

## Financial Performance of Local Government and Social Welfare: The Case in Indonesia

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### Abstract

This study aims to examine the relationship between financial performance and community welfare among the Indonesian local governments. Using content analysis, this study measures the financial performance by utilizing financial ratios such as financial independence, financial effectiveness, financial efficiency, and financial growth whilst community welfare is measured through the Human Development Index (HDI). Based on 146 Indonesian local governments, this study shows that the financial performance and the community welfare in Indonesian local governments are not favorable. This study also shows that financial independence, financial effectiveness and financial efficiency of the local governments are positive significantly affect community welfare. However, financial growth of the local governments has a negative and significant effect on community welfare. This study confirms the stakeholder theory, in which the local governments provide benefits to the stakeholders in the form of community welfare although such benefits has yet to reach the community's expectations.

**Keywords:** Financial performance; Financial ratios; Community welfare; Local Governments; Indonesia.



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### 1. Introduction

The local governments in Indonesia play an important role in administering their areas attributed by the Law Number 22 Year 1999 on Regional Government which was later changed into Law Number 32 Year 2004 and updated into Law No. 23 Year 2014 (Vadeveloo and Singaravelloo, 2013). The law stated that all regions at the provincial and district/city levels are given the flexibility to implement regional autonomy. Regional autonomy is the right, authority, and obligations of the autonomous regions to organize and manage their own internal affairs and interests of local communities in accordance with laws and regulations. The granting of regional autonomy through fiscal decentralization and regional authority is expected to provide flexibility to the regions in implementing regional development to improve community welfare (Khusaini, 2006).

Improving community welfare can only be achieved if the local government has good financial performance because without funding support, the developmental and the provision of public services activities in order to achieve community welfare improvement will not be able to run well. It means that the local government can improve its community welfare if the local government has improved its financial performance as well (Christy and dan Adi, 2009). However, the facts that occurred in Indonesia showed that the community welfare as measured through Human Development Index (HDI) for the entire Districtor City Local Governments in Sumatera Island increased not more than 1% every year in average, while the realization of District or City income in Sumatera Island increased more than 10% annually in average. It means that the financial growth of District or City Local Governments in Sumatera Island is not accompanied by an increase in the community welfare (Badan Pusat Statistik Republik Indonesia, 2016). This condition indicated that the financial performance of local government has not been effective enough to achieve community welfare improvement.

This study aims to examine the relationship between financial performance and community welfare of the local governments in Indonesia. The findings of this study could assist the local governments to increase the local revenue through various channels such as taxes and budgets. The next section, Section 2 presents the literature review and hypothesis development. This is followed by Section 3 that provides the research design and Section 4 presents the results and discussion. The final section, Section 5 summarizes and concludes this study.

## 2. Literature Review and Hypotheses Development

The research on stakeholder has been exhaustively performed in the financial reporting literature due to the interest of many researchers attributed by their importance to the credibility and accountability of the public and private organisations. Stakeholder is defined by Gray (2001) as “....interested parties of a company or an organisation that can affect or be affected by the activities of the company or organisation which includes community, employees, government, suppliers, capital market, and others”.

One of the theories that has been suggested in the community welfare literature is the stakeholders' theory which was developed by Freeman (1984). Freeman (1984), argued in his theory that managers to protect the various rights of all stakeholders. Stakeholder theory can be applied in the governmental field since the government institutions depend on legal, political and social perspective (Freeman, 1984). For the interest dimension, Freeman (1984) suggested three categories, namely equity, economic and 'influencer' interest. On the power dimension, Freeman (1984) suggested that there are external agents that have power over the organisation. He categories the external agents into three aspects namely, formal, economic and political power. According to Ghozali and dan Chariri (2007), stakeholders' theory relates to an organisation not operating for its own interest but must also providing benefits for its stakeholders such as the shareholders, creditors, consumers, suppliers, government, communities, analysts and other parties. Thus, as an organisation, the local governments do not only providing benefits to themselves in the form of good financial performance, but also be beneficial for other stakeholders. Therefore, arguably, this theory is deem suitable for this study as it examines the relationship between the local governments' accountability on the welfare of the community in the form of providing good financial performance.

A body of the community welfare literature has examined the relationship between financial performance and community welfare (Iskandar and dan Subekan, 2014; Simanjuntak and Mukhlis, 2015; Vadeveloo and Singaravelloo, 2013). Financial Performance represents a snapshot of a position of concern and ability to withstand the ever-changing environment (Ghani *et al.*, 2018; Jamal and Ghani, 2016), often as a blue print of the financial affairs of an organization which serves as an evaluation tool. These studies have often used the financial ratios in measuring the financial performance of the organisations. One of the financial ratios is the financial independence. For example: (Simanjuntak and Mukhlis, 2015) stated that financial independence has a positive effect on community welfare. Similarly, (Vadeveloo and Singaravelloo, 2013) stated that local governments in Indonesia has been assigned an important role to play in community development so that they closed to the citizens and central to the participatory development. In addition, (Iskandar and dan Subekan, 2014) revealed the results of their research that local government financial independence has positive and significant effect on community welfare as measured through Human Development Index (HDI).

From the government's perspective, financial independence is defined as the dependency of local government on external resources. The performance of independence also describes the level of community participation in local development. The higher the community pay taxes and levies, the higher level of community participation, and support the community welfare (Halim, 2004). Amalia *et al.* (2014), found that the performance of local government financial independence significantly influence HDI. Another study conducted by Dewi and dan Sutrisna (2014) also suggested that the performance of local government financial independence has significant influence towards HDI. Therefore, this study develops the first research hypothesis:

**H1:** *The local government financial independence has a significant positive effect on the community welfare*

Another body of the financial reporting literature has examined the link between financial effectiveness and community welfare. Financial effectiveness can be defined as the degree to which an organisational objectives can be achieved which is often referred to as the revenue generated (Setyowati and Suparwati, 2012). Studies that have examined financial effectiveness in the local governments have suggested that local governments having higher revenue do not necessarily can perform their tasks of providing public services well if the revenue is not properly managed. The level of success of local government in carrying out their duties are not only depend on the amount of income, but also on the way it is managed. The financial factors reflect the condition of the government's internal finances (Gómez *et al.*, 2009).

Several studies have specifically examined the influence of local revenue on HDI such as (Ardiansyah and Vitalis, 2014; Setyowati and Suparwati, 2012). The results of these studies showed that the local governments' revenue often significantly influence HDI. Similarly, (Iskandar and dan Subekan, 2014) revealed the results of their research that local governments' financial effectiveness has a positive and significant effect on community welfare. The local governments that manage their local revenue effectively are expected to have sufficient resources to perform duties in terms of the provision of public services so that with good public services. Therefore, the second research hypothesis is developed:

**H2:** *The local governments' financial effectiveness has a significant positive effect on the community welfare.*

A group of studies on the other hand, has examined the link between financial efficiency and community welfare (Asatryan and De Witte, 2014; Iskandar and dan Subekan, 2014) Financial efficiency is a measure of an organisation's ability to translate its financial resources into targeted activities. It measures the intensity with which how an organisation utilises it assets to generate gross revenue and the effectiveness of producing, purchasing, pricing, financing, and marketing decisions. Financial efficiency is also defined as the efficiency with which resources are correctly allocated among competing uses at a point of time. From the context of the local government, financial efficiency refers to the performance that describes the ratio between output and input or between the realisation of the expenses and the realization of the income.

Studies that have examined financial efficiency in the local governments found that the smaller the efficiency performance means the better the local government performance. For example: Asatryan and De Witte (2014) found

that there was efficiency-enhancing effects of direct democracy in certain sectors of government service, such as trash collection, public sector employment, primary education. They overcame the complexity in measuring overall government efficiency by estimating a fully non-parametric conditional efficiency mode. They used data on the key of municipal functions, namely education, public facilities, health care, social welfare, public sector employment and health, sports and leisure.

Iskandar and dan Subekan (2014), revealed the results of their research that local government financial efficiency has negative and not significant effect on community welfare as measured through HDI. This is because the more inefficient local governments in the use of budget, then the development programmes will be stalled and eventually the community welfare cannot be achieved. Similarly, (Ani and dan Dwirandra, 2014) examined the effect of local government financial performance on economic growth, unemployment, and poverty. The results indicated that local government financial efficiency performance has no significant effect on economic growth, unemployment and poverty. Therefore, the third research hypothesis is developed:

**H3:** *The local governments' financial efficiency has a significant negative effect on the community welfare*

There are studies that have examined local governments' financial growth ratio. This ratio is often used to measure the ability of local government to maintain and increase its achieved success from period to the next (Halim, 2004). For example: Rifai (2010) found that the local government financial growth has no significant effect on HDI due to the allocation of local government expenses were still focused on spending the budget and are not be based on the outcome that will be produced. Scutariua and Scutariua (2015), also found positive and high intensity correlation both the degree of local financial autonomy and the local development level. The analysis made in linkage to the facts found in the case of Romanian local communities. Furthermore, they found that without local financial autonomy, local public administration authorities will be unable to ensure the efficiency of the local administration process, which disadvantage the local development. Medar *et al.* (2011), investigated socio-economic indicators, structural reforms and fiscal policies in European countries which preserve or enhance income redistribution in Europe. They argued that to measure the socio-economics, the social welfare and welfare policy approach, economics approach, and ecological approach should be used. They further argued that there are differences in the welfare structure and economic growth between European countries and territories.

(Ani and dan Dwirandra, 2014) studied the effect of local government financial performance on economic growth, unemployment, and poverty. The results indicated that local government revenue growth has no significant effect on economic growth, unemployment, and poverty. The hypothesis formulated in relation to the above description is as follows:

**H4:** The local governments' financial growth has a significant negative effect on the community welfare

### 3. Research Methodology

#### 3.1. Sample Selection

This study chooses the local government in Indonesia as the sample study. Specifically, this study relies on the local governments in the province of Sumatera. There are 114 districts and 32 city governments in Sumatera. Since the enactment of Law Number 22 Year 1999 on the local government, the local governments play an important role in administering their areas (DTE 46, 2000). The heads of local governments are directly elected via election.

#### 3.2. Data Collection and Analyses

This study utilises the content analysis. The data used in this study were taken from Badan Pusat Statistik Republik Indonesia (BPS-RI) in the form of HDI and Badan Pemeriksa Keuangan Republik Indonesia (BPK-RI). The financial statements for 2015 of the local governments in Indonesia was obtained. Financial performance in this study was measured through the ratio of local governments' financial independence, financial effectiveness, financial efficiency, and financial growth (Halim, 2004) whilst the level of community welfare was measured through HDI (UNDP, 1990). The research hypotheses were tested using simple linear regression, hypothesis test, and coefficient determination test. A regression model was developed in this study as follows:

$$\text{HDI} = a + \text{FP} + \text{et}$$

### 4. Results and Discussion

Table 1 presents the results of the descriptive statistics of financial performance ratio. The financial performance ratios include financial independence, financial effectiveness, financial efficiency, and financial growth and HDI. The data was obtained from the 2015 financial statements of the Indonesian local governments.

Table-1. Descriptive Statistics

	N	Minimum	Maximum	Std. Deviation	Mean
Independence Ratio	146	2	43	6.35	8.60
Effectiveness Ratio	146	16	195	20.22	96.15
Efficiency Ratio	146	70	169	12.13	94.95
Growth Ratio	146	-35	68	16.40	9.11
HDI	146	57	98	5.49	68.65
Valid N (listwise)	146				

Table 1 indicates that the financial performance and the community welfare of Indonesian local governments are not favourable, in which the mean value of financial independence ratio is only 8.6% (belongs to very low criteria in instructive relationship pattern); the mean value of financial effectiveness ratio is above the value of 90% (belongs to effective criteria); the mean value of financial efficiency ratio is 96% (above 60% and belongs to less efficient criteria) and the mean value of financial growth ratio is still low, under 10%. These findings reinforced the findings in [Khairudin and Aminah \(2017\)](#) stated that the financial performance and the community welfare in the local governments in Lampung Province were not favourable.

Table 2 presents the results of testing the research hypotheses. Table 2 indicates that the value of financial independence coefficient against community welfare is 0,467;  $t$ -statistic of 7.692 and significance value of 0.000. With a significance value of 0.000, then the first hypothesis can be confirmed. The results of this study reinforced the findings of [Simanjuntak and Mukhlis \(2015\)](#); [Iskandar and dan Subekan \(2014\)](#); [Amalia et al. \(2014\)](#) and the [Dewi and dan Sutrisna \(2014\)](#) which suggested that local government financial independence has positive and significant effect on community welfare as measured through HDI. A significant value for the second hypothesis is 0.020, thus the second hypothesis can also be confirmed. These findings certainly support the results of the study conducted by [Iskandar and dan Subekan, \(2014\)](#) which revealed that local government financial effectiveness has positive and significant effect on community welfare.

Table-2. Hypotheses Testing

	Coefficient	t_statistic	Sig	Meaning
Independence_community welfare	.467	7.692	0.000	Confirmed
Effectiveness_community welfare	.087	2.347	0.020	Confirmed
Efficiency_communitywelfare	.022	1.981	0.035	Confirmed
Growth_community welfare	-.076	-2.781	0.041	Confirmed

This study also shows that the third hypothesis is confirmed. The results show that the value of financial efficiency coefficient against community welfare is 0,022;  $t$ -statistic of 1.981 and significance value of 0,035. So the financial efficiency has negative effect on community welfare is confirmed. These findings support the research conducted by [Iskandar and dan Subekan \(2014\)](#) which states that local government financial efficiency has negative and not significant effect on community welfare. This is because with the efficiency of the use of funds, the local government programs that can improve the community welfare cannot be run maximally.

Finally, this study also confirmed the fourth hypothesis, in which the test results show the value of financial growth coefficient against community welfare is -0,076;  $t$ -statistic of -2.781 and significance value of 0,041. This is because the allocation of local government expenses are still focused on spending the budget and are not be based on the outcome to be produced, so that the community welfare is still an issue.

## 5. Summary and Conclusion

This study examines the relationship between financial performance and community welfare among the Indonesian local governments. The results of this study show that all five research hypotheses are significant. Specifically, the results of this study shows that the financial performance and the community welfare in Indonesian local governments are not yet favourable. This study also shows that the local governments' financial independence has a positive and significant effect on community welfare. In addition, the local governments' financial effectiveness has a positive and significant effect on community welfare. The local governments' financial efficiency has negative and significant effect on community welfare and that their financial growth also has a significant effect on community welfare.

This study is not without limitations. First, this study only focused on a province in Indonesia. Future study could extent the study sample in order to provide a more robust findings. Secondly, this study utilises five financial performance ratios. Perhaps, future study could include other ratios in order to produce more comprehensive information.

This study suggests that the local governments should immediately increase the local revenue through the intensification and extensification of taxes; the local government must immediately improve the orientation of the use of budget for capital spending; the local government must immediately make strict rules for the use of budget to focus on the outcome to be produced.

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