CHAPTER THREE

LOCAL GOVERNMENT BUDGETING SYSTEM IN INDONESIA: DEVELOPMENTS UNDER FISCAL DECENTRALISATION

3.1. Introduction

The idea of reforming the budgeting system had actually emerged a long time before the collapse of the ORBA (*Orde Baru*/ New Order) regime. This initiative arose because the existing system applied during the ORBA era was considered to be a failure in promoting a reliable, transparent, and accountable financial management system. Nevertheless, the intention to reform the budgeting system was thwarted by the authoritarian government.

Along with the collapse of the ORBA regime in 1998, which was followed up by comprehensive governance reform, the new Indonesian authorities reformed the budgeting system starting at the beginning of the 2000s. The budgeting reform was officially marked by the issuance of two laws which are widely known as the 'package of local autonomy law'[1].

This chapter intends to clarify the following questions: How did the local government budgeting system and process operate in the eras before and after local autonomy? What are the divergences in the budgeting system and process in the

[1] The package of local autonomy law consist of two laws include Law 22 of 1999 regarding Local Government and Law 25 of 1999 concerning Financial Balance between the Central and Local

period before and after local autonomy? What are the crucial points of the policy regarding budgeting management introduced in the local autonomy era?

The depiction of the local budgeting system development applied in Indonesia is elaborated into two sections. The first section elucidates the budgeting system implemented by local governments in the period before local autonomy, while the second section elaborates the budgeting system adopted in the local autonomy era.

3.2. Local Government Budgeting: the Scenario Prior to Current Reform

This section briefly elaborates upon the local government budgeting and financial management system implemented in the pre-reform period under the authoritarian regime of ORBA (*Orde Baru*/ New Order). The section starts with an elaboration of the traditional budgeting process, after which it elucidates the budgeting process and the structure of the local government budget (APBD). Finally, an outline of the accounting system applied in the pre-reform era will be presented.

3.2.1. The Traditional Budgeting System

In the days before the reforms (before the year 2000), the budgeting system adopted by Indonesian local governments was the traditional budgeting method using the line-item incremental approach. This meant that local governments created an annual budget (APBD) incrementally and the APBD was formed in a line-item structure. The incremental principle in this context was characterized by the use of 'last-year' data as a basis for drafting the current year budget. Consequently, the formulation of the structure of the APBD was conducted without rational analysis, as, generally, local staff simply increased certain percentages (based on the figures from the previous year's budget) to determine the present budget figures (Bastian, 2006).

Additionally, the line-item budget structure tended to maintain existing revenue or expenditure items, although, in reality, some of the items may not have been relevant any longer for listing in the 'current budget' period. Another prominent disadvantage of a line-item and incremental budgeting system is that these systems did not consider performance factors in preparing and executing the APBD. Local government authorities only focused on spending the allocated budget and executing programmes and activities without considering whether or not these activities were implemented efficiently and effectively.

The traditional budgeting system applied during the pre-reform period had a number of prominent characteristics such as being centrally-controlled, being a yearly budget, and also being a gross budget[2]. According to Mardiasmo (2002), this budgeting method is not able to provide accurate information about the actual costs of local government projects and activities and therefore, it is impossible to measure the performance of local governments in managing their annual budget (APBD).

A number of informants explained that during the pre-reform era, the budgeting system did not pay attention to the principles of value for money, economy, efficiency, and effectiveness. Moreover, the budgeting system was not really connected with the

[2] A gross budgeting system records any financial transaction based on the gross amount of the transaction, hence it is considered to be unable to reflect the actual financial condition of local government.

development planning system. As a result, local governments almost always had a huge amount of remaining funds prior to the end of the financial year. Consequently, local government officers often executed impromptu and less-useful projects and activities in order to spend the remaining allocation of funds. This practice simply wasted money and did not contribute to improving the prosperity of the community.

As the old system was based on an annual budgeting framework, informants for the government officials stated that an annual budget is actually too short, especially for capital projects. Consequently, this system failed to connect and harmonise the annual budget with a long-term development plan. Additionally, Mardiasmo (2002, pp. 119-120) contends that Indonesia's traditional budgeting system, which was characterised by an incremental approach, resulted in a large amount of expenditure not being thoroughly analysed for its effectiveness. This system focuses more on input than output in analysing budget performance, which means that budget performance is measured from how much of the allocated budget was spent, instead of to what extent the targeted goals were realised. Local government staff members admit that this atmosphere may encourage illegal practices, such as corruption, collusion, and so forth.

Under the conventional budgeting system, the Indonesian authorities separated the local budget (APBD) into routine expenses and capital expenditure/ investment. By classifying the amount/ percentage of routine expenses (allocated to finance routine/ administrative activities) and capital expenditures (allocated to fund development programmes/ projects), this separation intended to emphasise the importance of the development budget. Nevertheless, as explained by the local officials, in fact, this condition repeatedly causes a conflict and a sense of overlapping, as the capital budget was frequently utilised to finance routine activities and *vice versa*.

The pre-reform period put local government authorities in a less strategic position in managing local government finances and budgets as the local budgeting process (from the formulation, validation, execution, and supervision/ evaluation) as well as the structure of the APBD was fully determined and controlled by the central government. This centralized situation often led to a budgetary gap, whereby the centrally-allocated budget often did not match the real needs of local government and the community (Bastian, 2006).

As the data shows, the traditional and centralised budgeting system failed to provide an ideal environment for developing a budget accountability system due to a lack of reliable data and transparency. This circumstance significantly hampered efforts to control and oversee budget management. This also demonstrates that budget supervision, control, and accountability are conducted only as routine-formalised activities. Consequently, these practices were not able to reduce corruption, manipulation, and other illegal actions.

Stimulated by the spirit of improving financial management, along with the governance reform which occurred as a result of the collapse of the New Order regime, the Indonesian authorities launched the budgeting reform policy. Budgeting reform in Indonesia was officially marked by the issuance of local autonomy legislation, Law 22 of 1999, regarding Local Governance, and Law 25 of 1999, concerning Financial Balance between Central and Local Government[3]. Furthermore, to specifically regulate local government finances and budgeting, the national authorities issued the PP (*Peraturan Pemerintah*/ Government Regulation) 105 of 2000 regarding Local Financial Management and Accountability, followed by the issuance of *Kepmendagri* (*Keputusan Menteri Dalam Negeri*/ Decree of Minister of Home Affairs) 29 of 2002 concerning guidelines for managing local government finances and the annual budget (APBD/ *Anggaran Pendapatan dan Belanja Daerah*)[4].

Indonesia's budgeting reform comprised the reform of the formulation, validation, execution, and supervision and accountability of the APBD (*Anggaran Pendapatan dan Belanja Daerah*/ annual local government budget). The main objective of the budgeting reform was to convert traditional budgeting to a performance-based budgeting system. Additionally, this reform also aimed to change the budget structure, the time-frame of the APBD, the accounting system, and the mechanism of the budgeting process (Halim, 2008).

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[3] Law 22 of 1999 and Law 25 of 1999 were valid for only five years as the government made improvements to the local autonomy policy by issuing new laws regulating local autonomy and finance. In light of this, the authorities issued Law 32 of 2004 regarding Local Autonomy to replace Law 22 of 1999; and also Law 33 of 2004 concerning Financial Balance between Central and Local Government to replace Law 25 of 1999.

[4] PP 105 of 2000 was then replaced by PP 58 of 2005 on Management of Local Government Finance; while the *Kepmendagri* 29 of 2002 was replaced by *Permendagri* (*Peraturan Menteri Dalam Negeri*/ Regulation of Minister of Home Affairs) 13 of 2006, concerning the guidelines of local government finance. The *Permendagri* 13 of 2006 was also revised several times in particular sections, as mentioned in *Permendagri* GRI 59 of 2007, *Permendagri* 21 of 2011, and *Permendagri* 39 of 2012.

3.2.2. The Budgeting Process at a Glance

The journey of Indonesia's local governance towards autonomy started in 1948 with the enactment of Law 22 of 1948 about Local Government[5]. The process of decentralization in Indonesia continued in a better direction with the enactment of Law 5 of 1974 about the Principles of Local Government. This law lasted around a quarter of century and was replaced when the ORBA regime (*Orde Baru*/ New Order) collapsed in the late 1990s.

As stipulated in PP (*Peraturan Pemerintah*/ Government Regulation) 6 of 1975, the annual local government budget (APBD) process began with the preparation of a proposed budget for routine expenses and development expenditure. In terms of proposing routine expenses, local executives created the DUKDA (*Daftar Usulan Kegiatan Daerah/* List of Local Government Proposed Activities); while for the proposals for Development Expenditure, local government staff arranged the DUPDA (*Daftar Usulan Pembangunan Daerah/* List of Local Government Proposed Projects). Both DUKDA and DUPDA were prepared by each unit of local government. In creating the DUPDA and DUKDA, local government officials referred to the various development plan documents set up earlier, such as the POLDAS (*Pola Dasar Pembangunan*/ Local Development Basic Pattern), the *Repelita* (*Rencana Pembangunan Lima Tahun/* Five-Year Development Plan of Local

[5] Nine years later, in 1957, Law 22 of 1948 was no longer valid being replaced by Law 1 of 1957 concerning the Principles of Local Government. But this Act did not last long either because, in 1965, the government of the Republic of Indonesia enacted new legislation governing local government, namely Law 18 of 1965.

Government), and the RUTPD (*Rencana Umum Tata Ruang dan Pembangunan Daerah*/ Master Plan of Local Government) guidelines issued by the Ministry of Home Affairs and *Bappenas* (the National Development Plan Board).

Once the draft of DUKDA and DUPDA were completed, then each local government body handed in its institutional DUKDA to the finance unit (*Bagian Keuangan*) of local government; while the DUPDA was submitted to the Local Development Plan Agency (*Bappeda*/ *Badan Perencenaan Pembangunan Daerah*). Subsequently, the finance unit officials comprehensively reviewed the proposed DUKDAs. On the other hand, *Bappeda* officers reviewed the proposed DUPDAs. If the finance unit and/ or *Bappeda* found something inappropriate in the proposed DUKDA and/ or DUPDA, then the proposing institution would be asked to revise it.

Subsequently, the officers of *Bappeda* and the finance unit of local government compiled the completed/ revised DUPDAs and DUKDAs as a draft of the APBD (*Anggaran Pendapatan dan Belanja Dearah*/ Annual Local Government Budget), which was then submitted to the local parliament (DPRD/ *Dewan Perwakilan Rakyat Daerah*). Afterwards, the local legislators discussed the proposed APBD draft. Along with the discussion of the draft, the DPRD might invite local executives to obtain further clarification about the budget proposals. After reviewing and discussing the proposed APBD draft, the DPRD either approved the proposed budget, or would reject or amend it. In the light of this, as the data show, the DPRD always approved the proposed APBD draft and had not, on even a single occasion, rejected or amended it during the pre-reform era when Indonesia was under the administration of the New Order (*Orde Baru*/ ORBA)[6] regime. This was due to the fact that the ORBA regime placed DPRD as part of local government, and also put the DPRD under the control of the local government head. This environment made the DPRD have a less strategic position and role in the governance of local government (Bastian, 2006).

The next step was for the approved APBD draft to be submitted to the provincial government for approval from the governor. Further, after the governor approved the APBD, the draft would then be returned to the local government to be set into a Local Government Regulation (PERDA/ *Peraturan Daerah*) concerning the annual local budget (APBD).

As mentioned in the PP 6 of 1975, once the APBD had been approved and formalised, then the term of DUKDA (*Daftar Ususlan Kegiatan Daerah*/ list of activities proposed by local government) and DUPDA (*Daftar Usulan Proyek Daerah*/ list of projects by proposed local government) would be changed to DIKDA (*Daftar Isian Kegiatan Daerah*/ list of local government activities) and DIPDA (*Daftar Isian Proyek Daerah*/ list of local government projects). In executing any activities and projects funded through the annual local budget (APBD), local government bodies would refer to their institutional DIKDA and DIPDA. Moreover, prior to executing the APBD, the officials of local government units also had to

[6] After replacing the first Indonesian President Soekarno through a 'silent coup' in the late 1960s, the (former) President Soeharto declared the era as the New Order (*Orde Baru*/ ORBA). During this era, Soeharto remained Indonesian president until the ORBA regime collapsed in 1998. Under the administration of President Soeharto, Indonesia was governed centrally whereby executive officials both in the central and local governments played a completely dominant role.

prepare a number of supporting documents, such as a Decree of Authorisation (SKO/ *Surat Keputusan Otorisasi*), a Request Letter for Payment (SPP/ *Surat Permintaan Pembayaran*), an Order Letter for Payment (SPMU/ *Surat Perintah membayar Uang*) and a Letter of Accountability (SPJ/ *Surat Pertanggungjawaban*). All processes in preparing these documents were carried out by the officers of local government units under the direction and supervision of the finance unit of local government.

3.2.3. Structure of APBD and Local Government Financial Resources

In developing the structure of the APBD in the pre-reform era, local government officials strictly referred to the formal guidelines issued by the central government, therefore the APBD structure was exactly the same among local governments across Indonesia[7]. In this period, the structure of the annual local budget (APBD) was split into two main components, the Routine Budget and the Development Budget. The Routine Budget consisted of two elements which were

[7] The main legal framework of local financial management was the PP (*Peraturan Pemerintah/* Government Regulation) 5 of 1975 regarding Management, Accountability, and Financial Supervision of Local Government. Other than this, local governments also referred to PP 6 of 1975 regarding Procedure for Composing Budgetary Revenue and Expenditure, Implementation of Local Government Financial Management, and Calculation of Local Revenue and Expenditure Budget (APBD/ *Anggaran Pendapatan dan Belanja Daerah*). Furthermore, the standardisation of the APBD structure was regulated by regulations from the Minister of Home Affairs such as *Permendagri* (*Peraturan Menteri Dalam Negeri*/ Minister of Home Affairs Decree) 900/099 about Manual of the Local Financial Administration (*Manual Administrasi Keuangan Daerah*/ MAKUDA); *Permendagri* 020-595 concerning Manual of Local Property Administration (*Manual Administrasi Barang Daerah*); and *Permendagri* Number 970 regarding Manual of Local Revenue Administration (*Manual Administrasi Pendapatan Daerah*).

routine revenue[8] and routine expenditure[9]. On the other side, the Development Budget also contained two elements, development revenue[10] and development expenditure[11].

The figures within the APBD were mostly determined by the central government. The local authorities were not allowed to modify the figures or the composition of the APBD without first consulting with central government officials in the Ministry of Finance. In addition, as Indonesia applied line-item budgeting, every year local governments had to set up the structure of the APBD in the same way as the previous year (Mardiasmo, 2002). As stipulated in the Law 5 of 1974 which was valid during the New Order era, local governments were provided with several sources of income, among others, Own-Local Revenue (PAD/ *Pendapatan Asli Daerah*), income derived from the central government, and other (miscellaneous) revenues.

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[8] The Routine Revenue Budget contained 5 (five) sections including: (a) the remaining budget of the previous financial year; (b) revenue from higher-level government and/ or institutions; (c) Own-Local revenue; (d) loans of local government; and (e) miscellaneous routine revenue.

[9] The Routine Expenditure Budget consisted of 16 (sixteen) sections such as: (a) the deficit from the previous financial year, (b) public affairs governance, (c) general work, (d) traffic of land, river, and ferry; (e) public health; (f) culture and education; (g) social, housing and labour; (h) agriculture, forestry, plantation, husbandry, fisheries and cooperatives; (i) industry and cooperatives; (j) local government enterprises; (k) installment of loans and interest; (l) retirement and veterans; (m) rewards, subsidies, and donations; (n) expenses that are not included in other sections; (o) unpredicted expenditures; (p) miscellaneous routine expenditure.

[10] The Developmental Revenue Budget consisted of 5 (five) types, including: (a) the remaining budget from the previous financial year; (b) revenue from higher-level government and/ or institutions; (c) Own-Local revenue; (d) loans of local government; and (e) miscellaneous routine revenue.

[11] The division of development expenditure depends on the number and type of developments executed by local government. However, in setting the types of development expenditure, local government authorities have to refer to the normative guidelines stated above.

Own-local revenue was collected from a number of sources such as local taxes and levies, the profits from local-government-owned enterprises, and other legal PAD. In addition, revenues derived from the central government consisted of two types. Firstly, there was SDO (*Subsidi Daerah Otonom/* Autonomous Local Subsidy) which was transferred by the central government to cover the routine expenditures of local governments. Secondly, there was financial assistance allocated for investment at the local level. This assistance was widely known as Presidential Assistance (BANPRES/ *Bantuan Presiden*) because it was governed through the instructions of the President (INPRES/ *Instruksi Presiden*) (Yani, 2002)

Presidential assistance consisted of two types known as Specific Grants (*Bantuan Khusus*) and Block Grants (*Bantuan Umum*). Specific Grants were allocated based on specific goals set up by the central government, such as for building bridges, schools, health facilities, and other public facilities. In such cases, local governments had no right to change or modify the utilisation of the Specific Grant. On the other hand, local governments were allowed to determine the allocation and utilisation of Block Grants as long as they were utilised for particular sectors or programmes/ projects that had been previously approved. Block Grants consisted of various types of financial assistance such as financial aid for the provincial government (*Bantuan Propinsi*), aid for local government (City and District/ *Bantuan Kabupaten/Kotamadya*), and aid for villages (*Bantuan Desa*).

The data show that during the ORBA period, financial aid transferred from the central government was mostly in the form of Specific Grants (80%), whilst Block Grants amounted to only 20% of total transfers. Due to the funds coming from the central government being mostly in the form of Specific Grants - whereby the allocation and utilisation of the grants had been previously determined by the national authorities - hence the discretion of local governments to utilise the grants, based on their own initiative, was very limited.

Local governments implemented activities, programmes and projects based on two principles, being de-concentration and decentralisation. Once local governments executed the de-concentration activities, these were generally financed through Presidential Aid, while decentralization activities were usually financed by Own-Local Revenues (Yani, 2002). In general, as the data show, the percentage of APBD funds allocated to national-government-initiated activities (de-concentration) was more than 70% of the total APBD fund; while allocations for implementing decentralization (initiated by local authorities) activities was only around 30% . The condition elaborated above clearly indicates that local government finance was managed in a very centralised manner, both in the expenditures and revenues management.

3.2.4. The Accounting System

In the pre-reform era, Indonesian local governments applied a simple accounting system known as the *Makuda*[12] system. The *Makuda* accounting system has several main characteristics, which are: (a) a single-entry accounting system; (b) a cash-based accounting system; (c) no factually recorded capital expenditure

[12] This system was called *Makuda* because the implementation of this accounting system was guided by the Decree of Minister of Home Affairs (*Kepmendagri*) number 900-099 year 1980 regarding *Makuda* (*Manual Administrasi Keuangan Daerah*/ Manual of Local Finance Administration).

accounts; (d) accountability reports focused more on administrative accountability; and (e) accountability reports that do not involve external auditors (USAID-LGSP, 2009, p. 24).

Cash-based and single-entry accounting systems can actually describe the real amount of revenue and expenditure reflected in the cash outflow and cash inflow of local government. However, this method is not able to reflect the actual performance of local government finances because it cannot accurately measure the efficiency and effectiveness of activities and programmes/ projects executed by local government institutions (Halim, 2008). According to informants in the study sites, single-entry accounting was implemented for reasons of simplicity and practicality.

In the light of the characteristics mentioned above, the study conducted by USAID-LGSP (2009, pp. 24-25) identified several disadvantages of the *Makuda* system, such as not being able to provide a balance statement, hence it could not supply information about the assets (particularly the non-cash assets) owned by local governments. Moreover, this method was not able to explain the factors that caused the accretion and reduction of local government assets. Other than this, the old system (*Makuda*) failed to assist local governments to develop performance-based accountability reports for APBD utilisation.

3.3. Local Government Budgeting under Current Policy

This section elaborates upon the current budgeting system adopted by Indonesian local governments. It starts with an elucidation of the general policy on budgetary and financial management in the local autonomy era. Subsequently, it illustrates the present structure of the APBD (*Anggaran Pendaptan dan Belanja Daerah*/ local government annual budget), and then concludes with a brief description of new approaches to the current budgeting system.

3.3.1. The General Policy on Budget and Financial Management

The governance reforms have led to the decentralisation of local government financial management and annual budgets (APBD). It has also led to a better financial balance (*perimbangan keuangan*) between the central government and local governments. This situation provides far larger funding sources to local governments and gives them much more authority to manage their own financial resources than before. Unlike the previous era, currently all revenues and expenditures of local governments must be allocated in the local annual budget (*APBD*) and have to be executed efficiently and effectively under the principle of 'money follows function' (Mardiasmo, 2002).

The decentralisation of financial management has also created a better environment for central and local officials to manage the number of functions and authorities delegated to local governments, thus both parties can precisely estimate the amount of funds required by local governments to execute the decentralised functions and authorities. Hence, it can avoid the overlap of funding between the central government and local governments upon executing decentralised governmental affairs.

In addition, the budgeting reforms have significantly changed the role of elites in the local executive and legislature in the budgeting process. In the previous era, the budgeting process at the local government level was carried out under the direction of the central government. On the contrary, local governments and local parliaments currently have full discretion at all stages of the budgeting process including formulation, validation, execution, and the supervision/ accountability phase (Syahruddin, 2007). This circumstance inevitably requires a more skilled apparatus within local governments and legislatures.

The next important point about the budgeting reform is the shift in control over the local financial management and the budgeting process. In the centralised era, the financial management and budgeting process were mostly controlled, supervised, and audited by internal-government agents. External-government parties did not have access to do the same. In contrast, non-governmental bodies are presently allowed to control and supervise the management and budgeting of local finances (Boediono, 2002). This provision aims to reduce corruption, nepotism, and collusion in the management of local government finances.

In respect to local government revenue, as the data denote, generally local governments are still very dependent on funding sources from the central government. Evidently, most local revenues are derived from the balancing fund (*Dana Perimbangan)* transferred by the central government in the form of the DAU (*Dana Alokasi Umum*/ General Allocation Fund), the DAK (*Dana Alokasi Khusus*/ Special Allocation Fund), and the DBH (*Dana Bagi Hasil*/ Shared Fund)[13].

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[13] The phenomenon of the financial dependence of local governments on the central government is presented in Chapter Eight (Execution of APBD: the third stage) which displays the data of proportion of Own-Source Revenue (PAD/ *Pendapatan Asli Daerah*) compared to the Balancing

Moreover, the current reality demonstrates that local governments still face the problem of budget deficits because local government revenues are not able to cover local government expenditures. This is worsened by the fact that many local governments are wasteful and lack a spirit of efficiency. In the light of this, the authorities have introduced a number of policies to strengthen the financial condition of local government.

Firstly, there has been a strengthening of the capacity and authority of local governments to collect local taxes. Unlike the atmosphere in the pre-reform era, where local governments had less potential to collect local taxes, currently local governments have more potential local taxes. It can be seen from the policy of the national government, which started in 2000, that local governments were authorised to collect local taxes on seven objects and this then increased to eleven objects starting from 2009[14]. Furthermore, local governments were also authorised to collect levies on 30 (thirty) objects. This policy has significantly contributed to an increase in local government income.

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fund (*Dana Perimbangan*) transferred from the central government in the District of Trenggalek, the City of Batu, and the City of Surabaya.

[14] In 2000, the Indonesian government issued Law 34 of 2000 regarding local taxes and levies. This law stipulates that local government tax comprises 7 (seven) objects, including Taxes on Hotels, Restaurants, Entertainment, Advertising, Street Lighting, Mineral Group C, and Parking Tax. Hereinafter, Law 34 of 2000 was revised by the issuance of Law 28 of 2009 concerning Local Government Tax. Under the new law, local government tax contains eleven objects: (a) Hotel tax; (b) Restaurant Tax; (c) Entertainment Tax; (d) Advertising Tax; (e) Street Lighting Tax; (f) Mineral Tax, excluding Metal and Rock; (g) Parking tax; (h) Ground Water Tax; (i) Swallow's Nests Tax; (j) Land and Building Tax for Rural and Urban areas; and (k) Tax of Ownership Acquisition of Land and Buildings.

Secondly, local governments are now authorised to obtain loans. This policy aims to optimise development funds and can therefore optimally accelerate local development activities. As the *Permendagri* 13 of 2006 stipulates, local governments can obtain loans which can be sourced from: (1) the central government, (2) other local governments, (3) banks and financial institutions, (4) non-bank financial institutions, and (5) the community. To obtain a domestic loan, local authorities are authorised to issue municipal bonds as a strategy to obtain loans from the community. Additionally, local government authorities can also get a loan from the central government (national budget/ APBN) by proposing debt to the Minister of Finance. Nevertheless, local governments are not allowed to obtain a loan directly from overseas (governmental or non-governmental) parties. In this case, local governments have to get approval first from the national authorities if they want to get an overseas loan.

Thirdly, the central government provides various grants (*dana hibah*) to local governments. Other than this, local governments may also receive grants from domestic and international sources (Boediono, 2002). Moreover, the national authorities have intensified control over deficits in local government budgets. As regulated in the guidelines[15], local governments should limit their budget deficit to a maximum of three per cent of total revenue. This policy primarily aims to prevent

[15] Control over the deficit of the national budget (APBN) and local budgets (APBD) is stipulated in the *Permenkeu* (*Peraturan Menteri Keuangan*/ Regulation of the Minister of Finance No. 95/PMK.07/2007 regarding the Maximum Limit of the National Budget (APBN) and Local Budget (APBD) Deficit as well as Maximum Limit of Local Government Loans for Fiscal Year 2008. This regulation requires that the deficit of the national budget (APBN) should not exceed 0.3 per cent of GDP projections. It also regulates that the maximum deficit of the local government budget (APBD) is 3 per cent of total budget revenues.

local governments from falling into the 'debt trap' which would increase the risk of national and local financial instability.

Fourth, the central authorities have formulated a new design for financial transfers to local governments. In the era before local autonomy, funds transferred from the central government were known as Autonomous Region Subsidies (*SDO/ Subsidi Daerah Otonom*) and Presidential Instruction Aid (*Banpres/ Bantuan Inpres*). The allocation and utilisation of these funds were fully determined and controlled by the central government. The role of local governments was only to be an executor and "cashier" of the use of these funds (Mardiasmo, 2002).

In the autonomy era, SDO and *Banpres* were changed to make up the Balancing fund (*Dana Perimbangan*). The law 33 of 2004 stipulates that the Balancing fund comprises three kinds of funds: (a) the General Allocation Fund (*DAU/ Dana Alokasi Umum*); (b) the Specific Allocation Fund (*DAK/ Dana Alokasi Khusus*); and (c) the Sharing Fund (*DBH/ Dana Bagi Hasil*). The amount of these funds is determined by the central government based on data supplied by local governments; subsequently the allocation, management, and utilisation of these funds are fully determined by local governments. The balancing fund intends to assist local governments with the financing of particular local government affairs and central government functions delegated to the regions. This policy also aims to reduce the financial gap between the central and local governments as well as the gap among local governments.

As an effort to improve the vertical fiscal imbalance, starting from 2009, local governments were delegated with an additional Sharing Revenue fund (*DBH/ Dana Bagi Hasil*)[16] sourced from: (i) additional sharing fees from oil and gas (*tambahan DBH minyak bumi dan gas*) amounting to 0.5 per cent, which is specifically targeted to finance basic-level education in the regions, and (ii) a sharing fee from the tobacco excise (*DBH cukai hasil tembakau*) amounting to up to 2 per cent of national revenues from the tobacco excise.

Between 2001 and 2008, the nomenclature of decentralisation funds within the structure of the APBN (national budget) was adapted several times. These funds were initially known as the 'localised fund' (*Anggaran yang Didaerahkan*), which later changed to 'local expenditure' (*Belanja Daerah*), and then, in the year 2007, was revised as 'expenditure for local government' (*Belanja ke Daerah*). Eventually, from 2008, the nomenclature was changed to 'transfer to local government' (*Transfer ke Daerah*).

The change of nomenclature from 'Expenditure to Local', to become 'Transfer to Local', is intended to enhance the idea that spending/ expenditure is different from transfers. In this case, transfer means the relocating of funds from the national treasury to local government without the obligation for local governments to present a report on the achievements of the projects/ activities funded through the transfer. Additionally, local governments do not need to submit a request or proposal to obtain transfer funds because the national executives and legislatures have set up

[16] As stated in the Financial Statement of the National Budget 2009 (*Nota Keuangan APBN tahun 2009).*

the type and amount of transfer funds for each local government (Yani, 2002). This scheme undoubtedly supports the spirit of fiscal decentralisation.

In 2009, the government through the *Perpres* 53 of 2009[17] reformulated the format of the General Allocation Fund (DAU/ *Dana Alokasi Umum*) which is now conducted through: (a) determination of Net Domestic Revenue by calculating the burden of fuel subsidies and fertilizer subsidies; (b) review of the proportion of each variable of fiscal need; and (c) realignment of the calculation of fiscal capacity in the formula of the DAU.

The policy regarding the Special Allocation Fund (DAK/ *Dana Alokasi Khusus*) proposes to increase the quality of public services in the regions as well as to reduce the disparities between public services among the regions. The *Permenkeu* 216 of 2010[18] regulates the reformulation of the DAK, among others, and is conducted by: (i) the enhancement and expansion of the criteria of the DAK; and (ii) encouraging a gradual change from de-concentration funds become the DAK

The balancing fund was created under the spirit of decentralisation which aims to provide an appropriated funding for local governments to implement local government functions. In this respect, the amount of the balancing fund is determined yearly by the national authorities (the Ministry of Finance) based on data supplied by local governments. The present policy gives local governments greater authority to

[17] Perpres (*Peraturan Presiden*/Regulation of President) 53 of 2009 regarding DAU (General Allocation Fund) for Provincial and Local Governments (City and Regency) in financial year 2010

[18] The *Permenkeu* (*Peraturan Menteri Keuangan*/Regulation of Minister of Finance) 216 of 2010 concerning General Guidelines on allocation of the DAK (Special Allocation Fund) for financial year 2011

manage the decentralisation fund (balancing fund) transferred from the central government. Evidently, except for the DAK - whereby its management and utilisation remains centrally regulated by the central government - the greatest allocation of balancing funds (DBH and DAU) are managed and utilised under the full discretion of local government authorities.

3.3.2. The Current Structure of the Local Government Budget (APBD)

During the pre-reform era, the annual budget for local governments was set up in a T-account format. The implementation of a T-account system contains a number of major weaknesses. The T-account format of APBD was not able to provide clear, real, and valid financial information, particularly in terms of controlling the deficit and enhancing transparency (Halim, 2008). Along with the implementation of the local autonomy policy, therefore, the APBD format was changed to an I-account format from the fiscal year 2001.

Adoption of an I-account format makes it easier for any party to analyse, evaluate, supervise, and calculate the APBD balance. Therefore, the stakeholders of the annual local budget are able to comprehend whether the budget will be in surplus or deficit; hence local government officials can prepare an appropriate strategy to anticipate this situation[19].

Table 3.1. The Current Structure of the APBD in the I-account Format

Account Code	Account Name	Amount
	REVENUE	

[19] In this case, local officials would seek funding sources to cover the shortage if the APBD shows a projected deficit. Otherwise, the officials will determine the utilisation of excess funds in case the APBD shows a projected surplus.

	Own-Source Revenue (PAD) Local Tax Local Levy The profit of Local-government-owned Enterprises Other Legal Revenue **Balancing Fund** Sharing Fund of Tax Sharing Fund of Non-Tax General Allocation Fund (DAU) Special Allocation Fund (DAK) **Other Local Government Legal Revenues** Grants Emergency Funds Sharing Funds of Tax from Provincial and Other Local Governments Adjustment Fund and Special Autonomy Financial Assistance from Provincial and Other Local Governments Sharing Funds of Non-Tax from Provincial and Other Local Governments **TOTAL AMOUNT OF REVENUE**	
	EXPENDITURE **Indirect Expenditure** Personnel Expenditure Interest Grant/Subsidy Social Assistance Sharing Fund to Lower-level Region Assistance to Lower-level Region Unpredicted Expenditure Assistance to Vertical Institutions **Direct Expenditure** Personnel Expenditure Goods and Service Expenditure Capital Expenditure **TOTAL AMOUNT OF EXPENDITURE**	
	FINANCING **Financing Acceptance** Remaining Balance of the previous fiscal year (SiLPA) Disbursement of Reserve Funds Proceeds from Sales of the Separately Managed Local Government Assets Getting Loans The Acceptance from Repayment of Lending The acceptance of Local Government's Receivables Other Financing Acceptances **Financing Expense** Transfer to Reserve Funds The Receipt of Capital (Investment) of Local Government; Payment of Debt Principal Giving loans Other Financing Expense **TOTAL AMOUNT OF FINANCING**	

Source: summarised from *Permendagri* 13/2006

As described in the table above, the annual local government budget (APBD) consists of three main components, including: (a) Local Government Revenues, (b) Local Government Expenditures, and (c) Local Government Financing.

Local Government Revenue

Local Government revenue comprises all income of the local government in the form of cash or non-cash money within a financial year. Local government revenue includes three basic types[20] which are: (a) Own-Source Revenue (*Pendapatan Asli Daerah/ PAD*), (b) Balancing Fund (*Dana Perimbangan*), and (c) Miscellaneous Revenues (*Pendapatan Lain-lain*).

Own-Source Revenue (Pendapatan Asli Daerah/PAD)

The PAD (own-source revenue) consists of four main sources, namely: (1) local taxes, (2) local levies; (3) profit from local-government-owned enterprises; and (4) miscellaneous revenues. In detail, the Local Government Tax consists of 11 types[21], while the local government levy comprises three types[22], namely (a) General Services (*Jasa Umum*) which consists of 14 types[23], (b) Business Services (*Jasa*

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[20] This classification is as stipulated in the *Permendagri* (*Peraturan Menteri Dalam Negeri*/Decree of Minister of Home Affairs) 13 of 2006 article 22 clause 1.

[21] As stated in clause 2 article 2 of Law 28 of 2009 concerning Local Government Tax, the kinds of local government tax are: (a) Hotel tax; (b) Restaurant Tax; (c) Entertainment Tax; (d) Advertising Tax; (e) Street Lighting Tax; (f) Mineral Tax, excluding Metal and Rock; (g) Parking tax; (h) Ground Water Tax; (i) Swallow's Nests Tax; (j) Land and Building Tax for Rural and Urban areas; and (k) Tax of Ownership Acquisition of Land and Building.

[22] As mentioned in Law 28 of 2009 article 108.

[23] Article 110 of Law 28 of 2009 stipulates that the types of General Services Levy are: (a) Levy of Health Services; (b) Levy of Waste Disposal; (c) Levies of Identity Card and Civil Certificate; (d) Levy of Funeral Services and Crematorium; (e) Levy of Parking Service on Public Roads; (f) Levy

Usaha) containing 11 objects[24], and (c) Special Licensing (*Perizinan Tertentu*) containing 5 types[25]. Other than this, local government revenue also comes from the profits of local-government-owned enterprises (*Badan Usaha Milik Daerah*/ BUMD). Moreover, the last type of own-source revenue (PAD) is miscellaneous revenue[26]. This type accommodates the revenues which are not included in the three types of local government revenue (local taxes, local levies, and the profits of local-government-owned enterprises) mentioned earlier.

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of Market Services; (g) Levies of Motor Vehicle Inspections; (h) Levy of Fire Extinguisher Inspections; (i) Levy of repayment of printing cost of map; (j) Levy of Provision and/ or Lavatory Suction; (k) Levy of Liquid Waste Treatment; (l) Levy of Re-stamp Service; (m) Levy of Educational Service; and (n) Levy of Telecommunication Tower Control.

[24] As stipulated in Law 28 of 2009 article 127, the types of business service levy comprises: (a) Levy of Use of Local Government property; (b) Levy of Grocer Market and/or Shopping Centre; (c) Levy of Auction Place; (d) Levy of Public Transport Station; (e) Levy of Special Parking; (f) Levy of Lodging/ Guesthouse/ Villa; (g) Levy of Slaughterhouse; (h) Levy of Port Service; (i) Levy of Recreation and Sport venues; (j) Levy of Crossover Service on Water, and (k) Levy of Local Production Sales.

[25] Types of Specific Licensing, as stated in Law 28 of 2009 article 141, among others are: (a) Levy of Building Permit; (b) Levy of Permit to sell Alcoholic Beverages; (c) Levy of Disturbance Permit; (d) Levy of Route Permit; and (e) Levy of Fishery Permit.

[26] The group of Other Legal Revenues consists of: (a) The Sales of Non-Separated Local Government Assets; (b) Income from clearing account; (c) Interest income; (d) Income from compensation. claimed by Local Government; (e) Income from commissions, discounts or other forms as a result of the sale and/ or procurement of goods and/ or services by Local Government; (f) Revenue gained from the difference of the rupiah rate against foreign currencies; (g) Revenue from penalties for lateness in executing work; (h) Income from Tax Fines; (i) Income from Levy fines; (j) Income from the execution of the guarantee; (k) Income from the Return; (I) Income from social facilities and public facilities; (m) Revenue from providing education and training; and (n) Income from installment sales.

Balancing Fund (Dana Perimbangan)

The Balancing Fund contains three types of revenue, being: (a) Revenue-Sharing (*Dana Bagi Hasi/ DBH*), (b) General Allocation Fund (*Dana Alokasi Khusus/ DAU*), and (c) Special Allocation Fund (*Dana Alokasi Khusus/ DAK*).

Sharing Funds (Dana Bagi Hasil/DBH)

Sharing Funds (DBH) are allocated from the national budget (APBN) and then distributed proportionally to local governments based on the volume of revenue earned by the region. In general, DBH comprises a Sharing Fund from taxes (*Dana Bagi Hasil Pajak*) and a Sharing Fund from natural resources (*Dana Bagi Hasil Sumber Daya Alam*). In detail, the Sharing Fund from taxes consists of: (a) Land and Building Tax (*Pajak Bumi dan Bangunan/ PBB*); (b) Fees for the Acquisition of Land and Buildings (*Bea Perolehan Hak atas Tanah dan Bangunan/ BPHTB*); and (c) Income Tax (*Pajak Penghasilan*/ PPh). On the other hand, the Sharing Fund from natural resources contains a range of sources of income derived from: forestry, general mining, fisheries, petroleum mining, natural gas mining, and geothermal mining.

General Allocation Fund (DAU/ Dana Alokasi Umum)

The General Allocation Fund (DAU) aims to equalize the financial capabilities among local governments across Indonesia. The DAU is distributed to local governments based on a formula which accommodates four factors, being fiscal need, fiscal capacity, fiscal gap, and basic allocation[27]. At the national level, the total amount of DAU is determined to be at least 26% of Net Domestic Revenue (*Pendapatan Dalam Negeri Netto*) in the national budget (APBN). The proportion of the DAU divided among provincial and local governments is based on the proportion of authority among those governments[28].

Special Allocation Fund (DAK/ Dana Alokasi Khusus)

The Indonesian government established the DAK (Special Allocation Fund) with the intention of providing funding to the regions to implement particular activities that are considered to be national priorities[29]. The volume of the DAK is determined annually in the national budget (APBN). The national authorities set the limits of the DAK based on three criteria, being general, specific, and technical criteria[30]. As stated in the normative guidelines, DAK recipients must provide complementary funds (*dana pendamping/ pendukung*) which amount to at least 10% of DAK allocations. Complementary funds are budgeted for in the local budget. Local

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[27] The fiscal need of local government is determined through consideration of the area, geographic conditions, population, community health and welfare, community income level in the region, Construction Cost Index, Gross Domestic Product per-capita, and the Human Development Index, while the fiscal capacity of local government is the total of Own-source Revenues (PAD), and Revenue Sharing of Tax and Natural Resources (DBH). Fiscal gap is fiscal need minus fiscal capacity. Basic Allocation is calculated based on the total salaries of Local Civil Servants.

[28] If the determination of proportion cannot be calculated quantitatively, the proportion of DAU between provinces and districts/ cities is determined by the balance of 10% (for provinces) and 90% (for districts/ cities). Distribution of DAU is conducted monthly, with each month distributed for 1/12 of allocated DAU.

[29] The kinds of activities which are categorised to be national priorities are determined annually and then stipulated in government regulations.

[30] General criteria are established by considering the ability of local government finance reflected by the figures in the APBD; specific criteria refers to the stipulation and requirements stated in legislation; technical criteria are set up by the technical institution (local government bodies) or department (ministry) of the central government.

governments with low fiscal capacities are not required to contribute to the complementary funds.

Miscellaneous Revenue

Miscellaneous revenue consists of a number of revenue types, including: (a) grants; (b) the emergency fund of the government in order to help the victims or the damage caused by natural disasters; (c) sharing funds of tax from provincial government to local governments (District/ City); (d) adjustment fund and special autonomy fund established by the central government; and (e) financial assistance from the provincial government or from other local governments.

Local Government Expenditure

The expenditure of local government comprises all expenses spent to fund local government (district/ city) functions, which consists of obligatory functions[31] and optional functions[32]. Additionally, the APBD structure of local government

[31] As stipulated in *Permendagri* 13/2006 Article 22 paragraph (1) letter (b), local government expenditure for obligatory affairs is prioritized to protect and improve the quality of community life through delivering local government functions such as the improvement of basic services, education, health, social facilities and public facilities as well as to develop a social insurance system. In detail, the classification of expenditures according to obligatory affairs, includes: (a) education; (b) health; (c) public works; (d) public housing; (e) spatial planning; (f) development planning; (g) transportation; (h) the environment; (i) land; (j) population and civil registration; (k) empowerment of women; (l) family planning and family welfare; (m) social; (n) labor; (o) cooperatives and small and medium enterprises; (p) investment; (q) culture; (r) youth and sports; (s) unity of the nation and politics in the country; (t) general government; (u) employment; (v) empowerment of communities and villages; (w) statistics; (x) archives; and (y) communications and informatics.

[32] The classification of expenditure according to optional affairs are: (a) agriculture; (b) forestry; (c) energy and mineral resources; (d) tourism; (e) marine and fisheries; (f) trade; (g) industry; and (h) transmigration.

expenditure presents a new classification consisting of two components,[33] (a) indirect expenditure (*Belanja Tidak Langsung*), and (b) direct expenditure (*Belanja Langsung*).

Indirect Expenditure (Belanja Tidak Langsung)

Indirect expenditure is a type of local government expenditure that is not directly related to the execution of local government programmes or projects. This means that local governments always incur this kind of expenditure regardless of whether they execute any programme/ project or not. This type of indirect expenditure essentially replaces the old nomenclature of 'routine expenditure' (*Belanja Rutin*). Indirect expenditure consists of: (a) personnel, (b) interest, (c) subsidies, (d) grants, (e) social assistance, (f) expenditure for the sharing fund, (g) financial assistance, and (h) unpredicted expenditure.

Direct Expenditure (Belanja Langsung)

Direct Expenditure is a type of expenditure which is directly related to the implementation of programmes, projects, or other activities. This means that if local governments do not execute any development programmes/ projects, this expenditure will not be needed. The classification of direct expenditure basically replaced the old nomenclature of 'Development Expenditure' (*Pengeluaran Pembangunan*). Direct Expenditure consists of: (a) Personnel Expenditure, (b) Expenditures for Goods and Services, and (c) Capital Expenditure.

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[33] As mentioned in article 24, verse 2, *Permendagri* 13 of 2006.

Local Government Financing (*Pembiayaan Pemerintah Daerah*)

Local Government Financing consists of two types, financing acceptances (*Penerimaan Pembiayaan*) and financing expenses (*Pengeluaran Pembiayaan*). Financing acceptances are all financial transactions aimed at covering deficits - usually in the form of obtaining a loan from external parties and/ or taking reserve money saved in the local government account. Meanwhile, financing expenses are all financial transactions intended to utilise the budget surplus, either in the form of providing loans for external parties and/ or saving the surplus into a reserve fund account[34].

3.3.3. New Budgeting Approaches

The budgeting system applied in the present local autonomy era is primarily characterised by the adoption of the Performance-Based Budgeting System (PBBS)[35]. The implementation of PBBS substantially replaced the traditional budgeting system (with the line-item and incremental approach) which had been applied during the pre-regional autonomy era. The PBBS approach focuses on efforts to achieve the best

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[34] This classification is stipulated in article 22 verse 1c *Permendagri* 13 of 2006. As mentioned in these guidelines, the type of acceptance of financing includes: (a) remaining balance of the previous fiscal year (*Silpa*), (b) disbursement of reserve funds, (c) proceeds from sales of the separately managed local government assets, (d) getting a loan; (e) the acceptance from repayment of lending, and (f) the acceptance of local government receivables. Meanwhile, the financing expense account includes: (a) the establishment of reserve funds, (b) the receipt of capital (investment) of local government; (c) payment of debt principal, and (d) giving of loans.

[35] The implementation of the Performance Based Budgeting System (PBBS) is stipulated in a number of normative regulations such as PP (Peraturan Pemerintah/ Government Regulation) 105 of 2000 (then revised by PP 58 of 2005 regarding Local Financial Management), Law 17 of 2003 concerning Public Finance, *Kepmendagri* 13 of 2006 about Guidelines of Local Finance management, and other regulations. According to these regulations, PBBS applied in Indonesian government institutions focuses on the effort to achieve the best output based on the input (allocated costs/ resources).

output/ outcomes based on allocated costs/ input. This system also encourages local government officers to work more professionally in delivering government functions.

To optimise the implementation of the performance-based budgeting system (PBBS), the Indonesian authorities also required government institutions to apply the Medium-Term Expenditure Framework (MTEF) approach, particularly in the execution of capital projects. As discussed at the previous chapter, the MTEF (Medium-Term Expenditure Framework) is a tool for linking policy, planning and budgeting over the medium-term (usually around three to five years). It consists of top-down resource allocation and the bottom-up estimation of current and medium-term costs of existing policies (Swaroop, 2000). Some formal regulations[36] state that the implementation of the MTEF is intended to reduce the obscurity of the linkages between policy, planning, and budgeting. Furthermore, it is also intended to improve the quality of public service and fiscal discipline.

Further, the adoption of the PPBS is also to be followed by implementing the 'double-entry' accounting system (to replace the 'single-entry system') and the 'accrual system' (to replace the cash-based system) of local financial management. The implementation of these accounting systems aims to respond to demands for transparency and accountability in the financial management of public sector institutions. It also makes local government staff able to precisely determine the cost of services provided by local government; therefore, the service provider can determine how much money has to be paid by the public who intend to access a

[36] Law 17 of 2003 regarding Public Finance, Law 25 of 2004 on National Development Planning System, and *Permendagri* 13 of 2006 concerning the guidelines of local finance management.

particular service. Double-entry and accrual-based accounting methods are very useful in producing reliable, actual, accurate, and comprehensive financial reports.

In addition to this, government bodies have been requested to adopt the integrated budgeting approach to develop their annual budgets. Under this approach, planning and budgeting of all government activities are prepared through an integrated process. Additionally, this approach requires the integration of the routine and the developmental budget (*Anggaran Rutin dan anggaran Pembangunan*). As stipulated in the formal guidelines, application of an integrated budget is a strategic step as part of a long-term effort to make the budget more accountable. Also, integrated budgeting significantly supports the implementation of the performance-based budgeting method. These new budgeting approaches outlined above and adopted in the local autonomy period are now termed as the 'new paradigm of the budgeting system'.

In addition, local governments are also obliged to apply a participatory approach towards the APBD budgeting process. A participatory budgeting approach is actually an old idea that was applied in the pre-reform period; nonetheless, it was considered to have been poorly implemented. In the post-reform era, this approach has been enhanced with the expectation that the quality and intensity of public participation in the local budgeting process will grow significantly. In detail, the implementation of the new paradigm budgeting system and the enhancement of participatory budgeting are elaborated in the following chapter (Chapter Five) which is entitled 'Introducing the New Paradigm and Enhancing the Participatory Approach Towards the Local Budgeting System'.

3.4. Summary

The reforms of governance have driven decentralisation of the local government financial management and annual budget (APBD). It has also led to a better financial balance (*perimbangan keuangan*) between the national government and local governments. This policy provides far greater finance bases to local governments and gives them much more authority to manage their own financial resources than before.

In the dates of the centralistic era, Indonesian local governments applied the traditional budgeting method involving the line-item incremental approach, annual budgeting, as well as single-entry and cash-based accounting. This was proven could not provide accurate report about the actual costs of local government projects and activities, hence it was difficult to measure the performance of local government units in managing the annual budget (APBD). On the other hand, the budgeting system adopted under the present local autonomy period is characterised by the principles of the Performance-Based Budgeting System (PBBS). This system is complemented by implementation of the Medium-Term Expenditure Framework (MTEF) approach and also double-entry and accrual-based accounting system.

In the previous system, the APBD was prepared without rational analysis and did not consider performance factors in preparing and executing the APBD. Local officials only focused on expending the allocated budget and accomplishing programmes and projects without considering whether or not these activities get implemented efficiently and effectively. Also, this system emphasised more on input than output in evaluating performance of the budget execution. On the contrary, the current method obligates local authorities to formulate and implement allocated budget efficiently and effectively based on the performance indicators arranged earlier.

The traditional budgeting system practiced during the pre-reform era was completely controlled by the central government and also managed under the system of yearly budget. On the contrary, the current budgeting system is encouraged to accommodate long-term budgeting (Medium-Term Expenditure Framework/MTEF) other than annual budgeting. Moreover, local governments and local parliaments currently have full discretion at all stages of the budgeting process including formulation, validation, execution, and the supervision/ accountability phase.

Under the conventional budgeting system, the local budget (APBD) was separated into routine expense and capital expenditure/ investment. In fact, this scheme repeatedly causes conflicts and overlapping, as the capital budget was commonly utilised to finance routine activities and *vice versa*. Unlike this scenario, in the current system, the local budget is divided into two types: direct and indirect expenditure, which purposes to avoid the overlap of funding in financing routine and developmental activities.

Overall, the traditional and centralised budgeting system have unsuccessful to create an ideal environment for developing a budget supervision, control, and accountability system. Consequently, these practices were not able to reduce corruption, manipulation, and other illegal actions. On the other side, the present system enhances accountability system as an integral part of the local budget management system. This also gives wider opportunity to the non-governmental parties to actively get involved in overseeing and controlling the APBD management. Unfortunately, this effort has not been really successful to reduce corruption and other misuses of the APBD funds.

Other than various phenomena above, in respect to local government revenue, generally local governments are still very dependent on funding sources from the central government. As before, most local revenues are derived from the balancing fund (*Dana Perimbangan)* transferred by the central government in the form of the DAU, the DAK, and the DBH.

Moreover, the current reality demonstrates that local governments still face the problem of budget deficits because local government revenues are insufficient to cover local government expenditures. This is worsened by the fact that many local governments are wasteful and lack a spirit of efficiency. In the light of this, the authorities have introduced a number of policies to strengthen the financial capacity of local governments, such as: (1) strengthening local taxing powers; (2) allowing local governments to create loans; (3) awarding grants to local governments; (4) allowing greater control over local budget deficits; (5) formulating a new design for financial transfers to local governments; and (6) reformulating the balancing fund.

Budgeting reforms have not only occurred within the budget structure, but have also been accompanied by changes in the budgeting process. The reforms have been intended to make the planning phase of budgeting operates more effectively, and also to equalise the role of local government, the local parliament (DPRD), and society in the budgeting process. The APBD budgeting, which consist of four main stages, will be comprehensively analysed in the next chapters. `