CHAPTER TWO

THE LOCAL GOVERNMENT BUDGETING PROCESS: A THEORETICAL OVERVIEW

2.1. Introduction

As stated in the previous chapter, this study intends to critically analyse the budgeting system and process under Indonesia's current fiscal decentralisation policy. In order to better understand the topic explored in this research, this chapter presents the theoretical discussion about themes associated with the research focus and objectives.

The following series of questions will be discussed in the first section. What are the main ideas and objectives of fiscal decentralisation? Does fiscal decentralisation promote better fiscal governance at the local government level? How does (or doesn't) it work? This is followed by an elaboration of the details of the budgeting system. Moreover, this section outlines the urgency of budgeting reform and the connection between budgeting methods with the government financial management.

The second section details the salient features of the budgeting reform. It aims to provide clarification about rationales, ideas, advantages, and disadvantages of each new approach introduced in the budgeting reform. In addition, the last section presents the theoretical framework of the budgeting process. It elucidates the theoretical and normative activities which should be conducted and avoided during the main stages of the budgeting process, namely formulation, validation, execution, as well as the accountability and supervision of the public budget. This section also identifies the actors and institutions that play dominant roles at each stage of the budgeting process.

2.2. Fiscal Decentralisation and the Budgeting System

Decentralisation reforms, as Hiskey (2006) points out, often lead to tension among stakeholders because decentralisation is basically about redistributing power within, and between, levels of government, with different parties have opposing interests in the reform.

Since the 1970s, a robust tendency towards decentralisation has mounted in both developing and developed countries. Fiscal decentralisation is a tool to allocate resource efficiently and to endorse development goals. Also, fiscal decentralisation is as a technique to escape the traps of inefficient governance, macroeconomic instability, and insufficient economic progression in which they have become common trend recently (Seymour & Turner, 2002).

A political-economy approach outlines the effect of politics in executing the reforms, indicating that decentralisation is a greatly political process because it pursues to reallocate resources within the regional boundaries of a given nation-state (Agrawal, et al., 1999, p. 2). Yilmaz, et al., (2008) state that decentralisation reforms award local governments new power and accountabilities through three dimensions: political, administrative, and fiscal.

The theoretical development of fiscal decentralisation was first pioneered by Tiebout (1956), Musgrave (1959), and Oates (1972). Later, Bird & Vaillancourt (1998, p. 3) constructed three varieties of fiscal decentralisation which are deconcentration, delegation, and devolution. In the context of administrative and fiscal decentralisation, Yilmaz, et al (2010, pp. 273-274), explain that there are three factors affecting local government discretion: (1) ability to regulate; (2) discretion to procure and administer services; and (3) discretion over civil service and employment policies. Further, Yilmaz et al. (2010, pp. 279-281) postulate four determinant factors of local fiscal discretion, including expenditure assignment, revenue assignment, financing of the fiscal gap, and the financing infrastructure.

Smoke & Lewis (1996) elaborate upon the problems with decentralisation that have been found in Indonesia as follows: (a) lack of coordination among central government agencies; (b) central-local government conflicts; (c) poor government performance incentives; and (d) counterproductive donor organization behaviours. More detail, Seymour & Turner (2002, pp. 40-44) reveal that local autonomy in Indonesia faces numerous challeges, among others are: (1) inappropriate levels of autonomy; (2) no improvement in the real fiscal autonomy; (3) lack of finance; (4) the central government treats local governments unequally; (5) 'grey areas' in central-local government control; and (6) issues with human resource capabilities. Additionally, Yilmaz, et al., (2010, p. 283) explains that internal controls and audit systems in Indonesia work poorly. As a result, this environment leads to illegal actions such as pervasive corruption, inefficient cash management, and collusive practices in procurement.

The implementation of the fiscal decentralisation policy leads to a controversy debating the advantages and disadvantages of fiscal decentralisation. Liu (2007, pp. 11-17) presents these debates by elaborating several arguments support the view that fiscal decentralisation can bolster economic growth. The first and most widely accepted argument is that fiscal decentralisation enhances economic efficiency (Oates, 1972). This argument relies on the hypothesis that the sub-national government better comprehends local community needs and is more capable than the national government of delivering services and collecting revenues.

The next argument, as postulated by Inman & Rubinfeld (1997), is that fiscal decentralisation can improve economic performance through strengthening social capital and encouraging political participation which usually goes on to encourage government accountability. Furthermore, fiscal decentralisation can promote economic performance by enhancing macroeconomic stability through modernising public sector activities, reducing the operational and informational costs of service delivery, and stimulating private sector development (Fukasaku & DeMello, 1998).

On the other hand, numerous contentions support opposing opinions on this issue, arguing that fiscal decentralisation may hamper economic performance. Prud'homme (1995) argues that fiscal decentralisation can actually undermine economic efficiency. Conyers (1990) agrees that decentralisation may increase the participation of people at the local level, but sometimes it is only a small privileged elite group who actually get involved. In fact, such elites often pursue their own self-interests which may be divergent from the needs of most of the local populace.

Fiscal decentralisation might also potentially generate conflict with macroeconomic policy. Musgrave (1959), for example, believes that it becomes more difficult to coordinate fiscal policy in a counter-cyclical sense under a decentralised fiscal structure. Prud'homme (1995) similarly considers the possibility that fiscal management of sub-national governments would work opposite to the fiscal policies of central governments. Additionally, fiscal decentralisation provides a strong incentive for sub-national governments to make loans which may possibly lead to a national debt crisis. Local governments tend to accrue significant debt when they are convinced that the central government will bail them out in a crisis.

In spite of dissenting opinions regarding the efficacy of fiscal decentralisation as presented above, the implementation of fiscal decentralisation in a regime inevitably requires a proper budgeting system which will 'fit' the governance system. Adjusting the budgeting method to the governance system is a must because, as Krafchik (2001) clarifies, the budget is the most important economic policy instrument to realise the priorities of government.

The budget is a reflection of a government's policies and priorities, as well as the planning and implementation processes for the delivery of goods and services. The budget is used to boost economic growth and development and is also a system of accountability and control over government officers and agencies, which sets limits on their activities and safeguards against corruption (Fubbs 1999).

In general, Alexander (1999) divides budgeting into two concepts. The first concept presents budgeting as a largely technical exercise. It emphasises neutral competence, economy, efficiency, and accountability. A second concept stresses the importance of institutions, individual roles, informal rules, and bargaining in forming budgetary action and outcomes. Also, the most familiar political depiction is *The Politics of the Budgetary Process* popularised by Wildavsky (1964).

Budgeting is essentially a process aimed at maximizing the benefits of public spending that is funded through available resources (Ljungman, 2009, p. 3). In respect of the function of budgeting, Fubbs (1999) explains that the budget should be understood as a political, economic, legal, and planning tool. It is also an instrument for allocation, reallocation, and redistribution, and an accountability mechanism. Moreover, Wildavsky (1961) points out that the budget is a pivotal instrument of public policy and a critical arena for political bargaining between the executive and the legislature. Most practical budgeting may take place in a grey area between politics and rationality. Later, Rubin (1993) argued that budgeting is highly political, but it is not the same thing as politics in general. It represents a special angle of politics, with many unique characteristics.

Virtually every conventional definition of the politics of budgeting is often simplified as “who gets what, when and how” (Unger, 1987, p. 145). `Wildavsky (1961, 1964, 1992) is widely known to have highlighted the influence of politics and the political process in making changes to budgeting systems. Nonetheless, once conceived as a management process, budgeting is regarded as a highly rational and value-neutral operation for translating policy into effective management (Evans & Wamsley, 1995). As a rational and technocratic process, public budgeting aims to perfect democracy (Lane & Wamsley, 1998).

Lynch & Lynch (1996) state that changes in information technology, an increasingly competitive environment, and the improving professional skills of budgeters will bring about changes to budgetary systems, including at the local government level. Over the past three decades, the demographic, economic, political, and technological environments of local governments have changed significantly. To cope with these changes, local governments have to find innovative ways to provide goods and services through systematic reform (Lu & Facer 2004).

Unfortunately, as numerous studies show, budgeting reform is frequently unsuccessful. The failures of budgeting reforms are largely due to a disjuncture between formal and legal democracy, which presupposes a rational bureaucracy, and the politicised nature of government (Schick, 1978; Wildavsky, 1964). Among other reasons, are that: (a) the reforms are irrational in practice because of their attempts at comprehensive calculation (Joyce, 1996; Wildavsky, 1992); (b) resource allocation cannot support rational decisions because of budgetary politics (Wildavsky, 1964); and (c) the mismatch between budget systems and an organization's environment results in the failure of budget reforms to achieve their intended outcomes (Forrester & Adams, 1997). Consequently, most efforts to make public budgeting better as a technical and managerial instrument have failed to meet expectations (Timney 1995).

Reforming the budgetary system can be an important approach in dealing with a change in the political and governance system. The way a local government manages its annual operating budget affects budgetary deliberations, which in turn can influence resource allocation among different programmes and agencies, and among the respective recipients of goods and services (Grizzle, 1986; Pettijohn & Grizzle, 1997).

According to Forrester & Adams (1997), successful budgetary reforms require attention to the organizational context and, in particular, to human behavioural dynamics. Moreover, it also requires organisational change in which the reform is planned and implemented.

As previously discussed, it can be seen that the literature in this area has identified several objectives of budgetary reform, including the rationalising of resource allocation, improving the internal operation of a governmental organisation, and improving budget deliberation processes. Another goal of budgetary reform is to fit a government financial system with its external environment. Conventionally, scholars consider budgeting primarily as a way to allocate resources among governmental agencies and programmes. Therefore, budgeting reform is mainly undertaken to improve the efficiency and effectiveness of resource allocation. Nevertheless, the linkage between reform and changing budgetary outcomes is uncertain (Rubin, 1993). Several empirical studies have shown that rational budget reforms do not improve resource allocation between agencies or between programmes (Connelly & Tompkins, 1988; Harkin, 1982; Joyce, 1996; Lauth, 1985; Schick, 1978).

Irrespective of the success or failure of budget reforms, many local governments constantly change the methods through which they manage the budget because they believe that reforming the budgetary system can be greatly beneficial in improving financial management and accountability. In light of this, it is necessary to gain a deeper understanding of the content and the new ideas introduced through the budgeting reforms.

2.3. Budgeting Reform: the Crucial Points

As indicated earlier, budgeting and budget documents should be a bridge linking the attempts of governments to meet the citizen's requests. Reforming the method of budgeting can promote better financial management and accountability. Also, on particular occasions, budget reform is a compulsion as it is an adaptive response to the present atmosphere and demands.

This section elucidates a theoretical discussion about critical efforts to reform the public budgeting system. It starts with the most essential agenda of budget reform which is the adoption of a performance-based budgeting system (PBBS) to replace traditional budgeting methods. This is followed by a discussion about the reforms related to other budgeting approaches, including the implementation of the Medium-Term Expenditure Framework (MTEF), the accrual-based accounting system, and participatory budgeting.

2.3.1. From the Traditional to Performance-Based Budgeting System

The traditional budgeting system is primarily characterised by the line-item incremental budget. The line-item budget has significant strengths therefore it has become the preference of numerous countries across the globe. Gianakis & McCue (1999, 22) identify factors that encourage government institutions to apply the line-item budgeting system. First, the line-item format can be used by all of the wide range of local government agencies. Second, the format and calculation require little or no analysis by the operating manager. Third, officials and legislators feel more comfortable in delivering simple duties in this system, as opposed to more complicated programmes or policy analyses. Fourth, the fact that policy is forced to minimise the conflicts associated with the allocation of limited resources. Finally, the line-item budget format optimises control over the function of budgeting.

Nonetheless, traditional budgeting is considered a failure in promoting reliable fiscal management and accountability. In consideration of this reality, Performance-Based Budgeting System (PBBS) was introduced to deal with the disadvantages of traditional budgeting. The OECD (2003b, p. 7) states that performance budgeting is a form of budgeting that relates funds allocated to measurable results. Meanwhile the GAO (1993, p. 4) points out that performance budgeting links performance information with the budget.

Harrison (2003) specifies three components of performance budgeting, including the result (the end outcome), the strategy (ways to achieve the end outcome), and activity/ outputs (what is actually done in order to achieve the end outcome). Performance budgeting establishes a link between the rationales for specific activities and the end outcome. This information enables policymakers to determine which activities are cost-effective in reaching their end outcome.

The question then becomes, why is Performance-Based Budgeting System (PBBS) needed? Robinson & Brumby (2005, p. 12) explain that, in respect to allocative efficiency, performance budgeting reformers have been driven by a belief that expenditure allocation in the public sector tends to be insufficiently responsive to changing social needs and priorities. In PBBS, resources are allocated to specific activities that produce immediate outputs, rather than to the line-items that indicate the materials consumed in the production process (Gianakis & McCue, 1999, p. 25).

In greater detail, Willoughby (2002) puts forward seven key reasons why government institutions need to use PBBS. This is because PBBS: (1) provides accountability to the public; (2) drives the redesign of programmes (it focuses on improvements); (3) helps to rationalise budget allocations (uses performance information as an evidence-base); (4) improves understanding on managing programmes in government; (5) helps agencies to link their daily activities to overall government outcomes and similar activities of other agencies; (6) compares cost-effectiveness between programmes; and (7) helps to align government spending with overall goals.

However, implementation of performance budgeting should be carefully undertaken as PBBS may not work for a variety of reasons. Robinson & Brumby

(2005, pp. 15-16) note that, in its most extreme form, the argument is that budgeting is inherently political rather than rational, and that politics will always win, thus the construction of the objective to prioritise rational expenditure is largely an illusion. In this context, politics and rationality are largely antithetical. In view of this, Gianakis & McCue (1999, p. 26) emphasise that the budget process is clearly dependent on the expertise of, and the information provided by, programme managers.

Other constraints related to the implementation of PBBS are that legislative members at the local government level tend to reject this system. This phenomenon confirms the opinion of Harrison (2003) who states that performance budgeting requires a change in the legislature's perspective on the budget, because the character of the legislature is one that tends to resist the measurement of performance and accountability.

Further, Wendland (2003, cited in Harrison, 2003) details the reasons that cause legislative members to prefer the incremental approach, and therefore to reject performance based budgeting, because: (1) it is easy to calculate; (2) the present activities are tied to a known past rather than to an unknown future; (3) traditional budgeting does not require analysis of policy. Line-item budgets are policy-neutral, thereby lessening conflict; (4) traditional budgeting lives on because it is easier, simpler and reduces conflict; (5) many portions of the current budget cannot be altered; and (6) the cost of auditing performance reports can be very high.

The discussion above clearly indicates that the Performance-Based Budgeting System (PBBS) is more advantageous than traditional budgeting. Nevertheless, it needs to be implemented very carefully otherwise this system is unlikely to produce optimal results as expected. Joyce & Sieg (2000) suggest - at least - four prerequisites in order for the PBB to be successfully implemented, including that: (a) public entities need to know what they are supposed to accomplish; (b) valid measures of performance need to exist; (c) accurate measures of cost need to be developed; and (d) cost and performance information needs to be brought together for budgeting decisions.

2.3.2. From Annual Budgeting to Medium-Term Expenditure Framework

In setting up budget planning and policy, Diamond (2003, p. 3) suggests that it should include an integration of the performance-budgeting model and a strategic medium-term expenditure plan which connects policy objectives with detailed annual plans. This is in tune with the trend in most countries that the introduction of a performance-budgeting approach has paralelled a greater reliance on medium-term budget frameworks rather than an annual budget.

As mentioned in Armenia (2013), in terms of public expenditure management, budgets developed and executed on an annual basis have certain limitations as they are based on short-term macroeconomic forecasts, and there is no definite linkage between the implemented policies and the annual budgetary expenditures due to inconsistency in the timing. Lewis (1952, cited by Gianakis & McCue, 1999, p. 19) asserts that budgetary decisions have to be based not only on relative needs as they are today, but also on forecasts of what the needs will be tomorrow, next year, or in the next decade.

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, 2001). Developing a comprehensive MTEF will be effective when the circumstances and capacities permit. Otherwise, as warned by Levy (2007), it can be a great consumer of time and resources and may distract attention from the immediate need for improving the annual budget and the budgetary execution process.

The introduction of the MTEF is not a simple task, therefore it needs proper preconditions. According to the IMF (Levy, 2008), the preconditions that ought to be in place before the implementation of the MTEF, among others, are: (a) reliable macroeconomic projections, linked to fiscal targets in a stable economic environment; (b) a satisfactory budget classification and accurate and timely accounting; (c) technical capacity and disciplined policy decision-making, including budgetary discipline; and (d) political discipline for fiscal management.

Planning of the medium-term public expenditure is an on-going process and, in essence, represents a complete logical chain of “policy formulation – planning – budgeting”. It enables the adjustment of possible inconsistencies between available resources and expenditure needs, as well as enabling changes in public expenditures equivalent to state policy changes in different sectors. The introduction of medium-term public expenditure planning aims to solve the following problems: (a) improvement of the macroeconomic balance; (b) promotion of efficient inter-sectoral and intra-sectoral redistribution of budget allocations; (c) reduction of existing uncertainties between policies and their financing; (d) establishment of robust budget ceilings by sectors in order to carry out targeted and efficient use of available resources; and (e) improvements in the system of assessing budgetary programs, and raising of the level of transparency of public finance management (Armenia, 2013).

Despite its popularity, the MTEF has been effective in only a few countries. Schick (2008) affirms that it is mostly a technical exercise which is institutionally and procedurally separate from the annual budgeting process. As a result, resource decisions are still made on an annual basis and the budget remains input-based and incremental.

Challenge of implementing the MTEF is about considering the right timing based on an objective assessment of conditions and a clear understanding of its benefits and limitations. Failure to do this may devalue the MTEF which then becomes meaningless term associated with unfulfilled expectations of public sector reform. In view of this, Kasek & Webber (2009, pp. 39-40) further suggest a number of practical considerations which need to be understood in deciding whether or not to undertake a MTEF, being: integration with existing budgeting systems and classifications; deployment of the MTEF process; leadership of the process; and linkages between the MTEF and national planning (Kasek & Webber, 2009, p. 40).

2.3.3. Accounting System: from Cash-Based to Accrual-Based

There are two basic accounting methods used to record income and expenses, the cash method and the accrual method. These methods differ only in the timing of when transactions are counted into the accounts (Tudor and Mutiu, 1990). Under the cash method, income is not counted until the cash is actually received, and expenses are not counted until they are actually paid. The advantages of cash-based accounting, among others, are that they are the easiest to conduct, and they are objective and easily understood. Nevertheless, cash-based accounting also has disadvantages such as the income statement and balance sheet cannot display an overall picture of recent activity and conditions (Tudor and Mutiu, 1990, pp. 7-8).

In light of this, the accrual accounting method was introduced to deal with the disadvantages of the cash-based system. Accrual accounting records the transactions when the order is made, the item is delivered, or the services are rendered, regardless of when the payment is actually received or paid (Tudor & Mutiu, 1990). In line with this, the accrual basis of accounting focuses on current financial resources. Accrual accounting recognises revenues in the period in which they are earned, regardless of when they are actually received, and recognises expenses in the period in which they are incurred (Gianakis & McCue, 1999, p. 43).

The advantage of accrual basis accounting is that this system measures current income, and estimates the financial position more accurately than the cash method (Tudor & Mutiu, 1990). It is very valuable as accurate and current information makes it far easier to predict future income and financial position. At the wider/ national level, Diamond (2002, pp. 9-10) identifes the general advantages of accrual accounting, including that it: (a) improves resource allocation; (b) strengthens accountability; (c) enhances transparency on the total resource costs of government activities; and (d) provides a more comprehensive view of the government's impact on the economy. In spite of its advantages, accrual-based accounting also contains disadvantages which are complicated and difficult to understand. This confusion exists because usually net income does not equal the amount of cash. The cash balance of a company with high income may even decrease during the year (Tudor & Mutiu, 1990, p. 7).

Nonetheless, it has to be understood that the atmosphere of public sector is not same with the private sector. Business in the public sector are not intended to make profit, hence, the method of accounting which is generally intended to measure profit is not always adoptable in the public sector. Also, the principle to match incomes against expenses is not applicable in the public area (Barton, 1999; Monsen & Nasi, 2001) because most transactions in the public zone are non-exchange transactions meaning that revenues collected (such as from taxes and levies) do not offer equivalent compensation, as well as the facilities provided (e.g. public infrastructures) do not obtain equal return.

Government has more various types of asset that private sector does not have. The government assets such as public infrastructures, military and heritage properties, are mostly not utilised to make profit. Moreover, since these assets is different compared to those in private sector, the system of valuation and methods applied to depreciate properties are disputable (Pallot, 1992; Carnegie & Wolnizer, 1995; Barton, 2000). As well, operation of accrual accounting is not simple and costly (Ezzamel et al., 2005), therefore the costs to implement accrual-based accounting may reduce the advantages of this method itself (Jones & Puglisi, 1997).

Implementation of the accrual accounting requires complex system and technology. In consequence, governments frequently lack of capable personnel who are able to manage the accounting system. Furthermore, adoption of accrual accounting in some public sectors has caused confusing financial statements (Barton, 1999; Mellett, 2002) and lead to the roles of managerial and political in governmental environment become vague (Liguori et al., 2009). Additionally, introduction of the accrual accounting in public sectors is also not clean from manipulation (Newberry, 2002). This argument opposes the assertions that this accounting method promises greater transparency. Even ironically it is some extent diminish transparency (Carlin, 2004).

As the implementation of accrual accounting is not easy, and it takes time, and also requires sustained political commitment, Diamond (2002, pp. 18-21) suggests a possible strategy for the reform of accounting systems through the 'from-cash-to-accrual' transition. This strategy consists of steps as follows: stage one, get cash accounting to work well; stage two, integrate operating accounts and financial asset and liability accounts to move to modified accrual; stage three, introduce more elements of accrual recording and move to a partial accrual presentation in ex-post reporting; stage four, recognize nonfinancial assets as the final stage for accrual accounting; and stage five, move from accrual accounting to accrual accounting and budgeting.

As elaborated above, the accrual system is not a magic device for improving the performance of the public sector. Even though the accrual method is simply a tool for getting better information about the true cost of government, it nevertheless needs to be used effectively and in tandem with a number of other management reforms in order to achieve the desired improvements in decision-making in government (OECD, 2002a, p. 11).

2.3.4. Participation of the Local Community in the Budgeting Process

The role of public administration in democratic society is still debatable. The debate centers on how, and to what extent, citizens should be involved in governance and administration. One perspective views public participation as problematic, another perspective reckons that citizen engagement is very valuable (Hornbein and King, 2012). According to Çağatay et al, (2000), applying a participatory approach may encourage people-centered development and may also meet the stated needs of the citizenry.

The participatory approach in the budgeting process intends to achieve three objectives. The first is administrative, where the participatory budget is seen as a way of improving the efficiency of public administration; the second is social, where it is expected that the participatory budget would invert investment priorities; and the third is political, where the goal of the participatory budget is to democratise development process (Beall, 2005).

Such studies show that the involvement of civil society and non-governmental elements in the budgeting process has a number of positive impacts. Krafchik (2001) notes that the benefits of civil society involvement may include a broader understanding of the choices facing budget decision-makers and greater accuracy in identifying citizen priorities. The involvement of civil society groups can be even more effective if they know about how the budget is drafted, approved, implemented, and evaluated.

Moreover, Berner (2001) mentions at least two main purposes of involving the public in decision-making processes: (1) to inform the public of government decisions; and (2) to involve the public in government decision-making. In addition, citizen input is generally viewed as a way to reduce the level of citizen distrust in government, and to educate people about government activities (Berman 1997, cited in Ebdon & Franklin 2004). Supporters of direct public participation view that citizen involvement helps to promote public trust in government, increases public acceptance, and develop social capital (Berman, 1997; King & Stivers, 1998; Wang, 2001). Also, public participation is an essential element of new governance management which can alleviate cynicism and alienation, build stakeholder consensus, and improve administrative decision making (Berman, 1997; King & Stivers, 1998; Wang, 2001). Furthermore, public participation is preferred as a fashion to enhance common interest, construct social capacity, and bolster societies (Owen, Videras, & Willemsen, 2008);

IDASA (2002) specifies the mechanisms that can be used by local governments to stimulate community participation in local governance, including: public meetings, public hearings, consultative sessions with advisory committees, and interest groups. In this context, public hearings are one of the most popular ways to apply the participatory principle. Nevertheless, as often occurs, public hearings usually take place late in the process, thus the public has little opportunity to influence the results (Berner, 2001). To anticipate this situation, Ebdon & Franklin (2004) advise government officers to gather input earlier in the hearing process.

From another perspective, a number of scholars do not view public meetings as very good mechanisms for gathering sincere input because, in most public hearings, the materials and results of the meeting have been constructed earlier. Besides, there is no guarantee that the public's input will be seriously considered (Denhardt & Glaser, 1999). Therefore, theorists, such as O'Toole, et al. (1996) recommend that government authorities provide multiple and interactive opportunities for collecting citizen input. Furthermore, Ebdon & Franklin (2004) suggest that city officials need to consider: (a) who will identify and invite the participants, (b) the type of invitation that is extended, and (c) the reasons why citizens become involved. In respect to time, Kathlene & Martin (1991) affirm that participation is most beneficial when it occurs early in the process of budgeting.

Unfortunately, public participation in developing countries usually gets obstructed by a number of 'negative myths' (Krafchik, 2001) such as: budgets must be formulated in a secret way; non-government intervention can destroy the integrity of the budget envelope; legislators and civil society have a greater interest in advancing the interests of their constituents as opposed to the interests of the country as a whole; it is the government's mandate to produce the budget internally in a closed process; and it is a prerogative for the budget to be rubber-stamped by the legislature. Besides, Frisby & Bowman (1996) warn that participation is possibly hampered by a lack of knowledge, citizen apathy, lack of time, and also public perceptions that their opinions are unwanted.

Additionally, public participation is stigmatized as mostly time consuming, costly, and generally inefficient (Doelle & Sinclair, 2006; Dola & Mijan (2006). Magnusson (2003, p.229) and Dietz & Stern (2008, p.3) also argue that public participation might not provide any positive effects that justify extra cost. Further, Charnley & Engelbert (2005, p.170) emphasise that direct involvement of people in the planning process might increase conflict between public and government institutions. Other than that, public participation may reduces efficiency and contradicts the idea of representative democracy (Berman, 1997; Schooley, 2008; Yang & Callahan, 2007). Direct participation is also seen pointless. It is therefore strongly insisted to completely ignore common people from any arena of policy making process (Rohr & Chandler, 1984; Stivers, 1990).

Public administrators play strategic role to articulate and facilitate public interests to be accommodated in the policy agenda (Frederickson, 1982). In view of this, capable public administrators are required to encourage and manage effective public engagement (Callahan, 2007). However, officials often lack expertise and capability to execute these tasks, hence they seem failed to develop effective and successful public participation (King et al., 1998; Yang & Callahan, 2007).

As public problems are generally complicated, so that citizen must have expertise if they intend to get directly involved at the process to solve those troubles (Callahan, 2007). Yao (2006, p.19) claims that public meeting to discuss planning process often contains significant scientific, technical and legal information; nevertheless residents mostly do not have sufficient technical knowledge, so that it can be difficult for the average citizen to understand. Moreover, residents are perceived as unenthusiastic and have poor knowledge, skills, and time for public participation. People who participate at citizen forums are often critiqued for their self-interest and lack of commitment for the greater society (Berman, 1997; Schooley, 2008; Yang & Callahan, 2007).

In particular condition, participation of citizen can be represented by interest groups; however the representativeness of public in this circumstance is still debatable as these groups may not represents whole public (Dola & Mijan, 2006). Yao (2006) points out that even though many interest groups claim as the representative of residents; nonetheless in practice the public is generally not satisfactorily represented. This point is supported by Eccleston (2000) contending that one of the primary barriers of public engagement is the matter of representativeness because the representations attending the meeting are usually more educated and sophisticated than the common public and in fact they tend to prioritise their own interests. This atmosphere could lead to three implications: first, the public is always satisfied and believed in the proposal; second, the public do not feel that participation is necessary and third, they do not understand the plan and do not know their rights (Dola & Mijan, 2006).

To optimise the benefits from the encouragement of public participation, Ebdon & Franklin (2004) suggest several precondition, such as: (a) input is representative of the community; (b) opportunity is available for large numbers of citizens to participate; (c) input occurs early in the process; (d) sincere preference/ willingness to pay is revealed; (e) participation includes two-way communication between the public and city officials; and (f) input is considered in decisions.

2.4. The Public Budgeting Process

The budget process is cyclical and, in almost all countries, the cycle is annual. The budgetary process outlines the bureaucratic tasks associated with the functional stages of: (1) budget formulation, (2) approval/ validation/ enactment, (3) execution, and (4) evaluation/ reporting (Norton & Elson, 2002).

The cycle of annual budgeting and the roles of institutional involvement in the process can be diagrammatically illustrated as follows:

Figure 2.1. **Budget Cycle and Institutional Roles**

Source: Mullins (2007, p. 223).

Associated with the stages of the budgeting process mentioned above, Krafchik (2002) argues that the budget process cannot be divided clearly into four stages as, in practice, the stages overlap with each other.

This section presents the theoretical framework of the budgeting process, which consists of four stages including formulation, validation, implementation, and supervision of the budget.

2.4.1. Formulation of the Annual Budget

The allocation of the budget to key sectors is essentially an expression of political priorities. The amount of resources allocated to various objectives such as education, defence, regional development, infrastructure, unemployment support, or social welfare, represents the characteristic differences between political parties or factions within parties (Ljungman, 2009, p. 12). At this stage, as Santiso (2004, pp. 55-56) states, the executive has a predominant role in budget policy-making, the drafting of the budget bill, and executing the budget. Executive predominance tends to confine parliament to a secondary role in the formulation stage. Meanwhile, the parliamentary prerogatives are greater in the stages of budget formalisation, and budget supervision and accountability.

Krafchik (2001) contends that the drafting stage is the most closed part of the budget process in virtually all countries and that which is most dominated by the executive. Nonetheless, despite their domination, as the GAO (1993) noted, the executive officials mostly face significant challenges in aligning and integrating the planning and budget structures in a way that meets the needs of all the stakeholders involved in the process.

One of the most fundamental points associated with budget formulation is how the budget gets formulated: whether through a top-down or a bottom-up approach. According to Ljungman (2009, p. 4), a top-down budget process means that a binding decision on budget aggregates is taken *before* allocating expenditure in detail. In this case, total expenditure level is determined before allocating main policies or sectors, and sectoral ceilings are set before discussing and deciding the detailed division of expenditure within each sector. On the other hand, a *bottom-up* approach indicates that total expenditure is determined residually in a process of discussing and establishing the details of the budget whereby there is no point of reference in terms of an expenditure limit for each sector. In view of this, Ljungman (2009, p. 6) points out that although there is a clear conceptual distinction between a top-down and a bottom-up budget process, there is no distinct line between these two approaches. This means that all budget processes involve both top-down and bottom-up elements.

Such empirical evidence shows that the dynamics of the budget process adversely affect the sustainability of policies. To avoid this situation, Ljungman (2009, p. 5) encourages government agencies to implement a top-down process of budgeting. In this approach, the starting point of budget preparation is a decision on total expenditure. Following this, total expenditure is allocated to a number of key sectors. As emphasized by Hendirck (1992, p. 332), a top-down procedure instructs the budget preparation of the lower levels - departments or agencies - by providing quantitative guidelines on the priorities of the government. Moreover, this (top-down) system should establish an upper-to-lower level flow of information and instructions that directs policy priorities within lower-level administrative units.

Top-down budgeting will not limit the discretionary powers of democratic institutions to propose and approve budget allocations. However, a top-down process highlights the trade-offs that have to be made, and brings clarity as to how the process of prioritisation will be resolved. Furthermore, strengthening the top-down budgeting process should be applied in all countries, including low-income countries, emerging economies, and high-income countries (Ljungman, 2009, p. 5)

Hagen (1992) declares that a top-down decision-making method in parliamentary system is more conducive to fiscal discipline than are bottom-up procedures. This point is supported by a number of studies conducted later by De Haan & Sturm (1994); Woo (2003); Gleich (2003); and Yläoutinen (2004). In addition, Ehrhart et al. (2006) emphasise that the top-down approach has a higher chance of leading to a fiscally sustainable budget. Ljungman (2009, p. 9) also points out that empirical studies of the relationship between institutions and fiscal performance provide support for the assumption that a top-down process is associated with lower deficits and debt. However, a study conducted by Perotti & Kontopoulos (2002) show contrasting findings to the studies mentioned earlier.

Even though most scholars tend to recommend the application of a top-down approach in formulating a budget, it may work better if combined with a bottom-up approach simultaneously. However this is quite complicated, as indicated by Ljungman (2009, p. 7) and the challenge is to find the right balance between top-down and bottom-up approaches, with the objective of establishing firm control over the use of public resources. Other than this, implementing a bottom-up approach - including involving the public in the budgeting process - is not a simple mission as public involvement in developing countries is mostly obstructed by negative myths (Krafchik, 2001), a lack of knowledge, citizen apathy, lack of time, and also the assumption that public opinions are undesirable (Firsby & Bowman, 1996).

2.4.2. Validation of the Annual Budget

Once approved by the government, the draft budget bill is submitted to parliament for consideration. During the budget validation process, the negotiations between the executive and the legislature occur within the standing budget and finance committee of parliament. Santiso (2004, p. 57) illustrates the process as follows: each spending agency must substantiate its budget requests to the committee. Once formally approved, the committee's opinion is debated in the plenary. Following this, the proposed amendments are discussed with the executive, which considers them and produces a final budget bill (accepting or rejecting the proposed amendments). Finally, the approved budget law must be published in the official bulletin before the beginning of the fiscal year to become effective.

According to Santiso (2004, p. 56), two issues are important to take into account when assessing the role of parliament in the review and adoption of the budget. These are the time allocated to review the budget and the powers endowed to the parliament to review and amend the budget. The role of parliament in the budgeting process - particularly in the budget validation process - is highly strategic. Fubbs (1999) states that parliamentarians can use their influence to allocate resources for various sectors and to set priorities for meeting the demands of the people. In line with this, Allen & Tommasi (2001) argue that the role of parliament in the budgeting process depends on four sets of variables, including whether parliament is legally empowered to intervene in the budgeting process; whether it is endowed with the required technical capacities; whether it possesses the necessary political will; and whether the governance environment is conducive.

The time allocated to parliament to review the budget and propose amendments varies greatly between countries. Allen & Tommasi (2001) contend that, as a general rule, federal states with bicameral legislatures tend to require more time to review the budget than unitary states with unicameral legislatures. Krafchik &

Wehner (1998) claim that *de facto* amendment power depends on the effective role of committees in the budget process. This role is determined by a combination of factors, including the scope of amendment powers, the time allocated to committee review, the organisation of committee involvement, and access to independent advisory and research capacities.

Santiso (2004, p. 51) reveals that unconstrained executives and an autocratic executive tend to abuse their constitutional authority and delegated powers. The use, misuse, and abuse of executive discretion in public budgeting have often led to serious economic mismanagement and pervasive corruption. In this condition, careful balancing of executive and legislative power is very important. As seen in Brazil (OECD, 2003a), compromise between executive and legislative prerogatives resulted in the 1988 Brazilian Constitution which gave parliament great powers in public budgeting and limited the discretionary prerogatives of the executive.

Formally, parliament has the supreme authority over the size and composition of the budget. In view of this, Ljungman (2009, p. 17) asserts that a complete rejection of the proposed budget would indicate a lack of support for the government's policies. Nevertheless, as Bradbury & Crain (2001) postulate, the prevailing consensus posits that legislative activism in public budgeting tends to be dysfunctional in fiscal terms, leading to greater budget deficits and public debt. In addition, budget rigidity and inertia tend to limit the scope for the exercising of legislative budgetary powers. Budget inertia is accentuated by the small size of budgets, in particular capital expenditures. To deal with this issue, it is important to restore the internal and external powers of parliament in public budgeting in general, and in budget validation in particular (OECD, 2003b, p. 4).

2.4.3. Execution of the Annual Budget

Budget execution should be understood and treated as one of several instruments of administrative control to ensure democratic accountability and management flexibility. This approach recognizes the political, legal, and management aspects of budget execution. The politics of budgeting cannot be separated from budget execution, and also politics cannot be excluded from budget development. Furthermore, budget execution is not simply an accounting function - a perfunctory assignment that budgeters can easily pass off to the accounting staff. Instead, budget execution involves complex management of revenues and expenditures, as well as the politics of budgeting (Thurmaier, 2007, p. 270).

From a technical angle, the steps in the execution of budgetary expenditures are schematically described by the World Bank (1998) as follows: record budget appropriations, apportionments and allotments; determine cash requirements and warrant amounts; record commitment transactions; verify receipt of goods and payment orders; process payments; and record receipts.

In general, budget execution has two perspectives, which are the control model of budget execution, and budget execution using a managerial approach. Under the first model, budget execution is often treated as the accounting phase of the budget cycle. The focus is on controlling expenditures so that public officials spend funds according to the wishes of the governing body. also explains that the control model of budget execution is not incorrect, but it is incomplete, because it neglects the management focus of budget execution (Thurmaier, 2007)

In a managerial approach to budgeting, Thurmaier (2007) elucidates that the execution of the budget is the tool for executing the management plan to achieve the goals and mission of local government. The oversight emphasis is not on legal compliance, but on whether the resources are being used to provide effective services. Furthermore, Giannakis & McCue (1999) argue that the managerial approach uses the budget execution periods in the budget cycle to evaluate how well departments are accomplishing their goals and missions with the resources they are allocated in the budget.

Poor budget execution generally leads to poor outcomes for the intended beneficiaries of government programmes. Peters (2002, p. 7) declares that poor budget execution impacts upon recurring expenses associated with prior capital expenditure, because expenditure for ongoing operations and maintenance was either not planned or was being diverted for other purposes. The outcomes of weak budget execution can be severe for the intended beneficiaries of government services, especially for the poorest members of society.

Referring to the case of budget execution in Nepal, the World Bank (2011, pp. 3-5) reveals a number of prominent phenomena that occur in the budget execution process as: allocated budgets are not released in a timely manner; technical and institutional capacity is limited at the local level; political wrangling has contributed to poor budgetary practices; user committees are susceptible to capture by political interests; and monitoring and supervision is often irregular and unsystematic.

In the general context, Santiso (2004, p. 62) reveals that executives often reassign expenditure during the execution of the budget. Consequently, budget reallocation is often abused in order to introduce important changes to the budget approved by parliament. Other than this, the World Bank (2007, p. 96) points out that budget execution, particularly of development projects, is typically slow and skewed prior to the end of the fiscal year. Slow disbursements are a symptom of structural blockages throughout the entire budget cycle, including overly-detailed documentation, complicated and lengthy revision procedures, massive mid-year budget revisions, and slow procurement processes.

In terms of procurement, the World Bank (2007, p. 97) states that while the regulatory framework for public procurement has been improved, the capacity to carry out compliant procurement processes is insufficient, hence causing delays in project implementation. Additionally, slow and back-loaded disbursements are symptoms of more severe challenges that are encountered at each stage of the public expenditure management cycle. Having noted this, the World Bank (2007, p. 99) concludes that there are three main reasons that explain the difficulties in efficient budget implementation, including: (a) weak budget preparation; (b) rigid budget execution; and (c) the phenomenon of bottlenecks at the last stage of budget execution.

2.4.4. Accountability, Evaluation, and Supervision of the Annual Budget

Parliaments play a critical role in strengthening economic governance, improving transparency in public finance, and ensuring government accountability. Enhancing legislative scrutiny of the budget and oversight of its execution are increasingly considered as a means to strengthen government accountability and prevent corruption (OECD, 2002b). Furthermore, Hõgye & McFerren (2002) point out that the audit function provides the key feedback loop in the budgeting process.

Without an effective audit, it is impossible to evaluate the efficiency and effectiveness of the budgeting system.

According to Schedler *et al*. (1999), legislative budgetary institutions perform critical accountability functions in public budgeting. They help to enforce *ex ante* accountability, ensuring that budget allocations adequately reflect policy priorities; concurrent accountability, overseeing the execution of the budget by the executive; and *ex post* accountability, holding government to account for performance and results.

Sound public finance management and accountability requires an adequate balance between executive and legislative prerogatives in the different phases of the budget cycle. Santiso (2004, p. 50) contends that while the executive dominates in public expenditure management, legislative oversight is critical to provide effective checks and balances and to enforce accountability in the formulation, execution, and control of the budget. Wehner (2001) declares that, in theory, increased legislative budgetary powers ought to enhance transparency, accountability, and integrity in public expenditure management. Risks nevertheless exist, as effective legislative budgeting requires the capacity to discharge budgetary functions in an effective and responsible manner (Wehner, 2001; Krafchik & Wehner, 1998).

The legislative majority has a decisive influence on the agendas and work plans of the budget and finance committees. Nevertheless, such institutional arrangements tend to lessen the incentives for legislative oversight since, as Messick (2002: 2) states, "in all legislatures, it is the party or parties out of power – the opposition – that has the incentive to oversee government". Moreover, timely and reliable access to independent budget information is a strategic step in strengthening parliament's capacities for independent budget analysis.

Constitutions give parliaments an important role in the oversight of budget execution, the scrutiny of budget reallocations, and the review of public accounts. Parliaments also possess a potentially powerful instrument to control budget execution and enforce accountability. In practice, however, Santiso (2004, p. 58) argues that legislative oversight of budget execution is still embryonic in emerging economies. Legislatures exercise only a limited monitoring of the government's compliance with budget rules and procedures. Largely unable to monitor compliance with the approved budget, they are even less able to monitor the performance of public expenditure and enforce results-based budgeting.

In general, budget and public accounts committees rely almost exclusively on the information provided by government agencies. Unfortunately, the information that is needed is often unavailable. Hence, this significantly constrains parliament's ability to carry out independent budget reviews and to adequately oversee budget execution (Santiso, 2004, p. 64). Lags and inconsistencies in the timing and sequencing of legislative scrutiny also constrain effective government accountability. This is reflected in the opinion of Santiso (2004, p. 59) who states that parliamentary reviews of the government budget proposals are largely dissociated from its control of the budget executed in the previous period, significantly weakening the accountability functions of legislative oversight.

Presidential systems marked by fused executive and legislative majorities tend to have inoperative systems for enforcing government accountability. As Messick (2002: 2) notes: "When the interests of a legislative majority and the executive branch coincide, the majority has little incentive to oversee the executive". As a result, "legislative oversight is often weak" (Manning & Stapenhurst, 2002, p. 2). In such cases, the role of the parliamentary opposition is particularly important as "opposition parties have the greatest incentive to oversee government" (Messick, 2002: 2).

Parliaments often lack the human and financial resources to effectively discharge their budgetary responsibilities. The lack of institutionalisation of parliaments is a result of repeated alternations between democratic and authoritarian regimes. It also impairs the effectiveness of parliamentary budget oversight to counterbalance the executive's overwhelming budgetary powers. In light of the circumstances highlighted above, enhancing the role of parliaments in public budgeting requires the strengthening of legislative budgetary institutions, in particular budget and public accounts committees, legislative budget offices, and legislative research capacities (Santiso 2004, p. 62)

2.5. Summary

Fiscal decentralisation offers numerous advantages for governance practices such as improving economic growth and performance. Nonetheless, fiscal decentralisation may also possibly lead to a number of disadvantages, particularly the undermining of economic efficiency. Irrespective of this, most countries across the globe, including Indonesia, prefer to apply the decentralisation of fiscal management as they believe that the benefits of fiscal decentralisation are greater than its weaknesses.

Changes in fiscal governance require a budgeting system which fits the financial management approach applied by government. In consideration of this fact, budgeting reform has become a common trend in recent years. The main agenda of budget reform is to convert the old traditional technique to the most recent budgeting method known as the Performance-Based Budgeting System (PBBS). As theoretically suggested, adoption of the PPBS will be more useful if it is simultaneously accompanied by the implementation of other budgeting approaches, such as the Medium-Term Expenditure Framework (MTEF), integrated budgeting, and accrual-based accounting systems. It is also recommended to apply a participatory approach by accommodating the participation of the community in the budgeting process. This conceptual outline has been adopted in order to elaborate upon the implementation of the new paradigm of budgeting at the Indonesian local government level which will be presented in Chapter Eight of this thesis.

As discussed earlier, the budgeting process is normatively divided into four main stages namely formulation, validation, execution, and accountability and supervision of the budget. However, the stages of the budgeting process may overlap with each other. This framework will be adopted to analyse the budgeting process in Indonesian local government as the main focus of this study. Moreover, the theoretical discussion about Performance-Based Budgeting (PPBS), Medium-Term Expenditure Framework (MTEF), integrated budgeting, and accrual accounting will be used to analyse implementation of those approaches at local level. Also, the range of theories regarding fiscal decentralisation and budgeting system will be applied to assess the political and managerial nature of local budgeting.

The elucidation of the local budgeting process is sequentially presented as follows: the formulation of the local budget is displayed in Chapter Four, validation of the budget in Chapter Five, budget execution in Six, and accountability and supervision of the budget is elaborated in Chapter Seven. Subsequently, the theories discussed in this chapter will be used to analyse the empirical findings of this study which are presented in Chapter Eight. In addition, the next chapter presents the development of the local government budgeting system in Indonesia.