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FACTORS AFFECTING THE FISCAL INDEPENDENCE OF DISTRICT CITY IN EAST JAVA

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Abstract

The fiscal independence can be understood as the allocation of the right to decide the amount and structure of the revenues and expenditures, the planning and also the execution of budgets. Furthermore, the ratio of local own revenue to total regional revenue not only reflects the financial condition but also a measure of independence, the ability to meet own needs, the ability to invest and also reflect the potency of economy. This study aims to analyze the effect of capital expenditure, investment, household consumption, and labor toward economic growth and to analyze the effect of economic growth towards the fiscal independence. This research used panel data which used the unit of analysis the districts and cities in East Java Province in the period of 2010 to 2014. This research used Simultaneous Equation Analysis Model with Two Stage Least Square (2SLS) method. The empirical results revealed that partially capital expenditure has a negative effect towards economic growth, investment and household consumption have a positive and significant effect toward economic growth, while labor insignificantly affect towards economic growth. Meanwhile simultaneously, capital expenditure, investment, household consumption, and labor have a positive and significant effect towards economic growth. Furthermore, the empirical results revealed that economic growth has a positive and significant effect towards the fiscal independence.

Keywords*: fiscal independence, economic growth, capital expenditure, investment, household consumption, labor.*

1. INTRODUCTION

Implementation of regional autonomy in Indonesia was starting effectively on January 1, 2000. It is marked by the enactment of Law No. 22 /1999 on Local Governance and the Law No. 25/1999 on Equalizing Fund beetwen Central and Local Governments, which then both Laws were updated to the Law No.32/2004 (it was updated to the Law No. 23/2014), and the Law No.33/2004. Through implementation of the Laws, its implies that Indonesia becomes one of the countries that implement the decentralization system after implement the centralization system for long time previously, which is marked by a shift in the role of central government that emphasize in improving regional independence (Fahman, 2011). Essentially, regional autonomy is a delegation of authorities by the central government to the local government, which also accompanied by the delivery of funding sources (money follow function). The central government seeks to encourage local government to enhance the fiscal independedce through strengthening the fiscal capacity. Ahmad (2011) in his research argues that through the enactment of regional autonomy is expected to reduce the dependence of local governments on the central government where local governments are expected to be more independent in managing local finances, and also be able to finance regional development in accordance with the financial capabilities sourced from its own potential.

Darumurti and Rauta (2000) in Fahman (2011) states that through delegation of authority, right, and obligation to the autonomous regions, hence the distict/city has a greater role in providing a better public service, so that it requires a serious readiness, both in aspect of financial resources, human resources, facilities and infrastructures. This is in line with the study conducted by Akyuwen (2013) that the availability of sufficient resources, especially in humans and budgetary resources is needed along with the greater role of local government after implementation of regional autonomy, mainly in order to improve the regional development and the welfare of society. Its implies that the regional independence, especially in regional financial, should be pursued by local government in order to improve the quality of public services and the public welfare. Study by Gluminska and Pawlic (2003) in Nowak and Ulfik (2013) states that the fiscal independence can be understood as the allocation of the right to decide the amount and structure of the revenues and expenditures, the planning and also the execution of budgets. Furthermore, the ratio of local own revenue to total regional revenue not only reflects the financial condition but also a measure of independence, the ability to meet own needs, the ability to invest and also reflect the potency of economy.

However, implementation of regional autonomy in Indonesia that almost two decades, most of regions still have low fiscal independence. This fact as shown from the regional revenue composition of regions in Indonesia which is dominated by the transfer revenue, whereas Original Local Government Revenue (PAD) still have low contribution to the total regional revenue (TPD). In the report of the Budget for Regional Income and Expenditure (APBD) of the Directorate General of Fiscal Balance (DJPK) in the period of 2010-2014, it was noted that the ratio of PAD to TPD in all districts / cities in Indonesia is still low at an average of 9.92%, while the ratio of the Transfer Revenue to TPD is so high at an average of 72.91%. In context of East Java Province, most of regions also still have low fiscal independence. In the APBD's report for the period of 2010-2014, it was noted that the ratio of PAD to TPD in all districts / cities in East Java is still low at an average of 11.48%, while the ratio of the Transfer Revenue to TPD is so high at an average of 81.59%. This fact shows that local governments are faced the problem of low local financial capacity to finance governmental affairs and regional development. Ridwan (2002) in his study which analyze the fiscal independence in the District of Gunung Kidul states that the implementation of regional autonomy that emphasize to district/city, then the problem that can arise later is how far the local government is able to build the basic aspects of the purpose of regional autonomy mainly in order to improve the financial capacity of the region. The PAD that should be expected to contribute substantially in regional financing, but in the fact its contribution is still low compared with the contribution of the transfer revenue.

Ahmad (2011) argues that through delegation of authorities, then the region is required to be more independence in fiscal, and each region is expected to enhance the economic growth which is can increase the fiscal capacity. Karamoy and Poputra (2014) in his study states that the ability of local government to increase PAD can be influenced by the regional economic conditions which cover the scale and growth. Adi (2012) also states that in order to improve the local financial capacity (PAD), then local government should encourage the regional economic growth. This supports the study by Saragih (2003:55-58) in Ardani and Suryaningrum (2011) that regions with a positive economic growth have the possibility to increase PAD or can be said that the increase in PAD is an excess of economic growth. Study by Nurany *et al.*, (2013) shows that the economic growth has a positive and significant effect on the fiscal independence in the cities of West Java. This is in line with study conducted by Risalam (2013) that the economic growth has a positive and significant effect on the fiscal independence in the district/city of Central Java. Triyanto (2015) in his research argues that local government can conduct public policy with the priority to increase economic growth that namely through allocation of budget to expenditures that are productive or investment. Furthermore, government expenditure in the form of capital expenditure is an investment expenditure that has a high multiplier effect to increase economic growth. In Keynes's theory states that in the short run the increase in government spending will increase the income or output of goods and services in larger quantities through aggregate demand (Mankiw, 2007). Meanwhile, in neoclassical theory states that capital accumulation is one of the factors that can increase economic growth (Sun'an, 2015:23-24). In this case the government expenditure in the form of capital expenditure can increase the accumulation of public capital that can increase the productivity of private sector and stimulate new investments. The previous study by Triyanto (2015) conclude that capital expenditure has a positive and significant effect on economic growth in district/city of East Java Province. Then Putri (2014) in her journal entitled The Effect of Investment, Labor, Capital Expenditure, and Infrastructure towards Economic Growth in Java Island conclude that capital expenditure has a positive and significant effect on economic growth. Consistent with the study of Tirtosoeharto (2009) that conclude the capital expenditure has a positive relationship with regional economic growth in Indonesia's 26 state government. Moreover, study by Sevitenyi (2012) connclude that the capital expenditure has a positive and significant effect on economic growth in Negeria. Furthermore, Alshahrani & Alsadiq (2014) that analyze the effect of the types of government spending on economic growth, conclude that capital expenditure stimulates economic growth in the long run in Saudi Arabia. On the contrary, the previous study was conducted by Panggabean (2014) conclude that capital expenditure has a negative effect on economic growth in the district/city of West Kalimantan Province.

The allocation of capital expenditure in most regions in Indonesia is still in low proportion and lower than the allocation of personnel expenditure. Based on the APBD's report in 2014, it was noted that overall, the public spending of all districts/cities in Indonesia up to Rp523.426 trillion with proportion of capital expenditure up to Rp114.091 trillion or 21.8%, lower than the allocation of personnel expenditure that up to Rp268,212 trillion or 51.2%. Similarly, the allocation of capital expenditure of all districts / cities in East Java is also still in the smaller proportion that is 23.6%, lower than the proportion of personnel expenditure that up to 53.7%.

Moreover, investment is one of the pillars of regional economic growth. Investment is an important factor for the sustainability of economic development or long-term economic growth (Tambunan, 2001 in Ladjin, 2008). Harrod-Domar gives a key role to investment in the process of economic growth, especially regarding the dual nature of investment: (1) investment creates revenue which is the impact of the demand of investment, and (2) investment increases the capacity of the economy by increasing stock capital which is the impact of the supply of investment (Arsyad,2010:82-85). Based on Central Bureau of Statistic's report of East Java Province, it was noted that realization of investment in all districts / cities of East Java as measured from Gross Fixed Capital Formation (PMTB) was increased in the period of 2010-2014, from Rp272 trillion to Rp344 trillion. Mariana *et al*., (2014) in their research states that the increase of investment growth indicates an increase of capital formation, which is increase the production of goods and services in economy, hence it will increase the economic growth. The previous study conducted by Wang *et al.* (2016) in their journal entitled The Research on the Relationship of Domestic Investment, Government Consumption, Household Consumption and Economic Growth -an Empirical Study of Fujian Province conclude that domestic investment is of relatively obvious promotion economic growth in short term, and of certain negative effect on economic growth in a long term. Moreover, Ramli and Andriani (2013) under the title The Effects of Consumption, Private Investment, and Government Expenditures on Economic Growth in South Sulawesi, Indonesia conclude that the private investment has a positive and significant effect on economic growth. Furthermore, Karim *et al*., (2010) in their journal entitled Fixed Investment, Household Consumption, and Economic Growth: a Structural Vector Error Correction Model (SVECM) Study of Malaysia revealed that fixed investment is only significantly influenced output growth in the short run. But the differ empirical result study has shown by Panggabean (2014) that the private investment insignificant affect economic growth in the district/city of West Kalimantan Province. Putri (2014) in her study also conclude that investment has a positive and significant effect on economic growth in Java Island.

Household consumption is also one of factors that can affect the level of output in the region. In the Keynesian macroeconomic model states that household consumption plays an important role in encouraging economic growth by affecting aggregate demand (Karim *et al*., 2010). Based on Central Bureau of Statistic's report of East Java Province, it was noted that the realization of the household's consumption in all districts/cities of East Java as measured from per capita expenditure was increased from Rp188 trillion to Rp306 trillion in the period of 2010-2014. According to Nurhuda (2013) the increase of consumption indicates an increase in demand of goods and services, which is encourage the economy to increase the production of goods and services, hence it will increase regional economic growth. Study by Wang *et al.* (2016) conclude that household consumption household consumption is of relatively strong positive impact effect on economic gain, which is served as major impetus of economic growth in Fujian Province. Consistent with the study of Ramli and Andriani (2013) that conclude the household consumption has a positive and significant effect on economic growth in South Sulawesi. Meanwhile, Karim *et al*., (2010) in their study revealed that the household consumption is only significantly influenced output growth in the short run in Malaysia.

Labor is also one of factors that can affect the level of output in the region. In Neo classical theory states that economic growth depends on the supply of factors of production such as population and labor (Sun'an, 2015: 23-24). Based on Central Bureau of Statistic's report of East Java Province, it was noted that the total labor force in all districts / cities of East Java tends to increase from 19.5 million people to 20.4 million people in the period of 2010-2013, but in 2014 the number of labor force drops to 20.1 million people from the previous period. The Labor Force is an economically active population that is divided into two main activities, that namely work and unemployment. The amount of working people was increased from 18.7 million to 19.5 million in the period of 2010-2013, but in 2014 the amount of working people was dropped to 19.3 million. Meanwhile, the amount of open unemployment was declined from 828 thousand people to 819 thousand people in the period of 2010-2012, but in 2013 the amount of open unemployment was increased drastically to 878 thousand people, and then it was dropped again to 843 thousand people in 2014. Todaro (2000) argues that the large population which accompanied by a high level of education and good skills will be able to encourage the rate of economic growth, because the large population of productive age will be able to increase the number of available labor force, hence it will be able to increase production of output in the region. According to Sukirno (2008) the increase of labor that offset by the increase in output that produced, it will be able to encourage regional economic growth. Furthermore, the increase of labor will allow of the region to increase the production of goods and services that needed by the community. Study by Putri (2014) conclude that labor has a positive and significant effect on economic growth in Java Island. Then Barimbing and Karmini (2015) in their study also revealed that labor has a positive and significant effect on economic growth in Bali Province. Consistent with the study of Rustianto (2008) that conclude labor force has a positive and significant effect on economic growth in Central Java Province, Indonesia.

Based on the background above, this study aims to analyze the effect of capital expenditure, investment, household consumption, and labor toward economic growth and to analyze the effect of economic growth towards the fiscal Independence of district / city in East Java.

2. RESEARCH METHODS

This study used a quantitative approach, which is focuses on testing the hypothesis. This research used panel data with used unit analysis the district/city in East Java Province in the period of 2010-2014 (5years). This study analyzes the effect of capital expenditure, investment, household consumption, and labor toward economic growth and to analyze the effect of economic growth towards the fiscal Independence of district/city in East Java. For the purposes of this analysis, the determination of variables is based on the previous studies and theory of regional autonomy, fiscal independence, theory of Keynes, growth theory (neoclassic, Harrord-Domar), and theory of government spending.

This research used econometrics analysis that namely Simultaneous Equation Model with Two-Stage Least Squares - 2SLS method, because the variables studied are related to each other. Therefore, the use of independent variable names and dependent variables in the system of simultaneous equations is no longer appropriate for the next variable in the simultaneous equation termed with endogenous variables, exogenous variables, and pre-determined variables. The pre-determined variables can be exogenous, exogenous, past, and endogenous in the past (Lains, 2006). The general form the model used are as follows:

$$PEit = \alpha_0 + \alpha_1 BMit + \alpha_2 INVit + \alpha_3 CONSit + \alpha_4 TK\ it + \mu_1 it \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots (2.1)$$

$$KFit = \beta_0 + \beta 1\hat{}PEit + \mu_2 it \ldots\ldots\ldots\ldots\ldots\ldots .(2.2)$$

Which:

PEit = economics Growth of Districts/Cities (i) in East Java in year (t)

^PEit = Economics Growth Estimation of Districts/Cities (i) in East Java in year (t)
BMit =Capital Expenditure of Districts/Cities (i) in East Java in year (t)
INVit = Investment of Districts/Cities (i) in East Java in year (t)
CONSit = Household Consumption of Districts/Cities (i) in East Java in year (t)
TK it = Labor Force of Districts/Cities (i) in East Java in year (t)
KFit = Fiscal Independence of Districts/Cities (i) in East Java in year (t)

The first step before analyzes, that is identification process of the simultaneous equation with the identification method, that namely order condition and rank condition, where both of method can determine quickly whether a simultaneous equation can be estimated or not (Widajarno, 2007). These two methods will deliver the same final conclusion. The method of identification "order condition" is easier to use and more understood than "rank condition", hence this research used "order condition" as identification method. There are three possibilities for simultaneous equation models: unidentified, just identified, and overidentified (Nachrowi, 2006):

1. Unidentified if the pre-determined variable does not appear in the equation (K-k) less than (<) the number of endogenous variables (m) contained in the equation minus 1. or K-k <m-1.
2. Just identified or exactly identified if the pre-determined variable does not appear on the equation (K-k) exactly (=) as much as the number of endogenous variables (m) contained in the equation minus 1. or K-k = m-1.
3. Overidentified if the pre-determined variable does not appear in the equation (K-k) more than (>) the number of endogenous variables (m) contained in the equation minus 1. or K-k> m-1.

which:
m = Number of endogenous variables in a given equation in the model
K = Number of pre-determined variables in model including intercept
k = The number of pre-determined variables in a given equation in the model

Based on the provisions of the identification rules, in equation (2.1) can be seen that m = 1 and K = 7, while k = 4, thus K-k > m-1 then 7-4 > 1-1 is obtained 3 > 0, so the equation is overidentified. While in equation (2.2) can be seen that m = 0 and K = 7, while k = 1 thus K-k> m-1 then 7-1> 0-1 is obtained 6 > (- 1) so the equation is overidentified. Because the structural equations is overidentified, therefore the Two Stage Least Square (2SLS) method is used to get the right of simultaneous equation parameter value.

3. RESULTS AND DISCUSSION

The empirical results of estimation the effect of Capital Expenditure, Investment, Household Consumption, Labor toward Economic Growth as shown in Table 3.1. and Table 3.2.

Table 3.1. Capital Expenditure, Investment, Household Consumption, Labor Estimation Results toward Economic Growth in The District / City of East Java in the period of 2010-2014

Variable	Coefficient	t-statistic	Prob
Const	-0.009226	-0.25439	0.7995
BM	-0.003736	-2.14665	0.0332
INV	0.002310	2.06684	0.0403
CONS	0.006067	1.88012	0.0618
TK	0.000355	0.19644	0.8445
R-squared			0.092479
F-statistic			4.33088
Prob (F-statistic)			0.00231

Source: EViews 7 (Data Processing)

Based on the empirical result of the first simultaneous equation, we can compile the following equation:

$$PE_{it}=-0{,}009226-0.003736LNBM_{it}+00.002310LNINV_{it}+0.006067LNCONS_{it}+0.000355LNTK_{it}+\mu_1 it$$

From the first equation can explained that:

1. Capital expenditure has a negative effect towards economic growth. A one percent increase in a capital expenditure is associated with a 0,003736 percent an

decline of economic growth, ceteris paribus.

2. Investment has a positive and significant effect towards economic growth at 5 percent level. A one percent increase in an investment is associated with a 0.002310 percent an increase of economic growth, ceteris paribus.
3. Household consumption has a positive and significant effect towards economic growth at 10 percent level. A one percent increase in an investment is associated with a 0.006067 percent an increase of economic growth, ceteris paribus.
4. Labor has an insignificant effect towards economic growth as shown by the probability value of 0.5026 which is greater than the alpha of 5 percent.
5. Based on the simultaneous test results, it can be seen that the variables of capital expenditure, investment, household consumption and labor have a positive and significant effect toward economic growth. This means that an increase in capital expenditure, investment, household consumption, and labor will lead to an increase in economic growth, and vice versa if the variables are declining then the value of the variable of economic growth will decrease significantly.

Table 3.2. Economic Growth Estimation Results towards The Fiscal Independence in The District/City of East Java in The Period of 2010-2014.

Variable	Coefficient	t-stat	Prob
Constanta	-1.1401	-9.90529	0.0000
PE	20.7398	10.9402	0.0000
R-squared			0.4089
F-statistic			119.68
Prob (F-statistic)			0.0000

Source: EViews 7 (Data Processing)

Based on the result of the second simultaneous equation, we can compile the following equation:

$$KF_{it} = -1.140130 + 20.73998\hat{}PE_{it} + \mu_2 it$$

From the equation can explained that the variable of economic growth that has been influenced by capital expenditure, investment, household consumption and labor have a positive and significant effect towards the fiscal independence. A one percent increase in economic growth is associated with 20.73998 percent an increase of fiscal independence.

Effect of Capital Expenditure towards Economic Growth

In Keynes's theory states that in the short run the increase in government spending will increase the income or output of goods and services in larger quantities through aggregate demand (Mankiw,2007). Meanwhile, in neoclassical theory states that capital accumulation is one of the factors that can increase economic growth (Sun'an, 2015:23-24). The government expenditure in the form of capital expenditure is an investment expenditure that has a high multiplier effect to increase economic growth. This study found that capital expenditure has a negative effect towards economic growth of districts / cities in East Java. This means that the government expenditure in the form of capital expenditures causes a decline or slowdown in economic growth. The cause is inefficient and ineffective in utilizing and managing the budget, so it is possible that capital expenditures are allocated for less productive activities, and consequently it causes the decline in economic growth. According to Deravajan (1996) in Tirtosuharto (2009) revealed that an important element in evaluating the relation between public capital and economic growth is to identify certain types of capital investments that are productive and have a positive effect on economic growth.

Triyanto (2015) in his research pointed out that capital expenditure divides into two categories that namely productive capital expenditure and unproductive capital expenditure, and his finding concluded that less productive capital expenditure has low impact on economic growth compared to productive capital expenditure. The implication of this finding is, when the capital expenditure in greater amount is allocated for nonproductive activities, consequently it will has low impact on economic growth, and even it may cause a decline in economic growth. Sjafii (2009) argues that the effect of public spending on economic growth depends on the types of expenditure, where government spending on investment and other productive activities can positively affect economic growth.

This finding contrast to the previous studies were conducted by Triyanto (2015), Putri (2014), Tirtosuharto (2009), Sevitenyi (2012), and Alshahrani & Alsadiq (2014) which conclude that capital expenditure has a positive and significant effect on economic growth. Meanwhile, the similar result as shown by Panggabean (2014) conclude that local government capital expenditures negatively effect on economic growth of district / city in West Kalimantan Province. Furthermore explained, this condition can be caused by the utilizing and managing of capital expenditures that are allocated for less productive activities, allocation of capital expenditures that relatively small, limited of availability in basic infrastructure, indications of budget leakage and inefficient in planning and implementation of local government programs. Meanwhile, the study of Chen and Lee (2005) in Anasmen (2009) revealed that in Taiwan the excessive government expenditure did not encourage economic growth but hampered economic growth due to the crowding out effect or increased taxes. In addition, Ram (76:191-203) in Anasmen (2009) revealed that theoretically government spending in great amount tends to reduce economic growth. Furthermore, explained that this is due to: (1) the inefficiency of government activities; (2) regulatory processes that impose excessive burdens and costs on the economy system; (3) the fiscal and monetary policies tend to distort economy incentives and lower productivity of the system. This is in line with study conducted by Munnel (1992) in Tirtosuharto (2009) revealed that the potential negative impact from increased public expenditure is lower aggregate investment and consumption in the private sector. Furthermore, explained that this condition is typically referred to as “crowding-out”, where public capital acts as a substitute to private capital and in doing so hinders incentives for the private sector to invest. Ultimately, the increase in public expenditure may come at the cost of higher taxes to finance public investments.

Effect of Investment towards Economic Growth

Investment is an important factor for the sustainability of economic development or long-term economic growth (Tambunan, 2001 in Ladjin, 2008). This study found that investment has a positive and significant effect towards economic growth of districts / cities in East Java. This means that the increase of investments has a positive effect on the increase of economic growth. The increase of investment indicates an increase in capital formation, furthermore an increase in capital formation will increase the production of goods and services, hence it will increase the economic growth. This finding is consistent to the previous studies of Mariana *et al.*, (2014), Wang *et al.* (2016), Karim *et al.* (2010), Rustianto (2008), Ramli and Andriani (2013), Putri (2014), which conclude that the investment has a positive and significant effect on economic growth.

Moreover, this finding supports to Harrod-Domar's theory which gives a key role to investment in the process of economic growth, especially concerning the dual nature of investment: (1) investment creates income which is the impact of the demand of investment, and (2) investment increases capacity the production of the economy by increasing the capital stock which is the impact of the supply of investment (Arsyad, 2010: 82-85). The finding of this study is also supports to neoclassical theory which states that the capital stock or investment is one of the factors that will affect economic growth (Sun'an, 2015: 23-24).

Effect of Household Consumption towards Economic Growth

In the Keynes theory states that in the short run household consumption expenditure plays an important role in driving economic growth by affecting aggregate demand (Karim *et al.*, 2010). This study found that household consumption has a positive and significant effect towards economic growth of district/city in East Java. This means that the increase of household consumption expenditure has a positive effect on the increase of economic growth of districts/cities in East Java. In Keynes’s theory states that household consumption is influenced by the income (Bekhet, 2011; Soediyono, 2000 in Ramli and Andrani, 2013). This means that the increase of household consumption expenditure due to the increase of income, and then the increase of income will increase the ability to pay or the purchasing power of goods and services. Furthermore, the increase of demand for goods and services, will increase the amount of goods and services that produced in the economy, which in turn can encourage the economic growth of districts / cities in East Java. This is in line with the study by Nurhuda (2013) that the increase in consumption indicates an increase in demand for goods and services, and it will encourage the economy to increase the production of goods and services, which in turn it will increase regional economic growth. This finding is consistent to the previous studies of Wang *et al*. (2016), Karim *et al*. (2010), Ramli and Andriani (2013) which conclude that household consumption has a positive and significant effect on economic growth. This finding is also support to the multiplier theory which states that consumption can encourage the growth of Gross Domestic Product through the use of unused production capacity to increase production in order to meet the increase of consumption (Husen, 2011).

Effect of Labor towards Economic Growth

The increase of labor that accompanied by the increase in output, it will be able can encourage regional economic growth (Sukirno, 2008). This study found that labor has no significant effect towards economic growth. In the neoclassical theory states that labor is one of factor that can affect economic growth (Sun'an, 2015: 23-24). Theoretically this condition is not appropriate. This condition due to the problem of unemployment in district / city of East Java. Conceptually, the labor force is divided into two main activities that namely work and unemployment. Central Bureau of Statistic of East Java Province noted that the amount of unemployment all districts / cities in East Java tends to fluctuate, where in 2010 the amount of unemployment up to 828 thousand then in 2012 drop to 819 thousand. In 2013 the amount of unemployment increased drastically, up to 878 thousand people, and then drop again to 843 thousand people in 2014. From these facts, overall, the rate of unemployment is so high, therefore local governments must increase the allocation of the budgets that expected can reduce the unemployment. Consequently, the budget that allocated to improve public services is reduced, and therefore it will allow has low impact on economic growth.

Besides of the rate of unemployment, then the low quality of labors can influence the rate of economic growth. Central Bureau of Statistics of East Java Province noted that most of the labors that absorbed in all sectors of economy (more than 50%) have low level of education (elementary school graduate). The level of education reflects the productivity of labor. Its implies when most of the labor that absorbed have low level of education, then the productivity of labors is also low. Todaro (2000) states that large amounts of population which accompanied by high levels of education and good skills will be able to encourage economic growth, because the large population of productive age will increase the amount of available labor force and it will be able can increase the production of output in the region. Thi finding contrast to Mariana *et al*., (2014), Putri (2014), Rustianto (2008), Barimbing and Karmini (2015) which conclude that labor has a positive and significant effect on economic growth.

Effects of Economic Growth towards The Fiscal Independence

The fiscal independence can be understood as the allocation of the right to decide the amount and structure of the revenues and expenditures, the planning and also the execution of budgets. Furthermore, the ratio of local own revenue to total regional revenue not only reflects the financial condition but also a measure of independence, the ability to meet own needs, the ability to invest and also reflect the potency of economy (Gluminska and Pawlic ,2003 in Nowak and Ulfik, 2013). This study found that the economic growth has a positive and significant effect towards the fiscal independence of districts / cities in East Java. This means that, an increase in economic growth can encourage an increase in Original Local Government Revenue (PAD) in the form of local taxes and local fees, so that it will increases the fiscal independence of the districts/cities in East Java. This finding is consistent to previous studies of Nurainy (2013), Risalam (2013), Imawan dan Wahyudin (2014), Anwar *et al*.,(2012) which conclude that the economic growth has a positive and significant effect on the fiscal independence. This finding is also support to the theory of Peacock and Wiseman which states that in under normal condition, an increase in GNP (Gross National Product) led to greater government revenue (Mangkoesoebroto, 2013). Moreover, this finding is also consistent with the study of Saragih (2003:55-58) in Ardani and Suryaningrum (2011) which states that the regions that have a positive economic growth will have the possibility to increase PAD or can be said that the increase of PAD is an excess of economic growth. Thereby, in order to improve regional fiscal independence is through the path of economic growth. In this case the local governments can conduct public policies that can encourage economic growth which in turn can increase the fiscal independence.

4. CONCLUSSIONS AND POLICY IMPLICATIONS

4.1. Conclusions

This study aims to analyze the effect of capital expenditure, investment, household consumption, labor toward economic growth, and to analyze the effect of economic growth towards the fiscal independence in the district/city of East Java. The enhancement of capital expenditure in the fact causes a decline in economic growth of districts / cities of East Java, because the utilizing and managing the budget is ineffective and inefficient, which is has possibility that the budget for capital expenditure is allocated for less productive activities, and consequently can causes the decline in economic growth. Furthermore, the enhancement of investment indicates an increase in capital formation, then the increment in capital formation can increase the production of goods and services that produced in economy; hence it will increase the economic growth. Moreover, the enhancement of household consumption due to the increment on income per capita, which is reflected on the increase of purchasing power for the demand of goods and services, and consequently it will increase the amount of goods and services that produced in the economy; hence it will increase the economic growth. Meanwhile, the problem of unemployment enforces to each local government to allocate more budget that expected can reduce the unemployment. Consequently, the number of budgets that should be used for improving public services is reduced, and then it will allow has low impact on economic growth**.** In addition, the low quality of labors, causes the low productivity of labors which is reflected on the lower income that received by labor, consequently the ability to pay or purchasing power for goods and services become smaller, hence it will allow has low impact on economic growth. Furthermore, the increment on economic growth increases the regional revenue in the form of local taxes and local levies, hence it will encourage the increase of the Original Local Government Revenue (PAD). The increase of PAD encourages the increase the fiscal independence of district / city of East Java.

4.2 Policy Implications

In order to improve the fiscal independence in districts / cities of East Java Province, hence the local government can conduct the public policy with priority to increase the regional economic growth. The local government should improve the allocation of capital expenditure for productive activities, so that it will allow has more positive impact on regional economic growth. Furthermore, the local government can conduct the public policy that can stimulate the investment, that namely through creation of good atmosphere for investment by maintaining the stability of economic, politics and defense, simplifying the bureaucracy of permits for investment, increasing the regional development through improvement the provision of basic infrastructures. Moreover, the local government should increase the income per capita of society, through enhancement of the employment in the region such as improving labor-intensive government's projects that empowering a lot of labors and it will reduce the amount of unemployment. The local government should increase the quality of human resources through increase the allocation of public spending on education that can improve the quality of the labors. Moreover, the local government should can conduct the policy that can improve the skills of labors through creation the Certified Workplace Training, which can absorb many labors in the formal sector.

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