

The Impact of Budgeting Approaches on the Budgeting Implementation and Local Governance (Study in Indonesia)

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Medium-term expenditure framework (MTEF), unified budget, and performance-based budgeting are approaches utilized in Indonesian government finance. This research aims to investigate those approaches affecting the government budget execution and principles of good governmental governance implementation. The methods employed for this research are descriptive and explanatory ones, surveying 36 Local Governments in Central Java-Indonesia. Data collection is conducted using surveying techniques with questionnaire complimented with observation. Secondary data are obtained by using the results of the audit reports of local government financial reports by the Supreme Audit Board (BPK) and the Ministry of Finance. The analysis method used is Path Analysis. The research was conducted from January until September 2009. The results show that the implementation of the Medium-term expenditure framework (MTEF) approach, unified budget, performance-based budgeting, and the implementation of local government budget, and the implementation of principles of good local government governance simultaneously affect the financial performance of local government by 65.84% in the condition of moderate impact. Partially, the implementation of budget has a dominant influence on the principles of good local governance.

Keywords: Medium-Term expenditure framework (MTEF), unified budget, performance-based budgeting, the implementation of the principles of good local governance.

Field of Research: Accounting

1. Introduction

The decline in Indonesia's financial condition in a prolonged crisis since 1997 is caused by various factors including the poor governance system, or often times popularly known as CCN (Corruption, Collusion and Nepotism). This condition is closely related to the economic crisis occurring in the government, banks and large corporations with tremendous growth before the crisis (Wyplosz, 2007; Allen et al, 2002).

The aspects of good governance are related to the achievements of the indicators of success in general. An empirical study in several countries concluded that there is a strong relationship between the character of a regime with the achievement of indicators of success (Turkewitz, 2004). Sumarto (2004), from the research institution Social Monitoring and Early Response Unit (SMERU), carries out a study showing that the negative impact of bad governance is real, systematically affects the lives of large number of people, and hampers efforts to reduce poverty in this country.

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The description above shows how important a good governance is. Indonesia's government has launched the State financial management reforms in both central and local governments with the enactment of a set of financial laws amended in the Regulation no. 17 of 2003 on State finance and Regulation no. 15 of 2004 concerning audit and financial responsibility of the State. Before the laws on State finance are set, the government has made efforts to develop regional financial sector by setting the Regulation no. 33 of 2004 concerning the financial balance between central and local governments, and PP 58 of 2005 on the main points of financial management and accountability in areas experiencing implementation problems. The problem is partly because of the areas of accountability for financial management are not equipped with more technical provisions or guidelines.

With a set of Regulations in the field of public finance, the local government has a legal basis for an adequate and reliable financial management reform. In the area of financial management, public accountability is a major requirement that must be met. Basically, public accountability is the provision of information and disclosure of financial activities and performance of local government to the parties concerned to report proficiency level. Local governments should be able to be the subject of informers in order to fulfill the rights of the public (Baridwan Zaki, 2003).

Therefore, the governance can work well and become a reality, and it takes commitment from the stakeholders. To achieve an effective governance, it is required to have coordination, integrity, professionalism, work ethic, and moral. Three approaches in the management of state finance include MTEF, unified budget and performance-based budgeting that have been mandated by the law to be implemented as an approach in the preparation of financial statements into a new paradigm of governance and management of state finance. In general, it can be stated that the enactment of the state finance is a priority in public finance reform program, as disclosed in the Financial Memorandum and the State Budget Draft 2007 Republic of Indonesia (page. 107, 2006).

There is still a gap between the theories, in this case the rules on state financial management with finance practices, accounting and budgeting practices in local government. Analysis of the causes of this gap is still a gap in state finances with the new paradigm pillars of MTEF, unified budgeting, and performance-based budgeting with a global concept of good governance.

The growing phenomenon shows that it is in line with the current material relevant to the problems faced in the central government and local government in order to implement the mandate in the State Finance Act. With this background, it is considered necessary to investigate the variables of MTEF, unified budgeting, performance-based budgeting and budget implementation associated with the the principles of good local governance. Previous researches conducted often focus not on a budget mechanism. This research highlights the budget system, since it is the most important part in state financial management. This study focuses on officials in government agencies in the financial area, to determine the existence of the influence of MTEF implementation, unified budgeting, and performance-based budgeting for the budget implementation. In addition, this study focuses on the principles of good governance.

This paper will be divided into five parts which are: Introduction, Literature Review, Methodology, Results, and Conclusion. *Introduction* explains phenomena in Indonesia's finance management reform to implement approaches in the management of state finance including (Medium Term Expenditure Framework) MTEF, unified budget and performance-

based budgeting. Further in *Literature Review*, the theories and previous research results related to those approaches and hypotheses will be presented. Methodology used in this research including type of research, population, data used and respondent, and data analyzed for testing the hypotheses are described in *Methodology*. Furthermore, the relationship among the variables of medium term expenditure framework, unified budget, and performance-based budgeting in local government; the effect of the implementation of medium term expenditure framework, unified budget, and performance-based budgeting simultaneously and partially on the implementation of local government's budget; and the effects of medium term expenditure framework, unified budget, performance-based budgeting and budget implementation simultaneously and partially on the implementation of principles of good local governance are presented on *Result*. Finally, the final part, *Conclusion*, shows the summarized conclusion of the study.

2. Literature Review

Financial management reform results in many changes. Based on the State's financial regulations, the fundamental change is budgeting approach. In preparing the budget it is known that there are three approaches: 1) Performance-based Budgeting; 2) Medium Term Expenditure Framework, and 3) Unified Budget System.

Through performance-based budgeting approach, each allocation is intended to achieve a performance goal. Every dollar cashed out of the State/regional budgeting system is expected to have an impact on improving the performance and increasing the use of government agencies. The budget expenditures that are not coupled with the agency's performance are not expected. They will only result in wasteful spending. While the unified budget system is more essential, there is a lack of distinction between regular budget and the development budget. The budgeting system is intended to prevent it from happening in the double budget allocation. Unified budget system is also intended to support the creation of budget efficiency.

As one approach to budgeting, medium-term expenditure framework is also intended to achieve efficiency and effectiveness of the budget. Efficiency in the sense to achieve the targeted results can be done using the budget provided as economical as possible, while efficiency means that goods/services or activities are undertaken to provide optimal benefits.

Poor governance, or in Indonesia popularly known as CCN (corruption, collusion, and nepotism), is one of the causes of the 1997 crisis. In general, these problems have been known before the crisis which is reflected by the high level of corruption perception. One of the changes that occurred after the crisis is decentralization. Usman (2001: 2002) states that the decentralization process is carried out in Indonesia related to the lack of a detailed plan in the transition process and lead to inadequate rules in the process.

The study conducted by KPPOD (Regional Autonomy Implementation Monitoring Committee) in 2007, the local economic governance in Indonesia, particularly for areas in Central Java shows varying results from one region to another (KPPOD, 2008). There are areas with good economic governance (on the top 10), and there are also areas with the opposite result (ranked 10th at the bottom).

An empirical study concludes that in some countries there is a strong relationship between the character of a regime with the performance indicators of the success (Turkewitz, 2004).

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Sumarto (2004), from research institution Social Monitoring and Early Response Unit, conducts a study that shows that the negative impact of bad governance is real, systematically affects the lives of large number of people, and hampers efforts to reduce poverty in this country.

The World Bank has praised Indonesia's corrective measures undertaken to improve the system of governance, although the results achieved have not been considered significant. This is supported by the World Bank report entitled "Governance Matters 2007: Worldwide Governance Indicators 1996-2006" (aufmann et al, 2007). This report is a collection of data regarding Indonesia's most comprehensive governance. It shows that Indonesia's commitment to improve governance and eradication of corruption has relatively significant results. The report observes the improvement of governance in 1996-2006 in six aspects, namely representation and accountability, political stability, government effectiveness, regulatory quality, regulations, and control of corruption.

From the description above, it shows how important this governance within a government is. The Indonesian government has launched the country's financial management reform both at the central and local governments with the enactment of a set of legislations Regulation No. 17 of 2003 on State finance and Regulation No. 15 of 2004 concerning the management and financial responsibility of the State.

With a defined set of legislations in the financial sector, the local authorities have a legal basis for the areas for an adequate and reliable financial management reform. In the area of financial management, public accountability is the main condition that must be met. Basically public accountability is the provision of information and disclosure of activities and financial performance of local governments to the parties concerned with report proficiency level. Local governments should be able to be the subject of a conduit of information in order to fulfill the rights of the public (Baridwan, 2003).

The budget system in Indonesia prior to the reform of state finances uses the traditional system. Traditional system of budgeting is incremental which includes adjusting the volume of the budget to changes in price levels or other marginal factors. This traditional method departs from the assumption that the overall situation remains as last year, thus the method is cheap, easy, and safe for the bureaucracy in preparing the budget. Relating to good governance and government performance, Fuadi et al (2002: 48) explains that the revenue budget plans emerge a tendency to shrink the target income. This trend occurs because there is no reference to the clear budgetary revenue. Usually reference budget revenue is not derived from the realization of revenue last year, but it comes from revenue budget assumptions from years ago.

As a result of this traditional budget, it can generally be seen from the phenomenon of shrink the targeted income, in contrast to the tendency to raise the expenditure budget target. This phenomenon helps to explain that the targeted revenue would be diminished if the area shows achievement in its realization. The revenue collected exceeds the target set. While raising budget targets, giving leeway to the implementation of the budget is loaded with mark-up practices and other forms of corruption.

The World Bank introduced the concept of good governance in the early '90s, initially to address the problem of poverty in Africa (World Bank, 1992; Amartya Zen, 1999). Economic growth or increase in one's income is just a tool to expand the freedom enjoyed by the people. In connection with efforts to implement good governance, Regulation No. 32

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2004 on regional government is an instrument that reflects the will of the government to implement good governance in the regional administration. It can be seen from the indicators of law enforcement, transparency, and participation.

From the review above, the hypotheses of this study are:

- H1:** There is a relationship among the implementation of MTEF, unified budget, and performance-based budgeting.
- H2:** There is an impact of implementation of the MTEF, unified budget, and performance-based budgeting simultaneously and partially on the implementation of local government budget.
- H3:** There is an impact of implementation of the MTEF, unified budget, performance-based budgeting and local government's budget implementation simultaneously and partially on the implementation of principles of good local governance.

3. Methodology

The type of research is explanatory using causal relationship. The population includes 36 local government institutions in Central Java. The data used in this study are primary and secondary data. The primary data are obtained by questionnaire, while the secondary data are obtained by using the results of the financial statement audit reports by local governments' Audit Agency (BPK). Respondents of this study are the regional financial management officers. In this instrument, each respondent is asked to measure each variable in their respective region using Likert scale by choosing a scale of one to five. The validity and reliability of the questionnaire is tested using Spearman rank correlation. The test of data normality uses Kolmogorov Smirnov's one sample test. The data are analyzed with path method for testing the hypotheses.

Local governance variable is measured by three indicators, namely transparency, accountability, and participation.

To see the strong-weak impact or high-low closeness of the relationship between variables Guilford's classification system is used (1956: 145) as follows:

- Less than 0.20: slight almost weigh legible relationship.
- 0.20 to 0.40: low correlation.
- 0.40 to 0.70: moderate correlation.
- 0.70 to 0.90: high correlation.
- 0.90 to 1.00: very high correlation.

4. Results

4.1 The Relationship among the Variables of Medium Term Expenditure Framework, Unified Budget, and Performance-Based Budgeting in Local Government.

The correlation between the MTEF with unified budget of 0.7462 is included in the category of high correlation. The correlation between the MTEF with performance-based budgeting

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for 0.8261 is included in the category of high correlation relationship. The correlation between the unified budget and performance budgeting for 0.8015 shows high correlation relationship. Thus, there is a positive relationship between the variables of MTEF, unified budget, and performance-based budgeting in local government.

The results of this study indicate that the approach adopted in the regulation of state finance in Indonesia since the financial reform of the state (Regulation no. 17 2003, PP. 24 of 2005, and MOHA decree no 13 of 2006) has a high relationship. This means that the correlation is high, then the adoption of the MTEF, unified budget, and performance-based budgeting in local financial management, is expected to improve the financial performance of the country in general. The correlation is in line with the Schiavo Campo's opinion, 2000.

4.2 The Effect of the Implementation of Medium Term Expenditure Framework, Unified Budget, and Performance-Based Budgeting Simultaneously and Partially on the Implementation of Local Government's Budget

The effects of implementation of the MTEF, unified budget and performance-based budgeting on local government's budget in Central Java is at 76.38%. This result means that the budget has been implemented properly as expected. This is because the obligation to implement the local government's budget with accountability, especially after the emergence of rules of public finance reform for central and local government is a necessity; it even has already been a duty for local government and it is set in the State Finance Law, Government Regulation, Minister's Decree and other technical regulations.

The epsilon magnitude of 23.62% suggests that there are still other factors which include:

Regulation and Accounting Standards. Regulations relating to the budget process, tax-sharing, national and local government relations are instrumental to the implementation of the local government's budget. (Government Accounting Standards, 2005).

1. Human Resources. Irwansyah (2005) says that to achieve the implementation of the budget and budget performance in local government, it is necessary to synergize the development of human resources in the area of financial management rules and regulations. Furthermore, Campo states that there is positive influence to the quality of human resources for the implementation of the budget.
2. Information, management control, and internal control systems. Mardiasmo (2002) says that in the budget implementation, the most important thing to be considered by the management of public finances is its accounting information and management control systems.

Partially, performance-based budgeting (X3) has a dominant impact on the implementation of the budget (X4). This suggests that performance budgeting is a major factor to consider in order to achieve the implementation of local government's budget. Performance-based budgeting is a pattern of fundamental change since the reform of state finance, especially replacing the old paradigm in the form of incremental budgeting.

The results are consistent with the opinion by Hackbart and Ramsey (1999) saying that the budget implementation of the budget cycle focuses on budget allocation decisions and how the implementation of the budget is a concern. Similarly Mardiasmo (2002) states that in budget implementation, it is crucial to prioritize performance budgeting mechanism and

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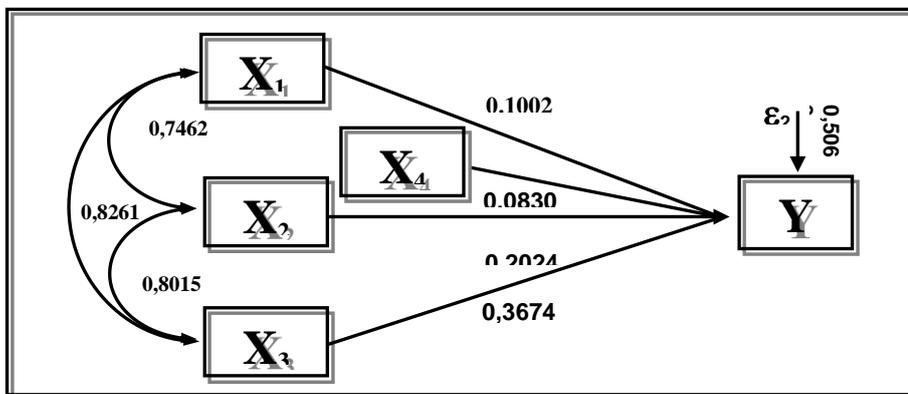
make the determination of priority objectives and approaches in a systemic and rational decision-making process of the budget implementation.

The findings of this study are also consistent with research conducted by the U.S. GAO (1997) stating that the implementation of performance-based budgeting is expected to support budget implementation, especially in terms of goal setting, performance measurement, and the concept of result-based public accountability.

4.3 The Effects of Medium Term Expenditure Framework, Unified Budget, Performance-Based Budgeting and Budget Implementation Simultaneously and Partially on the Implementation of Principles of Good Local Governance

Testing the hypotheses with path analysis is conducted to test the effect of implementation of the MTEF (X1), unified budget (X2); performance-based budgeting (X3); and budget implementation (X4) on the principles of good local governance (Y).

Figure 1: Results Testing Variables X1, X2, X3, and X4 Against Variable Y



The calculation result obtained by using the LISREL statistical test 8:54 is shown in Figure 1 as the results of path structure calculations, and the magnitude of the effect of independent variables on the dependent variable can be described as follows:

$$Y = 0.1002 * 0.2024 * X1 + X2 + X3 + 0.3674 * 0.0830 * X4, \text{ Error var.} = 0.5069, R^2 = 0.4931$$

From the results of data processing, it can be seen that the total effect of implementation of the MTEF, unified budget, performance-based budgeting and budget implementation simultaneously affect the principles of good local governance in local government institutions in Central Java amounted 49.31%. It means that the principles of good and bad local governance in the object of the research are caused by the implementation of the MTEF, unified budget, performance-based budgeting and budget implementation. In addition, the value of epsilon for 50.69% is influenced by other factors beyond the four variables.

Epsilon magnitude of 50.69% suggests that there is still an influence of other factors outside the studied factors according to the World Bank through research carried out by Kaufmann, Kraay, and Mastruzzi (2007) making six indicators of good governance as the criteria for the implementation of good governance in a country, namely:

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1. Voice & Accountability: freedom of expression for its people and accountable public officials
2. Political Stability and Lack of Violence: political stability and small intensity of violence.
3. Government Effectiveness: the effectiveness of government in running the office.
4. Regulatory Quality: the quality of regulations (laws and legislations).
5. Rule of law: law enforcement; whether the law has been executed by the public, administrators, and law enforcement officials.
6. Control of Corruption: controlling corruption; the extent to which the cleanliness of a country against corrupted practices.

From the magnitude of the impact of these independent variables on the implementation of the principles of good local governance, the greatest impact is budget implementation. This suggests that better budget implementation of the local government's budgeting in Central Java will be able to support the implementation of the principles of good local governance.

5. Conclusion

The empirical result shows that there is a relation between the implementation of the MTEF, unified budget, and performance-based budgeting in local government. The degree of correlation is high. We also found that the implementation of MTEF, unified budget, and performance-based budgeting significantly affect the budget implementation, meaning that local government will be able to improve the quality of implementation of the local government's budget. From the three independent variables, performance-based budgeting has the greatest impact on the budget implementation.

Moreover, we found that Implementation of MTEF, unified budget, performance-based budgeting and budget implementation affect the implementation of the principles of good local governance, meaning that the optimal role of the implementation of MTEF, unified budget, performance-based budgeting and budget implementation may increase the implementation of the principles of good local governance in local government institutions. The budget implementation variable has the greatest impact on the implementation of the principles of good local governance. Magnitude of the influence of performance-based budgeting and budget implementation simultaneously indicates that the principles of the regional governance in local government institutions in Central Java can be improved if the performance-based budgeting and budget implementation can act accordingly to the requirements.

Government budget in Indonesia should be based on a theoretical framework that is coherent and consistent. It should be adapted to the development of condition of Indonesia itself. Thus, this study contributes in the theories of thinking about budget development in the implementation of budgeting techniques in Indonesia. This research is expected to be developing a theory of budgeting at national and local government budgets with the coherent, logical and easy theories which explain and predict the phenomena arising in the practice of budgeting.

The results of this study suggests that the adoption of the paradigm of the pillars of public finance reform (namely the Medium Term Expenditure Framework (MTEF), unified budget and performance-based budgeting) should have more enhanced role, so that the budget implementation of local governance will run well.

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