CHAPTER ONE

INTRODUCTION AND RESEARCH METHODOLOGY

1.1.   Background

Since the 1970s, many governments in Asia, Latin America, and Africa have introduced new approaches to economic, social, political and administrative arrangements for implementing development programmes. As a result, the interest of politicians and policy-makers in the decentralisation of government authority to lower levels has gradually increased (Rondinelli & Cheema, 1983). This trend has become significant over the last two decades.

This study intends to comprehensively elaborate upon and critically analyse the process of APBD (*Anggaran Pendapatan dan Belanja Daerah*/ Local Revenue and Expenditure Budget) at the local level under fiscal decentralisation in Indonesia. Since the governance reforms of the early 2000s, the Indonesian government has introduced many new ideas about, and approaches towards, government budgeting, which are widely known as the new paradigm of budgeting. In view of this, local governments are obliged to apply the new budgeting system in order to comply with the policy of local autonomy and fiscal decentralisation.

Rondinelli (1981) defines decentralisation as the distribution of responsibility for planning, management, and resource raising and allocation from the central government and its agencies to: (a) field units of central government ministries or agencies; (b) subordinate units or levels of government; (c) semi-autonomous public

authorities or corporations; (d) area-wide, regional or functional authorities; and (e) non-governmental private or voluntary organizations.

Decentralisation can be categorised into three types, namely, delegation, de-concentration, and devolution (Rondinelli, 1981). Delegation is the transfer of managerial responsibility for specifically defined functions to organizations that are outside of the regular bureaucratic structure and that are only indirectly controlled by the central government. This implies that a sovereign authority creates or transfers specified functions and duties to an agent who has broad discretion to carry them out. According to Rondinelli et al., (1984, cited in Herath, 2009), de-concentration is the handing over of some amount of administrative authority and responsibility to units at lower levels within central government ministries and agencies. It is the shifting of the workload from centrally-located offices to offices outside of the national capital.

Devolution is the creation or strengthening - financially or legally - of subnational units of government, whose activities are substantially outside the direct control of the central government. Under devolution, local units of government are autonomous and independent of the central government, and it is their legal status that actually makes them separate and distinct from the central government. The central government may exercise only indirect supervisory control over such units. Sub-national governments have corporate or statutory authority to raise revenue and make expenditures (Sherwood, 1969).

Campos & Helman (2004) point out that decentralisation adds an alternative route to the accountability framework by shortening the link between policy-makers, on the one hand, and citizens and public service providers on the other. The proponents of decentralisation argue that it brings politicians closer to the people by

giving them better information about constituents' preferences, and also that it makes it easier for constituents to monitor politicians' performance.

Further, Herath (2009) explains that decentralisation can improve the allocation of public spending by making it more consistent with the wishes of the citizens (the spatial characteristic of public goods). It can provide a type of 'political glue' for countries with significant levels of ethnic diversity as well. Decentralized systems can become a surrogate for competition, allowing for experimentation and the creation of cost-efficient public service provision (Tanzi, 1996). Decentralisation can also strengthen national democracy and is relevant to meeting the needs of the poor (Smith 1985; World Bank, 1997).

Many scholars believe that decentralisation is a crucial step towards the consolidation or deepening of democracy (Huther & Shah, 1998), while others pay tribute to the potential of decentralisation to improve government efficiency (Tiebout, 1956). It is also proposed that decentralisation improves the accountability and responsiveness of political leaders (Ter-Minassian, 1997b), promotes political openness (Dillinger & Fay, 1999), and gives the public an opportunity to weigh the benefits of public programmes against their actual costs (Oates 1972). Decentralisation also brings the voice of the poor into the centre of the policy-making process and broadens the participation of the citizens (World Bank, 1997).

By delegating greater authority to local officials for development planning and management, decentralisation can be a means of overcoming the severe limitations of centrally-controlled national planning. It can lead to more flexible, innovative, and creative administration (Rondinelli & Cheema, 1983). Decentralised government operations can also improve the economic welfare of the community

(Ter-Minassian, 1997b), promote competition in the public sector, and eradicate poverty. Ultimately, decentralisation promotes growth and development.

Some economists maintain that there is a positive or direct relationship between the degree of decentralisation and economic growth and development (Oates, 1994). This idea is supported by the theoretical literature showing that the positive effects of decentralisation on growth and development have increased extensively. However, empirical studies are still in their infancy. The empirical studies conducted so far do not support a positive relationship between decentralisation and development (Bardhan, 2002; Jin & Zou, 2005; Ter-Minassian, 1997a; Baskaran & Feld, 2009). Almost all of these studies show that decentralisation has failed to promote development in developing countries. Some other studies show that decentralisation is an outcome of development and not *vice versa* (Bahl & Linn, 1992).

Many experts warn that decentralisation - particularly if poorly designed - might increase regional income inequalities (Prud'homme, 1995), increase the size of government (Stein, 1998), impede fiscal restraint (Alesina, et al., 1999), and/ or increase corruption (Tanzi, 1996; Treisman, 2000; Fisman & Gatti, 2000). Herath (2009) observes that there are three main findings and views on the relationship between the degree of decentralisation and growth. First, there is a positive relationship between the said variables in developed countries. Second, decentralisation is an outcome of development and not *vice versa*. Third, in developing countries, the relationship between growth and the degree of decentralisation is negative. Nevertheless, many countries including developed, developing, and transition economies, continue on the path of decentralisation.

In terms of the varieties of decentralisation, Tanzi (1996) divides decentralisation into three types, including fiscal, administrative, and political decentralisation. Administrative decentralisation is defined as a situation where most tax revenue is raised centrally, but the funds are allocated to decentralized entities. According to Herath (2009), fiscal decentralisation exists when sub-national governments have the power given to them by the constitution or by particular laws to raise some tax revenue and to carry out spending activities within clearly established legal criteria. Fiscal decentralisation is defined as being quite similar to devolution, as defined earlier. Moreover, political decentralisation aims to give citizens, or their elected representatives, more power in public decision-making. It is often associated with pluralistic politics and representative government, but it can also support democratization by giving citizens, or their representatives, more influence in the formulation and implementation of policies.

During the early 1970s, there was an upsurge of interest among development specialists, economists, and politicians in less developed countries in using fiscal decentralisation as a potentially powerful tool to promote national objectives (Oates, 1994; United Nations, 1991). Nonetheless, O'Neill (2003) has argued that the autonomous political and fiscal power of subnational officials, which means transferring fiscal resources to sub-national officials, will increase the number of actors involved in policy-making but will also maintain the accountability of these officials to the national government. In a similar way, electing subnational officials with no real fiscal power gives the central government veto power through its ability to withhold funding for local initiatives.

Theoretical discussion presented above indicates that decentralisation has positive and negative impacts. In view of this debate, the Indonesian authorities apparently take sides with the first contention. Indonesia believes that decentralisation is a worthwhile tool to accelerate and improve national and community development. Therefore, the post-reform Indonesian government established a decentralisation (including fiscal decentralisation) process as one of the priorities of governance reform.

Indonesia's decentralisation (broadly acknowledged as the local autonomy era) started with the issuance of Law 22 of 1999 about Local Government, and Law 25 of 1999 about Financial Balance between Central and Local Government. These two laws became officially effective from the 1st January 2001. Subsequently, as the Law 22 of 1999 and the Law 25 of 1999 have numerous downsides, in 2004 the Indonesian government replaced these two laws with Law 32 of 2004 on Local Government and Law 33 of 2004 regarding Financial Balance between Central and Local Government.

The laws mentioned above, which are well known as the 'package of local autonomy laws', essentially replaced the old local governmental system guided by Law 5 of 1974 about Local Government. This regulation was valid from 1974 to the end of the 1990's, a period in which Indonesia was under the administration of President Soeharto, with his authoritarian regime known as ORBA (*Orde Baru*/ New Order). During this entire period, every governmental matter at the local level was controlled by, and dependent upon, the policies of the central government. Local governments acted merely as "the agents of central government", executing the

central government's policy without the authority to initiate policy by themselves (Winarno, 2008).

Under the ORBA regime, local governments did not have the discretion to determine their own policies. As a result, the centralised approach discouraged the initiative and creativity of local government bureaucrats. Also, this atmosphere discouraged the capability and capacity of most local government officers, and it impeded local governments in responding to the aspirations of the local community. As consequence, local development projects did not significantly meet the interests of local people because most of them were fully designed and funded by the national administration.

With the adoption of the local autonomy policy, the situation has dramatically changed. The discretion of local governments in managing their governmental and financial matters has become far greater. Furthermore, the current system grants local government officers the power to independently design and execute development programmes and public services at the local level. Therefore, this policy can ensure that these activities will meet the aspirations, needs, and conditions of local communities. This approach is also expected to contribute significantly to economic prosperity at both the local and national levels.

Specific to the budgeting process and financial affairs, the present fiscal decentralisation policy has endowed local governments with significant power and authority to strengthen their financial capacity. Besides, the current system also requires local governments to implement the new paradigm of budgeting in order to ensure better financial management and accountability.

As stated in Law 33 of 2004, Law 17 of 2003, PP (*Peraturan Pemerintah/* Government Regulation) 58 of 2005, *Permendagri* 13 of 2006[1], and other normative guidelines, efforts have been made to strengthen the financial base of local governments. These attempts are carried out, among others, through: (1) strengthening of local taxing powers; (2) allowing local governments to create loans; (3) awarding grants to local governments; (4) control over local budget deficits; (5) formulating a new design for financial transfers to local governments; and (6) reformulating of the balancing fund (*Dana Perimbangan*).

The regulations mentioned above also encourage local governments to improve their budgeting systems and processes by adopting: (1) performance-based budgeting; (2) a medium-term budgeting approach; (3) integrated budgeting; (4) the 'money follows function' principle; (5) shifting of local governments' role; (6) control over budgets and financial management; and (7) the implementation of the double-entry accounting system.

By implementing these strategies and approaches, fiscal decentralisation policy sought to achieve the following objectives: (1) reduce the fiscal gap between the central government and local governments (vertical fiscal imbalance) as well as between local governments (horizontal fiscal imbalance); (2) improve the quality of public services at the local level and diminish the gap in public service quality among regions; (3) encourage the efficiency and utility of local and national resources; (4) increase the degree of excellence of management, transparency, and accountability in

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[1] Law 33 of 2004 on Financial balance between central and local government;
Law 17 of 2003 regarding Public Finance;
PP (*Peraturan Pemerintah/*Government Regulation) 58 of 2005 about Management of Local Government Finance;
Permendagri (*Peraturan Menteri Dalam Negeri/*Regulation of Minister of Home Affairs) 13 of 2006 concerning Guidelines of Local Financial Management. This *Permendagri* got revised two times by the *Permendagri* 59 of 2007 and *Permendagri* 21 of 2011

executing financial transfers from the central government to local governments so that they can be carried out efficiently, accurately, and fairly; and (5) support fiscal sustainability within the frame of macro-economic policy (Law 17 of 2003 & PP 58 of 2005).

Unfortunately, there are growing concerns with and scepticism about the implementation of fiscal decentralisation and the new paradigm of the budgeting process that has now been in operation for more than 10 years. Numerous studies conducted on Indonesia's fiscal decentralisation and budgeting system have disclosed a range of problems and distortions as well as other interesting findings.

Setiadi & Sobari (2004) reveal that there is lack of trust between the central and local governments in creating new regulations concerning public finance and the budgeting process at the local level. The issuance of new regulations by the central government is frequently assumed by local governments to be part of the process of the centralization of financial management. When local governments issue financial regulations, the central government tends to suspect that these regulations will only be used by the local apparatus to enrich themselves rather than to increase the welfare of the community. From another perspective, (Winarno, 2008) contend that, due to the extremely quick transition from the top-down to the bottom-up paradigm, most local governments are confused and not yet ready to execute their greater delegated authority and responsibilities. This is due to the centralised and top-down system which applied for a long time in Indonesian governance, which has significantly discouraged the ability, creativity, and responsibility of local government officials.

In addition, the implementation of local autonomy does not affect the quantity and quality of people's participation in the local budgeting process. This is due

mainly to inadequate opportunity for local people to participate in the local budgeting process. Moreover, the local community perceives that there is hardly any incentive for them to participate in the budgeting process of APBD. Other than this, diverse technical problems also contribute to the discouragement of citizen participation. Further, government officers as the leading actors in the promotion of citizen participation often lack the capacity to do so effectively (Hetifah, 2007).

A study conducted by the World Bank (2007) concludes that local autonomy has had negative impacts on the investment climate at the local level. This has happened because local governments tend to aim for short-term targets rather than for long-term investment. This tendency is associated with efforts by local governments to increase their Own-source Revenue (PAD/ *Pendapatan Asli Daerah*) by collecting taxes or levies as much as possible. This propensity is widely spread across the nation which leads to the distortion of local economies, such as: (a) putting an extra burden on the business community; (b) causing a high-cost economy; and (c) hindering the growth of investment in the regions (Campos & Hellman, 2005).

According to White & Smoke (2005), since decentralisation was introduced in a crisis situation, the general framework was built very quickly, without much thought given to how to make it work. The decentralisation policy is often referred to as a "Big Bang" because significant resources and functions were devolved so rapidly and drastically. In addition, Indonesia has tended to develop and apply weak implementation strategies, as decentralisation was adopted quite hurriedly.

Moreover, Syahruddin (2007) states that, in respect to local income, local governments are still highly dependent on the central government. This can be seen from the small contribution of own-local revenue (PAD) to the total amount of

APBD. The major source of local government finance is still dominated by funds released from the central government, particularly through the General Allocation Fund (*Dana Alokasi Umum*/ DAU).

In view of this, local governments argue that central government policies are the source of these problems. Local governments claim that the central government intervenes too much in the budgeting management of APBD (*Anggaran Pendapatan dan Belanja Daerah/ Local Revenue and Expenditure Budget*), hence local governments do not have enough discretion to independently administer their own annual budgets. As well, this fact demonstrates that public planning and budgeting still rely on the old approach. Although there have been significant changes in particular areas, the budgeting process and management at the local level is still dominated by the directions of the central government (Setiadi & Sobari, 2004).

On the other hand, the central authorities argue that their involvement in the APBD process is to guide local governments in the management of financial affairs. The national authorities affirm that they do this because many local governments are not completely ready to adopt the new fiscal decentralisation policy (Setiadi & Sobari, 2004). As a result, many projects funded through local budgets often do not meet local community needs. In addition, the national government argues that the need to intervene in local government affairs is caused by two other issues. First, the central government wants to ensure national stability and, second, the relatively weak capacity of human resources in local government is of concern.

The discussion above clearly denotes that existing studies in the area have not been able to provide an exhaustive understanding about the actual practice of the budgeting process at the local level. So far, no thorough study has been undertaken to

assess the implementation of the new paradigm of the budgeting. Therefore, it is essential to conduct research which intends to gain a comprehensive understanding and also to critically analyse the process of budgeting at the local level (city and regency) under Indonesia's fiscal decentralisation policy.

1.2. Objectives of the Study and Research Questions

As indicated earlier, the present research intends to elaborate upon, and critically analyse, the policy-practice gap and the prominent issues in the budgeting process of the APBD (annual local budget) at the local government level. More precisely, the present research aims to:

1. Elucidate the process of the APBD especially since the introduction of decentralisation policy;

2. Analyse the policy-practice gaps in the process of the formulation, validation, and execution of the APBD;

3. Assess the accountability and supervision system of the APBD, and appraise the effectiveness of the system in developing better management of local government budgeting and finance, and

4. Identify and analyse the challenges and issues associated with various stages of the APBD budgeting process.

In the light of the objectives specified above, the study is focused on a number of critical questions, as follows:

First, what are the characteristics of the APBD budgeting system being implemented under the decentralisation framework, and what are the crucial points associated with Indonesia's budgeting reform?

Second, how do local authorities formulate the APBD draft and who are the actors involved in the process?

Third, how does the APBD draft get validated; who are the dominant actors at this stage?

Fourth, how do local government officers execute the APBD, particularly the collection of local government revenues and the spending of local government expenditures? Where do local revenues come from and where do local expenditures go? Who are the real beneficiaries of the local government budget? Why?

Fifth, how is APBD execution supervised? To what extent does the APBD accountability and supervision system work? Why does (or doesn't) the accountability and supervision system work effectively?

Sixth, what are the issues and challenges facing local governments in the APBD budgeting process? What are the impacts of these issues on the local government budgeting and financial management? Why?

Finally, how and to what extent are the new approaches to budgeting being implemented at the local level?

1.3. Significance of the Study

Several researches have been conducted to study the management of local government budgets and financial management in the decentralisation era of

Indonesia (World Bank, 2007; Setiadi & Sobari, 2004; Campos & Hellman, 2005; Seymour & Turner, 2002; Yilmaz et al., 2010). However, these studies cannot present an intact picture of the current local budgeting process because the research only captures budgeting and financial management from particular angles. On the other hand, this study will give invaluable benefits to policy makers, communities, government officers, parliament members, scholars, and other related parties, because this research provides comprehensive understanding, in the theoretical, normative, and empirical senses, about the new paradigm of the budgeting of APBD, implemented at the local level in Indonesia's current era of local autonomy.

As the research in this area is limited, this study will contribute significantly to the development of the literature and the knowledge in this field. The results of the study can also be used as a useful reference by other researchers interested in the local government finance and budgeting system, particularly in Indonesia under the current fiscal decentralisation policy. In addition, this study is expected to contribute to the identification of various challenges and problems at each stage of the local budgeting process, including the formulation, validation and execution stages and the supervision and auditing phase. Recognising the nature of the problems, therefore, will make it easier for local government authorities to solve these issues. Moreover, it will also support the attempts of local officials to design better policy to facilitate the implementation of local budgeting systems in the future.

1.4. Limitations of the Study

The author has attempted to comprehensively analyse the budgeting process at the local level in Indonesia under current fiscal decentralisation policy. Nonetheless,

it is realised that the present study has certain limitations particularly in the following areas:

1. Due to the constraint of time, funds, and other resources, the present study focussed only on 3 local governments out of 505 across Indonesia. As there are significant variations among local authorities in Indonesia, it is difficult to capture all phenomena and make generalisations on the practice of budgeting process at local level.

2. This study has shed lights on the adoption of some new budgeting approaches –such as Performance-Based Budgeting System (PBBS), Medium-Term Expenditure Framework (MTEF), Integrated Budgeting, Accrual-Based Accounting, and so forth. However, being new developments these were still evolving and at the early stage of implementation. Consequently, it was not possible to fully capture the actual implementation of the new approaches and their actual impacts.

3. The political circumstance in Indonesia is very dynamic. Also, as the budgeting system in Indonesia is currently still in the transitional era, Indonesian authorities frequently change policies regarding public financial management. During last four years (while this study was in progress), the government has issued and/or revised some legal regulations and guidelines on the local government budgeting. Therefore, the normative policies elaborated in this study might not reflect the current and actual practice as those particular polices have been changed or/and revised.

1.5. Research Locations

The present research was conducted in three Indonesian local government areas located in East Java Province namely City of Surabaya, City of Batu, and Regency of Trenggalek, each of which is considered to be representative of urban, sub-urban, and rural areas. Indonesia has a large number of local governments (consisting of 412 districts and 93 cities; July 2013) located at urban, or sub-urban, or rural areas. Some of those, including the City of Batu, are new local government authorities created after government reform in 2000. It is believed that there are wide variations between local governments in term of experience in managing governmental affairs, human resources, fiscal capacity, local politic, and so forth. Consequently, each local government situated at urban, or sub-urban, and rural areas would have varied experience and records in planning and executing their budget. In view of this, the author has selected three local governments mentioned above representing urban, sub-urban, and rural areas in order to be able to capture more comprehensive picture of budgeting at the local level.

East Java Province was selected to be the location of the study because this province has the biggest amount of APBD funds every year. For 2013, its APBD funds amounted to 42.02 trillion (tn) Rupiahs. Additionally, East Java Province has 38 local governments (consisting of 29 regencies/*kabupaten* and 9 cities/*kota*) which represent the largest number of local governments in comparison to other provinces of Indonesia. This province is also the second largest in terms of population (37,476,022 people in 2010).

Figure 1.1. Location of East Java Province

Source: http://www.nationsonline.org/

Precisely, the three local government areas chosen as research locations for this thesis are:

1. City of Surabaya

This city represents an urban local government, for the purposes of this thesis. The City of Surabaya is the capital and largest city in East Java Province. This city is also the second largest metropolitan city in Indonesia. Surabaya City had a population of 3,114,700 in 2012, with a density of 8,300/km^2.

Surabaya was officially established in 1293. Surabaya is characterised predominantly by trade and industrial activities. Since the 18th century, Surabaya has had a considerable variety of manufacturing industries and has also had a strong trading connection with other port cities such as Shanghai, Calcutta, Singapore, and Hong Kong. Even in the early 1900s, Surabaya became the busiest and largest port

city in the territory of *Hindia Belanda* (the territory under the Dutch colonial government).

As the centre of governmental and economic activity, Surabaya has recorded a better growth rate, on average, than other local governments. In 2009, its economic growth reached 5.04%. This is slightly more than the average rate for East Java Province as a whole, which is 5.01%. In the period from 2005-2009, Surabaya's inflation rate has somewhat fluctuated. In 2005, the inflation rate reached 14.21%, and then dropped sharply to 6.71% in 2006 and 6.27% in 2007. In 2008, the inflation rate rose to 8.73%, and then dropped considerably to 3.39% in 2009 (Surabaya in Figures, 2013).

Gross Domestic Product (GDP) reached 264,335 trillion Rupiahs (USD26.4 Billion) in 2012. As a result, Surabaya has become the largest contributor (26.55%) of the GDP for East Java Province as a whole. The largest contributor of GDP comes from the trade, hotel and restaurant sectors which contribute 39.14% of the total. The second largest contributor of Surabaya's GDP comes from the manufacturing sector which amounts to 28.70%. Surabaya's GDP per capita was 79,125,490 Rupiahs per capita in 2012 (www.Surabaya.go.id)

As the provincial capital, Surabaya is home to many offices and business centres. Surabaya's economy is also influenced by the recent growth of foreign countries as Surabaya has a special connection (in the form of twin towns and sister cities) with many overseas cities[2]. Surabaya has 31 sub-districts (*kecamatan*) and is

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[2] The foreign cities that have special connection among others are: Seattle (United States since 1992); Busan (South Korea since 1994); Izmir (Turkey since 1996); Kochi (Japan since 1997); Kitakyushu (Japan since 1997); Rotterdam (the Netherlands); Johor Bahru (Malaysia); Manchester (England);

divided into 160 villages (*kelurahan*). In 2012, the municipality employed 17,070 staff which consisted of local government civil servants (*Pegawai Negeri Sipil*/ PNS) and temporary workers (*tenaga harian/ honorer*). The distribution of the number of PNS based on level of education is as follows: Doctorate (1), Masters (637), Bachelor (1,231), Undergraduate (8,893), Senior High School (5,043), Junior High School (551), and Primary School (417). In addition, the education levels of temporary workers are: Bachelor (4), Undergraduate (38), Senior High School (71), Junior High School (24), and Primary School (70) (Surabaya in Figures, 2013).

The annual budget of Surabaya City is the largest among local governments in East Java Province. Additionally, this city also has the largest amount of PAD (*Pendapatan Asli Daerah*/ own-source revenue) compared to other cities or regencies in East Java Province. In 2012, Surabaya City recorded a total revenue of 5.5tn Rupiahs, which consisted of PAD (Rp. 2.27tn), transfers from the central government in the form of the Balancing fund/ *Dana Perimbangan* (Rp. 1.4tn), miscellaneous transfers from the central government (Rp. 309bn), transfers from the provincial government (Rp. 594bn), and miscellaneous revenue (Rp. 938bn). On the other hand, the expenditure of the municipality amounts to Rp. 5.35tn, which consisted of operational/ routine spending (Rp. 3.37tn), capital expenses (Rp. 1,38tn), unpredicted expenditures (Rp. 3bn), and transfers to other governments (Rp. 597bn) (Surabaya in Figures, 2013).

Kaohsiung (Taiwan); Guangzhou (China since 2000); Xiamen (China since 2008); Perth (Australia since 2009); Varna (Bulgaria since 2009); and Marseille (since 2009).

2. City of Batu

Batu City represents the sub-urban area for this thesis. This city has specific characteristics, which mean that it has become widely known as an agribusiness and tourism city. Batu is situated about 100 km to the southwest of Surabaya. The native residents of Batu mostly work in the agricultural sector producing apples and a wide variety of vegetables. Batu is well-known as a major supplier of Indonesian apples to other regions across Indonesia, therefore it is often called 'apple city'.

Since the 10th century, Batu has been famous as a rest and recreation area for the royal family. Batu City is located in the highlands at 871 metres above sea level and is surrounded by a number of mountains. As a mountainous area, Batu has mild weather and has beautiful natural surroundings. At the beginning of the 19th century, the Dutch started developing tourism infrastructure in the Batu area, so that more foreign and domestic people would visit Batu. The Dutch community really admired the beauty of the area, labelling Batu as *De Klein Switzerland* or little Switzerland on the island of Java. As well, Batu was the favourite vacation place of the first Indonesian President, Soekarno (www.batukota.go.id)

Recently, a great number of tourist destinations have become available across Batu City and surrounding areas. Other than the legendary tourist sites such as *Songgoriti* and *Selecta*, there are some new tourist attractions in Batu. Currently, Jatim Park, the Batu Night Spectacular (BNS), the Secret Zoo, the Eco Green Park, and the international-standardised museum called '*Museum Satwa*' (animal museum), are some of the most popular tourist destinations in the city. These sites attract tens of

thousands of domestic and foreign tourists every weekend. This situation significantly contributes to local government revenue and the income of the local people.

This city is relatively new as an independent local government jurisdiction. Formerly, it was part of Malang Regency, and became an independent city as recently as 2001 when it was legislated for, through Act No. 11 of 2001, at the same time as the establishment of local autonomy laws. This city is relatively small in territory, but its own-source revenue (*Pendapatan Asli Daerah*/ PAD) is slightly above average compared to other local governments in East Java Province.

Batu City had a population of 190,184 in 2012 with a density of 873 people/ km^2, which is largely dominated by ethnic Javanese. The city is divided into three districts (*kecamatan*) including *kecamatan* Batu, *kecamatan* Bumiaji, and *kecamatan* Junrejo. These districts are further divided into 24 villages (*desa* and *kelurahan*). In 2012, the city of Batu employed 5,024 local government officers with a distribution in the level of education as follows: Masters and Doctorates (406), Bachelor (657), Undergraduate (2,755), Senior High School (1,003), Junior High School (115), and Primary School (68) (Batu in Figures, 2013)

The general election of 2009 saw 25 legislators elected to positions as legislative members of the local parliament (DPRD/ *Dewan Perwakilan Rakyat Daerah*) of Batu City. These 25 local legislators came from 12 political parties with a distribution as follows: PDI-P (5), GOLKAR (3), HANURA (3), PAN (3), Demokrat (3), PNI Marhainisme (1), Barhas (1), PKS (1), PKNU (1), Patriot (1), PKPB (1), and PIB (2) (Batu in Figures, 2013).

As stated in the APBD of Batu City, in 2012, this local government had a total revenue of Rp. 56.370bn which came from own-source revenue/PAD (Rp. 1,079bn),

Balancing funds/ *Dana Perimbangan* (Rp. 39.146bn), Miscellaneous Revenue (Rp. 6.229bn), and Revenue of Financing (Rp. 9.915bn). On the other hand, in 2012, the municipality had expenditures valued at Rp. 47.168bn which were allocated for Indirect/ Routine Expenditures (Rp. 27.803bn), Direct/ Capital Expenditures (Rp. 15.867bn), and Expenditure of Financing (Rp. 3.834bn) (Batu in Figures, 2013).

3. Regency of Trenggalek

The Regency of Trenggalek represents the rural area for this research. Economic life in Trenggalek is generally dependent on farming and fishing activities. The territory of this regency is quite sizable, but unfortunately most of the soil is barren. Due to this situation, the size of the annual PAD (*Pendapatan Asli Daerah*/ Own-source revenue) of this regency is smaller than average. Additionally, this regency is categorized as one of the poorest regencies in East Java province.

The size of Trenggalek's territory is 126,140 hectares^2 in total, 2/3 of which is mountainous. This Regency is divided into 14 sub-regencies/ districts (*kecamatan*) and 157 villages. The total population in 2012 was 827,873 people, which consists of 50.57% males and 49.43% females. The density is 656 people/km^2 and the population growth is 1.777% per year. This local government has 4 hospitals, 22 public health centres (*Pusat Kesehatan Masyarakat*/ *Puskesmas*) and 66 sub-public centres (*Puskesmas pembantu*). These health facilities employ 101 medical doctors, 19 specialists, 448 nurses, 170 midwives, and 11 apothecaries. In regard to educational facilities, the regency operates more than 500 schools consisting of 441 Primary Schools (SD/ *Sekolah Dasar*), 79 Secondary High Schools (SLTP/ *Sekolah Lanjutan*

Tingkat Pertama), and 39 Senior High Schools (SLTA/ *Sekolah Lanjutan Tingkat Atas*) (www.trenggalekkab.go.ig).

In 2012, there were 23,306 manufacturing businesses in the territory. These businesses generated total production valued at 1,592.31 billion Rupiah with total investment amounting to 124.72 billion Rupiah. In terms of farming activities, the agricultural land across the regency consists of rice fields of about 12,193 hectares, dry land of 39,535 hectares, and a plantation area of 2,538 hectares. During 2012, the fields produced 173,003 tons of rice, 79,663 tons of corn, and 473,015 tons of cassava and other agricultural commodities. Trenggalek Regency also has a national fish port located in Prigi Bay. Around 4,538 fishermen gain their livelihood in Prigi and surrounding areas. In 2012, they caught 37,070 tons of fish. Prigi Bay is also a prominent tourist site, being visited by 389,931 tourists during 2012. The economic growth rate of Trenggalek in 2012 was 6.62%, contributed to by the agricultural sector at 29.36%, the services sector at 15%, and other sectors, each of which has an averages contribution of less than 10%. Additionally, the income per capita of the Trenggalek population was about 10.94 million Rupiah in 2012 (Trenggalek in Figures, 2013)

As a result of the general election of 2009, the DPRD (local parliament) of Trenggalek has 45 legislators coming from 11 political parties with a distribution as follows: PKB (7), PDIP (8), GOLKAR (5), PAN (4), PPP (1), PKPI (1), Demokrat (5), Patriot (2), PKS (5), PKNU (4), and PRNI (1). In addition, the Trenggalek Regency recorded total revenue of Rp. 1.059tn and expenditure of Rp. 1.041tn. These revenues came from PAD of Rp. 70bn, Balancing fund of Rp. 958bn and miscellaneous revenue of Rp. 31bn. Meanwhile, local budget was spent on

operational expenditure of Rp. 905bn, capital expenditure of Rp. 134bn, unpredicted spending of Rp. 584bn, and transfers for other local governments of Rp. 2.9bn (Trenggalek in Figures, 2013).

Figure 1.2. Location of the City of Surabaya, City of Batu, and Regency of Trenggalek

Source: http://archipelagofastfact.wordpress.com/
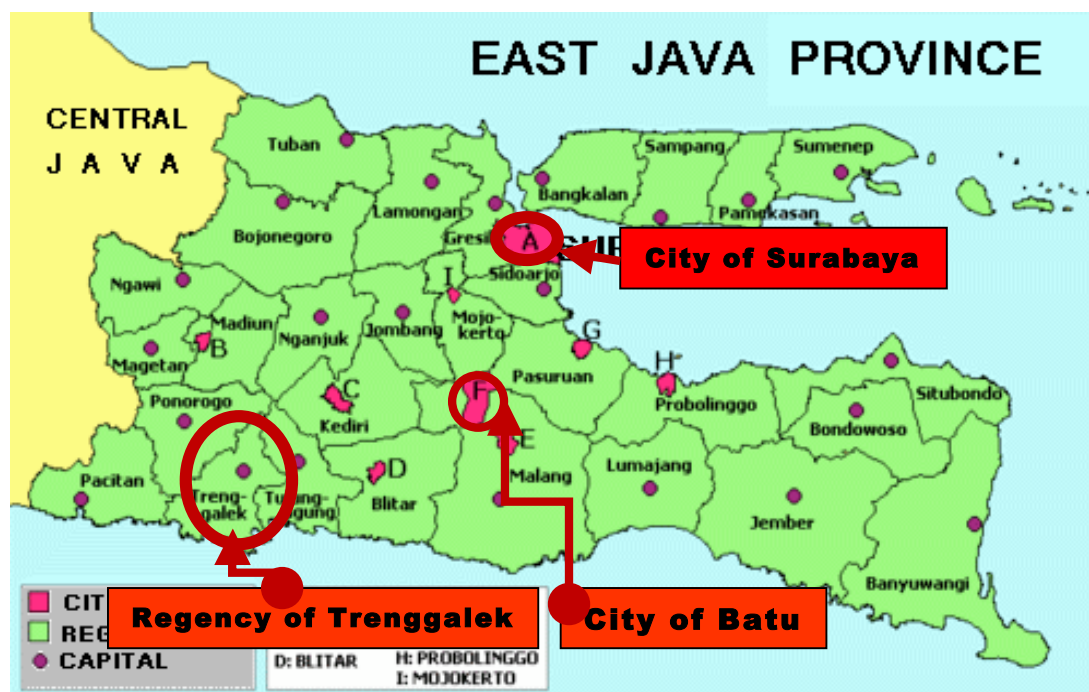
1.6. Research Methodology

1.6.1. Research Type

The present research applies a qualitative approach (Taylor & Bogdan, 1998; Strauss & Corbin, 1998; Miles & Huberman, 1994) and in particular employs grounded theory method (Strauss & Corbin, 1998) which aims to generate a 'thick description' (Geertz, 1973) about the current APBD budgeting process. This study applies a qualitative approach because the research problems themselves can only be resolved through qualitative research, such as, how the APBD gets formulated, validated, executed, and supervised, as well as numerous other issues arising in these

processes. The study also intends to seek a comprehensive understanding and to discover any phenomena and hidden tendencies in the APBD budgeting process that would be difficult or cannot be obtained by applying statistical or other quantitative procedures.

The data in this qualitative study are collected through several methods, particularly in-depth interviews, observation, and documentation (archival records). Hereafter, the collected data and information are displayed in a descriptive fashion, rather than as a series of numbers. In some sections, the study displays many quantitative data; however these data are accompanied and supported by narrative explanations.

Specifically, this study employs a grounded theory approach that uses several systematic procedures to inductively develop theories about budgeting process at a local level. This grounded-theory study finds, composes, and proves theories through systematic data collection which is related to the observed phenomena. Hence, data collection, analysis, and theory are linked to each other. The research identified and collected any data and information that is relevant to the research problems and objectives. Afterwards, these facts were interpreted deeply and then critically analysed. As well, the research objects were elucidated in detail and in a comprehensive manner, based on the natural facts found in the field. In view of this, the researcher expects that the (new) theories regarding the budgeting process constructed in this study will correlate cumulatively with other theories developed in other studies. Thereby, the validity of these theories will be legitimised.

1.6.2. Focus of the Research

The focus of this research is specified based on the research questions. As stated previously, this study aims to critically analyse the budgeting system and process of APBD (annual local government budget) under the current policy of local autonomy and fiscal decentralisation. Based on the objective and the research questions set up earlier, the focus of this research can be detailed as follows: (a) budgeting process of APBD including the formulation, validation, implementation, and accountability and supervision of the annual local government budget; (b) accomplishment and challenges in connection with the APBD process which runs under the new budgeting system; and (c) budgeting reform and introduction of the new budgeting system at the local government level.

1.6.3. Sampling

This study employs purposive sampling, which is often known as theoretical sampling and is not representative sampling (Strauss & Corbin, 1998; Geertz (1973). This means that the initial or key informants of this study were purposely selected instead of randomly. Subsequently, further informants were recruited by referring to the previous results or based on recommendations of the previous informants. The current study selects informants by considering several crucial factors such as individual knowledge, education, experience, occupation, and other factors related to the research focus.

Additionally, in order to gain the best results, maximum variation sampling was also applied in this research. This method of sampling provides the researcher with the opportunity to collect data or information from various people who have

knowledge or information associated with the research objective. As a result, the outputs of the research are more comprehensive, meaningful, and reliable.

1.6.4. Data Sources

In order to be able to capture phenomena more accurately, it is suggested that researchers adopt triangulation principles by applying two or more different instruments or approaches, whereby each would provide less accuracy if used on their own (Denzin, 1978; Singleton, et al., 1993). Considering the characteristics and objectives of the research, this study employs data and methodological (particularly the method to collect the data) triangulation. The data for this study were collected from two main sources, informants and documents (the archival record). Meanwhile, the researcher has collected the data through a number of techniques, such as in-depth interviews, documentary study, and direct observation.

Informants

As stated earlier, the informants for this research are selected based on their experience and knowledge about the research problems. Other than this, the researcher recruited informants according to the ownership of the data (documents) and their willingness to provide the data.

The informants can be categorised into eight groups, as follows:

(1) Executive officers of local government, particularly local officials who are involved in the APBD budgeting process, such as the officials of the Service of Financial and Asset Management of Local Government (*Dinas Pengelola Keuangan dan Aset Daerah/* DPKAD), the Board of Local Government

Development Planning (BAPPEDA), the budget team of the local executive, the officers of finance unit, and other local government officials.

(2) Legislators in the local parliament (DPRD/ *Dewan Perwakilan Rakyat Daerah*), primarily the members of *Banggar* (*Badan Anggaran*/ Budget Board) of the local parliament;

(3) Central government officials. Due to limitations of time and the difficulties faced by the researcher in conducting interviews with central government officers, the data and information required from central government officials were primarily collected from provincial government officials (from East Java Province);

(4) Representatives of the local community, mainly notable local people such as the chair of the local neighbourhood (*ketua RT/RW*) and other community leaders who often participate in budgeting forums;

(5) Former local government officials;

(6) Former local parliament members;

(7) Representatives of local NGOs who care about the local budgeting process and management, and

(8) Representatives from the business community, particularly those who are often involved in the procurement and execution of local government projects.

In detail, the number of informants in each category and location is specified on the table below:

Table 1.1. Classification and Number of Informants

Category of Informant	City of Batu	Regency of Trenggalek	City of Surabaya	Total
Executive officers of local government	14	17	7	**38**
Legislators in the local parliament	3	2	2	**7**
Central/provincial government officials				**3**
Representatives of the local community	13	15	5	**33**
Former local government officials	3	2	2	**7**
Former local parliament members	2	2	1	**5**
Representatives of local NGOs	5	3	3	**11**
Representatives from the business community	2	1	2	**5**
			TOTAL	**109**

Documents

The researcher collected secondary data in the form of documents (archival reports) which are consistent with the objectives and focus of the research, including: (a) regulations and guidelines issued by the central and local governments regulating the budgeting process of the APBD (Local Expenditure and Revenue Budget); (b) document of the APBD which consist of structure and figure of the local budget, including the proportion of the funds coming from the central and local governments; (c) the accountability report of the APBD implementation; (d) document of RKPD (Rencana Kerja Pemerintah Daerah/ work plan of local government) which consists of programs, projects, and activities funded through the APBD; (e) notations of meetings or discussions held in local government or parliamentary bodies, as well as meetings that involve non-governmental parties (the local community, NGOs, and the private sector) in the APBD budgeting process; and (f) other documents which are connected to the research focus and objectives.

The documents mentioned above were mostly collected from the government institutions in the study areas. For the requested data which were not available in the research sites, the researcher obtained them from on-line media (internet).

1.6.5. Data Collection Methods

This study employed multiple methods of data collection which include direct observation at the research sites, in-depth interviews with informants, and documentary study of archival materials (both published and unpublished documents). Silverman (2001, pp. 233-235) asserts that implementing multiple methods to collect data in qualitative research is very useful as this strategy can optimise the collection of more extensive data, minimise the bias of the researcher, and enhance the reliability and validity of the findings.

The fieldwork for this research was conducted during seven months in total, which consisted of two parts. The first fieldwork was conducted from December 2010 until May 2011, and then followed up by the second fieldwork which took place in September and October 2011. During the first fieldwork period, around 80% of the required data was collected from the study areas. Subsequently, the researcher conducted the second fieldwork to complete the data collection as well as to verify the previously collected data.

The researcher started collecting the data by introducing himself to the officials at each of the selected local government offices. Introductions were also carried out at other locations associated with the research topic. These introduction sessions aimed to obtain initial or general information and characteristics about the research sites. In these sessions, the researcher initiated the initial approach and made

closer relationships with the government officials, but primarily with those who were prospective informants for the research.

The researcher also met with legislators in the local parliament, notable people who usually represent the local community in the budgeting forum, NGO activists, and other parties linked with the budgeting process of APBD. This initial approach was discussed with the key informants who were then able to guide the researcher in making closer relationships with further informants. The next part of the process involved the researcher interacting with these informants intensively, based on an ethical and sympathetic relationship.

To collect the primary data, the researcher applied three main techniques, including in-depth interviews, documentary study, and observation.

In-Depth Interviews

The interviews for this study were not conducted through a rigid structure. Initially, general questions were given to the informants, which were then followed by more focused questions in line with the research problems and focus. This interview method was applied in all the research sites with the expectation that the informants would provide information honestly and truly based on their knowledge and experience; therefore, the researcher would be able to obtain deep, comprehensive, reliable, and useful primary data.

The in-depth interviews, of 1 to 2 hours duration, took place in the informants' offices, homes, workplaces, or in other venues. Regardless of the venue, the researcher always avoided a 'formal situation' in every interview. This is essential, because in a relaxed environment, both the researcher and the informant

will feel more comfortable and unrestricted in discussing matters related to the research objectives, hence the informants will feel free to provide the valid data and information required by the researcher

The majority of informants have been interviewed once. However, some key informants were interviewed twice or more because the researcher needed to do so, depending on necessity. After every interview session, the data or information that had been collected was then evaluated. If the collected data and information were considered to be inadequate, then the researcher would conduct a further interview with either the same or different informants. In such a case, the researcher implemented the *snow ball* technique. The researcher applied this strategy until the patterns in the data or information became saturated. Moreover, the researcher refined the data by seeking input from other people who have contrary opinions; thereby the collected data was more rounded and comprehensive.

Initially, to record the interviews, the author intended to use a sound recorder. However, many of the informants rejected this idea as the information they provided was considered to be confidential. In such situations, the researcher recorded these interviews in field notes.

Documentary Study

This technique obtains secondary data through collecting data from archives and documents related to the problems and focus of the research. The details of the documents (archival reports) collected in this study have been specified at the previous sub-section. Those data were mostly available at the research sites and were provided to the researcher by the officers holding authority at the designated units.

Moreover, to complement data which were not available in the sites, the researcher also gathered secondary data from appropriate data sources such as the library, the internet, and other sources.

Observations

In order to complete the data and information, the researcher also conducted a number of observations at the study sites through the technique of non-participant direct observation. For these observation sessions, the researcher visited the sites in an informal manner in order to minimise the possibility of changing or distracting the "real conditions" (the nature) of the objects under observation.

The researcher observed two types of events in the research locations: (1) the budgeting sessions held in the local parliament building involving legislative members and executive officials. The researcher conducted observations on these events twice in the DPRD of Trenggalek, three times in Batu City, and once in Surabaya City. These observations took place from January to April 2011. In these events, the researcher observed the process of budget sessions and the role of local officials and legislators in these sessions. Therefore, the researcher obtained understanding about the real situation of the budgeting sessions in the local parliaments, and also comprehension of the role of actors (local legislators and officials) involved at the sessions, and (2) the public participation forum known as *Musrenbang* (*Musyawarah Perencanaan Pembangunan*/ development planning meeting), particularly at the village (*desa*) level, which involved local people discussing the plans for the local government annual budget. The researcher observed these forums twice in Trenggalek Regency, four times in Batu City, and once in Surabaya City. These observations were undertaken in January to February 2011. By

observing these forums, the researcher gained comprehension regarding participation of local people in formulating annual budgets and also the responses of the local government elites in responding to the local communities' proposals.

1.6.6. Data Analysis

The researcher analysed the collected data as directed by Bogdan and Biklen (1990) and also by Strauss and Corbin (1990). The researcher developed data analysis during the data collection process, particularly once an event of the research focus had been completely recorded. The recording was elaborated in the field report. The analysis process was conducted continuously while the fieldwork research occurred, and then was continued after the fieldwork activities had been completed.

The researcher displayed the data primarily in a narrative fashion. Nonetheless, in some sections, other than the qualitative data, the researcher has presented quantitative data in tables to make better sense of it for the readers. The next step was that the researcher reduced the collected data, aiming to produce selected themes and phenomena relevant to the focus of the research. This step was very useful as the reduced and focused data provided a clearer picture of the phenomena under scrutiny.

The researcher analysed data in three main stages. In the first stage, the core activities were to specify, check, compare, conceptualise, and categorise the data based on the properties and dimensions which are relevant to the research topic. Moreover, in this phase, the researcher also labelled the phenomena, and found names and grouped categories based on their properties and dimensions.

In the second stage, the researcher carried out a series of actions with the following chronological steps: after a number of phenomena had been identified during the previous step, the author found the factors causing (and the context of) the emergence of the phenomena. Further, the consequences of these phenomena were also analysed.

In the third stage, the researcher assessed the systematic relationships between the core categories and other categories. In detail, the researcher conducted some activities such as: composing a description of the reality; explaining and analysing the process of the events or phenomena; mapping other categories around the core category; determining the properties and dimensions of the core events/ phenomena, and validating the relationships among the phenomena. These actions were undertaken because the researcher intended to obtain a clear and comprehensive picture about the action-reaction relationship as well as the impacts and/ or consequences of the interactions among these phenomena. Subsequently, the last activity of this stage was grounding the theory, which was implemented by conducting an empirical-theoretical analysis (comparing and contextualising the empirical findings with existing theories), through which the study could develop more comprehensive (or new) theories.

The final stage of the data analysis process was to draw conclusions and then verification. The researcher drew conclusions after presenting the results of the analysis which were displayed in a descriptive narrative through systematic and logical interpretation. The study, therefore, is expected to be able to provide a comprehensive understanding about the research objects and topics.

1.6.7. Reliability and Validity of Research

Qualitative research, which is less governed by scientific procedures and rules, is often criticised as being 'soft' or lacking in reliability and validity (Patton 2002). To be relevant to the aims of qualitative research - which are to understand, represent, or explain complex social phenomena more than to simply measure - research reliability and validity are crucial issues that need to be resolved.

The researcher evaluated the reliability and validity of the research findings for this study based on a number of criteria as suggested by Moleong (1996), Lincoln and Guba (1985), and Nasution (1996), Patton (2002) and Roe (2006). In practice, the researcher set up four criteria to evaluate the reliability and validity of this study. Those criteria are credibility, transferability, dependability, and conformability.

Credibility: The researcher implemented this criterion by prolonging the duration of the interviews and observations. The author also conducted data triangulation to cross-check the collected data and information with local government officials, local parliament members, local people, the business community, NGO activists, and others. Additionally, the researcher discussed the collected data and information with colleagues who have proper knowledge and experience relevant to the research topic.

Transferability: This criterion is correlated with the question of whether the results of the study are applicable to other institutions that have similar conditions. In the context of this study, this means whether the APBD budgeting process at the study areas is a similar phenomenon and has similar impacts on other Indonesian local governments. If so, the results of this research can be utilised as a reliable reference by policy-makers and executors in other local governments in making and

executing policy about local government budget management. The researcher applied this criterion by checking and comparing the existing phenomena found in the study areas to similar phenomena in other local governments as published in various on-line and off-line media such as newspapers, magazines, government reports, and others.

Dependability: In this context, this means that reliable data leads to valid results in the research. In view of this, the researcher has always attempted to manage the collected data and results of analysis, hence making it easy to re-check the data.

Conformability: To confirm that the study has produced results of a high standard, the researcher undertook several strategies as follows: (a) routine consultations and discussions with supervisors; (b) discussion of preliminary results with numerous key informants. The researcher held an event to this end in the conduct of the second fieldwork phase, and (c) regular discussion with colleagues and friends, particularly those with similar backgrounds and interests as the researcher.

1.7. Structure of the Thesis

This thesis is presented in nine chapters. Chapter One is the introduction and research methodology. Chapter Two is the theoretical discussion concerning public budgeting at the local government level. Chapter Three presents the Indonesian experience in conducting the budgeting process in the pre-reform era (the New Order Regime) and the key points of Indonesia's budgeting reform. Chapters Four to Seven elaborate upon and analyse the process of local government budgeting (APBD) in the following order: Chapter Four analyses the formulation of the APBD budgeting process; Chapter Five elucidates the validation process of the APBD; Chapter Six analyses the execution of the APBD with focus on local government

revenue collection and local government expenditure management; and Chapter Seven analyses the accountability and supervision system of the APBD. Then Chapter Eight presents an analysis of the entire APBD budgeting process and also assesses the implementation of new budgeting approaches. Finally, the results of this study will be concluded in Chapter Nine, as the final chapter of the thesis.