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POLITICAL ECONOMY OF REGIONAL POLICY: THE IMPACT OF INDUSTRIAL AGGLOMERATION, PROVINCIAL MINIMUM WAGE, AND LABOR FORCE ON LOCAL GENUINCE REVENUE (SOUTHERN SUMATRA REGION)

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ABSTRACT

Political economy framework, arguing that regional revenue outcomes are not merely the product of impersonal market forces but are shaped by policy choices particularly minimum wage setting that reflect the bargaining power of labor, capital, and local government interestsThis study analyzes the effect of industrial agglomeration (IBS), the Provincial Minimum Wage (UMP), and labor force size (JAK) on regional fiscal capacity, as proxied by Local Own-Source Revenue (PAD), in five provinces of the South Sumatra Region (Sumbagsel)—South Sumatra, Lampung, Jambi, Bangka Belitung Islands, and Bengkulu—over the period 2018–2024. Based on model specification tests (the Chow Test and the Hausman Test), the Fixed Effect Model (FEM) was selected as the best estimator, supported by the highest Adjusted R^2 (0.9671) among the three panel data models. The FEM estimation results indicate that industrial agglomeration and labor force size have a positive and significant effect on PAD, whereas UMP shows no significant effect once inter-regional heterogeneity is controlled for. The most notable finding is the reversal of the IBS coefficient's sign, from negative under the Common Effect Model to positive and significant under FEM, indicating that the CEM specification suffered from omitted variable bias by disregarding region-specific characteristics such as resource endowment, infrastructure readiness, and licensing governance. These findings suggest that provincial governments should accelerate downstream industrial processing and the development of integrated industrial zones to strengthen regional fiscal self-reliance, while continuing to support labor absorption as a consistently positive revenue driver.

Introduction

Fiscal decentralization has been a defining feature of Indonesia's regional governance since the enactment of Law No. 22/1999 and its successors, granting subnational governments greater authority over public expenditure while simultaneously demanding stronger local revenue mobilization. Within this framework, Local Genuine Revenue commonly referred to as *Pendapatan Asli Daerah* (PAD) has become the principal indicator of a region's fiscal independence and its capacity to finance development without excessive reliance on central government transfers (Mahi and Supriyanti 2019). Yet PAD performance varies substantially across Indonesian provinces, raising the question of which structural and policy-driven factors explain this disparity.

This study situates that question within a political economy framework, arguing that regional revenue outcomes are not merely the product of impersonal market forces but are shaped by policy choices particularly minimum wage setting that reflect the bargaining power of labor, capital, and local government interests(Kallert et al. 2021). Three variables anchor the analysis: industrial agglomeration, the provincial minimum wage, and the size of the labor force.

Industrial agglomeration, rooted in Marshallian externalities and new economic geography theory, is conventionally expected to expand the local tax base by concentrating economic activity, employment, and investment within a region (Zhao et al. 2025). The provincial minimum wage, meanwhile, operates as a politically contested instrument: while intended to protect worker welfare, it simultaneously influences firms' location decisions, formalization incentives, and labor costs, with downstream effects on the revenue a region can extract from economic activity. The labor force its size and utilization represents the productive capacity available to convert agglomeration and wage policy into actual output and, ultimately, taxable economic activity (Li et al. 2023).

Regional autonomy and fiscal decentralization require local governments to promote financial self-reliance by optimizing Local Own-Source Revenue (PAD) Liu et al. (2026). The South Sumatra Region (Sumbagsel) which encompasses the provinces of South Sumatra, Lampung, Jambi, Bengkulu, and the Bangka Belitung Islands—holds a strategic geoeconomic position as the main economic corridor of Sumatra Island and a key supplier of national commodities (palm oil, rubber, coal, fisheries, and mining). Although rich in natural resources, the main challenge facing the Sumbagsel corridor is the suboptimal level of regional fiscal autonomy due to high dependence on Regional Transfer Funds (TKD) from the central government.

Buscemi (2027) to strengthen their own-source revenue (PAD) capacity, various provincial governments in Sumbagsel are driven to transform their economic structures from a primary extractive-based model toward industrial agglomeration (such as downstream processing of palm oil and rubber, as well as integrated industrial zones and major ports). (Violita and Khoirunurrofik 2025) According to spatial economic theory, agglomeration can reduce logistics costs, promote economies of scale, and expand the base for Regional Taxes and Levies (PDRD). However, the formation of industrial agglomerations in Sumbagsel interacts in complex ways with key production inputs, namely the availability of the labor force and the level of the Provincial Minimum Wage (UMP).

Table 1. Local Revenue (PAD) in Southern Sumatera Region

Province	2021	2022	2023	2024	2025
South Sumatera	3.650,2	4.120,5	4.580,1	4.890,3	5.150,0
Lampung	2.850,4	3.100,2	3.320,8	3.550,0	3.780,5
Jambi	1.620,1	1.780,6	1.950,3	2.080,2	2.210,0
Bangka Belitung Islands	920,5	1.050,3	1.120,0	1.180,4	1.240,2
Bengkulu	810,0	890,4	940,2	990,1	1.050,0

Source: Data Processed BPS, 2026

The Southern Sumatra Region (Sumbagsel) which includes provinces such as South Sumatra, Lampung, Bengkulu, Jambi, and the Bangka Belitung Islands—has distinctive economic characteristics: it is rich in natural resources, has a growing manufacturing base, and is one of the regions contributing to the national labor force and export commodities. However, the contribution of local revenue (PAD) to total regional revenue in this region remains relatively low compared to transfer funds from the central government, making regional fiscal dependence a persistent structural issue that has yet to be resolved.

theoretical contributions, this study enriches the literature on regional economics and local finance by integrating three perspectives that have traditionally been discussed separately: agglomeration theory (Marshall, Krugman), labor market and wage-setting theory, and fiscal decentralization theory. By placing large and medium-sized industries, the minimum wage, and the size of the labor force within a single analytical framework for examining local government revenue, this study offers the insight that local fiscal capacity is the result of the interaction between the structure of production, wage policies, and the availability of labor. This study also expands the political economy analysis of regional policy by demonstrating that variables commonly treated as purely economic indicators are, in fact, the product of political decisions and negotiations; thus, explanations for variations in local government revenue across regions cannot rely solely on economic factors. Furthermore, this study examines the relevance of agglomeration externality mechanisms in the context of Indonesian regions specifically, whether industrial concentration actually translates into a stronger local tax and fee base.

Does the minimum wage have a greater impact on strengthening the tax base through increased purchasing power and consumption, or does it actually suppress business activity and local government revenue Findings regarding the size of the labor force indicate whether a large labor supply serves as productive capital for local government revenue or merely becomes a burden if it is not absorbed by the productive sector. The results of this study also provide an empirical basis for local governments in formulating spatial planning, wage, and labor policies that are aligned with efforts to increase local revenue, as well as serving as a reference for further research with different geographical scopes, time periods, or methods PAD.

Literature Review

Political Economy

The political economy approach focuses on the institutional arrangements that govern human interactions, thereby making economic analysis more sensitive to the allocation of resources and the systems involved. Based on this definition, the political economy approach links political governance—including its aspects, processes, and institutions—with economic activities carried out by society or introduced by the government. It must also be understood that this approach places the field of politics subordinate to economics (Yustika 2020). In short, economics and political science are indeed distinct in the sense that each has its own analytical tools, which may even be based on opposing assumptions. Thus, it is impossible to combine economic and political analytical tools, as this could be highly ambiguous and confusing. Indeed, economics and politics can be juxtaposed by considering that both involve similar processes (Clark 1998). At the very least, both share a common focus on issues such as organizing and coordinating human activities, managing conflicts, allocating burdens and benefits, and providing satisfaction for human needs and desires. James (2022) Based on this understanding, the political economy approach brings together the fields of economics and politics in terms of the allocation of (limited) economic and political resources to meet the needs of society. Therefore, the implementation of political economy policies always takes into account the power and social structures present in society, particularly among the communities targeted by these policies.

Industrial Agglomeration

The concept of agglomeration originated from (Marshall (1920) idea of agglomeration economies—or, as Marshall termed them, “localized industries.” According to Marshall, agglomeration economies—or localized industries—arise when an industry selects a location for its production activities that allows operations to continue over the long term, thereby enabling the community to reap significant benefits by establishing businesses around that location. Kuncoro (2019)as cited instates that agglomeration economies are savings resulting from proximity (economies of proximity) associated with the spatial clustering of firms, labor, and consumers to minimize costs such as transportation, information, and communication costs. Kuncoro (2019) states that agglomeration is a location that is not easily changed due to external economies that are open to all firms located in close proximity to other firms and service providers, rather than as a result of calculations made by individual firms or workers.

Regional Budget (APBD)

Rudi (2017) The Regional Budget (APBD) is a local government’s work plan that covers all local government revenue/receipts and expenditure/spending, whether at the provincial, regency, or city level, in order to achieve development targets within a one-year period, expressed in monetary terms and approved by the Regional People’s Representative Council (DPRD) through legislation known as a regional regulation. Fundamentally, the functions and objectives of preparing the APBD are the same as those of the National Budget (APBN); the difference lies only in scope. The APBN operates at the national scale, whereas the APBD is limited to a regional territory, and its implementation is delegated to the regional head—governor, regent, or mayor—in accordance with regional autonomy policy.

Provisions concerning the APBD are based on, among other regulations, Minister of Home Affairs Regulation No. 33 of 2019 on the fiscal balance between the central government and regional governments. According to the elucidation of Law of the Republic of Indonesia No. 33 of 2019 on the fiscal balance between the central and regional governments, the unitary state of the Republic of Indonesia administers state governance and national development to achieve a just, prosperous, and equitable society based on Pancasila and prevailing law.

Method

Type and Approach of the Research

This study uses a quantitative method. The quantitative approach emphasizes the testing of theories and hypotheses through the measurement of variables in numerical form, which are then analyzed using systematic statistical techniques and modeling (Muhammad 2019). Basuki and Prawoto (2017) The data used are secondary data in the form of panel data; panel data is a combination of cross-sectional and time-series data. The data series analyzed cover 7 years, from 2018 to 2024. This research relies on quantitative data—that is, figures sourced from official publications of the Central Statistics Agency (BPS), the World Bank, and other supporting sources such as reference books, scientific journals, and information from the internet.

The general panel data regression model is formulated as follows:

$$PADit = \beta 0 + IBSit + UMPit + JAKit + eit \quad (1)$$

where i = cross-section unit (i = 1, 2, …, 5) and t = time period (t = 2018, …, 2024).

Data Type and Source

The data used are secondary data in the form of annual panel data from 5 cross-section units over the period 2018–2024, sourced from the relevant official agencies/publications (e.g., BPS, regional financial reports, or other agencies relevant to the object of research).

Panel Data Analysis Method

In estimating the panel data regression model, three model approaches are used:

a. Common Effect Model (CEM)

The simplest model, which combines all cross-sectional and time-series data without accounting for differences between individuals or over time (the intercept and slope are assumed to be constant for all units).

b. Fixed Effect Model (FEM)

A model that assumes differences in the intercept across individuals (the individual effect is fixed), estimated using the dummy variable technique (Least Squares Dummy Variable/LSDV).

c. Random Effect Model (REM)

A model that assumes differences in the intercept across individuals are incorporated into the error term and are estimated using the Generalized Least Squares (GLS) method, under the assumption that the individual effects are not correlated with the independent variables.

Selection of the Best Estimation Model

To determine the most appropriate estimation model, two model specification tests are conducted:

a. Chow Test (Redundant Fixed Effect Test)

The Chow Test is used to choose between the Common Effect Model and the Fixed Effect Model.

Hypotheses:

- H0: Common Effect Model (no individual effect / same intercept)
- H1: Fixed Effect Model (individual effect present)

Test statistic using the F-test:

$$CHOW = [(RRSS - URSS) / (n - 1)] / [URSS / (nT - n - k)] \quad (2)$$

Table 2 Decision-Making Criteria

Condition	Decision	Selected Model
p-value < 0.05	Reject H0	Fixed Effect Model (proceed to Hausman Test)
p-value ≥ 0.05	Accept H0	Common Effect Model (finished)

b. Hausman Test

If the Chow Test selects the Fixed Effect Model, the Hausman Test is then conducted to choose between the Fixed Effect Model and the Random Effect Model.

Hypotheses:

- H0: Random Effect Model (individual effects are not correlated with the independent variables)
- H1: Fixed Effect Model (individual effects are correlated with the independent variables)

Test statistic using the Chi-Square statistic:

$$W = (\beta FEM - \beta REM)' \, [Var(\beta FEM) - Var(\beta REM)]^{-1} \, (\beta FEM - \beta REM) \sim \chi^2(k) \quad (3)$$

Table 3 Decision-Making Criteria:

Condition	Decision	Selected Model
p-value < 0.05	Reject H0	Fixed Effect Model
p-value ≥ 0.05	Accept H0	Random Effect Model

c. (Optional) Lagrange Multiplier (LM) Test

If the Chow Test selects the Common Effect Model but further confirmation against the Random Effect Model is desired, the LM Test (Breusch-Pagan) may be conducted as a complement. However, if the Chow Test has already selected the Fixed Effect Model and the Hausman Test also confirms the Fixed Effect Model, the LM Test is not required because the conclusion has already converged.

d. Testing Flow

- Estimate all three models: Common Effect Model, Fixed Effect Model, and Random Effect Model.
- Conduct the Chow Test to compare the Common Effect Model with the Fixed Effect Model.
- If the Common Effect Model is selected, the estimation process stops and that model is used as the final model.
- If the Fixed Effect Model is selected, proceed with the Hausman Test to compare the Fixed Effect Model with the Random Effect Model.
- The model selected by the Hausman Test (Fixed Effect Model or Random Effect Model) is established as the final estimation model used in the analysis.

Results and Discussion

Table 4 Common Effect Model (CEM)

Variable	Coefficient	Prob.	Significant
C	-1303.34	0.0004	**Yes**
IBS	-3.791	0.0031	Yes (negative)
UMP	0.000594	0.0000	Yes (positive)
JAK	0.001105	0.0000	Yes (positive)

$R^2 = 0.9564$; Adj. $R^2 = 0.9522$; F-stat = 226.60 (Prob = 0.0000)

In this model, all variables are significant at $\alpha = 5\%$. IBS has a negative effect on PAD, while UMP and JAK have positive effects. However, CEM assumes the intercept and slope are the same for all individuals/cross-sections, so heterogeneity across regions is ignored—this will be tested through the Chow Test.

Table 5 Fixed Effect Model (FEM)

Variable	Coefficient	Prob.	Significant
C	-3225.93	0.0003	**Yes**
IBS	8.120	0.0461	Yes (positive)
UMP	-0.000112	0.7295	No
JAK	0.001626	0.0001	Yes (positive)

$R^2 = 0.9738$; Adj. $R^2 = 0.9671$; F-stat = 143.62 (Prob = 0.0000)

After individual (cross-section) effects are controlled for using dummies, the sign of the IBS coefficient actually changes to positive and significant (unlike in CEM), while UMP becomes insignificant. JAK remains significantly positive. This reversal in the sign of IBS indicates the presence of region-specific effects that had previously been "hidden" in the CEM (omitted heterogeneity)—R^2 and Adj. R^2 also increase compared to CEM, indicating that FEM captures data variation better.

Table 6 Random Effect Model (REM)

Variable	Coefficient	Prob.	Significant
C	-1518.87	0.0017	**Yes**

Variable	Coefficient	Prob.	Significant
IBS	-1.998	0.3070	No
UMP	0.000637	0.0003	Yes (positive)
JAK	0.000990	0.0000	Yes (positive)

R^2 (weighted) = 0.8314; R^2 (unweighted) = 0.9524

Variance components: cross-section random SD = 233.01 (Rho = 0.4497); idiosyncratic SD = 257.75 (Rho = 0.5503) → the individual effect accounts for approximately ±45% of total error variance, which is fairly substantial.

In the REM model, individual effects are treated as a random error component (rather than as fixed dummies). The results show that IBS is insignificant while UMP and JAK are significantly positive—similar to the CEM pattern for the sign of IBS, but less significant than in CEM.

Chow Test (Redundant Fixed Effects Test) — CEM vs. FEM

- Cross-section F = 4.5056; d.f. = (4,27); Prob. = 0.0064
- Cross-section Chi-square = 17.8964; d.f. = 4; Prob. = 0.0013

Because both p-values are < 0.05, H0 is rejected (H0: the Common Effect Model is already appropriate). This means there are significant individual effects across cross-sections, so the Fixed Effect Model is better than the Common Effect Model.

Hausman Test — FEM vs. REM

- Chi-Sq. Statistic = 9.6709; d.f. = 3; Prob. = 0.0216

Because the p-value (0.0216) is < 0.05, H0 is rejected (H0: the Random Effect Model is already appropriate/consistent). This means there is a correlation between the individual effects and the independent variables, so the Fixed Effect Model is better than the Random Effect Model.

Conclusion on the Best Model

Based on the two specification tests:

Test	Comparison	Result	Selected Model
Chow	CEM vs. FEM	Reject H0 (p = 0.0064 & 0.0013)	**FEM**
Hausman	FEM vs. REM	Reject H0 (p = 0.0216	) **FEM**

The Fixed Effect Model (FEM) is the best model for this data. This is consistent with the highest Adjusted R^2 (0.9671) among the three models, and is in line with the results of both tests, which sequentially eliminate CEM (via the Chow Test) and REM (via the Hausman Test), meaning the Lagrange Multiplier (LM) Test is not required because the conclusion has already converged on FEM.

The change in the sign of the IBS coefficient from negative (CEM) to positive and significant (FEM) is a finding worth discussing—this is consistent with the Chow Test's conclusion that ignoring individual effects (heterogeneity across cross-sections) causes bias in the CEM estimation.

Political Economy Perspective Regional Policy

Referring to the political economy framework built in the introduction and literature review that PAD is not solely the result of market mechanisms, but also a product of power and institutional interactions—the empirical findings above can be read from several angles.

First, the positive effect of industrial agglomeration on PAD, which only emerges after controlling for regional individual effects, confirms that the success of agglomeration is not merely an economic-spatial phenomenon, but also the result of regional political policy choices—the designation of industrial zones, regional fiscal incentives, ease of licensing, and the allocation of connectivity infrastructure budgets. The inter-provincial variation "hidden" within the CEM reflects differences in institutional capacity and the political commitment of local elites in converting agglomeration potential into real fiscal revenue(Iftikhar 2025).

Second, the insignificance of UMP with respect to PAD in the FEM carries a fairly sharp political meaning. In Indonesia, the UMP is set through a tripartite process laden with negotiations of interest between the government, employers, and labor unions, and is often influenced by short-term political calculations (for example, the regional election cycle). The finding that an increase in UMP does not automatically expand the PAD base indicates a decoupling between wage policy—which is redistributive and political in nature—and regional fiscal instruments (PDRD). A wage increase may raise the welfare of formal-sector workers, but does not necessarily expand the regional tax base, particularly where the labor market structure is still dominated by the informal or low-wage extractive sector.

Third, the consistently positive effect of labor force size on PAD reveals a convergence of economic and political interests: growth in labor absorption is not only a popular electoral agenda, but is also empirically beneficial to regional fiscal capacity—so that the political incentives and fiscal incentives of local governments in promoting job creation are relatively aligned.

Fourth, at the level of central–regional relations, Sumbagsel's high dependence on Transfers to the Regions (TKD) relative to PAD reflects a political-economic asymmetry of fiscal decentralization: as long as TKD remains available as a soft budget constraint, regional political incentives to aggressively develop the PAD base—including through structural reform toward industrial agglomeration—tend to be weaker than they would be if regions depended entirely on their own revenue.

Fifth, the transition from an extractive economy (palm oil, rubber, coal) toward downstream processing and industrial agglomeration also faces political economy challenges in the form of path dependency and potential resistance from interest groups already established within the raw commodity value chain. The success of this structural transformation will ultimately depend heavily on the extent to which regional governments are able to manage conflicts of interest among actors (extractive-industry businesses, downstream-industry investors, labor unions, and the central government) within a single, coherent fiscal-industrial policy direction.

Conclusion

This study aimed to analyze the effect of industrial agglomeration (IBS), the Provincial Minimum Wage (UMP), and labor force size (JAK) on regional fiscal capacity, proxied by Local Own-Source Revenue (PAD), in five provinces of the Southern Sumatra region (South Sumatra, Lampung, Jambi, Bangka Belitung Islands, and Bengkulu) over the period 2018–2024. Panel data regression was used to achieve this objective. The Chow Test and the Hausman Test both selected the Fixed Effect Model (FEM) as the best estimator, supported by the highest Adjusted R^2 (0.9671) among the three models.

In line with the research objective, the FEM results show three findings. First, industrial agglomeration has a positive and significant effect on PAD (coefficient 8.120; $p = 0.0461$). Second, labor force size also has a positive and significant effect (coefficient 0.001626; $p = 0.0001$) and remains positive in all three models. Third, UMP has no significant effect on PAD once inter-regional heterogeneity is controlled for ($p = 0.7295$). The sign of the IBS coefficient reverses from negative under the Common Effect Model to positive under FEM. This suggests that the CEM suffered from omitted variable bias, because it ignored region-specific characteristics such as resource endowment, infrastructure readiness, and licensing governance. The effect of agglomeration on PAD therefore becomes visible only after structural differences among provinces are accounted for.

Overall, the research objective has been achieved. Industrial agglomeration and labor force size are the main drivers of regional fiscal capacity in Southern Sumatra, while the minimum wage does not show a strong direct relationship with PAD. Provincial governments are therefore advised to accelerate downstream processing and develop integrated industrial zones, and to keep supporting labor absorption. Increases in the minimum wage should not be relied on as a strategy to raise regional revenue. Future research should extend the observation period, add institutional variables (such as a governance index or ease-of-doing-business index), and test for non-linear or lagged relationships between UMP and PAD.

The policy implication that can be drawn is the importance of provincial governments in Sumbagsel accelerating downstream processing and the formation of integrated industrial zones (agglomeration hubs) as a medium- to long-term strategy for strengthening PAD, while continuing to encourage labor absorption as a revenue base that has also proven to have a consistently positive effect across all three models. Future research is recommended to extend the observation period, add institutional variables (such as a governance index or ease-of-doing-business index), and test for possible non-linear or lagged relationships between UMP and PAD.

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