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CONTENT

THE METHOD OF MEASURING *UMMAT* WELFARE FROM FINANCIAL DISTRESS PERSPECTIVE

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ABSTRACT

This study aims to predict financial distress in local governments by measuring only from the financial side using an analysis of their autonomy in obtaining revenue, expenditure alignment that not only focused on routine spending and the ratio of local revenue growth. This Indicator was used by taking into account both theories and conditions in Indonesia. This study was very essential to do. As regional autonomy has been enacted, the wasteful behavior of local governments that drain half of its budget only for personnel expenditure is feared would lead local governments to bankruptcy. The continued omission of employee recruitment without considering local financial capacity would result in reduced funds to build public facilities, accelerate regional development, and create quality services and equitable public welfare, as mandated in regional autonomy policies. This study measured the financial distress of local government from 3 (three) categories i.e. financial independence, expenditure alignment, and growth of PAD (Local Revenue).

The object of this study was the data of local governments' financial statement in Central Java Province. The number of samples used in this study was 28. The data were analyzed by using binary logistic regression.

This study found that local government in central java was still experiencing financial distress condition because extravagant behavior still happened evidenced by the amount of expenditure for operational needs and employees' salary either direct expenditure or indirect expenditure while infrastructure expenditure and public service percentage were smaller. Besides, the utilization of assets and the extracting of natural resources were also not maximal so that the welfare of the people felt less optimal.

Keywords: *Financial Distress; Local Government*; *Local Finance*

INTRODUCTION

Government entities consist of central and local government. During the New Order era, the central government made all economic regulation, so the central government fully supports all funds needed by regions in order to finance all local government activities to support the implementation of services to local communities. Therefore, the local government does not need to make an effort to earn an income to finance all activities undertaken. The crisis experienced by Indonesia from 1996 to 1997 resulted in a total reform of government from the new order to the regional autonomy which introduces the principle of fiscal decentralization in which each region is given full rights to decide all policies related to the budget owned and one of the main sources comes from the central government.

Islam teaches about the responsibility of the leader to improve the welfare of the people. This foundation should at least be applied in the fulfillment of good and clean government, so that, all people will feel prosperous. Ibn umar RA stated that *"I have heard Rasulullah SAW said: everyone is a leader and will be held accountable for his leadership. A head of the state shall be held accountable for the people he leads"*.

The Implementation of regional autonomy is expected to create healthy competition among regions and encourage local innovation to explore local wealth, so that the results of the exploration will become regional income which can be used to finance the need for governance activities and regional development. The extravagant behavior of local governments that drain half of their budgets for personnel expenditure is feared to lead the local government into bankruptcy.

According to Foster, 1986; Lau, 1987; Ward, 1994; Jones and Hensher 2004, Luo and Yu, 2011, the financial distress is disclosed as failure to meet financial commitments in the form of inability to pay off the loan, failure to pay dividends (or even deductions on the amount of dividend payments), deficiencies of working capital, and insufficient funds to pay the amount of the company expenditure. Whereas in public sector, financial distress is defined by Jones and Walker (2007) as the inability of the government to provide public services in accordance with quality standards service that has been established. This inability is because the government does not have sufficient funds to build public service infrastructure, such as roads, bridges, irrigation channels and other public facilities.

Research on financial distress especially in Indonesia is still relatively limited. This is evidenced by the development of research with the topic which only focus on the private sector and this becomes the basis of the researchers to try to predict the possibility of financial distress that occurred in local government in Indonesia, especially in Central Java Province. Several previous studies on financial distress in the government have been conducted, Jones and Walker (2007) used two indicators, namely financial indicators in the form of (1) the amount of funds allocated to bring up the infrastructure of public services and (2) the ratio of financial performance; and nonfinancial indicator consisting of (1) the characteristics of the board and (2) the quality of the public service. According to economic experts Islam, al-Maqrizi (766-845 H), that the carelessness of the government (corruption, poor administrative bureaucracy) in managing their budgets, in this case is the balance funds, is a source of disaster and economic crisis. Therefore, in addition to wealth, it is required *taqwa* (pious) in economic activity and policy, according to Yahya bin Umar (213-289 H). Piety is the principle of Islamic economy that will bring blessing and prosperity (al-A'raf verse 96).

The main objective of this study is to predict financial distress in local governments by measuring only from the financial side using an analysis of the local governments financial independence in obtaining revenue, expenditure alignment made by local governments on routine spending and the ratio of local revenue growth. This Indicator is used by taking into account on the theory and conditions in Indonesia.

LITERATURE REVIEW

Hadith on Ummat welfare

The first hadith is from Ibnu Umar ra. He said : *I have heard Rasulullah SAW said: everyone is a leader and will be held accountable for his leadership. A head of state will be questioned about the people he leads. A husband will be asked about the family he leads. A wife who takes care of her husband's household will be asked about her responsibilities and duties. Even an assistant / domestic worker who is in charge of maintaining the property of his employer will also be questioned from the thing he leads. And you are all leaders and will be asked (asked for accountability) from the things you lead. (buchary, Muslim).*

The essence of leadership is responsibility and the form of responsibility is welfare. The president in leading the country is not only limited to be the leader of the "government", but also to lift people from poverty to prosperity and when he is not serious on that, he cannot be said to be responsible.

The second Hadith is from Abu maryam al 'Azdy ra. He said to Muawiya: I have heard Rasulullah saw said: *those who are entrusted by God to govern the interests of the Muslims, then he hid from the livelihood of their (muslims) interests, then God will reject the livelihood of his interests and needs in the day of qiyamat. So, then Muawiyah appointed a person to serve all the needs of the people* (ash dawud, attirmidzy).

This hadith implied that the government is the figure of "maid" whose job is to serve the interests of the "master" (the people). In this context, they are the President, the Minister, the Parliament, Assembly, Supreme Court, Regents, Mayors, Governor, head of the village, and all the bureaucracy that supports it. These are the people that we trust (of course through elections) to take care of all our interests and needs as people. Therefore, if they do not perform their duties as servants of the people, then we as "masters" have the right to "fire" them from their positions.

The third hadith is from Abu Hunaidah (Wa'il) bin Hadjur ra. He said salamah bin Jazid Aldju'fy asked Rasulullah saw: *O Rosulallah, what if those lifted above our heads have just good in demand their rights and withhold our rights, then how do you make us do? At first the prophet ignored the question, until a second time, the rasulullah saw said: listen to and be obedient, It is real when everyone is responsible on his own and so you are.* (HR Muslim).

The explanation of this hadith is that the People have the right and the leader has a responsibility. Similarly, on the contrary, people have the responsibility and leaders also have the right and both must be a balance and equality. One should not dominate the other, because the essence of leadership is simply a mandate that must be carried out by a leader. If a leader cannot maintain the mandate, then power is back in the hands of the people.

Therefore, given the equality of these people and leaders, each has his rights and responsibilities. The above Hadith makes it clear that a leader can not only fulfill his right, and castrate the rights of his people, but a leader must recognize and guarantee the rights of his people freely.

Financial Distress

According to Jones and Walker (2007), *financial distress* is the inability of the government to provide public services in accordance with the service quality standards that have been set. The inability of this government is because the government does not have the availability of funds to be invested in the infrastructure used in the provision of services to the public. This condition is because of under-funding or unavailability of funds which indicates that the government is experiencing financial difficulties.

Financial distress of the local government in this study is defined as the inability of local governments to repay both principal and loan interest. Ability in concern here is debt service coverage ratio (DSCR) as stipulated in Government Regulation No. 54/2005 on regional loan. The regulation states that local governments can make regional loans if they have a minimum of 2.5 (two and a half) DSCRs. For local governments that are unable to reach that DSCR level, it is not allowed to undertake a regional loan because it is feared that they cannot return either the principal or the interest on the loan. If local governments are having trouble to return the principal and interest on the loan (DSCR has less than 2.5), it can be expressed in financial distress status.

Regional Financial Independence

The level of independence describes the level of community participation in regional development. The higher the level of local financial independence is, the higher the community participation in terms of payment of taxes and levies will be, as the main component of Local Fixed Revenue (PAD). Enhancement in the ability of the community in terms of payment of taxes and levies indicates an increased public welfare.

Conceptually, the pattern of relations between the central and the regional government, and inter-regional government, especially in order to organize regional autonomy, can be done by measuring the financial ability of regions in financing the implementation of regional development activities. According to Halim (2002, in Suprapto, 2006) there are four kinds of patterns that introduce "situational relations" in the implementation of regional autonomy, among others:

a. *Instructive* relationship pattern, i.e. the pattern of relationship where the role of central government is more dominant than the independence of local government.
b. *Consultative* relationship pattern, i.e. the pattern of relationship where government intervention has begun to decrease, because the regional is considered to be more able to implement regional autonomy.
c. *Participative* relationship pattern, i.e. the pattern of relationship where the role of the central government is on the wane, given the degree of independence of the region exceeds 50%, so that the region in concern is closer to being able to implement regional autonomy.

d. *Delegative* relationship pattern, i.e., a pattern of relationships in which central government intervention is not more than 25%, even almost no-exist.

Local Revenue Growth

The growth ratio measure how adaptable the local governments is in maintaining and improving its success that has been achieved from one period to the next. By knowing the growth for each component of revenue source and expenditure, it can be used to evaluate the potential of which areas need attention.

Expenditure Alignment

The ratio of expenditure management shows that the expenditure activities done by the local government which have positive equity periods, i.e. spending is not greater than the total revenue received by local government. This ratio indicates either surplus or deficit. Surplus or deficit is the difference of more or less between income and expenditure during one reporting period.

Local Government Expenditures

The operational implementation of local government to realize the development evenly requires a structured system of spending and earning in appropriate manner. According to Halim (2007: 322), Local expenditure is the obligation of governments to reduce net worth. Furthermore, Yuwono et al, (2005: 108) states that the local expenditure is all local cash disbursements or liability which is recognized as a reduction to net asset value in the period of one budget year that will not be earned back by the government payment.

Ease in determining the appropriate cost or expense according to the program and activity of local government requires classification. According to Darise, 2008, expenditure is divided into two categories:

1) Indirect expenditure, it is a budgetary expenditure that is not directly affected by the proposed program or activity. Indirect expenditure is divided by the type of spending which consist of:
    a) Personnel expenditure,
    b) Interest expenditure,
    c) Subsidy expenditure,
    d) Grants expenditure,
    e) Social Assistance expenditure,

f) Revenue Sharing Expenditure,
g) Financial Aid expenditure,
h) Unexpected expenditure,

2) Direct expenditure, it is expenditure whose budgeting is directly affected by the program or activity. Direct expenditure is divided by expenditure type consisting of:
    a) Employee expenditure,
    b) Goods and Services expenditure,
    c) Capital Expenditure,

Development of Hypotheses

On local government, power of financial resources can be reflected from the amount of revenue generated by the local government. According to the Act, local governments have three components as sources of revenue, namely local revenue (PAD), Transfer Revenue, and Other Income. The local government that has a low local Revenue will need funds from other sources to meet their needs. For the district Government, the source of such funds may come from central / provincial government balancing funds.

According to the resource dependency theory, local governments with independent financial resources will have the strength to survive and avoid financial distress. Financial independence has also been used by many researchers as an indicator in assessing government financial performance (Cheng, 1992; Christiaens, 1999; Christiaens and Pateghem, 2007). Kloha, Weissert, and Kleine (2005)

Financial distress is often associated with debt. Government debt is an important part of government funding. The government debt can be used as a support in financing the regional development if the local revenue and central government transfers do not meet the needs of local government funds (Halim and Damayanti 2008). According to PP. 54/2005 on Regional Loans, local governments can make loans to both the central government and third parties. If the debt is made to the central government, the interest and repayment terms are carried out flexibly in the case of low interest rates and negotiable returns. In contrast to central government lending, if loans are made to a third party (banking), then the treatment of government debt is similar to private sector lending.

One indicator of financial distress is a high amount of debt (Almilia, 2006). The ratio that measures the ability of the entity to repay current debt is the liquidity ratio that can be expressed with the current ratio. An entity with high liquidity indicates that the entity has an enough amount of current assets to meet current liabilities when matured without significantly disrupting operational nets. Conversely, a low liquidity indicates that the entity has a number of assets which are not sufficient to guarantee payment of current liabilities on the due, so that, it can affect the *financial distress.* Platt and Platt (2002) and Almilia and Kristijadi (2003) proved that the liquidity ratio effect financial distress of the company.

Several studies on the government sector that use the proportion of debt were conducted by Ryan et al. (2000) with the result that indebtedness gives depiction of financial health of local governments and influence the government's financial performance. Meanwhile, Groves et al. (2001) through the liability ratio of *debt structure* and *unfunded liabilities* gave depiction on government liability to pay its obligation. Empirical evidence proved that governments with high liabilities tend to have better performance than governments with low debt. Cohen (2006) used the ratio of government liability related to financial obligations in the form of *debt to equity ratio* and *long-term liabilities to total assets* in predicting the performance of the local government in Greece. The result of this study stated that the ratio of government debt influences the performance of the government even though its influence is low. Steven and McGowen (1983) used the *total debt to total revenue ratio* to describe the government's solvency associated with the government's financial performance. In addition, Groves et al. (2001) used *long-term to total assets ratio* associated with the performance of local governments. Jones and Walker (2007) and Sutaryo et al., (2010) also used the total debt to total assets as explanatory variables in testing government distress.

This study uses data testing framework of financial distress status in two years after the financial statement reporting by the local government. Local government financial statements prepared at the end of each year must be submitted to the central government no more than 6 months from the date of reporting. After that, such financial report is audited by the Supreme Audit Agency (BPK) which takes approximately 6 months. Therefore, this local government financial reports are published, accessed and analyzed by users of financial statements in the second year after their reporting. In addition, the effect on the results of the realization of the budget (surplus / deficit) occurs two years after the reporting is done.

On the basis of the above description and previous studies, it can be formulated the following hypotheses:

Ha: Independence Ratio, Expenditure Alignment and Growth of PAD has the ability to predict the Financial Distress status of Local government.

RESEARCH METHODS

The sample in this study is the financial statements of districts / cities in Central Java which was taken with purposive sampling method. The criteria that will be used include the following:

a) The data used are the data in 2013 -2016 of the regional financial statements from the district / city in Central Java province.

b) The Data are available at the Central Bureau Statistics or in the Ministry of Finance of the Republic of Indonesia.

In this study, there are four (4) variables to be tested, i.e. one dependent variable in the form of Financial distress (Y), and three (3) *independent* variables consisting of Financial Independence (X 1), Expenditure alignment (X 2), and Local revenue growth (X 3).

- **Financial Independence**: A higher financial Independence indicates a lower local dependence on others to provide the balance funds and loans.

$$\frac{\text{Local revenue}}{\text{Balance Fund + Loan}}$$

- **Expenditure alignment:** A lower expenditure alignment indicates a more budget is allocated to activities that are directly related to local government programs.

$$\frac{\text{Indirect expenditure}}{\text{Direct expenditure}}$$

- **Local revenue growth:** A higher local revenue (PAD) growth shows a better ability of the region in obtaining revenue compared to the previous period.

$$\frac{PADt - PAD(t\text{-}1)}{PADt\text{-}1}$$

- ***Financial Distress:*** The indications of financial distress in this study can be viewed from the portions of the local allocated expenditures for investments in capital expenditure in the fiscal year. If the government spends most of its budget on routine spending (operating expenditure), so, it is feared that the local government has no longer sufficient funds for the need to build public service infrastructure, such as building schools, hospitals, roads, bridges and other public facilities.

$$\frac{\text{Realization of Capital Expenditure}}{\text{Total Local Expenditure}}$$

The ideal rate for the ratio of capital expenditure to total spending is not regulated by Central government. Regional autonomy provides opportunities for local governments to manage their own regional expenditure. In general, capital expenditure ratio of total regional spending is between 5-20% (Mahmudi, 2010). However, inside coordination meetings, Minister of Home Affairs Gamawan Fauzi (2013) requested that local governments allocate capital expenditures of at least 30% of total spending. The goal is to encourage infrastructure development and in accordance with Presidential Decree No.5 of 2010 on Medium Term National Development Plan (http://www.antaranews.com).

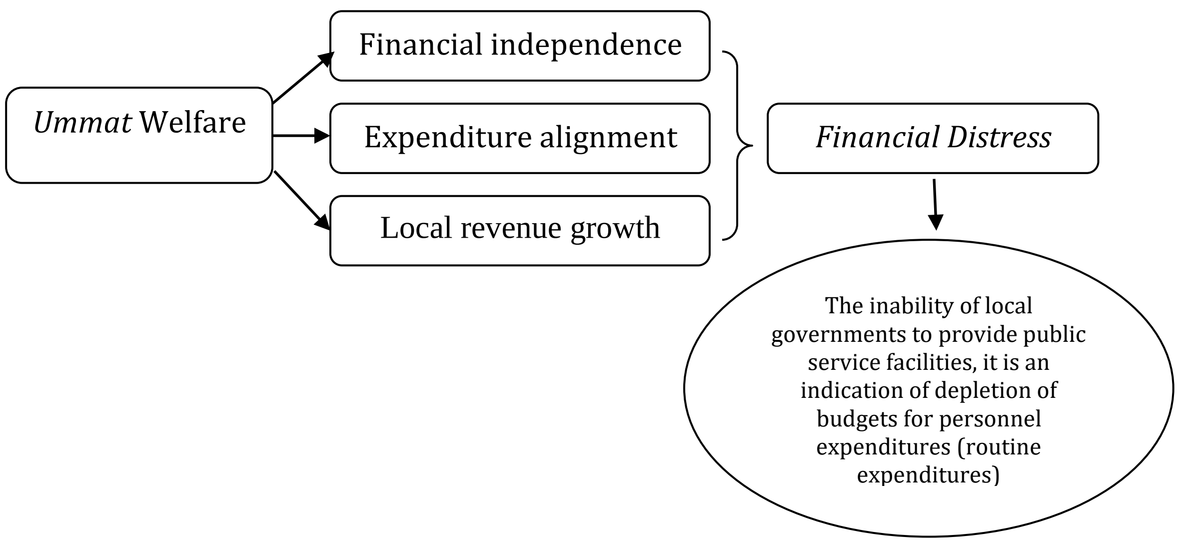

Figure 1: Research Model

The analysis used in this study is binary logistic regression with SPSS version 19. Binary logistic regression is used when the dependent variable is in the form of dichotomous variable or binary variable. In this study, financial distress is a dichotomous variable that has two different levels, namely the local government which experience and not experience financial distress. In addition to looking at the effect of independent on the dependent variable in the form of binary response variable, binary logistic regression is also commonly used to predict the value of a dependent variable Y (as binary variables) based on the value of independent variables x1, x2, ..., xk

Logistic regression model which is used in this study is as follows:

$$\textbf{Log (P/1 - p) = ß0 + ß1X1 + ß2X2 + ß3X3 + e}$$

Where p is the probability that Y = 1 (financial distress) is the dependent variable*;* and X1, X2, and X3, are the independent variable.

RESULTS AND DISCUSSION

The population used in this study is all districts / cities in Central Java, which has published a report on the realization of budgeting from 2013 until 2016. There are 35 districts / cities in Central Java and the samples found as many as 28 districts / cities. Such number is based on the criteria proposed and there are 7 districts / municipalities without budget realization report found during 2013-2016.

The Value of -2 log likelihood is used to see the feasibility of the model that has been used and it is done by comparing the value of -2 log-likelihood before adding independent variable with value of -2 log likelihood after adding independent variable.

Table 1

Overall Model Fit

Information	-2 log likelihood
Block Number = 0	76.272
Block Number = 1	76.272

From the table above, it can be seen that the -2 likelihood value is 76.272 and significant at alpha 5%. in Table 4.2., chi-square values obtained is 65.117, which means this figure is statistically significant and means that this model fit the data.

Omnibus Tests of Model Coefficients

		Chi-square	df	Sig.
Step 1	Step	65.117	3	.000
	Block	65.117	3	.000
	Model	65.117	3	.000

table 2

Source: processed data 2017.

The value of nagelkerke R Square is 0.893, indicating that 89.3% of the variation of the dependent variable can be explained by the independent variable, while the remaining 10.7% is explained by other variables not explained in this study.

Table 3

Negelkerke R^2

Model Summary

Step	-2 Log likelihood	Cox & Snell R Square	Nagelkerke R Square
1	11.155[a]	.441	.893

a. Estimation terminated at iteration number 13 because parameter estimates changed by less than .001.

Source: Data processed 2017

This goodness of fit test was conducted to see if the empirical model is suitable or in accordance with the research model. The results of the test can be seen in the table below:

Table 4

Hosmer and Lemeshow's Goodness of Fit Test

Hosmer and Lemeshow Test

Step	Chi-square	df	Sig.
1	.012	8	1.000

Source: processed data 2017

The above table shows that the value obtained is significant at 1.000 which is certainly greater than 0.05 and has a meaning that the model is acceptable because it matches the data provided by researchers.

Table 5 shows the estimated value of financial distress and non-financial distress. There were 100 districts / cities government which were predicted to have financial distress. However, the observation results show that there are 98 districts suffering financial distress and only 2 predicted incorrectly as non-financial distress. Therefore, the accuracy of the prediction of financial distress is 98/100 (98.0%).

District / city government which are predicted not experiencing financial difficulties (non-financial distress) are as many as 12. However, the result of observation showed that only 11 which are not experiencing financial distress, while the remaining 1 is predicted incorrectly as financial distress. So, the accuracy of non-financial distress prediction is 11/12 (91.7%). Overall, the level of prediction accuracy is 97.3%.

Table 5
Classification Table

Classification Table[a]

Observed			Predicted FD .00	Predicted FD 1.00	Predicted Percentage Correct
Step 1	FD	.00	98	2	98.0
		1.00	1	11	91.7
	Overall Percentage				97.3

a. The cut value is .500

Source: processed data 2017

Table 6

Results of Type I and Type II Error Classification

Classification	amount	Percentage (%)
The correct estimate	109	97.3%
Type I error	2	1.8%
Type II error	1	0.9%
Total	112	100%

Source: processed data 2017

The test result on financial independence variables found a significant value at 0.155 and a coefficient value at 0.052. The value of significance is greater than 0.05, indicating that financial independence has no significant effect on financial distress. While, the test result on the variables of expenditure found a significance value at 0.156 and a coefficient at 0.032. The significance value is greater than 0.05, indicating that the expenditure alignment does not significantly affect financial distress. Furthermore, the test result on the variable of the local revenue growth found a significant value at 0.152 and a coefficient at -0.043. The significant value is greater than 0.05, indicating that the local revenue growth has no significant effect on financial distress. Meanwhile, the coefficient value shows a negative number, which means the higher the local revenue growth is, the smaller the likelihood of financial distress will be.

CONCLUSION

The results of data processing by SPSS over to the data from the 112 district governments in Central Java in 2013-2016 obtained the following conclusions:

Of the 112 samples processed, it is noted that there is a total of 109 samples which are predicted to experience financial Distress. It means that 97.3% of local governments experience financial distress because the magnitude of the budget realization from 2013 to 2016 tends to be more focus on employee expenses and regional operations, not on infrastructure or capital expenditures. Meanwhile, the other three hypotheses do not have significant result.

Based on the research that has been done, there are some research limitations, such as: this research only took sample from the districts / cities in Central Java, so further research is expected to take a broader sampling; and The size of the category of financial distress in this study is limited to quantitative data only which focus on comparison of each local government expenditure.

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