



INTERVENTION OF CENTRAL GOVERNMENT IN LOCAL GOVERNMENT BUDGETING THROUGH FINANCIAL REGULATIONS (A CASE OF INDONESIA)

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ABSTRACT

This study aimed to assess and evaluate the compliance and ability of Indonesian local governments to financial regulations related to minimum budget allocations and deficit restriction. This study employed a qualitative based research method and was undertaken in 8 local governments in Aceh province. The data was collected through questioners, interviews and focus group discussions (FGD) participated by local government budgeting teams and key officers in the education and health departments. The data was gathered from July to September 2017. The study found that the local governments have mostly fulfilled the minimum budget allocation and maximum deficits while preparing their budget, although this task is not easy. It is also found that the minimum budget allocation regulation has been used by other departments to intervene budgeting in local governments and thus, a continual and substantial fund allocation can be granted.

Keywords: local government; budgeting; budget allocation; regulatory compliance; education spending; health spending regulatory effectiveness.

Cite this Article: Heru Fahlevi, Dewi Rosa Indah, Syukriy Abdullah, Afrah Junita and Rahmi Meutia, Intervention of Central Government in Local Government Budgeting Through Financial Regulations (A Case Of Indonesia) International Journal of Civil Engineering and Technology, 9(5), 2018, pp. 1283–1291.

<http://www.iaeme.com/IJCIET/issues.asp?JType=IJCIET&VType=9&IType=5>

1. INTRODUCTION

The government of Indonesia has implemented decentralization since the beginning of January 2001. National law No.32 (2004) as one of the guideline for local government

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financial administration states that any local government is given a broaden authority to manage its own administration with the support of central government. This includes the management of financial resources based on the local government and the citizen needs. The extension of local government autonomy is expected to increase the financial independency of the local government. The local governments receive transfers from the central government and the head of local government can use the money to develop financial source and increase the wealth of the citizen based on local potential and challenges. However, such financial autonomy leads to misuse of public money and ineffective public spending. Many head of local governments as well as local politicians are under arrest due to the misuse of public money. Moreover, financial and non-financial performance of local governments is not as it is expected. The performance of local government in Aceh can be seen from BPK's opinion.

Tabel 1 BPK's Opinion on Local Government Financial Report (LKPD) 2014

No	Regency/Cities	BPK opinion	No	Regency/Cities	BPK opinion
1	Aceh Province Gov	UO	13	Lhokseumawe	UO
2	Aceh Utara	UO	14	Banda Aceh	UO
3	Aceh Barat Daya	UO	15	Langsa	UO
4	Aceh Tenggara	UO	16	Sabang	UO
5	Pidie Jaya	UO	17	Aceh Tamiang	UO
6	Pidie	UO	18	Aceh Besar	UO
7	Simeulu	UO	19	Aceh Jaya	UO
8	Aceh Selatan	UO	20	Aceh Barat	UO
9	Aceh Singkil	UO	21	Aceh Tengah	UO
10	Subulussalam	UO	22	Gayo Lues	UO
11	Bener Meriah	UO	23	Nagan Raya	UO-N
12	Bireuen	UO	24	Aceh Timur	UO-N

UO/WDP = Unqualified Opinion

UO-N = Unqualified Opinion with Notes

Soures: BPK (2015).

Local government financial performance is indicated by an unqualified opinion of the auditor while local government financial performance is less than the maximum indicated by the opinion of qualified opinion, adverse opinion, and disclaimer opinion. From the table above there are 8 local governments that still get WDP opinion which means the financial performance of local governments has not been maximized. The local governments are struggling to increase the quality of health care and education sector (Nurlina and Muda, 2017). Besides, previous studies reported that financial independence of local government has not significantly increase (Muda & Dharsuky, 2015). Taken together, the central government initiative an intervention through the enactment of minimal allocation for certain sectors and restricted deficit to increase the quality of public spending in local government level. This study aimed to assess and evaluate how local governments in Aceh province comply with the financial regulation set by the central government and provincial government. It is carried out in seven local government in Aceh, namely Banda Aceh, Aceh Jaya, Aceh Barat, Aceh Selatan, Aceh Pidie, Pidie Jaya and Aceh Barat Daya. The results can be a basis for evaluation on the effectiveness of the financial regulations on public spending quality in local government context.

2. LITERATURE REVIEW

According to Lee and Johnson (1998), the budget was intended as a mechanism to set goals and objectives, measure progress in achieving the objectives, identify weaknesses and deficiencies in the organization, and controlling and integrating the various activities carried

out by many units of work. Lee and Johnson (1998) explains some of the differences between the characteristics of the business of government budgets, namely: (1) the availability of resources, (2) the profit motive, (3) public goods, (4) externalities, (5) pricing public services, and (6) other differences such as government interference in the economy through the budget, ownership of the organization, and the level of difficulty in the decision-making process. Insufficient resources allocation led to the decision making process becomes very dynamic and make budgeting as the most important mechanisms for allocating resources, especially in conditions where there are many (actors) with different interests and preferences (Rubin, 1993; Wildavsky, 1991, Yahya *et al.*, 2017; Erlina *et al.*, 2017a & 2017b). Budget is the government's main tool to implement all the obligations, promises, and his policies into plans for concrete and integrated in terms of what action will be taken, what results will be achieved, at what cost and who will pay these costs (Dobell and Ulrich, 2002).

According to Rubin (1993), public budgeting is a reflection of the relative strength of the various parties who have different interests or preferences on budget outcomes. Hagen, *et al.* (1996) and Alt and Lowry (2000) argued that budgeting is a process of bargaining, where politicians tend to allocate funds for the benefit of fewer people (Keefer and Khemani, 2005). Therefore, the determination of the budget requires agreement on the objectives to be achieved and the understanding of how the achievement of these goals (Wildavsky, 1991), so that the budget is the result of an agreement between the two parties, namely the executive and legislative branches.

In principle, the local budgeting process has long and loaded with the interests of the parties involved in it. Research Abdullah (2012) found that legislators behave opportunistically when carrying out their duties and functions in the discussion and determination of local budgets. This can be interpreted as a form of moral hazard from agency theory, in which the board member is agent for voters (voters) as well as the principal local leaders (Halim Abdullah, 2006). Opportunistic behavior of policy makers and budget can be reduced by the application of effective regulation (Abdullah, 2012). Regulation is needed because of the need to minimize the problem of information asymmetry between the principal and the agent so that the effectiveness of budgeting could be better. The rights and obligations of each party involved in contracts should be explicit, so that the conflict of interests over economic resources (tangible and intangible) could be resolved fairly (Patashnik, 1996). Halim and Abdullah (2006) stated that the realization of opportunistic behavior the executive to propose the budget of which is to propose activities that are not really a priority, propose activities that have lucrative opportunities are great, allocating expenditure component that is not important in an activity, proposed a number of shopping too big for the components of expenditure and budget of any activity, and increase the budget for activities that are difficult to measure the results.

The agency problem in budgeting has been a research issue that has long been discussed. In the context of Indonesia, Halim Abdullah (2006) describes how the agency relationship can be used to illustrate that the regulations designed to control opportunistic behavior of decision makers budget (budget actors). That is, to regulations have implications on the decline due to opportunistic behavior (1) of the regulation is used as a benchmark to assess the fairness of the behavior (ethics); (2) explicitly sanctions that would be obtained if there is a violation of applicable regulations; and (3) a comparison in performance assessment.

Irregularities in the budget can occur at all stages of budgeting (Isaksen, 2005). This deviation is called political corruption (Rose-Ackerman, 1978, in Mauro, 1998). Bias in government budgeting is not new and strange (Anessi-Pessina and Sicilia, 2015), thus distorting the outcomes to be achieved, so that budget allocation is not in line with the needs and interests of the public (Keefer and Khemani, 2005). In developed countries, efforts to

reduce the influence of opportunistic behavior of policy makers and the public budget is done with the strategy of increasing the transparency and accountability of public financial management, including by completing the regulations governing the technical aspects comprehensively and explicitly provide sanctions for public officials who commit irregularities by an independent body (regulatory budgeting) (Crews, Jr., 1998). Hughes (1998) looked at the need for regulation so that the economic and social aspects of the budget more in line with reality or needs in the field (surplus or deficit is not too big).

3. RESEARCH METHOD

It is a descriptive-qualitative research that is a research defines an existing phenomenon and describes it clearly from the research object. It used primary data in the form of the results of field observation (Gusnardi *et al.*, 2016; Dalimunthe *et al.*, 2016 & 2017; Lubis *et al.*, 2016; Achmad *et al.*, 2017; Azlina *et al.*, 2017; Badaruddin *et al.*, 2017; Hasan *et al.*, 2017; Lubis *et al.*, 2017; Nasir *et al.*, 2017 & Tarmizi *et al.*, 2016 & 2017). This data was taken through survey by performing direct interview using questionnaire given to respondents, such as stakeholders and community. This study is a qualitative study aimed to assess and elaborate the compliance and capacity of 7 local governments in Aceh province to the financial regulations related to the minimum budget allocation and maximum allowed deficit in budgeting. The studied local governments are Banda Aceh, Aceh Jaya, Aceh Barat, Aceh Selatan, Aceh Pidie, Pidie Jaya and Aceh Barat Daya These local governments are selected based on size and old or new established government. Data were collected through FGDs (focus group discussions), interviews, and questionnaires involving Team Local Government Budget (TAPD) and related agencies in the period from July to September, 2017. Questionnaires were distributed to senior staff involved in the budgeting process (key actors) in Bappeda, department of finance, health department and education department of the seven local governments. Later on, interviews are conducted to gain more detailed information and elaborate important findings. There were 26 questionnaires returned from 35 questionnaires were distributed. At least two questioners were returned from each visited local government and it can be used to assess all studied local governments. Furthermore, the interviews were conducted with the head of the financial department, the head/secretary of Regional Planning Agency (Bappeda), the budgeting staff in health and education program as well as the program division and planning division in both departments. The duration of interviews is 25 to 45. In total, 21 interviews have been carried out and mostly recorded. Purpose of the interview is to get more detailed information about the response of questionnaires. Furthermore, FGD conducted to confirm the findings of the questionnaires and interviews carried out previously. Data is analyzed by using qualitative data analysis approach. Firstly, all interview results are described and analysis to determine the key point/findings (codification). Secondly, the code will be transformed into categories and narration. Meanwhile, a descriptive analysis is used to analyses the questionnaires results.

4. RESULT AND DISCUSSIONS

4.1. The Local governments comply with the regulations

This study demonstrates the compliance of the local governments to the minimal budget allocation for education and health departments and maximum deficit regulation. Indeed, it is their priority in budgeting. The most possible reason of the high compliance level is the control and monitor of provincial government. The local budget draft which is required to be submitted to provincial government cannot be approved if the draft does not comply with any financial regulation (Nurzaimah *et al.*, 2016; Muda *et al.*, 2017a; 2017b; 2017c; 2018 &

Erwin *et al.*, 2018). Such punishment encourages local government to make the fulfillment of the minimal allocation and restricted deficit regulation becomes the budgeting priority.

Table 2 Summary of respondent answers

Statement	Local Governments							
	Banda Aceh	Aceh jaya	Aceh Barat	Nagan Raya	Aceh Selatan	Aceh Pidie	Pidie Jaya	Aceh Barat Daya
Local government budget (hereafter APBD) is prepared by considering the fulfillment of minimal allocation and maximal deficit regulation.	Agree	Agree	Agree	Agree	Agree	Agree	Agree	Agree
There are reward and punishment for local government related to the fulfillment of the minimal allocation and maximal deficit.	Agree	Disagree	Agree	Disagree	Agree	Agree	Disagree	Disagree
The compliance on the minimal allocation and maximal deficit is our priority in budgeting	Agree	Agree	Agree	Agree	Agree	Agree	Agree	Agree
The minimal allocation and maximal deficit make budgeting more complicated	Partially agree	Partially agree	Partially agree	Partially agree	Partially agree	Partially agree	Partially agree	Partially agree
Each minimal allocations related department (for example education or health department) proposes as can propose budget as much as it is allocated.	Agree	Partially agree	Agree	Agree	Agree	Agree	Agree	Agree
Each minimal allocation related department is able to spend its proposed budget.	Agree	Agree	Partially agree	Agree	Agree	Partially agree	Partially agree	Agree
The minimal allocation and maximal deficit make budgeting easier	Agree	Partially agree	Agree	Agree	Agree	Agree	Agree	Agree
The minimal allocation regulation of 20% local budget for education sector is difficult to fulfill	Disagree	Disagree	Partially agree	Disagree	Disagree	Disagree	Partially agree	Partially agree
The minimal allocation regulation of 10% local budget for health sector is difficult to fulfill	Agree	Agree	Agree	Agree	Agree	Agree	Agree	Agree

Sources: Data Tabulation (2018).

Moreover, the respondents reported that could lead to complicated budgeting process. The local government need to cut some program of other departments that might lead do conflict with other departments. Furthermore, both minimum allocation regulation related departments i.e. health department and education department have proposed budget/program as much as it is allocated by the local government budgeting team. The departments are also able to execute the entire program and spend their budget every year, except in Aceh Jaya where the education department cannot achieve its spending target. In term of 30% minimum budget allocation for capital expenditures, most respondents report difficulties and challenges. For

newly established governments (kabupaten pemekaran), this regulation could be easier to fulfill as the governments still need to build many important infrastructures. But, it will be difficult task for old established local governments.

Above all, the most important point is whether the minimum allocation can increase the quality of local government spending. One of obstacles is the potential contradiction with other budget regulation imposed by the provincial government. For example, the regulation on the use of special autonomy fund (or *dana otonomi khusus*) requires that only more than 500 million rupiah project/ fund can be funded. As a result, the local governments cannot finance the program for training and capacity improvement for their staff as the budget is lower than 500 million. Consequently, the governments are motivated to propose many infrastructure improvement projects where some of them are not really required.

4.2. Does the regulation increase quality of public spending?

Both central government and provincial government imposed these financial regulations to ensure that the most important services i.e. education and health received sufficient fund to provide high quality public services. The idea seems to be straightforward, but the consequences' seems to be far from it is expected. From the 7 local governments, all local governments are able to comply and believe that the financial regulations are required. Particularly, the new established local governments for example Pidie Jaya and Aceh Jaya believe that minimum allocations are still needed. However, the effectiveness of the minimum allocation policy or its effect on the improvement of the governmental spending is questionable. Firstly, the capacity of planner and quality of proposed program are need to be improved. With a guarantee of substantial grant every year, the related departments potentially use the money without comprehensive and proper justification. Secondly, both health department and education department managers cannot freely used the allocated money as there are other financial regulations that control or limit programs that can be funded. For instance, Special Purpose Fund (or *Dana Alokasi Khusus*) mainly can be used for infrastructure construction program (building school, health center etc.). Another example is regulation on Autonomy Special Fund (or *Dana Otonomi Khusus*). The regulation requires that only more than 500 million Rupiah can be funded by this source. Consequently, local governments are encouraged spend their money on infrastructure, although the infrastructures are not urgently needed, than spending on non-infrastructures which are more completed and could not be funded.

Lastly, proposing minimum allocation as a way to gain continues fund have become a trend. According to the respondents, some departments which usually received small amount of fund have proposed to the provincial government to have also minimum allocation for their departments. Some of these proposals have been granted. As a consequences, the budgeting in local government are getting more complicated and local government could lose its authority in budgeting and allocation financial resources as it is intervened by the upper level government through minimum allocation policy.

5. CONCLUSION

Budgeting in local governments can be very political and problematic. The regulation of minimum allocation for health department, education department and capital expenditure are expected to make sure that public funds spent for very important sectors and program. This study found that the seven studied local governments are able to meet the financial regulations, although there are some challenges. However, the conducted interviews uncovered that the minimum allocation and maximum allowed deficits could lead to

unintended implications, namely the lower quality of public spending. The explanation could be that other financial regulation is contradicted or not compatible with the minimum allocation regulation. As a result, higher quality of public spending could not be achieved. This issue should be taken into consideration by the provincial and central government to increase the spending quality of local governments.

This study has several limitations. Firstly, it only involves two departments and do not consider other departments which are not related to minimum allocation policy. Secondly, this study only takes local government in one province which may have a unique characteristic. Therefore, further studies are required to test whether the result can be verified also in other local government and to examine the relationship between compliance of local government to financial regulation and their financial/non-financial performance.

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