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The Effects of Financial Balance Transfer and Regional Own-Source Revenue on Regional Expenditure of Regencies and Municipalities in East Java Province

Khubbi Abdillah[1], Djoko Mursinto[2]

[1]Doctoral Study Program, Faculty of Economics and Business, Universitas Airlangga, Surabaya, Indonesia
[2]Economics Department, Faculty of Economics and Business, Universitas Airlangga, Surabaya, Indonesia

Abstract- This study aims to identify the flypaper effect and the effects of financial balance transfer and Regional Own-source Revenue on regional expenditure of regencies and municipalities in East Java Province. The population of this study consists of regional expenditure data of 29 regencies and 9 municipalities in East Java Province collected by Statistics Indonesia (Biro Pusat Statistik/BPS) from 2005 to 2012. The writer conducted analysis on the data using Eviews 7. The findings of this study indicated that Regional Own-source Revenue, General Allocation Fund, and Specific Allocation Fund significantly affect regional expenditure and the flypaper effect occurs on regional expenditure of regencies and municipalities in East Java Province. This conditionis marked by regional spending as the response against the General Allocation Fund is higher than regional spending as the response against Regional Own-Source Revenue. Therefore, it can be concluded that the dependency level of the regions upon financial balance transferred from central government is still relatively high.

Index Terms- Regional Own-source Revenue, Financial Balance, Regional Expenditure, Flypaper Effect

I. Introduction

East Java Province is one of provinces in Java. Its region consists of mainland East Java, which covers about 90% of total region and Madura Islands (about 10% of total region). Administratively, East Java Province consists of 29 regencies and 9 municipalities with 662 districts, 785 sub-districts, and 7721 villages (Gubernur Jawa Timur, 2012: 5).

In order to implement true and responsible regional autonomy widely, each region requires authorities and abilities to explore its own revenue resources. The authorities and abilities shall be supported by a financial balance distributed by the central government to the local governments (i.e. provincial governments, regencies, and municipalities) as one of pre-requirements of the regional government system. When we analyze further, the source of regional funding is implemented based on the principles of decentralization, delegation, and co-administration. The implementation of regional tasks in terms of decentralization effectuation is funded by the Local Government Budget (*APBD)* while the implementation of central government tasks carried out by local government based on delegation principle is funded through the State Budget (*APBN)*. Central government tasks carried out by local and village apparatuses (in terms of co-administration) are also funded through the State Budget (Djaenuri, 2014: 87).

Transfers of human resources, infrastructure, and fund allocation shall entail delegation of authorities from central government to the local governments as the result of decentralization and de-concentration. Transfers of human resources, infrastructure, and fund allocation are required to assure the fluency of authority delegation. Assignments given by central government to the local governments in terms of co-administration tasks are accompanied by financial allocation (Djaenuri, 2014: 88).

Financial balance between central government and local governments that is closely related to financial distribution from central government to the local governments occurs as the effect of distribution of power from central government to the local governments in terms of financial management. Article 18 of Constitution 1945 explicitly states that Indonesia consists of large and small areas which its government structures regulated by laws. Principally, financial balance correlates with balance of authority, balance of surveillance, and financial balance. The financial relationship between central and local governments should be coherent with the implementation of regional autonomy. This relationship becomes the key for successful internal affairs governance by the regions. “Governing its own internal affairs” implies a meaning that every autonomous region must possess its own source revenue to finance its own internal affairs.

Central government builds central-local government financial relationship to improve fiscal capability of the regions and creating more conducive situation for the implementation of regional autonomy. Generally, fiscal capability of regions in developing countries is limited. Existing sources of regional revenue are limited to less potential sources and regional taxes that do not contribute much on the improvement of regional revenue. In order to cope with this problem, central government develops a systematic financial relationship with local governments (Djaenuri, 2014: 87).

Fiscal autonomy and decentralization implemented for the last 12 years has brought several consequences, including improvements on Regional Own-source Revenue (*PAD*) and Financial Balance transfer from central government to the local governments, which consists of General Allocation Fund (*DAU*), Special allocation Fund (*DAK*), and Revenue Sharing Fund (*DBH)*. Regional Own-source Revenue and Financial Balance transfer are used to finance regional expenditures, which consists of direct expenditure and indirect expenditure. This study aims to

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investigate and analyze partial and simultaneous effects of Regional Own-source Revenue (*PAD*), General Allocation Fund (*DAU*), Special allocation Fund (*DAK*), and Revenue Sharing Fund (*DBH*) on Regional Expenditure (*BD)*. This study also aims to analyze flypaper effect occurs in East Java regencies and municipalities from 2005 to 2012.

II. LITERARY REVIEW

In his book entitled *"Budgeting"*, Glenn A. Welsch stated that budget is viewed as a statement of managerial plans and policies used as guideline/blueprint in certain period. Meanwhile, M. Marsono in his book entitled *"Tata Usaha Perbendaharaan Republik Indonesia"* defined budget as work plan that in one side contains the highest expenditure required to finance the needs of a state in the future while on the other side, a budget must contain potential revenue (income) received by a state in that period. On the other hand, Jones and Pendlebury define budgeting as a work of government stated in form of currency (in this case, Rupiah) carried out in certain period (usually one year). The developed budget serves as means to measure the amount of expenses, as references in making future decisions and development plans. The budget also functions in authorizing future expenditure, establishing standards of performance evaluation, as motivation for employees, and as means to coordinate activities carried out by different working units (Halim & Damayanti, 2007: 143).

The main functions of budgeting are determining income received and expenditure, supporting decisions made in the future, and authorizing future expenditure. Budgeting also functions as the basis of revenue and expenditure controlling, as standards of performance evaluation, as motivation for employees and managers, and as means to coordinate various activities. Approaches in budgeting process refer to method used to in developing or formulating a budget. The approach shall describe the orientation of budget preparation and formulation process. Budgeting approaches also indicate the sources of initiative and how these initiatives applied. There are three approaches in budgeting process, namely *top-down approach, bottom-up approach*, and *mixture approach*.

Article 157 of Law Number 32 Year 2004 of Local Government mentions the sources of regional revenue consist of Regional Own-source Revenue (regional income comes from regional taxes and regional retributions, income from local resources, and other legal sources of regional revenue); financial balance transfer from the central government (general allocation fund, specific allocation fund, and revenue-sharing fund); and revenue collected from other legitimate sources.

Regional Own-source Revenue refers to regional income comes from sources owned by and situated on the region collected according to established regulations. Regional taxes are compulsory contribution paid by individuals and institutions to the local government without direct compensation. Regional levy collection is imposed by regulations in force. Regional taxesare used to fund the operation of local government and regional development. Regional retributions are compensation for service and license given by local government to individuals and institutions. Service refers to efforts made by local government that enables individuals or institutions can use expediencies, goods, and infrastructure provided by local governments. Regional service can be categorized into general service, service by regional enterprises, and licensing. Minister of Domestic Affairs Regulation Number 50 Year 1999 defines Local Government Owned Enterprises (BUMD) as corporations owned by local government, except waterworks (*PDAM), Bank Perkreditan Rakyat (BPR),* and Regional Development Bank (BPD). Regional income comes from local resources management include share of profits and dividends of regional enterprise stocks. Other legitimate sources of regional incomes include sale of goods owned by local government, current accounts, third party donations, compensations of local assets, deposits of excessive third party payment, penalties for delayed work, vehicle installments, sales of asphalt drums, guano patcher, bird nest patcher, plants, income from concrete material testing, revolving income, tax penalties, and so on.

Financial balance is regional income coming from State Budget (APBN). Its utilization is to support the implementation of local government authorities in achieving the goals of local autonomy, mainly in order to improve public service and prosperity. General Allocation Fund (*DAU)* transferred by central government to equalize financial capabilities of the regions. The minimum amount of DAU is 25% of State Revenue (tax income and non-tax income) after reduced by national income shared to regencies and municipalities with proportion of 10% and 90% of APBN. Special allocation Fund (DAK) is transferred from State Budget to support special needs of certain regions. The allocation of DAK is based on availability of fund in the State Budget, therefore the amount of DAK allocated changes every year. Revenue-sharing Fund (DBH) comes from natural resources income received nationally, which includes forestry income, mining income, fishery income, crude oil income, LNG income, and geothermal income.

There are several reasons why financial balance transfer becomes importance. First, financial balance transfer prevents vertical disparity of fiscal imbalance between central government and local governments, which in turn triggers horizontal fiscal imbalance among local governments. Second, financial balance helps set minimum standards of public service because there is positive bias of public service carried out by local governments. Third, financial balance helps maintain stability (Simanjuntak, 2003: 24).

In order to maintain sustainable policy reformulation, financial balance transfer from central government to the local governments directs towards several goals. Financial balance helps improve fiscal capacity of the regions and prevents vertical fiscal disparity between central government and local governments and horizontal fiscal disparity among regions. Financial balance transfer aims to conform financial needs of a region to its governance distribution. It improves quality of public service carried out by a local government and reduce disparity of public service quality among regions. Financial balance also supports sustainability of national fiscaland helps the regions to improve its capability in exploring its economic potentials. Finally, financial balance improves the efficiency of natural resources utilization and synchronizes national development plans and regional development plans (Azis, 2013: 368).

Article 36 Paragraph 1 of Minister of Domestic Affairs Regulation Number 13 Year 2006 on Guidelines of Regional Financial Management categorizes regional expenditure into two types, namely direct expenditure and indirect expenditure. Direct expenditure refers to regional spending that directly relates to programs and activities carried out by local government, including employee expenses, goods and service expenses, and capital expenses. Meanwhile, indirect expenditure is regional spending that is not directly relating to activities and programs carried out by local government, including employee expenses, interests, subsidies, grants, social aid funds, revenue sharing expenses, financial aids, and unexpected expenses.

Rostow and Musgrave correlates development of government expenditure with phases of economic development. They categorize economic development phases into three. First is primary phase of economic development where a government puts its investment totally on facility provision. Second is secondary phase of economic development where a government allocates parts of its investment to improve its economic development, and finally advanced phase where the focus of economic activities carried out by the government changes from facility provisions to social expenses (Mangkoesoebroto, 2011: 170).

Wagner (1883) stated that increasing income relatively increased the amount of expenses. Peacock and Wiseman (1961) stated that a government tends to increase the amount of its expenditure while its people are hesitant to pay increasing taxes to fund the expenses of its government. People hesitation to pay more taxes becomes limitation for raising taxes arbitrarily. In normal condition, the improvement of GNP, which indicates increasing government revenue, triggers the increasing of government expenditure. When the condition changes (for example a nation is in war), many activities carried out by private transferred to government (transfer effect) and many activities carried out by government come to effect during war (inspection effect). Social chaos also causes changes on economic activities concentration where the government undertakes most of activities carried out by private sector before. Bird (1972) states that during social chaos, government expenditure changes to expenditure related to the event. Transfer effect occurs as one of short-term symptoms that does not last for long. Clarke (1977) defines the limit of taxes determined by a government is 25% of national income. Exceeding taxes beyond this limit may cause inflation and trigger social disruption (Mangkoesoebroto, 2011: 176).

Rukhaniyah and Nugroho (2011) analyzed flypaper effect on expenditure of several local government (regencies and municipalities) in Indonesia during period 2006- 2008. The results of their analysis indicated that ingeneral flypaper effect does not occur in expenditure of regencies and municipalities in Indonesia. Dummy variables showed that flypaper effect only occurs in Java regencies and municipalities. Flypaper effect does not occur in regencies and municipalities outside Java. A study on the effect Regional Own-source Revenue and financial balance on capital expenditures of regencies and municipalities in Central Java Province conducted by Masdjojo and Soekarnoto (2009) showed flypaper effect on expenditure of regencies and municipalities in Central Java Province. Kusumadewi and Rahman (2007) conducted a research on the effect of Regional Own-source Revenue and General Allocation Fund on regional expenditure of regencies and municipalities in Indonesia. The finding of their study suggested that Regional Own-source Revenue and General Allocation Fund significantly affected regional expenditure but they also caused flypaper effect. Murniasih and Mulyadi (2011) analyzed the effect of regional tax income, general allocation fund, and special allocation fund on regional expenditure of East Kalimantan Province. They found that flypaper effect occurred in that region.

III. RESEARCH METHOD

In this study, the writers applied panel-data regression model. The model was similar to the model applied by Masdjojo and Soekanto (2009) where both models utilized Regional Own-source Revenue, General Allocation Fund, Special allocation Fund, and Revenue Sharing Fund as the independent variables while Regional Expenditure was the dependent variable.

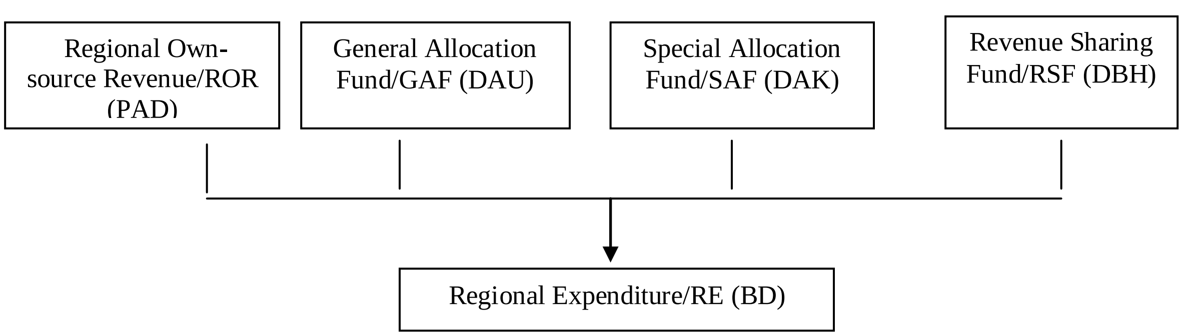

Figure 2.1: Research Model Framework

Figure 2.1 above described research model framework how Regional Own-source Revenue/ROR (*PAD)*, General Allocation Fund/GAF (*DAU*), Special Allocation Fund/SAF (*DAK)*, and Revenue Sharing Fund/RSF (*DBH)* affected Regional Expenditure/RE (*BD)*. Analysis on flypaper effect was conducted through four research models where each independent variable was estimated to the dependent variable. Mathematically, the estimation was expressed by the following formula:

$$RE = \alpha + \beta 1ROR + \beta 2GAF + \beta 3SAF + \beta 4RSF + \varepsilon$$

Note:
RE = Regional Expenditure
α = intercept constant
β1, β2, β3, β4 = Regression Coefficients
ROR = Regional Own-source Revenue
GAF = General Allocation Fund
SAF = Special Allocation Fund
RSF = Revenue Sharing Fund

The data used in this study covered financial statistics of 29 regencies and 9 municipalities in East Java Province from 2005 to 2012. The data was secondary data collected from statistics agencies in regencies and municipalities of East Java Province. Estimation phase was conducted to identify the correlations of regional own-source revenue, general allocation fund, special allocation fund, and revenue sharing fund on regional expenditure by using panel method run by Eviews 7 software. Eviews 7 software was chosen for its ability to perform intercept constants of each regencies and municipalities in East Java Province.

IV. FINDINGS AND DISCUSSION

Analysis methods applied in this study were data panel regression methods. There are three methods commonly operate data panel. They are Pooled Least Square (PLS) which simply pools all cross section and time series data and Fixed Effects Model (FEM), which accommodates the probability that the researcher may find omitted variables altering time series and cross section intercepts. Fixed Effects Model provides dummy variables to accommodate intercept alterations. The third approach is Random Effects Model (REM), which improves efficiency of least square models by estimating errors of cross section and time series. Random Effect Model is a variation of generalized least square estimation (Gujarati, 2003).

Revenue Sharing Fund (DBH) Variable turns out does not significantly affect Regional Expenditure (See Table 3.1). Regional Own-source Revenue (PAD), General Allocation Fund(DAU), and Special Allocation significantly affect Regional Expenditure as indicated by parameter coefficients 1.439, 0.716, and 5,521 respectively. Improvement of regional expenditure caused by Special Allocation Fund is higher than regional expenditure as the effects of Regional Own-source Revenue and General Allocation Fund. Results of Chow test shows that chi-square value is higher than α=5%. Results of determination test (R^2) shows that the magnitude of regional expenditure alteration caused by alterations of Regional Own-source Revenue, General Allocation Fund, Special Allocation Fund, and Revenue Sharing Fund is 0.89%. Excessive Regional Expenditure as much as 11% was caused by other variables that did not include in F-statistic model with probability value 0.000. Based on this finding, all independent variables (i.e. ROR, GAF, SAF, and RBF) simultaneously affect Regional Expenditure as the dependent variable.

Table 3.2 below show that three of the independent variables (i.e. ROR, GAF, and SAF) in partial have significant correlation with Regional Expenditure. Estimation models applied to measure each independent variables was Pooled Least Square (PLS), except for GAF variable the writers used Random Effect Model (REM) because chi-square value of this variable (based on result of Chow Test) was lower than α (≤ 5%) and its probability rate (based on Hausman Test) was higher than α (≥ 5%). The highest R^2 value of determination coefficient is also found on GAF variable. The result of F-statistic shows probability rate 0.000 indicating that simultaneously all independent variables (i.e. ROR, GAF, SAF, and RSF) significantly affects Regional Expenditure (RE). Regional Expenditure as a response towards General Allocation Fund was higher than regional expenditure as a response against Regional Own-source Revenue, as indicated by GAF coefficient 20.17 higher than ROR coefficient 4.97. This condition proves that the flypaper effect does occur on Regional Expenditure of Regencies and Municipalities of East Java Province. This finding is in coherence with findings of previous studies conducted by Rukhaniyah and Nugroho (2011), Masdjojo and Soekarnoto (2009), Kusumadewi and Rahman (2007), and Murniasih and Mulyadi (2011) proving that flypaper effect does occur in most of Indonesian provinces due to high dependency level towards central government.

Table 3.1: The Correlation of Regional Own-source Revenue (ROR), General Allocation Fund (GAF), Special Allocation Fund (SAF), and Revenue Sharing Fund (RSF) on Regional Expenditure (RE) of Regencies and Municipalities in East Java Province 2005-2012

Variable	Coefficient	t-statistic	Probability
C	1,01	3,01	0,002*
ROR	1,439	8,43	0,000*
GAF	0,716	5,48	0,000*
SAF	5,521	4,47	0,000*
RSF	0,307	0,75	0,451
Adjusted R^2	0,8986	F-statistic	672,35
Prob (F-statistic)	0,000	Durbi-Watson Stat	1,1127
Cross-section Chi Square	47,94	Prob	0,1073
Cross-section Random	1,657	Prob	0,798

*significance level (α) 1%, Data analysis by Eviews 7

Table 3.2: The Correlation of Each Independent Variable (ROR, GAF, SAF, and RSF) Partially on Regional Expenditure (RE) of Regencies and Municipalities in East Java Province 2005-2012

Variable	Coefficient	Variable	Coefficient
C	4,86*	C	-7,28
ROR	4,97*	SAF	20,17*
Adjusted R^2	0,55	Adjusted R^2	0,80
Prob F-statistic	0,00*	Prob F-statistic	0,00*
Cross-section Chi Square	61,89*	Cross-section Chi Square	72,85*
Cross-section Random	1,24	Cross-section Random	2,85
C	1,77*	C	4,40

GAF	1,31*	RSF	5,60
Adjusted R^2	0,86	Adjusted R^2	0,80
Prob F-statistic	0,00*	Prob F-statistic	0,00*
Cross-section Chi Square	44,19	Cross-section Chi Square	83,39*
Cross-section Random	0,08	Cross-section Random	0,88

*significance level (α) 1%, data analysis by Eviews 7

V. CONCLUSION

1. In partial, Regional Own-source Revenue (ROR), General Allocation Fund (GAF), Special Allocation Fund (SAF) significantly and positively affect Regional Expenditure (RE) of Regencies and Municipalities in East Java Province during 2005-2012 period.
2. Revenue Sharing Fund (RSF) does not significantly affect Regional Expenditure of Regencies and Municipalities in East Java Province from 2005 to 2012 because the local governments do not optimally exploit natural resources owned by each region.
3. Simultaneously, Regional Own-source Revenue (ROR), General Allocation Fund (GAF), and Special Allocation Fund (SAF) significantly and positively affect Regional Expenditure (RE) of Regencies and Municipalities in East Java Province during 2005-2012 period.
4. Flypaper effect occurring in Regencies and Municipalities of East Java Province during 2005-2012 is because Regional Expenditure as the response against Special Allocation Fund is higher than Regional Expenditure as the response against Regional Own-source Revenue. This condition indicates local governments' high dependency towards financial transfer from the central government, especially in terms of funding special needs of a region that are different from other regions, such as new infrastructure, developing roads in rural areas, primary irrigation, primary drainage, reforestation, and humanity projects to fulfill basic needs of the people. In order to reduce flypaper effect and minimizing dependency of financial balance transfer from central government, every regency and municipality in East Java Province should be able to improve its Regional Own-source Revenue by intensifying and optimizing its regional tax income.

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AUTHORS

First Author – Khubbi Abdillah , Doctoral study program, Faculty of Economics and Business, Airlangga University Surabaya, Indonesia, email address: abdillahobbie@gmail.com
Second Author – Djoko Mursinto, Professor, Faculty Economic and business, Airlangga University Surabaya, Indonesia

Correspondence Khubbi Abdilah– email address: abdillahobbie@gmail.com