economic stability and growth of the region. The research design specifically addresses the research problems, objectives, and hypotheses. Employing a quantitative research approach, the study utilizes panel data measurement, comprising observations across 19 districts/cities in West Sumatra, and incorporates five years of time series data spanning from 2016 to 2020.

According to the earlier conceptual variables, identifying research involves two independent variables and one dependent variable, comprising exogenous and endogenous variables. The exogenous variables are categorized as fiscal decentralization and regional income inequality, while the employed endogenous variable is regional financial performance. These research variables are presented in **Table 1** below.

Table 1. Research Object based on Research Variables

No	Variable Name	Indicator Code	Indicators
1	Fiscal Decentralization (X1)	DF 1	Indicator of Regional Expenditure
		DF 2	Indicator of Regional Income
		DF 3	Indicator of Regional Autonomy
2	Regional Income Inequality (X2)	KPD 1	Williamson Index
		KPD 2	Theil Entropy Index
		KPD 3	Jamie Bonet Index
3	Regional Financial Performance (Y)	KKD 1	Compatibility Ratio
		KKD 2	Independency Ratio
		KKD 3	Efficiency Ratio
		KKD 4	Effectiveness Ratio
		KKD 5	Fiscal Effort

KKD 6	Regional Income Growth Rate

Source: Data Processed, 2022

This study incorporates two independent variables and one dependent variable. The indicators used for Decentralization Fiscal include the Indicator of Regional Expenditure, Regional Income, and Regional Autonomy. Additionally, the study utilizes indicators of Regional Income Inequality, such as the Williamson Index, Theil Entropy Index, and Jamie Bonet Index. Furthermore, the study examines Regional Financial Performance using indicators like Compatibility Ratio, Independency Ratio, Efficiency Ratio, Effectiveness Ratio, Fiscal Effort, and Regional Income Growth Rate. Detailed explanations of the measurement for each research variable can be found in Table 2:

Table 2. Operational variables

Variables	Types of variables	Measurement Variable	Measurement Scale
Fiscal Decentralization (X1). (Halim, 2001)	Independent (X1)	$DF1 = \frac{TER}{TCGE}$ TER = Total Expenditures of Regency TCGE = Total central government expenditures $DF2 = \frac{TDGR}{TCGR}$ TDGR = Total District Government Revenue TCGR = Total Central Government Revenue $DF3 = \frac{TODR}{TDR}$ TODR = Total Original District Revenue TDR = Total District Revenue	Ratio
Regional Income Inequality (X2)	Independent (X2)	KPD 1 Williamson Index $IW = \frac{\sqrt{\sum (Yi - Y)^2 \, fi/n}}{Y}$ where: Yi = GRP Nominal per capita at Province i Y = Average Per Capita Income in West Sumatera Fi = Total Population of District I N = Total Population in West Sumatra Province KPD 2 Theil Entropy Index $T_d = \sum \left(\frac{yj}{Y}\right) X \log \left\{\frac{yj/Y}{xj/X}\right\}$ I = Theil Entropy Index Yj = GRP Nominal per capita at Province J Y = GRP Nominal per capita at West Sumatera. XJ = Total Population of District j X = Total Population in West Sumatra Province KPD 3 Jamie Bonet Index $I\,it = \left\| 1 - \frac{yj}{Y} \right\|$ Iit = Regional Inequality in I at Year t Yj = GRP Nominal per capita at Province J	Ratio

		Y = GRP Nominal per capita at West Sumatera Province	
Regional Financial Performance (Y)	Dependent (Y)	$KKD1 = \frac{DCER \ x \ 100\%}{DER}$ DECR = District Capital Expenditure Realization DER = District Expenditure Realization $KKD2 = \frac{RODR \ x \ 100\%}{RRTR}$ RODR = Realization of Original District Revenue RRTR = Realization of Regency Transfer Revenue $KKD3 = \frac{DER \ x \ 100\%}{DRR}$ DER = District Expenditure Realization DRR = District Revenue Realization $KKD4 = \frac{RROI \ x \ 100\%}{TROR}$ RROI = Realization of Regional Original Income TROR = Target of Regional Original Revenue $KKD5 = \frac{RROI \ x \ 100\%}{DGRDP}$ RROI = Realization of Regional Original Income DGRDP = District Gross Regional Domestic Product KKD 6 Growth rate of Regional Income Growth $R = \frac{Pn \ - \ P0 \ X \ 100\%}{P0}$ Information: R = Growth Ratio Pn = Total Regional Revenue for Regency/City calculated in the n^{th} year Po = Total Income of West Sumatra Province calculated in the n^{th} year	Ratio

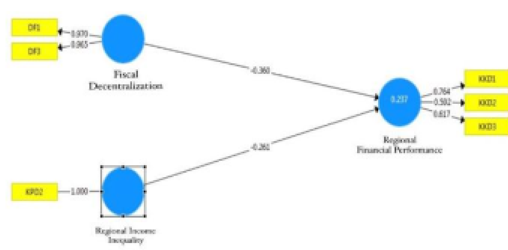
Source: Data Processed, 2022

III. Results

A. The Outer Model Result

The researchers performed a measurement assessment (outer model) to evaluate the validity and reliability of the research instrument. Below is a diagram illustrating the path analysis (PLS algorithm Literacy). The loading factor values for the indicators of each valid and invalid research variable are presented. Any invalid loading factor values will be removed, with a minimum loading factor of 0.50 being the benchmark. Following this, the diagram will be revised and retested multiple times to ensure improvements in the research model.

Figure 2. Outer Model Result



Source: Data Processed, 2022

In this study, the outer model aims to assess the validity of each indicator, as outlined in Figure 2. The study employs three types of validity tests: convergent validity, discriminant validity, and reliability tests. Convergent validity entails a group of indicators representing a single latent variable underlying the latent variable. The study demonstrates that during the initial stage of testing the measurement model, an item with a loading factor of 0.50 to 0.60 is considered satisfactory (Sarwono, 2006). The image above indicates that all indicators for fiscal decentralization, regional income inequality, and detection of fraud in regional financial performance have passed the convergent validity test, as the loading factor value is > 0.50. The discriminant validity parameter displays the cross-loading value, showing that each indicator corresponds to a variable in the measurement model. The results of the discriminant validity test reveal that the cross-loading value for each indicator in the research variables differs from those in other variables, with a loading value > 0.5. Furthermore, a reliability test is conducted using the PLS algorithm iteration. According to Chua (2023), the general rule of thumb indicates that Cronbach's alpha or composite reliability value must exceed 0.5 to meet the reliability test requirement.

B. The Inner Model Result

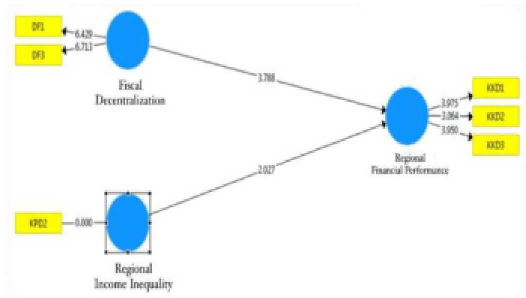
The inner model serves as a tool to estimate the causal relationship among latent variables. Evaluating this inner model examines the R-Square for each latent variable. The structural model (inner model) within this conceptual framework will be determined using the Goodness of Fit Inner Model, which is based on the R2 value of each endogenous variable.

Table 3. R-Square Value of Endogenous Variables

Endogenous Variable	R-square Value
Regional Financial Performance	0.352

According to the data in Table 3, the R-square value for the endogenous latent variable of Regional Financial Performance is 0.352, equivalent to 35.2%. This result indicates that approximately 35.2% of the variability in Regional Financial Performance can be explained by fiscal decentralization and regional income inequality studied in this study. The remaining 64.8% is likely influenced by other factors not included in this study model. Ghozali (2016) explains that a low coefficient of determination suggests limited substantive explanatory power of the independent variables in relation to the dependent variable. Therefore, these findings highlight the necessity of considering other factors that may affect Regional Financial Performance beyond the variables examined in this study.

Figure 3. Inner Model Result



Source: Data Processed, 2022

The results of the SmartPLS test with Bootstrapping, as depicted in Figure 3, provide insights into the impact of fiscal decentralization on Regional Financial Performance. The path coefficient indicates that a one-unit increase in fiscal decentralization results in a 3.788-unit increase in Regional Financial Performance, assuming other variables remain constant. Similarly, the path coefficient for Regional Income Inequality to Regional Financial Performance is 2.027, signifying that a one-unit increase in regional income inequality leads to a 2.027-unit increase in regional financial performance. Bootstrapping is a statistical technique that is valuable for examining the significance or probability of various effects in structural model analysis, including direct effects, indirect effects, and total effects. Additionally, this method can be utilized to assess the significance of model quality measures such as R-square, adjusted R-square, f-square, outer loading, and outer weight.

Table 4. Path Coefficient (Bootstrapping PLS)

	Original Sample	Sample Mean	Std. Deviation	T-Statistics	P-Values
Fiscal decentralization -> Regional Financial Performance	-0,360	-0,373	0,095	3.788	0,000
Regional Income Inequality -> Regional Financial Performance	-0,261	0,259	0,129	2.027	0,043

Source: SmartPLS output, Data Processed by Researchers (2021)

Based on the findings from Table 1, the initial hypothesis (H1) suggests that the variable of Fiscal Decentralization has a positive and significant impact on Regional Financial Performance. This is supported by a T-statistic value of 3.788 ≥ T-Table (1.66) and a P-value of 0.000 (indicating support for the hypotheses). The results imply that a one-unit increase in Fiscal Decentralization leads to a 0.3788 increase in regional financial performance. This suggests that transferring government authority to lower levels will enhance regional financial performance. These findings align with the conclusions of Muryawan & Sukarsa (2016), who also found that fiscal decentralization leads to improved regional financial performance. By providing local governments greater financial autonomy, they are compelled to seek independent sources of financing for regional governance. Furthermore, as Hendri (2020) highlighted, managing finances through regional expenditures can enhance regional economic performance across various indicators such as poverty reduction, employment, Per Capita Gross Capital Formation, and regional GDP per capita. Additionally, as noted by Christy et al (2019), regional autonomy is largely free from interference by the Central Government, allowing regional governments to generate their revenues effectively.

Policies designed to address income inequality in West Sumatra aim not only to enhance regional inequality but also to foster balanced regional development according to each area's potential. One of the primary focuses is creating new job opportunities as part of these efforts. The success of these policies can be observed through concrete measures of regional development achievements

Based on the results presented in Table 1, the second hypothesis (H2) posits that the variable of Regional Income Inequality has a significant positive impact on Regional Financial Performance. This is supported by a T-statistic value of 2.027, which surpasses the critical T-Table value of 1.66, and a p-value of 0.043, falling below the significance level of 0.05. These findings provide evidence in favor of the hypothesis. The results indicate that efficient allocation of resources within the community can lead to a more balanced income distribution among households in the region, thereby enhancing regional financial performance. Developing specific policies tailored to each area to address income inequality is imperative. Furthermore, directing regional funds and equity investments to individual districts or cities can improve regional financial performance. (Dharmayanti, 2021) have also stressed the importance of effectively managing diverse regional potentials to reduce inequality. The presence of a development plan aimed at fostering economic growth signifies the potential to enhance regional financial performance through strategic regional development planning.

IV. DISCUSSION

The effective management of finances in regional governments, including the handling of regional income and expenditure, is crucial for ensuring successful decentralization and autonomy for regional authorities. As highlighted by (Leki et al., 2018), the allocation of funds from the central government to regional administrations plays a crucial role in providing the necessary financial resources for these regions to manage their finances independently. This autonomy enables regional governments to efficiently utilize local resources, ultimately contributing to improved economic conditions, lower unemployment rates, reduced poverty levels, and greater income equality within the region. Furthermore, the research conducted by Leki et al (2018) and Thaha et al (2021) underscores the importance of addressing income inequality to enhance the financial performance of regional governments by increasing local original income.

Fiscal decentralization can increase efficiency, reduce regional disparities, and accelerate economic growth, thereby reducing poverty This is because local governments can increase local revenue (PAD) (Manduapessy, 2020). This research study provides an in-depth analysis of how fiscal decentralization and regional income inequality impact the financial performance of the West Sumatra region (Marya et al., 2024). The lack of specific legislation governing fiscal decentralization has led to exploring its influence on the control and management of regional resources and its overall effect on financial performance. The effective management of regional financial resources is vital, and fiscal decentralization has the potential to increase government revenues while reducing regional income inequality. The West Sumatra Provincial Central Statistics Agency (2024) data indicates consistent growth in the region's gross domestic product from 2021 to 2023. Specifically, Payakumbuh has achieved the highest average economic growth at 3.99 percent, followed by Bukittinggi and Padang at 3.96 percent each. However, areas such as Padang Pariaman and South Solok have experienced slower economic growth, attributed to disparities in income distribution and resource allocation.

V. CONCLUSIONS

After conducting a thorough analysis and engaging in extensive discussions, we have determined that fiscal decentralization has a notably positive and substantial influence on the financial performance of the regions within West Sumatra Province. This is due to the substantial contribution of regional revenues from the balanced fund, which currently surpasses the original regional revenues. As a result, local governments must be able to independently manage their regional finances, leading to the need to explore alternative financial sources for funding various regional government initiatives.

Moreover, the substantial and positive impact of regional income inequality on regional financial performance can be attributed to various factors, including the influence of regional revenue sources on income inequality. This situation is expected to foster innovation and creativity within each region, ultimately leading to effective financial management and the exploration of more efficient revenue sources.

To enhance transparency and accountability in local financial management, effective management of regional financial performance plays a crucial role. This can be achieved through the implementation of strong accountability principles in local financial management and by enhancing transparency in all aspects of regional administration.

Recommendations

Local governments must prioritize enhancing Regional Original Revenue (PAD) through promoting entrepreneurial initiatives. This approach will contribute to the development of human resources, strengthen financial performance, and promote societal welfare, ultimately leading to an improved overall standard of living. To tackle income inequality, local governments should foster inclusive economic growth by actively involving all segments of society in the development process and reinforcing social institutions. This collective effort will help create a more balanced and equitable economic landscape for all community members. To address income inequality, the local government of West Sumatra should improve its public services, increase employment, and provide opportunities for labor to practice skills. In addition, they should use taxes and government spending to reduce current and future inequality.

Limitations

The study has several limitations. Specifically, the ability to measure fiscal decentralization variables and regional income inequality about the financial performance of local governments is restricted within public sector accounting research, particularly when using secondary data. This study's findings only apply to district and city governments in West Sumatra from 2018 to 2020. Future researchers are encouraged to use samples from other districts and cities to adapt the research model to fit the context of the phenomenon and research issues and to develop proxies for measuring fiscal decentralization and regional income inequality in regional financial performance.

This will contribute to expanding public sector accounting research literature, specifically when use the secondary data. The study results offer a relatively imprecise analysis, with the coefficient of determination from hypothesis testing still relatively low, at 35.2%. Therefore, it is crucial to explore alternative empirical research models and more sophisticated analytical methods to generate research analysis results that are more accurate and aligned with expectations.

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Disclosure statement

The authors report that there are no competing interests to declare.

Final approval and accountability

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All authors have rigorously reviewed and approved the final version of the manuscript and have agreed to uphold accountability for the accuracy and integrity of the work, thereby meeting the authorship criteria.

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Data availability statement

The data that support the findings of this study are available from the corresponding author, Eva Herianti, upon reasonable request

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