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THE INFLUENCE OF FISCAL DECENTRALIZATION ON THE LOCAL ORIGINAL RENEVUE AND PUBLIC EXPENDITURE IN INDONESIA

THESIS

A thesis submitted in partial fulfillment of the requirement for the degree of Magister Sains

by
Eni Jufriyah Sulistyorini

PROGRAM STUDI MAGISTER AKUNTANSI

FAKULTAS EKONOMI

UNIVERSITAS SEBELAS MARET

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DECLARATION

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I hereby sincerely state that the thesis titled "The Influence of Fiscal Decentralization on the Local Original Revenue and Public Expenditure in Indonesia" is my real masterpiece. The things out of this thesis are signed by citation and referred to in the references.

Surakarta, September 2009

As for state,

Eni Jufriyah Sulistyorini

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LIST OF ABBREVIATIONS AND ACRONYMS

Local Government Budget	APBD
National Government Budget	APBN
Balance Fund	BF (Dana Perimbangan)
Special Allocation Fund	DAK (Dana Alokasi Khusus)
General Allocation Fund	DAU (Dana Alokasi Umum)
International Monetary Funds	IMF
Organization for Economic Cooperation and Development	(OECD)
Others Revenue	OR (Pendapatan Lain-lain)
Local Original Revenue	PAD (Pendapatan Asli Daerah)
Government Regulation	PP (Peraturan Pemerintah)
Regional Annual Budget Proposal	RAPBD (Rencana Anggaran Pendapatan Belanja Daerah)
Central government programs and projects	DIP
Revenue Sharing Funds	DBHK (Dana Bagi Hasil Kekayaan)
Budget Realization Statement	LRA
Legislation	DPRD

Directorate General of Local and Central Financial Balance (Dirjen Perimbangan Keuangan Pusat dan Daerah)

Directorate General of Financial Balance and Budget (Direktorat Jendral Anggaran dan Perimbangan Keuangan)

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ABSTRACT

The purpose of this research is to investigate the influence of fiscal decentralization components on the public expenditure in Indonesia. This research used data of the local budget realization which consisting of balance fund, others revenue, local original revenue, and public expenditure that was obtained from financial statement regencies and municipalities in Indonesia. The selection is based on consideration that regencies and municipalities have similar characteristic of economic and geographic and also the result of the research would be expected to give a description of general condition in Indonesia's local government. As for the data source was from Directorate General of Local and Central Financial Balance and also Directorate General of Financial Balance and Budget. It is related with information readiness in the financial report which is having completion data. Data analysis is done by two phases. That is (1) descriptive statistic analysis, (2) hypothesis testing using multiple regressions.

The results of this research proved significant positive influence of fiscal decentralization through component of balance fund in increasing original revenues while others revenue is not. Regarding with the public expenditure, both of balance fund and local original revenue positively influence on the public expenditure, while others revenue is not significantly influence. It indicated that there was dependence on receipt from central government through balance fund on regencies and municipalities in order to stimulate the increasing of local original revenue and improving public service in Indonesia. Therefore, decentralized system is expected to be better respond to local preferences and needs and to promote competition among local units in the provision of public goods and services.

Keywords: Fiscal decentralization, Balance Fund, Other Revenues, Local Original Revenue, Public Expenditure.

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ABSTRAKSI

Tujuan penelitian ini adalah untuk menyelidiki pengaruh komponen desentralisasi fiskal pada belanja publik di Indonesia. Penelitian ini menggunakan data realisasi anggaran daerah yang terdiri dari dana perimbangan, pendapatan lain-lain, pendapatan asli daerah, dan belanja publik yang di dapatkan dari laporan keuangan kabupaten dan kota di Indonesia. Pemilihan ini berdasarkan pertimbangan bahwa kabupaten dan kota di Indonesia memiliki karakteristik ekonomi dan geografi yang hampir sama dan juga hasil dari penelitian ini diharapkan dapat memberikan kondisi umum pada pemerintah daerah di Indonesia. Adapun sumber data diperoleh dari Dirjen Perimbangan Keuangan Pusat dan Daerah dan juga Dirjen Anggaran dan Perimbangan Keuangan. Hal ini berkaitan dengan kelengkapan informasi yang tersedia dalam laporan keuangan. Analisis data dilakukan melalui dua tahap, yaitu (1) analisis statistik deskriptif, (2) uji hipotesis dengan menggunakan regresi berganda.

Hasil penelitian ini membuktikan bahwa desentralisasi fiskal melalui komponen dana perimbangan berpengaruh positif secara signifikan dalam peningkatan pendapatan asli daerah sedangkan pendapatan lain-lain tidak berpengaruh secara signifikan. Berkenaan dengan belanja publik, dana perimbangan dan pendapatan asli daerah berpengaruh positive pada belanja publik sedangkan pendapatan lain-lain tidak berpengaruh secara signifikan. Hal ini mengindikasikan bahwa ada ketergantungan pada penerimaan dari pemerintah pusat melalui dana perimbangan pada pemerintah kabupaten dan kota dalam rangka menstimulasi peningkatan pendapatan asli daerah dan peningkatan perbaikan pelayanan publik di Indonesia. Oleh karena itu sistem desentralisasi diharapkan dapat memberikan respon yang lebih baik terhadap kebutuhan daerah and dapat meningkatkan kompetisi antar daerah dalam penetapan pelayanan publik.

Keywords*: Desentralisasi Fiskal, Dana Perimbangan, Pendapatan Lain-lain, Pendapatan Asli Darah, Belanja Publik.*

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CHAPTER I

INTRODUCTION

This research discusses influence fiscal decentralization on the local original revenue and public expenditure in Indonesia. In this chapter, are explained backgrounds of the study, problem statement, research purpose, and research contributions.

A. Background of the Study

The interest in fiscal decentralization is increasing among developing and develops countries. The reason is that fiscal decentralization is believed as an effective tool to increase the efficiency of public expenditures. Another reason is that fiscal decentralization is sometimes seen as a panacea for reaction to the failures of centralization system over past decades particularly in developing and transitional countries (Widhiyanto 2008). Over past decade, most of developing and transitional countries have either embarked upon or stated their intention to embark upon some types of fiscal decentralization as an engine of economic growth.

Indeed, the pressure of decentralization has generally come from both internal and external drivers. From internal drivers, these pressures were supported by country's historical and experiences, deepening democratization, increasing levels of public services, countries disintegration phenomena, responding to failure centralization system and so on. While from external drivers, the pressure could come from country and/or institutional donors who have influenced the country recipient's policies due to decentralization.

World Bank (2003) states that in East Asian countries, a tendency towards decentralization is underway in almost every country while in Indonesia the 'big bang' decentralization program approach was applied in 2001. Widhiyanto (2008) says that the principle matter in implementation of local autonomy is the trust and the authority given to the region in managing and governing. Moreover, the most frequent problems in its territory are implementing local autonomy, expectedly that the region can be more democratic; independent; creative; and innovative, in managing and handling of its problem. Public services expectedly become better in gaining a social welfare (Yudani 2008). The implementation of local autonomy in principle consists of fiscal decentralization from central government to local government in Indonesia.

Local autonomy has been done for eight years, with the purpose that the regions are capable to run their own governing based on initiation, creativity, and the active role of society. It aims to develop and to accelerate the realization of society welfare, its capability in increasing the competitiveness concerning with democratic principle; distribution; justice; potential; and region variety in Republic Indonesia. Hence, according to improvement of efficiency and affectivity of fostering local autonomy, local government is necessary to pay attention on the relation among governing composition and local government, potential and variety.

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Local autonomy in Indonesia based on the *Undang-Undang* No. 22 year 1999 juncto *Undang-Undang* No. 32 year 2004 about local government and *Undang-Undang* No. 25 year 1999 juncto *Undang-Undang* No. 33 year 2004 about financial balance between central and local with the decentralization government system have been already done effectively since January 1st 2001. Those *Undang-Undang* are to form a policy which is viewed really democratic and meet the truly government decentralization aspect.

Hirawan (2007) says that the purposes of local autonomy program are accelerating economic growth and local development, decreasing inequality inter region and increasing public service quality in order to more efficient and responsive against of need, potential, and characteristic in each regions. These situations are reached through authority improvement and local government responsibility in direction to govern their domestic itself (Bastian 2006).

Concerning the main mission of *Undang-Undang* No. 22 year 1999 jo *Undang-Undang* No. 32 year 2004 and *Undang-Undang* No. 25 year 1999 jo *Undang-Undang* No. 33 year 2004 not only desire transferring the authority of development from central government to the local government, but also the most important is efficiency and affectivity of the financial sources. Hence, it is needed a financial report that valid and reliable in order that can describe the local financial sources along with prestige analysis of the local financial sources management itself (Bastian 2006).

Hirawan (2007) states that one of the main objective of decentralization implementation is to bring closer between government and society, therefore the

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need of society to be understood by government. The expectation is policies done by government can meet the society demand through the economic development to reach the social welfare in line with increasing public service quality as an ending goal. This expectation based on assumption that the relation between local government as an agent and local society as a principal go on properly.

Since January 1st 2001 had been occurred rearrangement of the relation vertically that is between central government, local government of province, and regencies and municipalities (Hirawan 2007). Rearrangement also occurred horizontally in central level (between executive, legislative, and judicative), and local level (between local government and legislation both of province and regency/municipality). The foundation of its decentralization execution is to meet democratization purpose and realize society welfare. It means that this policy of decentralization is aimed to compose public decision making process democratically and provide public services.

Many literatures have pointed out that fiscal decentralization maybe dangerous in developing and transitional countries. In line with increasing better public services, the cost of service delivery also will increase. It causes regional governments expanded their expenditures while externalizing cost to others (Rodden 2002). Fiscal decentralization also could increase regional disparities based on traditional view. It was underlined the fact that central government's power to redistribute income among regional governments is higher in the centralization system than in the decentralization system.

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In contrary, new theories argue that the benefits from decentralization are increasing efficiency and reducing regional disparity because by implementing decentralization government system, the regional government will be pursued to increase their own efforts in providing better public services in its region. Oates (1993) argues that there is much current interest in the potential contribution of fiscal decentralization to economic development. The increasing quality and quantity of public sector service may be seen as the result of economic development for particular region. Davoodi and Zou (1998) point out that fiscal decentralization is seen as part of a reform package to improve efficiency in the public sector, to increase competition among sub national government in delivering public service and to stimulate economic growth. Therefore, fiscal decentralization encourages efficiency public services and reduces regional disparities.

So far, there are some arguments toward impact fiscal decentralization on public services spending. It makes this study more interesting to reveal whether fiscal decentralization influence upon public service expenditure. This study observes **"The Influence of Fiscal Decentralization on the Local Original Revenue and Public Expenditure in Indonesia"**.

B. Problem Statement

Basically, decentralization and specifically fiscal decentralization has aim to bring government and society closer. Therefore, it will increase the efficiency of the public sector, from transparent side and accountability of policy making to

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consume of public fund in order to provide public services and improve local society welfare. Therefore the implementation of authority possessed by government that decentralization principle and democratization be demanded in base of government process of financing sources preparation to meet local government independence in finance their necessity.

Based on the regulation of *Undang-Undang* No. 32 and 33 year 2004, there is a changing in the accountability and the responsibility of the local government from vertical of the central government become horizontal to the public through the legislation. Central government as a principal gives authority to the local government as an agent to manage of own goods and services preparation. Mardiasmo (2002) stated that the management of the local government which has its accountability relies on the local government budget. The realization of the decentralization is the using of the resources economically, efficiently, fairly, and covers all area in order to reach the public accountability.

The implementation of fiscal decentralization is expected to become and to use as one way to ease, so that it will not trapped in the condition of ineffectiveness, inefficient, and instability of macro economic. Fiscal decentralization is assumption as an important factor in answer of various problems. Bird (2002) emphasize on the importance of fiscal decentralization to improve economic efficiency, cost efficiency, and improving government accountability, although decentralization implemented by the similar pattern, can give different result depend on condition deviation among region.

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Regarding with the decentralization, Slinko (2002) suggests that central government gives to municipalities targeted subsidies, it can directly control to use of the funds transferred to municipalities. He also suggested that in the fully decentralization local governments use public funds more efficiently, then decentralization is more optimal to give the opportunity of municipalities to decide upon the use of public funds independently since it would realize in the higher social wealth and lower inequality. This ensures that fiscal decentralization influences the output elasticity to public production.

Relate to the fiscal decentralization in Indonesia, Purwantoro (2007) proves significant positive influence of fiscal decentralization in increasing original revenues and public expenditures. Meanwhile, Yudani (2008) finds that the results of the research supported positive influence of implementation of fiscal decentralization through component of transfers and own revenues but not with other revenues component. For development expenditure, only own revenue has positive influence on development expenditure, while transfers and others revenue has not. The other result shows that the regions with better readiness facing fiscal decentralization still have better economic growth during the implementation of fiscal decentralization (Adi, 2008). In addition Kuncoro (2007) states that the increasing of transfer is followed by increasing of spending growth while local original revenue only capable to finance local government spending at the utmost 20%. Yustikasari (2008) also finds that either local original revenue variable and public allocation fund variable has a positive relation towards capital budget.

Based on the explanation above, the researcher proposes several problems in this research, which are:

1. Whether the fiscal decentralization which is prioritized by balance fund and others revenue influence on the local original revenue of regencies and municipalities in Indonesia.
2. Whether the fiscal decentralization through the proxy of balance fund, others revenue, and local original revenue influence on the public expenditure.

C. Research Purpose

According to the problem formulation, the purpose of this research is to provide empirical evidence about:

1. The influence of fiscal decentralization components prioritized balance fund and others revenue on the increasing of local original revenue
2. The influence of fiscal decentralization through the proxy of balance fund, others revenue, and local original revenue on the public expenditure of regencies and municipalities in Indonesia.

D. Research Contributions

This research is expected to provide contributions as follow:

1. The result of the research is expected to be useful in understanding the influence of fiscal decentralization on the increasing local original revenue and public expenditure.

2. The result of the research is also expected to be useful for decision maker in local government, public sector institutions as one of matter consideration to improve decentralization policy. In order to the implementation fitted with the expectation in the using of the resources economically, efficiently, fairly, and covers all area, so the public accountability can be reached and government accountability can be improved. In practice, it could lead legislative and executive can make an accurate planning revenue and expenditure and it will be useful input to determine further policy.
3. Moreover, the result of the research could be a reference for the academic related to the fiscal decentralization and could be a reference for another following research.

E. Writing Systematics

The writing systematic will be discussed in this study are:

Chapter I : Introduction

To explain concerning with the background of the study, problem statement, research purpose, and research contributions.

Chapter II : Literature Review and Hypothesis Development

This chapter consist of theory which related to the fiscal decentralization and public expenditure. It will explain the literarture review, the previuos researches in developing of the research hypothesis and conseptual schema.

Chapter III : Research Method

In this chapter will be discussed related to the research design, population and sample, data collection, variable, and analysis technique.

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Chapter IV : Data Analysis

This chapter explains about analysis results toward data which used in this research and analysis results discussion.

Chapter V : Conclusion and Recommendation

This chapter consists of research conclusion, limitation, and recommendation of the study.

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CHAPTER II

LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

This chapter will explain the literarture review, the previuos researches in developing of the research hypothesis and conseptual schema.

A. Literature Review

The literature review discuss about fiscal decentralization, fiscal decentralization in Indonesia, revenue sources, public expenditure, public accountability, and public expenditure.

1. Fiscal decentralization

While fiscal decentralization has several reasons for being adopted around the world, the common motive of the fiscal decentralization is considered to have the potential to improve the performance of the public sector. The theory of fiscal federalism holds that for certain public goods or services such as local public goods, providing them in a decentralized fashion can increase efficiency and accountability in resource allocation. It is because (1) local governments can be better tailored to the geographical benefit areas of the public goods, (2) local governments are better positioned to recognize local preferences and needs, and (3) pressure from inter jurisdictional competition may motivate local governments to be innovative and accountable to their residents (Oates 1972).

Along with globalization, fiscal decentralization and the desire for local discretion and devolution of power is seen by the World Bank as one of the most

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important forces shaping governance and development today. The World Bank Report (2000) points out that the decentralization interprets as a bargaining process between central and sub-nation government and in their report. The World Bank describes that one of primary objectives of decentralization is to maintain political stability in the face of pressure for localization. Then it is acknowledged that when a country finds itself deeply divided, especially along geographic or ethnic lines, decentralization provides an institutional mechanism for bringing opposition groups into a formal, rule-bound bargaining process. According to the Kee (2003) the definition of fiscal decentralization is:

> "the devolution by the central government to local governments (states, regions, municipalities) of specific functions with the administrative authority and fiscal revenue to perform those functions".

This definition shows that fiscal decentralization is a process of transferring the responsibilities and powers from the highest level of government to the lower tiers. Generally, the proper devolution of fiscal authority and expenditure responsibility is focus on issues of efficiency and equity, while public administration and political science scholars tend to focus on distribution of powers, responsiveness and accountability, and tax competition and coordination. The stabilization function involves the role of tax and spending policies and monetary policy in managing the overall level of economic activity. Therefore, the fiscal decentralization is an interest issue.

There are three basic reasons (Kee, 2003) that is why the fiscal decentralization interest, that is (1) central governments increasingly are finding that it is impossible for them to meet all of the competing needs of their various constituencies, and are attempting to build local capacity by delegating responsibilities downward to their regional governments, (2) central governments are looking to local and regional governments to assist them on national economic development strategies, (3) regional and local political leaders are demanding more autonomy and want the taxation powers that go along with their expenditure responsible. Fiscal decentralization is now seen as part of a reform agenda of many nations to strengthen their regional and local governments to meet the challenges of the 21st Century.

The traditional theory of public finance has made a strong case for a major role for fiscal decentralization. This case is based on an improved allocation of resources in the public sector and it has four basic elements (Oates 2006). First, regional or local governments are in a position to adapt outputs of public services to the preferences and particular circumstances of their constituencies, as compared to a central solution which presumes that one size fits all. Second, in a setting of mobile households, individuals can seek out jurisdictions that provide outputs well suited to their tastes, thereby increasing the potential gains from the decentralized provision of public services (Tiebout 1956). Third, in contrast to the monopolist position of the central government, decentralized levels of government face competition from their neighbors; such competition constrains budgetary growth and provides pressures for the efficient provision of public services. And fourth, decentralization may encourage experimentation and innovation as individual jurisdictions are free to adopt new approaches to public policy; in this way, decentralization can provide a valuable “laboratory” for fiscal experiments.

Oates (2006) proposes a straightforward decentralization theorem that formalizes the basic efficiency argument for the decentralized provision of certain kinds of public goods. The theorem lays out a set of sufficient conditions for the decentralized provision of these goods to be Pareto-superior to a centralized determination of public outputs. The decentralization theorem stated that for a public good; the consumption of which is defined over geographical subsets of the total population, and for which the costs of providing each level of output of the good in each jurisdiction are the same for the central or for the respective local government. It will always be more efficient (or at least as efficient) for local governments to provide the Pareto-efficient levels of output for their respective jurisdictions than for the central government to provide any specified and uniform level of output across all jurisdictions.

Moreover, Oates (2006) address that there are three issues relate with decentralization theorem, that is: the first, and perhaps the most straightforward, is the matter of inter jurisdictional spillover effects (or externalities). First, the theorem assumes that the benefits from the consumption of the public good are limited to those individuals within the jurisdiction where it is provided. There is no inter-jurisdictional spillover effects associated with the good. Note that it is still a public good in the sense that it is jointly consumed (i.e., consumed in the same quantity) by all residents of the jurisdiction, but it has no impact on the well-being of those outside its borders. We are all familiar with the allocate distortions that typically occur when externalities are present, and this assumption simply rules out any such external effects.

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Second, there are the closely interrelated issues of the mobility of individuals across jurisdictions and the precise nature of the public good. A second key issue in the theorem has to do with the precise nature of the public good. Often when treating public goods in general or those that are provided by a central government, the assumption is made that they are pure public goods in the Samuelsonian sense that an additional person can consume the output of the good without reducing the consumption of anyone else; in standard parlance, consumption is said to be "non-rival." National defense is the ubiquitous example. Most of the literature in local public finance, however, has adopted a different conception of public goods. So called "local public goods" (as envisioned, for example, in the Tiebout model) are not pure public goods: they are subject to costs of congestion. Often the assumption is made that they are "fully congestible" (i.e., doubling the size of the group requires a doubling of inputs in order to maintain the level of consumption unchanged).

All that the theorem requires is that whatever the nature of these public goods, the cost of providing a given level of output in a particular jurisdiction is the same, be the provider the central or local government. The third matter, one (which for good reason) has gotten much attention, is the assumption in the theorem that the central government is constrained to provide a uniform level of output across all jurisdictions. The third issue concerns the nature of central government provision of local public goods. It may help to be a bit more precise on this.

The decentralization theorem also suggests a straightforward way to generate a cardinal measure of the welfare gains from the decentralized provision of public goods. Fiscal decentralization can produce welfare gains where costs vary, since with given demands, differing costs will result in differences in efficient levels of output. The decentralization theorem assumes that cost functions for local public services are identical across all jurisdictions. It thus focuses solely on differences in demand as the source of welfare gains from fiscal decentralization.

Regarding to the fiscal decentralization, Zorn (2008) views positive response that local governments can better respond to citizen preferences, assess willingness to pay, and target services to the right people. Because of this, services can be designed according to tastes and preferences of the particular locality; efficiency can be improved; resources can be saved without making anyone worse off; and also increased government responsiveness and accountability. Gurgur and Shah (2002) support that decentralization results in greater public sector accountability and lower corruption in unitary rather than federal countries. Term sound fiscal decentralization with regard to the extent it is conducive to macroeconomic stability. The term efficient fiscal decentralization refers to the extent it enhances microeconomic efficiency in the input and output mix of public service delivery. Clarity, transparency, stability and well-defined rules of the game are paramount for achieving accountability that efficient and sound decentralization requires (Dabla-Norris 2006). In general, institutional reforms that minimize adverse incentives and promote transparency,

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predictability, and accountability are the key to an effective decentralized system. Wildasin (1997) argues that ultimate impact of the decentralization on fiscal performance is highly dependent upon basic characteristics of the system of inter-governmental fiscal relations such as transparency, accountability, and predictability.

The other side, Zorn (2008) states that fiscal decentralization has negative effect, that are, (1) horizontal fiscal imbalance, (2) intergovernmental competition, (3) hindrance of ability to impose national standards. Horizontal fiscal imbalance can be happen due to different fiscal capacities among local governments; economic activity and tax bases vary across jurisdictions; the “haves and the have not”, so fiscal decentralization will result in inequities. Meanwhile, the competition is not always good, so competition for economic development results in reductions in taxes on businesses, reduction of environmental controls, and reduction in services. In fact, decentralization means differences in public service delivery within a nation and differences in how local governments are financed. So, this condition will become hindrance of ability to impose national standard due to the service delivery by the various lower units of government is up to standard and the financing mechanisms result in reasonable outcomes.

Recent studies argue that the conventional wisdom may remain true in developed countries, but it is not the case in developing countries. They hold that the conventional argument that decentralized provision of public goods will increase efficiency in resource allocation may not be applicable in developing countries (Prud’home 1995). Moreover, Rodden (2002) states in many literatures

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have pointed out that fiscal decentralization maybe dangerous in developing and transitional countries. It causes regional governments expanded their expenditures while externalizing cost to others. Therefore, in light of the possible effects that depend on the institutional design of fiscal decentralization on economic growth, macroeconomic management and corruption, a key challenge for many transition economies has been to reap the economic benefits of decentralization while maintaining control over public expenditures and borrowing, restoring growth and improving accountability of local governments and officials to limit corruption.

2. Fiscal decentralization in Indonesia

Sidik and Kadjatmiko (2003) state that the general goals of Indonesia's fiscal decentralization program are to help: (1) increase national allocate and local government operational efficiency; (2) meet local aspirations, improve overall fiscal structure, and mobilize local and therefore central revenues; (3) enhance accountability, increase transparency, and expand society participation in decision-making at the regional level; (4) mitigate fiscal disparities among regional governments and assure the delivery of basic public services to citizens across the country; (5) improve social welfare of Indonesians; and (6) support macro-economic stability.

Implementation of fiscal decentralization in Indonesia has been done in order to give wider responsibility and autonomy to local government. The application of decentralization in form of financial balance is expected to cover the realization of local autonomy, particularly in income side and expenditure sides since the implementation of decentralization in the beginning year 2001

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based on *Undang-Undang* No. 22 year 1999 juncto *Undang-Undang* No. 32 year 2004 about local government and *Undang-Undang* No. 25 year 1999 juncto *Undang-Undang* No. 33 year 2004 about financial balance between central government and local government. Grayson (2000) state that there is no doubt that Indonesia is in a chronic state of crisis. However, the Indonesian nation-state is unlikely to disintegrate at the moment. This situation could change in the future if the authority of the Abdurrahman regime wanes, if the decentralization laws fail when implemented and if Aceh and Papua succeed in their bids to achieve independence.

The basic principle of fiscal decentralization implementation in Indonesia is money follow functions. It means that transferring or delegating government authority with its budget consequence needed for doing its authority, until exist equilibrium between authority and responsibility which is transferred to region with its fund provision source (*Undang-Undang* No. 33 year 2004). Therefore, decentralization execution and government process necessary be supported by fund provision source from financial balance between higher level government and lower level government. Financial balancing is done through Balance fund mechanism that is revenue sharing among government level to running main functions of governing in decentralization sketch.

According to the *Undang-Undang* No 33 year 2004, the principle of money follow function still have to be followed with capacity strengthening of human resource who will govern local financial in order to transferring of balance fund from central to local both in form of general allocation fund, special

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allocation fund and sharing fund are not misused. In the fiscal decentralization era, central government allocates resource in big amount to the poorer regions as an effort to balance disparity in Indonesia. Central government also give transfer support fund to the region in a shape of local central balance fund that is consist of general allocation fund that have purpose to overcome gap problem among regions (horizontal fiscal imbalance) and tax sharing fund and nature resource to overcome defect problem between central government and local (vertical imbalance) together with special allocation fund. Hence, fiscal decentralization is wished to overcome local defect problem in Indonesia.

Within fiscal decentralization, the equalization of unconditional grants from Jakarta to the provincial and local government, including general allocation fund and revenue sharing funds, are intended to ensure fiscal sustainability in the context of macro-economic policy. Other purposes include correcting vertical and horizontal fiscal imbalances, improving efficiency and affectivity of resource allocation and bringing the government closer to their citizens. Regencies and municipalities are expected be able to provide several public services. Thus general allocation should be considered as part of an equalization grant which also includes natural resource revenue and tax sharing. One cannot be separated from the other. Therefore, instead of formulating the amount of general allocation fund to be distributed in the very first instance, the central government should be able to estimate total amount of transfers, including general allocation fund, revenue sharing and special allocation fund.

The center piece of Indonesian fiscal decentralization is the general allocation fund that gives the full autonomy to local governments in spending and managing the grant. Instead of ad-hoc basis, the general allocation fund utilizes the formula to allocate the grant to all provincial and local governments in Indonesia. In most local governments, general allocation fund is basically their budget since its role is very dominant. This heavy dependence to general allocation fund creates disincentive for local governments in raising or intensifying the collection local original revenue. While excessive local tax collection and illegal charges might harm the local investment climate, the local governments still have to intensify the collection of legal local taxes and charges revenue up to the optimal level through better local tax administration system and law enforcement.

Another new source of revenue for local and provincial governments is special allocation fund intended for the specific needs of local government or for special tasks assignment by the central government. However, it is not a central government priority at present. Special allocation fund could be considered as a matching grant for local government should they intend to develop infrastructure that could have positive impacts beyond their jurisdiction. Meanwhile, the special allocation fund that theoretically should be devoted to handle the jurisdictional spill-over effects, ensure minimum service standard, and to pursue the national interest, is the best instrument to gradually devolve the line ministries power. With the scheme of special allocation fund that still involves the central government ministries and agencies, the local government will own the projects or

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programs but they will be under the monitoring and evaluation from respective central ministries and central ministries will still have the decision on the types of programs or projects to be financed.

The shift from central government programs and projects to special allocation fund could be designed in medium term perspective to make smooth adjustment both at central and local level. With greater special allocation fund, the local governments will have higher opportunity to develop the regions based on their plans and assessment. As many agree, the local governments know better the local needs than the central ministries.

From fiscal sustainability point of view, this kind of shift will not affect the national government budget much since the transaction is basically transfer from development expenditure account to intergovernmental transfer account, in this case special allocation fund. Currently, there are requests from local governments to central government in allocating more than 25% net domestic revenue for the general allocation fund. This slight increase might not affect the national fiscal sustainability but the idea from one of influential ministry to increase the general allocation fund to be 30% of net domestic revenue might threaten the sustainability. That threat becomes more significant if there is no shift from central government programs to special allocation fund since the central government is forced to find additional revenue or to cut other types of expenditure. The move to increase the general allocation fund up to 30% of net domestic revenue will not affect the sustainability if accompanied by the shift

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from central government programs to special allocation fund and by defining the better the devolution of authorities (Brojonegoro 2005).

On the fiscal sustainability perspective, the central government has relatively managed the debt well so that the proportion for the intergovernmental transfer is higher in national government budget. A prudent and cautious national budget management is the key to success but the latest request to increase the general allocation fund portion might have to be observed carefully. As a result of the present general allocation fund and revenue sharing system, the vertical fiscal disparity might be lessened, but the horizontal fiscal disparity tends to widen, especially between Jakarta and some regencies in the oil producing regions, notably, Aceh, Riau, East Kalimantan on the one hand, with other districts and municipalities in Indonesia.

Another potential disruption of fiscal sustainability that relates to fiscal decentralization process is the disbursement of natural resources revenue sharing. The central government has committed to avoid the late disbursement program in the past that caused the large surplus at natural resources rich regions due to inability of absorbing the budget closed to the end of budget year. This late disbursement also caused the uncertainty in the local government cash flow management with few regions have to borrow from external sources to anticipate the incoming revenue.

The central government, especially some line ministries, is still trying to be involved more in the local activities, and it is understandable given their almost absolute power in the past. The local governments might be still in the learning

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process on how to rely on their own but they are learning quickly and given the limited budget, they can still manage the government administration relatively well. The amendment of *Undang-Undang* No. 22 year 1999 and *Undang-Undang* No. 25 year 1999 jo *Undang-Undang* No. 32 year 2004 and *Undang-Undang* No. 33 year 2004 should be treated as a significant improvement of decentralization process with the emphasis on better monitoring from central government and accountability at local level. On the fiscal side, there might be a problem of less than equal General allocation fund but it is improving albeit gradually. The central government also improves the natural resources revenue sharing disbursement that could neutralize the restless local governments.

The new regional autonomy and fiscal decentralization policy is not only a matter of distributing funds and authority from the central to the local government; but also more importantly how to establish and develop democratic administrative and political institutions and good governance which should be able to stimulate local participation. Firman (2009) states that under the new regional autonomy and fiscal decentralization system, cities and regions in Indonesia face the challenge of how to improve their institutional development, while they are mostly inexperienced in self governing and are confronted with the lack of guidelines and operational procedures to implement the new regional autonomy leading towards good governance.

The success of decentralization process will lie on the central government that designs the process and commits to the implementation. Although it is not visible, there is a tendency that decentralization is not one of priorities of central government. The decentralization activities are already considered as routine activities. It might be a good one if all the process is perfect and smooth, but it is dangerous if everything is not in place yet. At the fiscal side, the central government still has to manage the fiscal sustainability that has effects on decentralization process and most importantly, Indonesians should avoid a large scale of economic crisis due to local government behavior in borrowing and managing their budgets as in the case of Brazil.

3. Revenue sources

Concerning with implementation of local autonomy and fiscal decentralization, local government is claimed to possess greater local financial independence. By the greater local financial independence level means that region is not depended on central government grant and province through balance fund. In the fact is many region with the abundant nature riches, even though there are region have not possess the great nature riches but caused by economical structure managed well then tax potential can be optimalized until the region become rich. Although a lot of region both of naturally and economical structure left behind. According to that reason then transfer from central government in form of general allocation fund still given. For several requirements which can not be fulfilled by general allocation fund then government gives transfer in a form of special allocation fund.

Undang-Undang No. 25 year 1999 jo *Undang-Undang* No. 33 year 2004 concerns with fiscal balance between central and regional governments, which would be accompanied with new responsibilities delegated to regional governments under the law for administrative decentralization. As a result, by running *Undang-Undang* No. 33 year 2004 the total revenue received by regional government consists of local original revenues, fiscal balance funds and others revenue.

a. Local original revenue

Based on the *Undang-Undang* No. 33 year 2004, local original revenue defines as the income that sourced from *pajak daerah* (local tax), *retribusi daerah* (local retribution), *pengelolaan kekayaan daerah yang dipisahkan* (separated managed of the local resources) and *lain-lain pendapatan asli daerah yang sah* (others legal regional own revenues). So, local original revenues is composed of regional taxes, levies (retributions), and revenue from profit regional own enterprises and others legal regional own revenues which is purposed for giving local freedom to obtain fund provision in order to local autonomy implementation as a realization of decentralization.

Local original revenue has an important role relate to the ability of local economic. Logically, if the local original revenue is increase then fund owned by local government is increase too. This increasing will be profitable for government to fulfill local needed. While general allocation fund becomes the center of attention for most of local governments, another serious issue in the local finance, the local original revenue, seems to be neglected.

The *Undang-Undang* No. 25 year1999 and *Undang-Undang* No. 33 year 2004 obviously do not give significant local taxing power since the Indonesian decentralization was designed to be the expenditure-led decentralization

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financed by transfer. Comparison between annual growth rate of local original revenue during 1994-1996 periods and 2001-2002 periods indicated that prior decentralization growth (20%) is much higher than decentralization growth (5%). On the other hand, the central government is highly reluctant to give more local taxing power by transferring one or more of their taxes to the local government (Brodjonegoro 2005).

However, after three years of decentralization, the aspiration of higher local taxing power emerged. One important indicator of regional autonomy should be the ability of the local governments to find their own sources of revenue and to reduce the dependence to the transfer.

b. Balance fund

The *Undang-Undang* No. 25 year 1999 is became basis for new intergovernmental transfer arrangements as equality reflection revenue sharing. The balance fund consists of three components according to this *Undang-Undang*. The first is revenue sharing at certain portion of taxes on land and buildings, the transfer of land and buildings, and the net-tax revenue from the exploitation of forest, mining, fisheries, oil and gas. The second component is the general allocation fund, a block grant which is aimed to equalize the fiscal capacities of regional governments to finance their purchase expenditures. It is stated in the law that the amount of general allocation fund per fiscal year is at least 25 percent of the central government domestic revenue, and this amount should be distributed among local governments through formula that was designed with considering the regional needs and potential capacity. The third component is the special allocation fund. Basically special allocation fund is also block grant that distributed to finance special needs that either cannot be included by the formula used in general allocation fund or categorized as national priorities and commitments.

Grants from central government to regional governments can be categorized into three forms. First form is grant from the central government to be spent by the regional governments that integrated into the regional budget and registered into regional government's account. The second form is grant from central government to be spent by regional governments, but not integrated into the regional budget and not registered in regional government's account. The third form is funds that allocated by the lines ministries to finance development activities in the region.

c. Others revenue

Others revenue is composed by revenues from intergovernmental transfers such as grant, emergency fund such as funds used to cope with disasters, and saving from previous year. Others revenue is a local revenue source consist of grant revenue and emergency fund revenue. Grant is local revenue come from foreign state government, foreign institution, international institution, government, domestic institution or individual, both in a shape of foreign exchange, rupiah and goods and or service, include expert and training that is not necessary paid back. Emergency fund is a fund come from national government budget that is allocated to the region for natural disaster, extraordinary event, and or solvability. Others revenue aim to provide authority to the local autonomy execution as transformation of decentralization suppose. Beside of that local revenue source, there is an alternative other financing for region to finance government process and local development in the form of loan both credit and bond.

4. Public expenditure and public accountability

In recent years, a confluence of factors has focused attention on the allocation of public expenditures. Macroeconomic imbalances in developing countries have underscored the need to cut spending and deficits (Pradhan 1996). In this case, governments have had to make difficult choices about where to cut spending, and how to allocate scarce resources to achieve societal goals for economic growth and poverty alleviation. Public expenditures in many developing countries are still financing the provision of private goods and services which can be provided in the private market-not only in industry and agriculture, but also within health, education and infrastructure.

According to the Pradhan (1996), there are six elements which should be an integral part of an ongoing exercise to analyze the level and composition of public spending, that are: (1) the aggregate level of public spending and deficit must be consistent with the medium-term macroeconomic framework, yielding a sustainable deficit and public debt, (2) this aggregate spending should be allocated within and across sectors to maximize social welfare, including the impact on the poor. In this context, it is easier to analyze intersectoral allocations (or allocations within a sector), before dealing with complex comparisons of benefits a cross sectors in intersectoral analysis, (3) the role of the government versus the private sector ought to be a principal criterion governing the choice of programs for public financing and provision, (4) the impact of key programs on the poor should be analyzed, including their incidence and total costs, to identify those which help achieve poverty alleviation objectives cost-effectively, (5) the input mix, or the allocations for capital and recurrent expenditures, should be analyzed in an integrated manner within programs and sectors to address the shortcomings of traditional capital-led budgeting with unsustainable recurrent cost requirements and the crowding out of non-wage operations and maintenance by wage expenditures, (6) the public expenditure review exercise should seek to build government capacity and ownership so that the exercise can be undertaken by the policymakers themselves as an integral part of their planning, budgeting and evaluation system.

In sum, public expenditure should fund programs that make the most contribution to social welfare relative to what the private sector can do, rather than merely substituting for or event marginally improving upon private sector activities and outcomes. Public expenditure planning needs to be informed by a rich, disaggregated analysis of poverty drawing on a range of sources and methodologies (Fozzard and Foster 2001). This should allow decision makers to identify which groups within the population are poor, where the poor are geographically, the location of communities with worst social and physical infrastructure and the groups making least use of public services, all of which are important in targeting public interventions.

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At the same time, public expenditure management has also moved upstream, recognizing that policy decisions are expenditure decisions and that system performance can only be assessed in relation to policy goals. Additionally, Fozzard and Foster (2001) state that in tandem with the new focus on performance, public expenditure management systems have also come to be viewed as a key instrument of governance. This requires that public expenditure management systems are not only transparent and accountable to parliament, but also involve citizens in decision making.

At the paramount, the most desirable aspects of public expenditure are that public money be spent with a minimum of irregularities and wastage, and that such spending result in the maximization of benefits with the minimization of costs. Khan and Chowdhury (2008) conclude though not explicitly explored in the analysis, is that countries which combine political and civic freedoms with a high degree of decentralization which brings public institutions closer to the citizenry and creates conditions for greater civic engagement in public accountability achieve greater corruption control and ensure more efficient and equitable delivery of public services.

Relate to the public accountability aspect, Boncondin (2007) cited on Khan and Chowdhury (2008) define that public accountability concerns the obligations of persons and/or entities entrusted with public resources to report to and be answerable to the public for the manner in which public money has been allocated, spent and utilized. From this definition of public accountability, it is clear that the public entities that utilize public resources have an obligation to

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account for the way these resources are allocated, used and the results these spending have achieved. In other words, the main objectives of all public accountability initiatives are to ensure that public money is spent most economically and efficiently, that there is minimum of wastage or theft and finally that public actually benefit from public finance.

Accountability of local government to its constituents is a pre-condition for successful decentralization. Without it, the efficiency gains from better matching local services with local preferences will fail to transpire. Decentralization did not just bring new accountability at the local level; it also changed the relationship between levels of government. In addition, Indonesia's species of democracy adds another layer of complexity through the party system, central and local. Each of these accountability relationships is in the process of evolution, and manifests strengths and weaknesses. And while community demand and simultaneously response from the local executive and legislative, for public accountability has grown, variation across localities is large.

In the course of specifying the detailed distribution of functions across levels of government, the authorities have to decide whether to set standards of service provision for the decentralized functions. Minimum service standards are mainly justified by a government's social objectives, including ensuring that each citizen of the country, no matter where he or she lives, should have the same access to basic public services such as basic education, health care, clean water, and minimum social protection. However, setting such standards involves a fine balance: if they are too restrictive, the gains from decentralization may prove in difficult situation, and the local governments will be unable to exploit local circumstances.

The standards should also be truly minimum standards, in order not to bind local government too much, and overburden the central budget. As a result, service delivery beyond the minimum standards could be provided by a local government's own revenues, including by user charges. For instance, government could provide some minimum environmental services from general means, but beyond that minimum, locally levied pollution charges could serve to maintain water and air quality.

In a unitary state such as Indonesia it is normal that the central government sets the standard for service delivery in the obligatory functions of local government. In the end, local governments are an instrument of the state to achieve its goals and objectives, and thus specifying what is expected of local governments is only natural. In addition, some understanding of what the regions are supposed to deliver in terms of services would promote local accountability. In fact, the head of the region is, according to government regulation 108/2000, accountable for achieving these standards. Thus, many heads of regions have been eagerly asking for standards, in order to be held accountable against those centrally set criteria, rather than against arbitrary standards set by the local parliament. Regions have been keen to obtain minimum standards for other reasons as well: the more standards they have to meet, the more money they expect from the central government.

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5. Fiscal decentralization and public expenditure

Decentralization may be driven by fiscal concerns to align responsibility for services with the level of government best able to manage and mobilize resources for them. One danger then is that the national government uses this as an excuse to off-load expenditure responsibilities onto jurisdictions without recourse to potentially inflationary financing. While this could lead to a greater willingness to pay more local taxes because citizens perceive a direct link between taxes and service quality. Decentralization can also be driven by a desire to move services closer to the people. But success depends on how decentralization affects relationships of accountability. If decentralization just replaces the functions of the central ministry with a slightly lower tier of government (a province or state), but everything else about the environment remains the same compact, management, and client power there is little reason to expect positive change. The assumption is that decentralization works by enhancing citizens' voice in a way that results in improved services.

Decentralization can strengthen accountability in two ways: between the center and a sub national government and within a sub national government. When local taxing and spending powers and central financing are well matched, decentralization can create checks and balances that hold sub national governments accountable for local services (Dehn, Reinikka, and Jakob 2003). If local governments are equally or less vulnerable to captured, than the center decentralization is likely to improve both efficiency and equity (Bardhan and Dilip 2002). World Banks (2002) argues that to make local governments responsive to citizens, sub national governments should be assigned local tax instrument. Ideally, expenditures, revenue assignments, and transfers should be designed jointly so ends along with the freedom to set rates. That once set, additional demands can be met through taxes rather than grants.

In addition to the democratization process, the slow economic recovery process is another circumstance that accompanied the decentralization process since 2001. While focus of the national government budget should be to overcome the crisis and maintain economic stability, at the same time national government budget has to dedicate some amount for new scheme of fiscal decentralization as mandated by *Undang-Undang* No. 25 year 1999. Fortunately, there were no significant negative effects on the national government budget created by that new scheme and most of local governments could understand that the relatively low amount of transfer is mostly due to heavy burden of national government budget rather than the lack of central government commitment in fiscal decentralization. On the other hand, the intergovernmental transfer scheme itself is still far from optimal due to heavy political interference especially in general allocation fund, natural resources revenue sharing, and tax revenue sharing.

Local expenditure used in order to fund government matter that become province and regency/municipality authority consist of obligatory matter, selection matter, and the matter handling by certain department which can be done together between local government definite by the determination of *Undang-Undang*. The structure of local expenditure consists of apparatuses expenditure and public expenditure. Public expenditure of obligatory matter fostering is

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prioritized to keep and improve society life quality in order to perform local obligation that realized in a shape of basic service improvement, education, health, social facility, and public facility properly together with develop social warrant system.

B. Hypothesis Development

Brodjonegoro and Martinez (2002) reveal the significant negative correlation between the size of general allocation fund and local original revenue. This clearly hurts the fiscal capacity equalization purpose that should be the general allocation fund responsibility. The equality problem, for now, is resolved gradually by keeping the “rich” regions at the same level as in 2001 and at the same time, giving more to “poor” regions through the inflation effect of general allocation fund or increasing domestic revenue at national government budget.

Rodden, Eskeland, and Litvack (2003) point out; soft budget constraints frequently arise in settings where fiscal responsibility is ill defined. In some countries, there exist serious ambiguities about which level of government is responsible for providing certain services (such as health care or pensions) or at least the funding of them. Where spending and revenue authority and responsibility are not clearly defined, there may be good reason for governors or mayors to expect fiscal assistance from higher levels.

In short, Rodden et al. (2003) find that unclear or shared responsibilities have a cost in terms of accountability and incentives. Moreover, it is described such a setting as involving transfer dependency. In order to make the tough fiscal decisions and weigh the benefits against the costs of new or expanded programs, public officials need to be in a position of raising the monies from their constituencies through their own state and local tax systems. A heavy reliance on transfers creates incentives for turning to an expansion of these transfers rather than increasing taxes in one's own jurisdiction.

This issue actually has a long history in the literature on fiscal federalism where it has been called the problem of vertical fiscal imbalance. It is fairly general agreement that for a sound fiscal system, the various levels of government need their own sources of tax revenues. Proposals for additional spending need to be evaluated in a setting in which benefits are weighed against their costs, and having to rely on own revenues (rather than transfers) provides incentives for a more careful balancing of these two sides of the ledger. A condition of vertical fiscal imbalance (or transfer dependency) is said to exist where own-revenue systems are weak and lower level governments rely heavily on transfers from above. So the argument here is that having a better overall tax system if relying more heavily on the central government and use transfers to provide some portion of state and local funds.

Purwantoro (2007) proves significant positive influence of fiscal decentralization in increasing original revenues and public expenditures. Meanwhile, Yudani (2008) find that the results of the research supported positive influence of implementation of fiscal decentralization through component of transfers and own revenues but not with other revenues component. Those findings lead to the following hypothesis;

H_{1a}: Balance fund positively influence on the local original revenue.

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In many countries, limited formal revenue autonomy has encouraged the widespread use of informal revenue generating mechanisms, such as tax offsets and extra budgetary funds (Dabla-Norris 2006). Whether sub central governments' expenditure is funded by intergovernmental grants, some revenue-sharing program, or own-source revenue through independent taxes and user charges clearly makes a difference.

Utilizing a similar panel data set, Rodden (2003) also find that governments tend to grow faster when sub central governments are much more dependent on grants. In addition, Zhuravskaya (1999) find that in spite of the process of decentralization in Russia Russian municipalities have never been independent of the regions they belong. Increase in the own revenues of the municipality is accompanied by decrease in "shared" revenues (share of VAT retained of the size of federal or regional transfers). Yudani (2008) proves that the results of the research supported positive influence of implementation of fiscal decentralization through component of transfers on own revenues but not with other revenues component. Based on those findings, hypothesis will be examined is;

H_{1b}: Others revenue negatively influence on the local original revenue.

In Russia and Ukraine, however, the use of other ad hoc and non-transparent transfers, such as mutual settlements, which accounted for over 75 per cent of all non-equalization transfers in Russia in 1998, provided a soft budget constraint environment at the sub national level. Learning from evidence in Russia; Martinez-Vazquez, Timofeev, and Boex (2004) say that in recent year,

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however, those have witnessed significant improvement in the design and implementation of intergovernmental transfers. Consistent with recent studies that take the distinction between different types of decentralization seriously, notably Jin and Zou (2002), Rodden (2003), and Stein (1999), find an asymmetric effect of tax revenue decentralization and expenditure decentralization on government spending. Fiscal decentralization reflects how responsibilities for tax revenues and public expenditures are distributed among different tiers of government. The complexity of vertical government structures make this notion challenging to quantify.

Indonesian case in Bali province, Yudani (2008) finds that the results of the research for development expenditure, only own revenue has positive influence on development expenditure, while transfers and others revenue has not. It indicated that there was dependence on receipt from central government through transfers in regencies/municipalities in Bali Province. Purwantoro (2007) also proves that significant positive influence of fiscal decentralization in increasing original revenues and public expenditures. Abdullah & Halim (2004) find that local revenue source is the local original revenue and balance fund influence to the local expenditure totally. Abdullah & Halim (2006) found that local revenue source consist of balance fund associated positively to the capital expenditure. Those findings lead to the hypothesis below;

H_{2a}: Balance fund positively influence on the public expenditure.

Oates (2006) suggests that these grant systems have often not been designed properly, frequently have not functioned very well, and in some cases

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have had perverse, if unintended, consequences. Recent studies suggest that the design and implementation of a multi-tier system of government can significantly affect overall resource allocation in the economy and, hence, economic efficiency, growth, and welfare (Davoodi and Zou 1998; Martinez-Vazquez and McNab 2003; Akai and Sakata 2002). A central argument for fiscal decentralization leading to improved resource allocation rests on the assumption that fiscal decentralization increases local influence over the public sector.

Apart from equalization transfers, other types of grants and transfers are used across the region. Matching grants for funding centrally mandated services in the areas of education, health or social spending are used widely in Croatia, the Kyrgyz Republic, and Poland, and for investment purposes, in the Czech Republic and Hungary (Martinez-Vazquez *et al.* 2004). So, grant from central government must match for funding public service area in line with mandatory from central government.

The study from China by Ping, Xian-Qiau, and Bai (2005) found that the local governments in China play the role like agent for economic development, but this role of agent is mainly played by local extra budgetary expenditure. The increase of extra budgetary revenues (fiscal incentive) with the same direction in increase of budgetary revenue would improve the responsiveness of public services in education to the real need, meaning that fiscal incentives would guide marginal propensity for public good provision more closely to local citizen's preferences so that decentralization with fiscal revenues improved the sensitivity of local public good provision to local needs.

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Evidence from Korea showed that more decentralized public sector is associated with a more local spending, but there is no statistically significant relationship between local expenditure and fiscal decentralization. The coefficients of income in all three equations are not statistically significant. This finding indicates that level of income does not affect the level of public spending in Korea (Kwon 2002).

Public expenditure tracking surveys can follow the flow of funds through different tiers of government to determine whether they actually reach the schools or the clinics they are destined for. Not only highlight the uses and abuses of public funds, but also give insights into capture, cost efficiency, decentralization, and accountability (Dehn, Reinikka, and Svensson 2003).

Evidence from Indonesia, Yudani (2008) finds that the results of the research supported positive influence of implementation of fiscal decentralization through component of transfers on own revenues but not with other revenues component. Other research shows that the economic growth during the implementation of fiscal decentralization significantly better than before the implementation. The other result shows that the regions with better readiness facing fiscal decentralization still have better economic growth during the implementation of fiscal decentralization (Adi 2008). Based on the previous findings, research hypothesis to analyze of the influence of balance fund and others revenue as a proxy from fiscal decentralization to the public expenditure is stated below;

H_2b: Others revenue positively influence on the public expenditure.

Government regulation 105/2000 states that budget approach that is used is surplus-deficit budget, which is the total amount of revenue is not equal with the total amount of expenditure, and there are financing component in running local government operational. It means that if the revenue can not cover all expenditure, so that can be looking for others revenue source through financing, such as borrowing, separated asset sold etc. Contrary, if the revenue more than expenditure, become surplus, so that its rest will covered in financing, for example to pay borrowing, shape saving fund, become current budget rest of calculation.

Conceptually, based on government regulation 105/2000 shows that the changing of revenue influence to the expenditure. Although its addition revenue is not always all of them will be allocated into expenditure. Abdullah & Halim (2004) find that local revenue source is the local original revenue and balance fund influence to the local expenditure totally. Even though the proportion of local original revenue maximal only 10% from total of local revenue, its contribution to the budget allocation is sufficient great, mainly if it related by political interest (Abdullah 2004; Abdullah & Asmara 2006). While balance fund is main revenue source of local government (around 90-95%), but it is contingency because determined by central government. Abdullah & Halim (2006) find that local revenue source consist of balance fund associated positively to the capital expenditure, meanwhile Local original revenue is not. With multiple regression analysis, Yustikasari (2008) finds that either local original revenue variable and public allocation fund variable has a positive relation towards capital budget.

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Evidence from Bulgaria revealed that minimum expenditure requirements for social services imposed by the central governments impinge upon the budgetary autonomy of local governments. In Bulgaria, municipalities have to fund 50 per cent of social welfare payments from their own revenue which results in significant disparities among municipalities in residual spending on other services (Mc Cullough *et al.* 2000).

Freinkman and Yossifov (1998) find that fiscal decentralization is positively related to the share of education spending to the regional education spending, real industrial growth and purchasing power of population. The role of the local governments substantially increased since 1992 and municipalities were demonstrating gradually increasing share of their own municipal expenditures in the total regional expenditures. Regions were at the same time demonstrating more and more increased share of their own expenditures in the total amount of expenditures. However, there was very high variation of this coefficient across the whole country. Hence, they suggest that regions with more decentralized finances tend to have lower economic decline.

The main finding of Zhuravskaya's paper (2000) is Russian localities never became independent from the regional governments. Local officials have not been given sufficient responsibility for their decisions on expenditures and have not been granted the right to raise their own revenues. In his paper provides some evidence that revenue sharing relations between local and regional governments hinder local government's incentives for providing infrastructure for private business development. In addition, it shows that the fiscal dependence of local governments on the regions affects the distribution of public spending among different uses and has a negative effect on the efficiency of local public goods provision.

The main results from the OLS analysis are tax revenue decentralization is associated with less transfers (but now only statistically significant at the 10% level), and expenditure decentralization is associated with increased government consumption. There is evidence (on the10%level of significance) that overall government spending increases with increasing decentralization of spending powers (Fiva 2006). The more autonomy local government has strong fiscal independence, the more economic development expenditure the government expenses. Main attention is paid to the effects that fiscal decentralization influences on the ratio of economic development expenditures and social development expenditures.

Some papers examine the influence of fiscal decentralization on expenditure composition proposed by Mc Nab, Martinez-Vazquez, and Granado (2005) find strong evidence that decentralization increases the share of education and health expenditures in total government expenditures. They note that the influence of decentralization on the composition of public expenditures may be greater in developing countries relative to industrialized countries. Papers by Devarajan, Swaroop, and Zou (1996) find that defense expenditure and infrastructure investments appear to negatively influence economic growth. Contemporaneous consumption-oriented public expenditures on the other hand, appear positively influence economic growth. Suggesting that the developing

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countries in their data sample could increase economic growth by reallocating resources from military and infrastructure expenditures to consumption oriented expenditures.

Sanz and Velazquez (2002) employ an augmented median voter model to study the determinants of expenditure composition at one single level of government in panel of OECD countries, they find that income, and private-public relative prices, institutional factors, and demographics significantly affect public expenditure composition. Another interesting study from the International Monetary Fund (2003) examined the impact of economic crises and fiscal deficits on social expenditures and social protection programs. The main conclusion is that IMF supported programs which are typically implemented as a result of external shocks; do not adversely impact education and health expenditures. In addition, Faguet (2004) examined the influence of fiscal decentralization on expenditure composition in Bolivia from 1991–1996. He finds evidence that fiscal decentralization increases investment in socially-oriented sectors, such as education, urban development, water and sanitation, and health care. Faguet's results are suggestive of a relationship between fiscal decentralization and the functional composition of public expenditures. He shows that these results can be generalized and that they are not a reflection unique experience of a specific country. The result also can develop a theoretical model that can explain the channels through which fiscal decentralization may influence the composition of public expenditure.

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Based on the previous findings, research hypothesis to analyze of the influence of Balance fund, others revenue and Local original revenue as a proxy from fiscal decentralization to the public expenditure is stated below;

H_2c: Local original revenue positively influence on the public expenditure.

C. Conceptual Schema

Based on the previous explanation, the conceptual schema of this research is stated below:

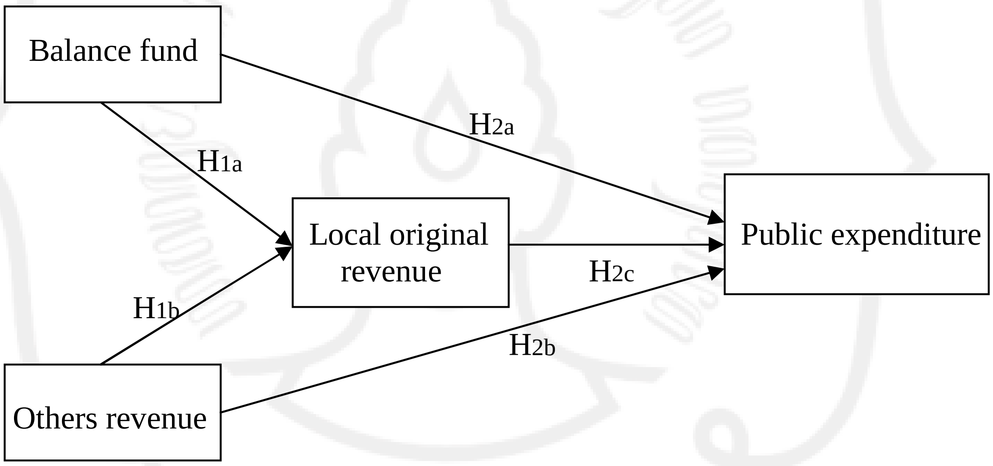

Figure 1
Theoretical Schema of Hypothesis Testing

CHAPTER III

RESEARCH METHODOLOGY

The previous chapter has been discussed theoretical review and hypothesis development. The chapter III explains related with research design, population and sample, data collection, variable, and analysis technique.

A. Research Design

The type of research is empirical research to test the influence balance fund, others revenue, and local original revenue as a proxy of fiscal decentralization to the public expenditure. This research is done by descriptive statistic analysis approach which developed from hypothesis related to the cause of prediction of specific situation problem. This research is run by collecting, processing, and presenting data for achieving a conclusion by means of generalize of collected data.

B. Determination of Population and Sample

Population refers to the entire group of people, events, or thinks of interest that the researcher wishes to investigates. Population can be explained as collection or numbers of people or events that are interesting to be analyzed. Meanwhile, sample is a part of population, which is consisted of elements having similar characteristics with population (Sekaran 2003). The population in this study is all Indonesian local government financial statement of regencies and

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municipalities. The total population is 455 consist 369 regencies and 86 municipalities financial statements of regencies and municipalities in year 2006.

Sekaran (2003) divides of purposive sampling into two major types that are judgment sampling and quota sampling. Judgment sampling involves the choice of subjects who are most advantageously placed or in the best position to provide the information required, meanwhile quota sampling ensures that certain groups are adequately represented in the study through the assignment of a quota. Sampling design which used in this study is purposive sampling, exactly judgment sampling. It is related with information readiness in the financial report which is having completion data. The reason of choosing the sample of regencies and municipalities in Indonesia is because regencies and municipalities have similar characteristic of economic and geographic and also the result would be expected give a description of general condition (Kuncoro and Ari 2005).

The researcher collects all of information from the population which determination of completion data. Sample collection use judgment sampling. So that the sample with the completion data used in this study is 232 financial statements of regencies and municipalities in year 2006. The sample of 232 from 455 populations is beyond of the standard by Rosche (1975), Krejcie and Morgan (1970) as well as Cohen (1969) for decision on sample size that cited on Sekaran (2003). According to Rosche (1975), the sample in multiple regression analysis minimal should be ten times of the independent variable. Additionally, Krejcie and Morgan (1970) as well as Cohen (1969) determined the sample size for the research project that if the population 455 so the minimum sample

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requirements is 210. Therefore, 232 samples have fulfilled the minimum sample requirement.

C. Data Source and Data Collection

The study use data which is gotten from Local Government Budget and others relevance of references. So, this research use published data source which is taken from many sources that is from Directorate general of local and central financial balance and also Directorate general of budget and financial balance.

The data which will be analyzed use local government budget realization in a form of budget realization statement which is gotten from website (http://www.djpkpd.or.id 2006) in budget year 2006. The researcher takes data in year 2006 because of that is the most possible to obtain the real condition of Indonesians decentralization as a whole after five years decentralization reflected relate to the availability of the data. The data would be taken are the total amount of local original revenue, balance fund, others revenue as a proxy of fiscal decentralization, and public expenditure.

Local government that used in this study has to fulfill the criteria: (1) the local government in form of regency and municipality, (2) the budget realization statement covered the data needed in this study. The data must fulfilled data of local original revenue, balance fund, others revenue, and public expenditure.

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D. Research Variable and Measurement

1. Hypothesis 1 (H1a and H1b)

Dependent variable in this research is local original revenue that is measured by the total amount of local original revenue from budget realization in year 2006.

Independent variable are (1) balance fund, (2) others revenue that are measured by the total amount of balance fund and the total amount of others revenue from budget realization in year 2006.

2. Hypothesis 2 (H2a, H2b, and H2c)

Dependent variable in this research is public expenditure that is measured by the total amount of public service expenditure from budget realization in year 2006.

Independent variables are (1) balance fund that is measured by the total amount of balance fund, (2) others revenue that is measured by the total amount of others revenue, and (3) local original revenue that is measured by the total amount of local original revenue from budget realization in year 2006.

E. Operational Definition of Variable

According to the local autonomy policy with the authority decentralization and fiscal decentralization that conducted by *Undang-Undang* No. 32 year 1999 about local government and *Undang-Undang* No. 33 year 2004 about financial balance between central government and local explained that the source of local revenue consist of local original revenue, balance fund, and others revenue. The definition of those variables as follow:

1. Local original revenue is the revenue which is obtained by local government and collected based on local regulation in line with the laws regulation. Local original revenue consist of four components that is, *pajak daerah* (local tax), r*etribusi daerah* (local retribution), *pengelolaan kekayaan daerah yang dipisahkan* (separated managed of the local resources) and l*ain-lain pendapatan asli daerah yang sah* (others regional own revenues). This variable in line with the previous research by Purwantoro (2007),Yudani (2008), and Slinko (2002).
2. Balance fund is fund which is sourced from national government budget revenue. It is allocated to local government to fund local needed in order to implementation of decentralization. Balance fund consist of share fund, general allocation fund, and special allocation fund. This variable in line with the previous research by Purwantoro (2007), Yudani (2008), and Slinko (2002).
3. Others revenue consist of grant, emergency fund, tax share fund from province and other local government, adjustment fund and special autonomy fund, and financial support from province/other local government. This variable in line with the previous research by Purwantoro (2007) and Yudani (2008).
4. Local Expenditure used in order to fund government matter that become province and regencies/municipalities authority consist of obligatory matter, selection matter, and the matter handling by certain department which can be

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done together between local government definite by the determination of *Undang-Undang*. The structure of local expenditure consists of apparatuses expenditure and public expenditure. Public expenditure of obligatory matter fostering is prioritized to keep and improve society life quality in order to perform local obligation that realized in a shape of basic service improvement, education, health, social facility, and public facility properly together with develop social warrant system. This variable in line with the previous research that used by Purwantoro (2007) and Slinko (2002).

F. Analysis Technique

The framework of analysis used in this study is descriptive and analytical in nature. Descriptive statistics, measures of association of the data. The analysis of the data measures the influence of the dependent variable. Data analysis is done by two phases. That is (1) descriptive statistic analysis, (2) hypothesis testing using multiple regressions. Before running multiple regressions, the data should fulfill classic assumption examination which is cover normality test, heteroscedasticity test, autocorrelation test, and multicollinierity test.

1. Descriptive analysis

Descriptive statistic analysis will describe the data generally from the process of collection data to the presentation of properly data. The descriptive analysis consists of counting minimum, maximum, mean, standard deviation from each data. This analysis purposed to give the description relate to the distribution and data sample behavior.

2. Multiple regression

The multiple regressions used to know the influence of the independent variable to the dependent variable. In the regression analysis, not only measure the power of association between two variables or more, but also show the direction between dependent variable and independent variable (Ghozali 2005). Multiple regressions will be running after fulfilling classic assumption test. The analysis is conducted through SPSS program by 16.00 versions. The regression model is employed to examine the influence of the dependent variable to the set of independent variables (predictor) identified in the literatures that are believed to have influence the dependent variable. F test is used to test the significance of all independent variables. The F test uses significance level of 5%. The basic regression model is as follows:

1. Equation of statistical regression to examine first hypothesis is:

$$Y = a + b_1X_1 + b_2X_2 + e \quad (1)$$

Where:

Y	=	local original revenue
a	=	constant
b_1 & b_2	=	regression coefficient
X_1	=	balance fund
X_2	=	others revenue
e	=	estimated error.

2. Equation of statistical regression to examine second hypothesis is:

$$Y = a + b_1X_1 + b_2X_2 + b_3X_3 + e \quad (2)$$

Where:

Y	=	public expenditure
a	=	constant
b_1, b_2, & b_3	=	regression coefficient
X_1	=	balance fund
X_2	=	others revenue
X_3	=	local original revenue
e	=	estimated error.

Before running the multiple regressions, the researcher run classic assumption test to fulfill the qualification of regression analysis for hypothesis testing. So, classic assumptions test become the qualification to multiple regression analysis and hypothesis testing (Gujarati 2004). It is in order to ensure that the data analyzed is valid, consistent, and efficient on the regression coefficient. According to Ghozali (2005), the classic assumption test covered:

a. Normality test

The normality test functions to test whether disturbance variables or residual distributed normally in the regression model. The normality test used is One-sample Kolmogorov-Smirnov test. It functions to determine how well the sample of data in normality and uniformity.

b. Heteroscedasticity test

This test is the test to see the distribution of population points. The scattered test usually shows if the distribution does not form a certain shape, it means the population is distributed well. However, the study uses Glejser test.

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Glejser test suggests that regressing the residual absolute value to the independent variable (Gujarati 2004).

c. Autocorrelation test

Autocorrelation is to seek the interrupting variable or relation in the regression model. Kendall and Buckland (1971) cited on Gujarati (2006) defined the term autocorrelation as correlation between members of observations ordered in time (as in time-series data) or space (as in cross-sectional data). Because of that Gujarati (2006) suggests, autocorrelation can occur in cross-sectional data also, in which case it is called spatial correlation. In this case the correlation in space rather than in time. So that the study uses Durbin-Watson Test and Langrange Multiplier test or Breusch-Godfrey test. LM test or BG test used for sample > 100 observation. This test is more precise than DW test particularly for big amount sample (Ghozali 2005).

d. Multicolinearity test

It defines the perfect linear relation between or among all independent variable in regression model (Gujarati 2004). The method in this test is using Variance Inflation Factor (VIF).

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CHAPTER IV

DATA ANALYSIS AND DISCUSSION

This chapter explains about analysis results toward data which used in this research and analysis results discussion.

A. Data Description

The analysis targets of this study are 33 provinces in the Indonesian's local governments which consist of 369 regencies and 86 municipalities (http://www.djpkpd.or.id) while the sample is regencies and municipalities in all provinces which have completed data. We analyzed data for year 2006 only. While a few preceding studies tried to analyze the time-series analysis focusing on specific events related to local governments, but in this study tries to analyze of data in year 2006 by cross-section analysis. According to *Undang-Undang* No. 34 year 2004 about financial balance between central government and local government, the relative fiscal importance between a central government and a local government has been kept to a steady level. However, such analysis is expected to draw a significant result because there are large differences between inter-regions relatively. The scope of our study limited in year 2006 because it was the latest period available to get data and the maximum accumulation of experience on a local self-governing system after the implementation of *Undang-Undang* No. 34 year 2004.

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Relate to the availability data and completion data in informing all of points which will be needed, there are only 232 budget realization statements that complete all of information. The descriptive statistics analysis of variables can be checked in Appendix 1 and variables are broadly distributed according to regions. From the descriptive test result can be seen that the total data (N) taken is 232. The 232 data are tested to fulfill the classical assumption test; unfortunately it failed to fulfill the classical assumption test because of failed in heteroscedasticity test and autocorrelation test. The result of the classical assumption test can be seen in Appendix 2. Then the researcher did logarithm transformation of the 232 data. By using the log data, the classical assumption test is ran later. Therefore it failed to fulfill the classical assumption test again. Heteroscedasticity still occurred and data is not distributed normally. The result of the classical assumption test using log data is revealed in Appendix 3. After the researcher knows that heteroskedasticity still exists and the distribution of data is not normal so that the researcher cuts of data by determining outliers. Indeed the researcher finds some data with extreme value. Fifty five are quitted from sample because of outliers. Finally, by trial and error process, in can be verified that 177 financial statement of regencies and municipalities as a final sample which can be tested in this study.

These data and information are retrieved from the website (http://www.djpk.or.id, 2006). In addition, other data and information which are taken from published source or combined. Those were directly obtained by officers of local governments. The measurement and patterns of the local original revenue, balance fund, and others revenue as a proxy of fiscal decentralization,

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and public expenditure used the total amount which taken from budget realization statement. The testing for the influence of fiscal decentralization to the public expenditure in local governments was performed by multiple regression analysis. Data processing and analysis were run by SPSS 16.0 for Windows and simple descriptive statistics were calculated using Microsoft EXCEL 2003.

B. Statistical Results and Discussion

In this subsection discuss the result of research that covered descriptive statistic, classical assumption test, and data analysis.

1. Descriptive statistic

After the completion data is sorted and the researcher did outlier data, and then verifies that 177 regencies and municipalities can be tested in this study. Descriptive statistic is derived from statistic analysis before another test performed using multiple regression analysis. The descriptive statistics figures of variables can be checked by Table 1 and variables are broadly distributed according to regions. From the descriptive test result, we can see that the total data (N) taken is 177. The minimum value, maximum value, mean, and standard deviation have been depicted on the table below:

Table 1
Descriptive Statistic Result (in Million Rp)

Variable	N	Min	Max	Mean	Std. Deviation
Local original revenue (LOR)	177	1,768.99	160,259.23	22,586.70	21,353.32
Balance fund (BF)	177	196,359.93	824,822.58	391,618.46	132,494.65
Others revenue (OR)	177	342.85	501,331.83	14,309.60	48,716.33
Public expenditure (PE)	177	21,444.87	480,839.68	201,191.55	95,558.91

Table 1 shows the result of local original revenue in Indonesia on the average 22586.70 million. It means that regencies and municipalities in Indonesia have ability to collect their own revenue on the average Rp 22,586,700,000. While the mean value of balance fund is 391618.46 million. It means that regencies and municipalities in Indonesia achieve transfer from central government on the average Rp 391,618,460,000. Beside that, the other revenue obtained by regencies and municipalities is others revenue. It can be seen from Table 1 that the average of others revenue is 14309.60 million. It means that the ability of regencies and municipalities in Indonesia to collect their others revenue on the average Rp 14,309,600,000. The other side, regencies and municipalities distribute their revenue for public expenditure in order to meet public demand. The mean value of public expenditure is 201191.55 million. It means that the average spending for public expenditure is Rp 201,191,550,000. So, it can be concluded that the average revenue of regencies and municipalities in Indonesia is used for public expenditure is around 47%. It can be counted from the sum of average local original revenue, balance fund, and others revenue divided by the average of public expenditure. It means that 47% local government revenues use for financing public service needed.

2. Classical assumption test

By using data after outlier, then the researcher did heteroscedasticity test and normality test. The statistical result of the classical assumption test is revealed in Appendix 4. Finally, due to the heteroskedasticity still occurred then the all of the data could be transformed first into logarithm value. The statistical result of classical assumption test use data log is shown in Appendix 5. The result of classical assumption test after outlier and use data log will explain below:

a. Heteroscedasticity test

Heteroskedasticity test aims to test whether the regression has difference variance from the residue between observations. If this research uses the cross-sectional data, a heteroscedasticity problems being possible occurred. Therefore, the researcher does the heteroscedasticity test in this study.

The result of Glejser test shows that there are no heteroskedasticity. It means that heteroskedasticity does not exist on the regression model.

b. Normality test

The purpose of normality test is to know whether or not residual has a normal distribution in the regression model (Ghozali 2005). The appendix 5 reveals that the distribution of the data is normal. It can be seen from Kolmogorov-Smirnov is 1.333 with p-value 0.057. Therefore, because of p-value > 0.05 it can be said that the data normally distributed.

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c. Multicollinearity test

The assumption of multicollinearity is not exist according to Gujarati (2004) happened when there is no exact linear relationship among independent variables, or there is no multicollinearity if more than one exact linear relationship is involved, is new and needs some explanation. The calculation results of tolerance value show up that none of independent variables have tolerance value < 0.10. It means no correlation among independent variables which have value > 95%. Variance Inflation Factor (VIF) shows that none of independent variables have VIF > 10. So, it can be concluded that there is no multicollinearity.

d. Autocorrelation test

Autocorrelation is to seek the interrupting variable or relation in the regression model. Autocorrelation test aims to test whether or not the correlation happens in regression model. It can be known by Durbin-Watson test or Lagrange Multiplier test (Breusch-Godfrey test). BG uses criteria that if parameter coefficient for lag residual shows the probability of significance > 5% means autocorrelation is not exist (Ghozali 2006). There is no autocorrelation by LM test or BG test due to the Lag_Res has significance level > 0.05 and by Durbin Watson (1.913) is seen from du = 1.74 and 4 – du = 2.26. Because of (du) 1.74 < Durbin-Watson 1.609 < (4 - du) 2.26 then it can be concluded that there are no autocorrelation.

After the data fulfill the classical assumption test that there is no heteroscedasticity, data normally distributed, no multicollinearity, and no autocorrelation; then the researcher run the regression analysis as on the next subsection.

3. Data analysis and discussion

By using data log, it can be proved that all of classical assumption has been fulfilled, and then the test of hypothesis could be done. Hypothesis testing was done through multiple regressions. Multiple regression done by measuring goodness of fit test model to measure the appropriateness of sample regression functions in predicting actual value. Regression model goodness of fit could be seen from determination coefficient, F-value, and t-value.

a. Statistical analysis of the first hypothesis

The purpose of the first step is to test the influence between the independent variable (balance fund and others revenue) to the dependent variable (local original revenue). Multiple regressions will be done simultaneously toward all independent variable with significance level 0.05. Due to the using data log, then the empirical model is formulated in the following regression equation:

$$\text{Log LOR} = a + b_1 \text{ Log BF} + b_2 \text{ Log OR} + e \qquad (3)$$

The result of regression test and the result of regression model are revealed on Table 2 below;

Table 2
Regression Test and Model (Enter Regression Method)

Variabel	Coefficient	Std.Error	t	Sig
Constant	-2.325	.974	-2.386	.018
Log BF	1.197	.179	6.681	.000 (H_{1a})
Log OR	-.037	.047	-.796	.427 (H_{1b})
R^2	.206			
Adjusted R^2	.197			
F-value	22.576			
Sig	.000			

**Significant level 0.05*
Dependent variable = Local Original Revenue

Based on the data execution on the table 2, it can be verified that the formulation is follow:

$$\text{Log LOR} = -2.325 + 1.197 \text{ Log BF} - 0.037 \text{ Log OR} \qquad (4)$$

Determination coefficient (R^2) is measured how far the independent variables can explain the dependent variable. The Table 2 revealed that the value of adjusted R square is 0.197 which means that 19.7% variation local original revenue (dependent variable) can be explained by the variation from the combination of independent variables that is others revenue and balance fund. The rest of 80.3% explained by the others factors outside of the model.

The F-value is used to decide whether the regression model could be used to predict the dependent variable. Based on the empirical results of the F test, it can be seen that the F-value is 22.576 with the significance probability 0.000. The regression model can be used to predict local original revenue because of the probability < 0.05. It means that the independent variables of the research influence the dependent variable. Therefore, balance fund and

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others revenue at the moment influence on the local original revenue. Based on the result of regression test on Table 2, it can be seen on the following discussion:

1) Hypothesis $_{1a}$ stated that balance fund positively influence on the local original revenue. Relate to the result of the regression test, it proved that H_{1a} supported by the finding of the research results that is the implementation of fiscal decentralization through component of balance fund positively influence on the increasing local original revenue.

   The result of the hypothesis testing shows that balance fund significantly influences on the local original revenue. It can be seen that the p-value 0.000 in the significance level 0.05. Regression coefficient of balance fund 1.197 indicates that each addition of balance fund at the amount of 10 (in million) will increase local original revenue 1.197 (in million rupiahs). Coefficient is positive that it reflects the positive relation between balance fund and local original revenue. It means that balance fund affect to the increasing of the local original revenue. It can be said that the increasing of balance fund is followed by the increasing of local original revenue. In other word, local original revenue will increase if balance fund is increase.

   It indicates that local government in Indonesia strongest dependent on the balance fund to increase their own revenue. It reveals that local government reliance on central government fund through balance fund to enhance local revenue. This result is consistent with the previous study that is Purwantoro (2007) and Yudani (2008). Therefore, it can be

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concluded that both of balance fund and others revenue affect the local original revenue.

2) Hypothesis $_{1b}$ stated that others revenue negatively influence on the local original revenue. The result of the regression test can be said that H_{1b} is not supported by the finding of the research results because of the implementation of fiscal decentralization through others revenue component is not affect significantly on the increasing local original revenue.

   It can be seen on Table 2 reveals that others revenue is not influence significantly on the local original revenue because of the p-value > 0.05. Others revenue regression coefficient shows –0.037 informs that each addition of others revenue at the amount of 10 (in million) will decrease local original revenue 0.037 (in million rupiahs). Coefficient of others revenue is negative that it reflects the negative relation between others revenue and local original revenue. It means that others revenue is not affect to the increasing of the local original revenue.

   Although the hypothesis is not supported by this result, but the finding of this result is in line with the previous study that is Yudani (2008) and Zhuravskaya (1999).

In sum, it can be concluded that balance fund together with others revenue influence on the local original revenue. Meanwhile, balance fund is statistically strongest variable affects to the local original revenue even though others revenue is not affect significantly. Transfer from central government

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through balance fund hoped that regencies and municipalities in Indonesia can be independently and do not depending on central government by building up local original revenue. Therefore, regencies and municipalities have to effort by improving their own revenue in line with the spirit of local autonomy.

b. Statistical analysis of the second hypothesis

The purpose of the second step is to test the influence between the independent variable (balance fund, others revenue, and local original revenue) to the dependent variable (public expenditure). Multiple regressions will be done simultaneously toward all independent variable with significance level 0.05. Due to the using data log, then the empirical model is formulated in the following regression equation:

$$\text{Log LOR} = a + b_1 \text{ Log BF} + b_2 \text{ Log OR} + b_3 \text{ Log LOR} + e \qquad (5)$$

The result of regression test and the result of regression model are depicted on Table 3.

Table 3
Regression Test and Model (Enter Regression Method)

Variabel	Coefficient	Std.Error	t	Sig
Constant	.275	. 509	.540	.590
Log BF	.807	.103	7.811	.000 (H_{2a})
Log OR	.034	.024	1.408	.161 (H_{2b})
Log LOR	.086	.039	2.203	.029 (H_{2c})

R^2	.400
Adjusted R^2	.389
F-value	38.380
Sig	.000

**Significant level 0.05*
Dependent variable = Public Expenditure

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Based on the data execution on the table 3, it can be verified that the formulation is follow:

$$\text{Log PE} = 0.275 + 0.807\ \text{BF} + 0.034\ \text{OR} + 0.086\ \text{Log LOR} \qquad (6)$$

It can be seen that the value of adjusted R square is 0.389 which means that 38.9% variation public expenditure (dependent variable) can be explained by the variation from independent variables that is balance fund, others revenue, and local original revenue. The rest of 61.1% explained by the others factors outside of the model.

Table 3 shows that the F-value is 38.380 with the significance probability 0.000. It can be seen that significance probability less than 0.05. Hence, the regression model can be used to predict public expenditure because of the p-value < 0.05. It means that balance fund, others revenue and local original revenue simultaneously influence on the public expenditure.

The empirical results on Table 3 can be concluded that all of the independent variables (balance fund, others revenue, and local original revenue) affect to the public expenditure.

Based on the result of regression test on Table 3, it can be seen on the following discussion:

1) Hypothesis 2a sated that balance fund positively influence on the public expenditure. Relate to the result of the regression test, it can be said that H_{2a} supported by the finding of the research results that is the implementation of fiscal decentralization through component of balance fund positively influence on the public expenditure.

On the Table 3 reveals the individual parameter significance which it shows each of the dependent variable affect to the independent variable. The significance probability of balance fund is 0.000. It means that public expenditure significantly influenced by balance fund. It can be seen that the significance probability < 0.05. Beside that, the regression coefficient of balance fund 0.807 indicates that each addition of balance fund 10 (in million) will increase public expenditure 0.807 (in million Rp). The coefficient value is positive that it reflects the positive relation between balance fund with the public expenditure. It means that of balance fund affect to the increasing of public expenditure.

It can be said that if balance fund increase then public expenditure increase too. It means that regencies and municipalities in Indonesia allocate their revenue for public expenditure along with the increasing of balance fund. This is in line with the previous study by Purwantoro (2007), Abdullah & Halim (2004) and Kuncoro (2007).

Therefore, balance fund positively influence on the public expenditure. It indicated that there is dependence on receipt from central government through transfers in regencies/municipalities in Indonesia.

2) Hypothesis 2b stated that others revenue positively influence on the public expenditure. The result of the regression test can be said that H2b is not supported by the finding of the research results that is the implementation of fiscal decentralization through component of others revenue does not positively influence on the public expenditure.

It can be seen that the significance probability of others revenue is 0.161. It means that others revenue does not significantly affect to the public expenditure because of the significance probability > 0.05. Others revenue regression coefficient shows 0.034 inform that each addition of others revenue 10 (in million) will increase public expenditure 0.034 (in million rupiahs). So, it can be said that if others revenue are increase then public expenditure is increase too.

Although the hypothesis is not supported by this result, but the finding of this result is consistent with the previous study by Ping et al. (2005) and Yudani (2008).

3) Hypothesis 2c stated that local original revenue positively influence on the public expenditure. According to the result of the regression test, it can be said that H2c supported by the finding of the research results that is the implementation of fiscal decentralization through component of local original revenue positively influence on the public expenditure.

The significance probability of local original revenue is 0.029. It means that public expenditure significantly influenced by local original revenue. It can be seen that the significance probability < 0.05. Beside that, the coefficient value is positive that it reflects the positive relation between, local original revenue with the public expenditure. It means that local original revenue affect to the increasing of public expenditure.

Regression coefficient of local original revenue 0.086 informs that each addition of local original revenue 10 (in million) will increase public

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expenditure 0.086 (in million rupiahs). So, it can be said that if local original revenue increase then public expenditure increase too. It means that regencies and municipalities in Indonesia allocate their revenue for public expenditure along with the increasing of their own revenue. So that local original revenue positively influence on the public expenditure.

This is in line with the previous studies by Freinkman and Yossifov (1998), Zhuravskaya (2000), Fiva (2006, Mc Nab et al. (2005), Faguet (2004), and Abdullah & Halim (2004).

In sum, the result of the hypothesis testing shows that all of balance fund, others revenue, and local original revenue simultaneously influence on the public expenditure. The other side from the individual parameter significance, local original revenue and balance fund significantly influence on the public expenditure even though others revenue is not influence. So, local original revenue and balance fund are statistically strong variable affects to the public expenditure although others revenue is not. It indicated that the large amount of revenue obtained by regencies and municipalities will be followed by public expenditure. Therefore, transfer from central government through balance fund truly importance for regencies and municipalities in Indonesia to improve public service demand.

It can be concluded that the fiscal decentralization through the proxy of local original revenue, balance fund, and others revenue totally influence on the public expenditure. The increase of revenues (fiscal revenues) with the same direction in increase of budgetary revenue would improve the

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responsiveness of public services demand to the real need, meaning that fiscal decentralization would guide marginal propensity for public good provision more closely to local citizen's preferences so that decentralization with fiscal revenues improved the sensitivity of local public good provision to local needs.

Hence, the more autonomy local government has strong fiscal independence, the more public expenditure or the lower its preference for social welfare development. Public expenditures in local governments are directly proportional to the size of the financial power. Rather, it could be assumed that the fiscal decentralization level is proportional to the public expenditure in Indonesia.

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CHAPTER V

CONCLUSION AND RECOMMENDATION

A. Conclusion

From the descriptive statistical results, it can be concluded that the average of revenue of regencies and municipalities in Indonesia used for financing public expenditure is 47%.

Statistically, balance fund is significantly affects to the local original revenue although others revenue is not affect significantly. So, the increasing of balance fund is followed by the increasing of local original revenue. Therefore, regencies and municipalities have to effort by improving their own revenue in line with the spirit of local autonomy. This result is line with the previous study by Zhuravskaya (1999), Purwantoro (2007), and Yudani (2008).

For the public expenditure, it can be concluded that the fiscal decentralization through the proxy of local original revenue, balance fund, and others revenue simultaneously influence on the public expenditure. Indeed, balance fund; others revenue; and local original revenue positively influence on the public expenditure although both of balance fund and local original revenue significantly affect to the public expenditure while others revenue does not significantly affect. So, the second hypothesis is proved. The result of this study in line with the previous studies by Freinkman and Yossivof (1998), Zhuravskaya (2000), Faguet (2004), Abdullah and Halim (2004), Ping et al. (2005), Mc Nab et al. (2005), Fiva (2006), Kuncoro (2007), Purwantoro (2007), and Yudani (2008).

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The increasing of revenues (fiscal revenues) with the same direction in increase of budgetary revenue would improve the responsiveness of public services demand to the real need, meaning that fiscal decentralization would guide marginal propensity for public good provision more closely to local citizen's preferences so that decentralization with fiscal revenues improved the sensitivity of local public good provision to local needs.

B. Limitation and Recommendation

The conclusions to be derived from our analysis must be tempered by the study's inherent limitations. The primary limitation is the investigation of local budget realization just for a single budget year rather than over several years. The researcher chose to limit its investigation to cross-sectional analysis because of the availability and completed data. These findings, no matter how statistically significant, would therefore have to be validated by time-series analysis.

Secondly, the independent variables that the researcher incorporated into the model may be inadequate surrogates for the underlying conditions or circumstances that are intended to represent. For example, political competition, change in population, may influence on the fiscal instability.

A third limitation is confining the study to the local government in Indonesia. The budget practices of local government will undoubtedly be influenced by the political, ethical, demographic factor and economic factors that differ from regency to regency and which are not captured by this study.

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In accordance with the local finance theory, fiscal decentralization can contribute to the demand of public service development from society on a dynamic aspect. Means that the government must control their revenue for public service spending rather than apparatus spending in order to fulfill public accountability and also support public demand. These opinions could be verified by this study.

The conclusions have implications for the theory of decentralization: shifts in expenditures towards higher decentralization will not achieve the expected benefits without a concurrent shift in control towards localities over how much revenue local governments can collect. A decentralized system is expected to be better respond to the local preferences needs and to promote competition among local units in the provision of public goods and services. Additionally this research has implications for the budgetary policy.

Future research should be followed by utilizing the latest data and information which are accumulated since 2006 for the better understanding of the detailed policy effects of fiscal decentralization. At the same time, the effects of fiscal decentralization on more specific spending of local self-governing entities need to be assessed.

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