Local Governance and Local Government Finance

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Abstract

The rationale of this study is to examine the effect of state governance on performance of local government finance in Indonesia. Local governance implementation was measured by local government transparency, accountability, rule of law, people participation and local government size. Using the secondary data of sixty local governments surveyed by Transparency International Indonesia in 2019, a cross-section regression using the econometrics method of Generalized Least Square (GLS) was applied to examine the effects of each factor on local government financial performance. Results show that enforcement of the rule of law which is proxy by the corruption perception index, and people participation proxy by the number of eligible voters had positive significant impacts on Indonesian local government financial performance. The novelties of the study implies that rule of law enforcement and people participation foster people's trust to pay taxes and to participate in local government decision making that increasing local government revenue.

Keywords: local governance, local government finance , financial performance, public sector accounting , transparency
JEL Classification: H71, H83

INTRODUCTION

Specific institutions or entities created by national constitutions in Japan, Denmark, India, state constitutions such as Australia and United States, by ordinary legislation of a higher level of central government such as New Zealand, the United Kingdom and most countries, by provincial or state legislation such as in Canada and Pakistan, or by executive order such as China to provide a range of specific services to a relatively small area, is called local government. The planning and implementation of collective activities at local level is a broader concept of local governance. Therefore, it covers the direct and indirect roles of formal local government institutions and governmental hierarchies, as well as the roles of informal procedures, community network and organizations and local association in pursuing collective action by defining the framework for citizens-citizens and citizens - state interactions, collective decision making and provision of local public services. All purposes of live in communities are included in local government or local state government (Anwar Shah, 2006). Providing a range of local services is not only the purpose covered by good local government, but also that of preserving the life and freedom of the residents, creating space for democratic participation and civic dialogue, supporting local market-driven and sustainable development from an environmental point of view and facilitate results that enrich the quality of life of the residents. The concept of local governance is currently part of academic and practical literature whereas previously it has been implemented long time as long as the human history. The globalize world and information spreading worldwide and the relationships of various government orders with entities outside the government and therefore greater attention to local governance forces the review of citizen-state relationships and roles and the relationships of various government orders with entities outside the government

A number of authors (Bailey 1999; Dollery and Wallis 2001; Rhodes 1997; Stoker 1999) have recently claimed that the existence of a large network of entities outside the government involved in providing local services or quality of life issues makes it unrealistic to deal with local government as one unity. This broader concept of local governance is analytically recognized as the basis for developing a responsive local governance protocol such as proper action in giving services to people that are consistent with their preference and having accountability by providing efficient work that lowering the cost of public services. Governance also can be used in several contexts such as corporate governance, international governance, national governance and local governance. Governance is also the process of decision-making and the process by which decisions are executed or not executed on the formal and informal stakeholders involved in decision-making and executing the decisions made and the formal and informal structures that have been set in place to arrive at and execute the decision.

The government is part of the stakeholders in governance. Bailey (1999) designed four local government models. Local governments who believe that they know better and maximize the welfare of their people are good models of the despotic rulers. Local governments that provide services in accordance with the willingness of citizens to pay in line with the fiscal model. Local governments that focus on providing public services to achieve social goals that are consistent with the tax transfer model. And local governments captured by selfish bureaucrats and politicians that are more levers than models that fit the prospect of elections. In the same tradition, Breton (1995) offers a complete typology of government models. A distinction is made between two main types of government: the first embodies the teaching of the common good and the second act to represent the personal interests of the elites in government. The second type can take a monolithic or composite structure. In a monolithic structure, local government can be captured by bureaucrats or interest groups. In addition, the government's new vision of regional governance can maximize economic rent to dominant interest groups (as in the Leviathan model) or promote coercion or coercion. If the owner-controlled model adopts a composite structure, it can encourage competition among local governments in sequence. Other stakeholders involved in governance vary depending on the level of government. In smaller cities, other stakeholders can be influential property owners, dealers' associations, cooperatives, NGOs, religious leaders, savings and loan institutions, military personnel, etc. The situation in urban areas is far more complex. At the national level, in addition to the interest groups mentioned above, the media, lobbyists, international donors, multinational companies, etc., can play a role in the decision making process or in influencing the decision making process. Civil society is grouped of all parties together excluding the government and the military.

Good governance has 8 major characteristics. It is participatory, consensus oriented, accountable, transparent, responsive, effective and efficient, equitable and inclusive and follows the rule of law. It assures that corruption is minimized, the views of minorities are taken into account and that the voices of the most vulnerable in society are heard in decision-making. It is also responsive to the present and future needs of society. The needs of transparency and public accountability is affecting the process of developing the management of the government in Indonesia. Transparency and accountability are two unseparated sides which are parts of good governance principles. Both are interchangeable for implementation in planning pattern, execution and accountability of local government finance. Issues on transparency and accountability is originated from abuse of authority and misused of funds by government officials including the high ranks officials. Transparency and accountability needs media to enable better and swift communication to the people (Bertot, Jaeger, & Grimes 2012).

The local governance focused on how the public policy is implemented and how public services is executed (Osborne. 2010) that regard to behaviour and contribution on government performance (Hill & Lynn, 2004). Transparency in the process of governing local government finance requires developing of government accounting system that providing better and accurate information based on its performance in providing maximum services to the people, and also as a stewardship and accountability process, and as management control in local government. Implementation of the public policy and process of the public service has underwent regime stages such as: public administration since early of 19th century till end of 1970s, New Public Management era from early 1980 till early 21st century and New Public Governance era till today (Osborne, 2010). Bovaird and Loffler (2003) concluded that public administration is studying on work of government officials and public services including networking with politician involved in law making and policy maker for public. New Public Management (NPG) discussion is on budget, contract, entrepreneurship and accountability for performance. Discussion on NPG is on how is the interaction amongst stakeholders in maximizing the benefits of the public policy. In Indonesia, good public governance (GPG) is required for achieving national target which is to obtain the welfare for the people.

Good Public Governance (GPG) has contributing important role in achieving good governance not only for the state but also for other aspects of people life including implementing of good corporate governance by business entities. On other part, business entities and the people are playing important role in achieving Good Public Governance (GPG). Therefore, in providing conducive conditions to execute GPG there are three pillars required which are state, business entities and the people. Good governance is needed to minimize arising agency conflicts. In practice, there are still many local governments in Indonesia which are still not able to give a good account in terms of their financial management. The performance of local government finance tend to deteriorate in several regions (Hariyadi, 2002; Azhar, 2010). Study done by

Akbar, Pilcher and Perrin (2012) shows that local government tend to achieve better performance in complying on regulations instead of creating efficiency and effectiveness on program and policy. The governance problem in local government in Indonesia has not improving much as many corruption cases still exist and continuous process for improving bureaucracy. The research question of the study is whether there is governance problem for local government in achieving its better financial performance. Previous studies specifically focusing on governance in local government is still inadequate and need more studies. The financial performance of local government is under people spot light in line with demand for transparency and accountability. Various problems occurred in terms of financial performance accountability in Indonesia is what lies behind the author to explore more about the characteristics of local government as anything that affect the quality of local government financial performance.

Indonesia Rapid Decentralization Appraisal (IRDA) program conducted by the Asia Foundation on 40 municipals and 27 regions in Indonesia found that the roles of local government officials is more dominant than the participation of the people in the making of the public services policies. This findings shows lack and limited space for people to participate in public policy making. As a results, budget is allocated more on routine local government financing instead of for public services.

The objective of this study is to perform the empirical examination of the implementation of the good public governance (GPG) on the local government financial performance in Indonesia. The principles of GPC ranging from democracy, transparency, accountability, rule of law enforcement, fairness and equality. Akbar et al. (2012) found that the achievement of local government is only limited on compliance to the regulations and not focusing on serious attempts in achieving performance. Other efforts by Azhar (2010) is by comparing the local government performance against the degree of fiscal decentralization given by central government. Sumajo (2010) and Mustikarini and Fitriasari (2012) uses the government characteristics as predictor for performance instead of utilizing efforts made by the local government.

This study uses efforts by the local government in achieving the performance target set up previously. The public governance principles is utilized as proxy for efforts by local government such as participation, transparency, accountability and rule of law. The model used by research on governance applied for business such as corporate governance is adopted in this study. The study that connecting the local governance with local government financial performance to the best of our knowledge is still scanty. This is worth to start and to be follow up to bridge the research gap as compared to research in corporate governance. In this paper, we will develop a formal model to analyze the effect of local governance on local government financial performance. International studies ever been conducted related to government finance management accountability will be one basis for the author in examining the conditions in Indonesia.

Therefore the study on local governance and connecting the local governance with local government financial performance would contribute to the literature or forthcoming study reviewing the accounting of public sector or government and also as considerations for local government in issuing proper policies to strengthening the factors of local governance that beneficial for improving local government performance.

2. LITERATURE REVIEW

Zimmerman (1977) stated that no agency relationship arises when principal delegated decision making authority to agent. There are several assumptions of conditions occurred in such agency relationship, namely: subordinate or in this case is the agent who won the trust of principal assumed to be homo-economicus that are individualistic, opportunistic, and selfish desires of the individual (Davis, Schoorman & Donaldson; 1997), as well as the existence of asymmetric information between principal and agent (Mc Cubbins,Lupia, 1994). Divergence of interests between principals and agents which are accompanied by the opportunistic behaviour can be detrimental to public interest (Davis & Donadson, 1991). In the public sector, this agency relationship should be run to maximize the goals that only concern on private interests by scarifying public interests (McKean, 1964). In the sphere of local government in Indonesia, it can be said that there are some agency relationship that exists are: Public (principal) and Local Government (agent). The emergence of agency problems is no other than because of the view that the two parties, both agent and principal are rationale individuals who will act for their own interests. Agency problem can be minimize by the principal to monitor and supervise the agent (Zimmerman, 1977).Therefore the local government should be able to provide a transparent and accountable information so that people can known the actions of their

representatives in managing public affairs (Laswad, Fisher, Oyelere, 2005). One of the real efforts is done to bring transparency and accountability

Arja Sadjiarto (2000) stated that there are two elements affecting the performance of government, which are the uncontrollable element such as demography, environment, etc and the controllable elements such as funds allocation, supply of manpower/personnel. Performance improvement can be motivated by improving the organization accountability. Studies found deficiency in accounting system the main weakness in public sector management specifically in the developing coutries (Marwata & Alam 2006; Wyk 2007; Adhikari & Mellemvik 2011). In terms of performance, relatively few were known on the measurement of performance of public sector in developing countries. (Mimba, Helden, & Tillema 2007).

Local government are urged to maximize its resources to achieve the target by the people and communicate the results to the people. Local government financial problem is still overcome by the support of fund distributed by the central government that create dependency of the local government (Patrick, 2007). These conditions motivate the important of the role of private investments and corporate owned by local government to boost growth and development of regional economics so that local government are forced to prepare the adequate infrastructure. The incoming investment will positively affect the regional economic growth.

The transparency by government can be executed by information technology such as e-government by providing a website to enable local government to communicate efficiently with their people and external environment. The website is the sophisticated medium of communication that reflecting the culture and level response by government on people issue (Deakins et al., 2010, Patrick 2007). Study by Patrick shows that website quality affect innovation of government organization. Organization innovation is required to achieve the performance target set up earlier. In this study transparency is proxy by e-government. Quality index of e-government is based on evaluation by independent institutions on specific time frame. Index is ranging from 0 to 1. Index approaching 1 is indicating that the quality of the e-government is of the higher quality. Based on earlier studies, the following hypothesis is stated as

H1: Transparency have positive impact on the performance of local government Finance
Accountability is reflected by how serious the local the government in justifying their ongoing implementation of work program and policy. The role of independent body such as government financial supervision institutions is very important to evaluate the accountability of the local government. Accountability is focused to improve performance instead of complying with certain policy embedded in the regulations (Forbes, Hill, & Lynn, Jr. 2006). In this study accountability is proxy by the audit opinion from the Government Financial Supervision Agency on the report reported by the local government. Audit opinion is a dummy variable which 1 is for unqualified opinion and 0 is for other opinions. Therefore the hypothesis is

H2: Accountability positively affecting the financial performance.
Rule of law is the government orientation that enforce the law to all people without exception and based on understanding. One of the implementation of rule of law is to eradicate corruption in government. Tanzi & Davoodi (1997) stated that corruption will reduce government income reduce financial performance. Good rule of law will improve compliance of government officials on regulation and law. The compliance may motivate the government to make efforts for better performance. In this study the rule of law is proxy by corruption perception index (CPI) compiled by Transparency International Indonesia in 2019. The indices is ranging from 10 to 100, which 10 is most corrupt and 100 is clean government (no corruption). With a score of 40, Indonesia improves by two points on the CPI. A promising emerging economy is coupled with repression of civil society and weak oversight institutions. However, despite these improvements, the country's score is still well below 50, and an indicator of serious corruption issues. In order to build on its short-term gains, the country must make more progress in its anti-corruption efforts and agenda. The independence and effectiveness of Indonesia's anti-corruption commission, the KPK, is currently being thwarted by the government. The *Komisi Pemberantasan Korupsi* (KPK)/ Corruption Task Force is seen as a symbol of progress and modernisation, but is undergoing a loss of autonomy and power. Keeping big money out of politics is essential to ensuring political decision-making serves the greater public interest.

According to the CPI, countries that perform well on the index have strong enforcement of campaign finance regulations, while countries that perform poorly have weaker enforcement. With corruption issues in the

limelight, Indonesia risks scaring off investors and slowing economic progress. Paradoxically, this contradicts the government's aspiration agenda, which prioritises foreign investment and a booming economy. With corruption issues in the limelight, Indonesia risks scaring off investors and slowing economic progress. However, despite these improvements, the country's score is still well below 50, and an indicator of serious corruption issues. In order to build on its short-term gains, the country must make more progress in its anti-corruption efforts and agenda. Based on previous discussion and research, the third hypothesis is,

H3: Rule of Law positively affect the financial performance

Participation is the participation of people in setting up the public policy. Participation is one of the main factors in democracy in which their participation in general election is evidencing the people participation. The participation enable to implement good governance in government organization as the people as the stakeholder is important in running the state or government. Cohen and Uphoff (1977:8) stated that participation by the people receiving the funds for development program is covering aspects such as decision making (input, ideas, recommendation from people) implementation (manpower sourced from people,etc), benefits received, and evaluation of the development program. Arnstein stated that there are three level of participation. The highest level of participation is citizen control in which people is fully authorized to control the development program from planning, implementation and evaluation. The second level is delegated power in which people is authorized to manage several aspects of the developing program, and the third level is partnership in which there is partnership between people and the government officials in running the development program. The level of participation is measured by the level of willingness of the local government officials in involving the people such as publicity, collecting information, public interaction, etc in which the percentages or number of the participation can be quantified using classifications and Likert scale.

Coryanata (2007) shows empirical finding that participation affect the relationship between the member of representative knowledge with the supervision by the member of the representative.   The good supervision by member of representative is expected to pressurize the government for better performance. Participation would increase people trustworthiness and compliance on government so that government will be motivated in improving its performance. Based on the abovementioned discussion, the fourth hypothesis is

H4: Participation positively affect the local government financial performance.

METHODOLOGY

We use the Generalized Least Square (GLS) regression to estimate the model below (Wooldridge, 2010) as using the Ordinary Least Square will produce the regression coefficient which having violations of classical assumption such as heteroscedasticity and autocorrelation. GLS is able to minimize residual square which has been weighted(weighted least square) so it can fulfil the standard assumption of the ordinary least square.

$$Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \beta_5 X_5 + \varepsilon \dots\dots\dots\dots\dots 1$$

Y is the local government revenue which include tax and non taxable income. X1 is the quality index of e-government based on evaluation by independent institutions on specific time frame. Index is ranging from 0 to 1. Index approaching 1 is indicating that the quality of the e-government is of the higher quality. X2 is the accountability based on category of audit opinion by State Financial Supervisory Agency, X3 is the corruption perception indices compiled by Transparency International Indonesia in 2019, X4 is the level of participation of the people (percentage of voting and attendance). And X5 is the size of the province (population).

SAMPLE AND DATA

The sample for this study is local government in Indonesia consists of cross- section data of 32 regions and 28 city/ municipals which combined sample totally 60 observations. The data is sourced from the survey by Transparency International Indonesia 2019, indices of e-government by Gunadharma University 2019 and financial report to the Ministry of Finance.

RESULTS AND DISCUSSION

In general, the variables in this study is presented in a statistical description detailed in table 1 below,

Table 1: Descriptive Statistics

		Mean	Standard Deviation	N
Y	Local Government Income	4.8307	0.4987	60
X1	Transparency	0.1960	0.1808	60
X2	Accountability	0.17	0.2932	60
X3	Rule of Law	4.8303	0.6450	60
X4	Participation	5.9344	0.3874	60
X5	Size of Province/Municipal	12.43568	0.4796	60

Table 1 abovementioned shows that the average local government revenue is IDR 4.831trillion which is low compared from several regions which already above IDR 7.0 trillion (MOF, 2019). The dependence on fund from central government is still high. Azhar (2010) found that local government revenue in city of Aceh and North Sumatera is declining after the decentralization law issued in 2004.

E-Government is the government efforts to communicate with people through technology in line with improving the accountability and transparency (Deakins et al., 2010). The average indices of e-government is 0.196. This figure is still far below the minimum requirements to ensure adequate services for the people. It shows insufficient e-government implementation. Local government have to allocate more funds for implementing the e-government and should have higher political will to improve transparency and accountability.

The accountability of the local government could inform the quality of the financial statement. The audit opinion of the Government Financial Supervisory Agency will show the quality of the local government financial statement. The average score of audit opinion of all the local government is 0.17 which is equal to the category of unqualified opinion or the financial statement is not prepared and reported based on the accepted accounting standards.

Rule of law is achieved by eradicating corruption. The average indices of corruption   perceptions is 4.83 which shows that the level of corruption in local government is high. The strategy to prevent and eradicate corruption need to be improved. The preventive action can be executed by improving the accounting and auditing standards (Malagueno et al., 2010), or by bureaucracy reformation (Mistry, 2012).

Participation by the people propel the democratization process forward. Participation will provide specific pressure to local government to work harder and seriously to improve performance. The average level of people participation is 5.93 which is not categorized as sufficient as there are many groups not aware on the important of people participation in government process.

Table 2: Estimation results using Generalized Least Square (GLS)

Variables	Coefficient	t-stat.	Probability
(Constant)	6.692	7.531	0.000
Transparency (X1)	0.049	0.680	0.593
Accountability (X2)	0.006	0.091	0.252
Rule of Law (X3)	0.087	1.661	0.090**
Participation (X4)	0.493	4.325	0.000*
Size (X5)	0.691	6.874	0.000
R Square	0.918		
Adjusted R-Square	0.893		
F statistic	57.659		
Probability (F stat.)	0.000		
*significance level 5% **significance; level 10%			

Source: Calculated by using E Views 10

Table 2 abovementioned shows the hypothesis test using the multiple regression to empirically examine the effect of local governance factors on local government revenue or financial performance.   The F test shows that the combined factors of local governance significantly affect the local government financial performance. The adjusted R square shows that 89.3% the factors of state governance could explain its impact on local government financial performance whereas 11.7% is explained by other factors outside the

model. The results shows that participation, rule of law and size of the province/population significantly affect local government financial performance, whereas transparency and accountability have no significant effect on local government financial performance. This results does not support earlier study by Deakins et al (2010) concluding that e-government significantly affect local government performance in China, New Zealand, Oman and United Kingdom. Patrick (2007) shows that e-government significantly affect organization innovation on adoption of governmental accounting standard board (GASB) statement No.34. The causes among others are that not all information conveyed in the website, lack of training for website administrator, construction and running of the website is not dynamic, insufficient access facilities, etc. These shortages hindering people to access the local government website for the related needs, resulting the expected interaction becoming not effective.

The accountability coefficient is 0.006 shows that the increase of accountability by 1 unit will increase performance of local government finance by 0.006 unit. This insignificant effect of audit opinion on local government financial performance is not in line with the study by Mustikarani and Fitriasari (2012) that empirical findings shows that audit opinion from government financial supervisory agency negatively affecting the local government financial performance meaning that problems occurred in the financial reporting need to be follow up by educating the financial officials of the local government.

The results shows that increase of 1 unit in the rule of law variable will increase positively and significantly increase the local government performance by 0,076 unit meaning that the clean local government will improve the local government financial performance whereas the corrupted local government will slowdown the local government financial performance. This results is in line with Hasthoro (2014) and Picur and Riahi-Belkaoui (2006) that its empirical findings shows that the controlling of corruption in 30 developed countries and developing countries will improve the tax compliance that increase income and economic development. The high corruption rate is also related to the low government income (Tanzi & Davoodi, 1997).

The increase of participation variable by 1 unit will increase significantly the financial performance of local government by 0.473 unit meaning that participation is playing important role in improving local government financial performance. This result is in line with study by Coryanta (2007) showing that participation is strengthening the representative member knowledge in terms of financial supervision by the representative member on local government. Improving supervision by representative member will motivate local government to improve its performance.

Size of the local government as control variable in this study shows the significant effect on local government financial performance. This result support previous study by Sumarjo (2010), Mustikarani, and Fitriasari (2012) and Hasthoro (2014) showing that the size is the important predictor in affecting local government financial performance in Indonesia.

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Robustness Check

In addition to assessing the impact of local governance factors on government revenues proxy by local government revenue from tax and non taxable income (i.e. local government's companies dividend) and using the GLS regression estimation approach, we test consistency of our findings above by using other proxy and estimation techniques. In this case, we used central government or state government transfer/grant

as a proxy for local government financial performance and robust least square as a method of estimation. The results is presented in table 3 below,

Variables	Coefficient	z-stat.	Probability
(Constant)	4.683	5.438	0.000
Transparency (X1)	0.098	0.481	0.683
Accountability (X2)	0.004	0.082	0.362
Rule of Law (X3)	0.147	3.962	0.050**
Participation (X4)	0.791	5.214	0.000*
Size (X5)	0.821	7.934	0.000
R Square	0.918		
Adjusted R-Square	0.893		
F statistic	57.659		
Probability (F stat.)	0.000		
*significance level 5% **significance; level 10%			

Source: Calculated by using E Views 10

The results obtained from this exercise, however, are not different from that obtained using revenue derived from tax and non taxable income as a proxy for government revenue and GLS estimation method. Specifically, the results in Table 3 show that people participation, rule of law enforcement, and local government size are positively and significantly linked with the local government revenue. It therefore implies that local governance factors are indispensable factors on local government financial performance.

CONCLUSION

This research is intended to provide new approach on how the local governance affect the local government revenue or financial performance by analyzing the factors such as participation of people, rule of law, transparency, accountability and size of the local government. Findings of this research conclude that participation and rule of law are the significant predictor for local government financial performance. And size of the local government is important for controlling its effects.

It is recommended to the local government authority or policy makers to consider intensifying the efforts on people participation as well as rule of law enforcement to obtain trust and support from the people that will ultimately improve local government revenue or financial performance.

The limitation of this study is that the research is limited only to the local government in Indonesia which other aspect such as differences in cultural, ideology of people from different countries are not covered in this study. For further study, it is encourage to do cross country study in developing and developed countries to enable more conclusive results.

Implication of this study is to encourage the local government to be more proactive in attracting participation from the people during the process of decision making or policy making as the development program is to be benefitted by the people. Local Government should strengthen the Government Public Relation to develop communication with the people. Equal law enforcement to all people without differentiating social groups and other interests must be implemented seriously.

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