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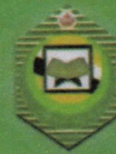

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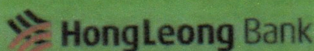

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# A METHOD OF PREDICTING LOCAL GOVERNMENTS' FINANCIAL DISTRESS BY USING RATIO OF INDEPENDENCE, EXPENDITURE CONFORMITY AND GROWTH OF REGIONAL REVENUE

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***Abstract***

The main focus of this study is to predict a financial distress occurring in a government sector which is defined as a condition where the government is not able to provide public services to society. The indicators used to measure this condition were seen in terms of finance where the indicators are measured using ratio of local governments' independence, ratio of expenditure conformity and growth of regional revenue. The samples used in this study were the data from the financial statements of the local governments in Central Java province, Indonesia for three consecutive years – from 2013 to 2015, which were obtained from the Central Bureau of Statistics, Ministry of Finance and Ministry of Domestic Affairs of the Republic of Indonesia by using purposive sampling method. The hypothesis testing in this study used binary logistic regression analysis. The results of this study indicate that local government in Central Java are still experiencing financial distress due to the large expenditure for operational needs and employees' salary needs, both direct and indirect expenditures, of which percentage was greater than capital expenditures, infrastructures and public services. The other conditions of financial distress problems were ineffective management of natural resources and assets owned by the local governments.

Keywords:

Financial distress, ratio of local governments' independence, ratio of expenditure conformity and growth of regional revenue

# 1. INTRODUCTION

## 1.1 Background

A governmental institution is an authority whose main orientation is non-profit and merely known as a political institution, which is different from other non-profit organizations. But this factor does not let the obstruction of the governmental institution to have a financial institution which can manage regional revenues, fees, taxes, and all of its expenditures which are mainly used to support the development sectors and public services.

The crisis happening in Indonesia from 1996 to 1997 resulted in a total governmental reform which was previously a regime of new order and switched into a system of regional autonomy that introduced the principle of fiscal decentralization in which each region was given full rights to determine all policies related to the budget they had, whose one of their vital sources was from the central government itself. Consequently, local governments were required to prepare a draft of annual budget with emphasis on performance-based budgeting. This was intended that the local governments planned work-programs independently by calculating the amount of expenditures to be incurred and comparing the amount of revenues to be earned. However, during the era of regional autonomy for nearly last ten years, there have not been any significant changes to progress; the local governments have done a lot of activities related to personnel expenditures which were too large, capital expenditures which were too high with unclear purposeful needs. One of the local governments' main goals was only dealing with the implementation of both expenditures because the realization of the expenditures was deemed more feasible, yet the needs of other expenditures which were far more important and beneficial to society's welfare as a whole were neglected.

The impact of the implementation of regional autonomy and so many kinds of reports which must be accounted for by the local governments become a threat to the sustainability of the government's financial matters, where the absorption of budgets does not possibly match the main target, which is to provide public services, instead of focusing on routine expenditure spending. FITRA (Indonesian Forum for Transparency) states that in 2012 There were 291 local governments projecting personnel expenditures over 50 percent, which means the rest of the budget which was still available for the program related to the fulfillment of public services was only 9 percent to 14 percent (seknasfitra.org, 2013).

The wasteful attitude of local governments which drained more than half of their budgets only for personnel expenditures may lead to a bankruptcy. The occurrence of continuously employees' recruitment without considering the financial capacity of the region will result in the reduction of funds for building public facilities, accelerated development of the region, creation of a quality service, and equitable distribution of public welfare, as settled in the policy of regional autonomy.

According to Foster, 1986; Lau, 1987; Ward, 1994; Jones and Hensher 2004, Luo and Yu, 2011 explain that financial distress refers to a failure to fulfill financial commitments, such as inability in paying loan off, failure in paying dividends (or even a reduction in the amount of the dividend payout), shortcomings of working capital, and insufficient funds in paying the amount of the company's expenditures. Whereas, in public sector, financial distress is defined by Jones and Walker (2007) as an inability of the government to provide public services which are appropriate with determined quality standards. This inability is due to the fact the government does not have sufficient funds to build the infrastructures of public services, such as roads, bridges, irrigation canals and other public facilities.

Studies on financial distress in governmental areas especially in Indonesia are still relatively limited, this has been proven by the development of related studies which only focus on private sectors, that is why, this fact becomes the basis for the researcher to attempt to predict the possibility of financial distress occurring in governmental areas, especially in

Central Java province. Several previous studies on financial distress in governments, according to Jones and Walker (2007), using two indicators, namely financial indicators which comprise of (1) the amount of funds allocated to bring up the infrastructure of public services and (2) the ratio of financial performance, meanwhile non-financial indicators consisting of (1) the characteristics of the board and (2) the quality of public services. The main objective of this study is to predict financial distress in the local governments in terms of financial measures by using an analysis of the local governments' independence in obtaining revenues, the local governments' expenditure conformity which is not only focused on routine expenditures and the ratio of regional revenue growth. These indicators are used by considering the theory and the conditions in Indonesia.

## 2. LITERATURE REVIEW

### 2.1 Theory Basis

#### 2.1.1. Financial Distress

According to Jones and Walker (2007), financial distress is a government's inability in providing public services in accordance with determined standards of service quality. This is due to the fact that the government does not have available funds to invest in infrastructures used in the public service provisions. These shortage or unavailable fund conditions indicate that the government is in financial difficulties.

Financial distress of the local governments in this study is defined as an inability of the local governments in returning both main and interest loan. Clark (1977) discusses four indicators of financial limitations / government fiscal including; 1) default probability, which is defined as the local governments' inability in paying their bonds; 2) ratio indicators, such as gross debt divided by taxes based on short-term debt, 3) social and economy based-indicators, such as population size and per capita income average, and 4) cash flow indicators. Another indicator which can potentially indicate the governments' financial distress is merger. Private companies experiencing financial difficulties may seek merging partners and usually merge with business partners with a strong financial position. However, the merger of local governments is limited by geographical considerations. Typically, the local government in financial distress merges with another adjacent local government and a few will have financial progress (Jones and Walker, 2007).

#### 2.1.2. Regional Independence

The degree of independence illustrates the level of community participation in regional development. The higher the degree of the regions' independence is, the higher the community participation in terms of payment of taxes and levies as the main components of the regional revenue (PAD) will be. The improvement of the community's ability in terms of taxes and levies payment indicates the increasing level of social welfare.

Conceptually, the pattern of the relationship between central government and local governments, as well as among local governments, mainly in order to implement autonomy, can be done by measuring the regional financial ability in financing the implementation of regional development activities. According to Halim (2002, in Suprapto, 2006) there are four kinds of patterns introducing "situational relationship" in the implementation of regional autonomy, namely: (a) instructive relationship pattern, where the role of central government is more dominant than that of local governments' autonomy. (b) consultative relationship pattern, where central government's intervention has begun to decrease, since the local governments are considered to be little bit more able to implement regional autonomy. (c) participative relationship pattern, where the role of central government center is getting decrease, knowing that the level of regional dependence exceeds 50%. (d) discretionary relationship pattern, where the central government's interference cannot be more than 25%, even almost non-existent.

#### 2.1. 3. PAD (Regional Revenue) Growth

The growth ratio measures how far the local government is capable of maintaining and increasing the success which has been achieved from the previous to the next periods. By knowing the growth of each component of revenues and expenditure sources, it can be used to evaluate which potential regions need attention.

**2.1. 4. Expenditure Conformity**

The ratio of expenditure management shows that the expenditure activities done by the local governments have equities among positive periods, where the expenditures spent are not greater than the total revenues received by the local governments. This ratio shows a surplus or deficit budget. Surplus or deficit refers to more / less between income and expenditures during one report period. The local governments' operational implementation is expected to realize the equitable development; therefore, structuring system of appropriate expenses and expenditures is badly required.

According to Halim (2007: 322), it is stated that regional expenditure is the government's obligation in reducing net worth. Furthermore, Yuwono et al, (2005: 108) states that regional expenditure refers to all regional cash disbursements or liabilities recognized as a reduction to net worth in one year budget of which payment will not be earned back by the government. The Ease in determining appropriate fee or expenditure placement in accordance with the local governments' programs and activities, classification is required. Based on Darise (2008), expenditure is divided into two categories; (1) indirect expenditure, an expenditure whose budgeting is not directly affected by the proposed program or activity. (2) direct expenditure, an expenditure whose budgeting is directly affected by the program or activity.

**2.2. Previous Studies and Hypothesis Development**

In local government level, the strength (power) of financial resources may be reflected in the revenues generated by the local governments. According to the Act, the local governments have three components of revenue sources, namely regional revenue (PAD), transfer revenue and other incomes. The local governments with lower regional revenue will require funding from other sources to meet their needs. For the Regency/City Governments, the funds sources may come from the central/province government's transfer funds (fund balance). Corresponding to the theory of resource dependence, the local governments who have independent financial resources will have strength to survive and avoid financial distress. Financial independence has also been used by previous researchers as an indicator in assessing government's 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 regional development if the local revenue and central government transfers are insufficient for the local government funds (Halim and Damayanti, 2008). One of financial distress indicators is a high amount of debt (Almilia, 2006). The ratio which measures entities in restoring good debt is liquidity ratio that can be expressed by current ratio. Platt and Platt (2002) and Almilia and Kristijadi (2003) prove that liquidity ratio affects company's financial distress.

Several studies in the government sector using debt proportion carried out by Ryan et al. (2000) with the result that indebtednes gave a depiction of financial health of local governments and influenced the government's financial performance. Meanwhile, Groves et al. (2001) used the ratio related to liabilities in the forms of debt structure and unfunded liabilities to describe the government's obligation related to the capabilities of government obligation payment in his study. The empirical evidence obtained was that the government with high liability tended to have a better performance than the government with low amount of debt.

Cohen (2006) used the ratio related to government's financial liabilities in the forms of debt to equity ratio and long-term liabilities to total assets in predicting the performance

of local governments in Greece. The result of this study was that the ratio of governments' debt affected the governments' performance, despite in low effects. Steven and McGowen (1983) used the total debt to total revenue ratio to describe the government solvency associated with the governments' financial performance. In addition, Groves et al. (2001) used the long term to total assets ratio associated with the performance of local governments. Jones and Walker (2007) and Sutaryo et al., (2010) used the total debt to total assets as explanatory variables in governments' distress testing.

This study used data testing framework of financial distress status two years after the financial statement report by the local governments. The local governments' financial statements are arranged every certain year end and shall be submitted to the central government no later than 6 months from the reporting date. After that, the local governments' financial statements are audited by the Supreme Audit Agency (BPK), which takes approximately six months. The local governments having a surplus budget in difference balance (SILPA) may only submit a maximum budget of the following year for the realization of the previous year and the surplus will be added to the regional cash balance only if the local governments are experiencing a shortage (deficit) in the following year. The existence of this provision gives effects on the availability of funds for the local governments so as to affect the status of the local governments' financial distress two years after the regional financial report.

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

**H1** : **The local governments' financial independence results in negative effects on Financial Distress prediction**

**H2** : **The expenditure conformity has positive effects on the prediction of financial distress prediction**

**H3** : **the Growth of PAD (Regional Revenue)** gives **positive effects on financial distress prediction**

## 3. RESEARCH METHODS

### 3.1. Population, Sample and Sampling Techniques

The populations used in this study were all regencies/cities in Central Java, which have published their reports on budget realization. The sample in this study was taken by using purposive sampling method, which is a method of sampling with certain criteria (Nur Indriantoro and Bambang Supomo, 2002). Those criteria to be used should include the followings; (1) the data used were the data in 2013-2015. (2) The data must be available at the Central Bureau of Statistics or the data taken from the Ministry of Finance of the Republic of Indonesia.

### 3.2. The Operational of Research Variables

In this study, there are four (4) variables to be tested, they are one dependent variable (bond) Financial distress (Y), and three (3) independent variables (free), namely: Financial Independence (X 1), Expenditure conformity (X 2 ), PAD growth (X3);

- **Financial independence**: Higher financial independence indicates lower regional dependence on the other party to provide the balance funds and loans.

$$\frac{\text{Regional Revenue}}{\text{Balance Fund + Loan}}$$

- **Expenditure Conformity:** lower expenditure conformity indicates more expenditure budget spending allocated for direct activities related to local government programs.

$$\frac{\text{Employees' Expenditure}}{\text{Capital Expenditure}}$$

- **PAD Growth:** higher PAD growth indicates regional's better abilities in obtaining PAD compared to previous periods.

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

- **Financial Distress:** the indication of financial distress in this study is viewed from the portions of the regional's allocated expenditures for investments in the form of capital expenditure in the financial year.

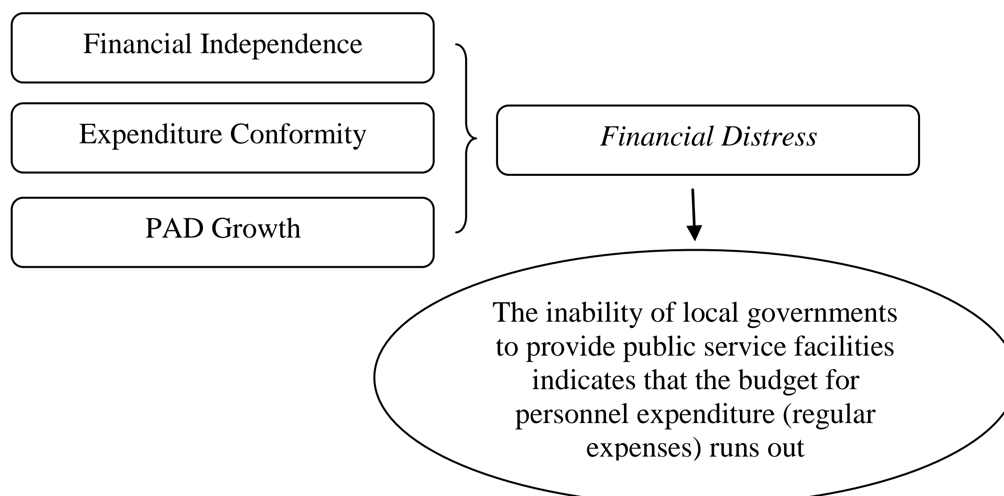
$$\frac{\text{Realization of Capital Expenditure}}{\text{Total of Regional Expenditure}}$$

The ideal number of capital expenditure ratio towards total expenditures is not set up by Central government. Regional autonomy provides an opportunity for local governments to set up their own portion of regional expenditures. In general, the capital expenditure ratio towards the total regional spending is between 5-20% (Mahmudi, 2010). However, in a coordination meeting, the Minister of Domestic Affairs, Gamawan Fauzi (2013) requested that local governments were to allocate their capital expenditure budget at least 30% of the total expenditures. The goal was addressed to support the development of infrastructures and in accordance with Presidential Decree No.5 of 2010 on National Medium-Term Development Plan ( http://www.antaranews.com ).

### 3.3. Data and Data Sources

The data sources of this strategy were secondary data, which were the data collection techniques taken from the data basis (Hair et al., 2009). These secondary data consist of; the local governments' financial statements in 2005-2009, the legislations and other regulations related to their arrangements, and the local governments' financial reports and presentations. The data needed in this study were collected from the records or databases of either hardcopy or softcopy obtained from downloading archive documentations on websites owned by Finance Audit Board of Indonesia (BPK), namely **www.bpk.go.id,** by the Ministry of Finance of the Republic of Indonesia (Kemenkeu RI), namely www.djpk.depkeu.go.id , and other relevant data sources.

### 3.4. Research Model



### 3.5. Hypothesis Testing Methods

The analysis used in this study was version 1.9 SPSS assisted-binary logistic regression. The binary logistic regression was used when the dependent variables were in the form of dichotomous or binary variables. In this study, the financial distress was a dichotomous variable having two different levels, namely the local governments which experienced financial distress and ones which didn't. In addition to the influence of the number of independent variables on the dependent variable in the form of a binary response variable, the binary logistic regression was also used to predict the scores of the dependent variable y (in the form of a binary variable) which were based on the scores of independent variables x1, x2, ..., xk

The logistic regression model used in this study is as follows:

**Log (P / 1 - p) = ß0 + ß1X1 ß2X2 + + + e ß3X3**

Where p is the possibility that Y=1 *(financial distress),* and X1, X2, X3, are the independent variables.

## 4. DISCUSSION AND ANALYSIS

4.1. Research Object Description

The populations used in this study were all regencies/cities in Central Java which have published their budget realization reports from 2013 to 2015. There were a total of 35 regencies/cities in Central Java and the samples found were as many as 28 regencies/cities. The amounts were based on the sampling criteria where there were 7 regencies/cities found with no data related to the budget realization reports during 2013-2015.

4.2. Hypothesis Test Results

4.2.1.-2 Log likelihood

The score -2 log likelihood was used to measure the feasibility of the model used, which was done by comparing the score -2 log likelihood before added with independent variables by the score -2 log likelihood after the independent variables added.

**Table 4.1**

**Overall Model Fit**

| Note | -2 Log likelihood |
|---|---|
| Block Number = 0 | 52.835 |
| Block Number = 1 | 52.835 |

Based on the above table, it can be seen that the score -2 Log likelihood was 52.835 significant at alpha 5%, while in table 4.2., it was obtained chi-square scores amounted to 16.605, which means this number was statistically significant and this model fit the data.

**Table 4.2**

**Omnibus Tests of Model Coefficients**

| | | Chi-square | Df | Sig. |
|---|---|---|---|---|
| Step 1 | Step | 16 605 | 3 | .001 |
| | Block | 16 605 | 3 | .001 |
| | Model | 16 605 | 3 | .001 |

Source: Data processed in 2016

4.2.2. Negelkerke $R^2$

The Nagelkerke $R^2$ score was 0.384 indicating that 38.4% of the dependent variable variation could be explained by the independent variables, meanwhile the remaining was 61.6% explained by the other variables which was not explained in this study.

**Table 4.3**

**Negelkerke $R^2$**

**Model Summary**

| Step | -2 Log likelihood | Cox & Snell R Square | Nagelkerke R Square |
|---|---|---|---|
| 1 | 36 229 [a] | .179 | .384 |

a. Estimation terminated at iteration number 8 Because parameter estimates changed by less than .001.

Source: Data processed in 2016

4.2.3. Hosmer and Lemeshow's Goodness of Fit Test

This testing technique was done to see if the empirical model fit the research model. The results of this test can be seen in the table below:

**Table 4.4**
**Hosmer and Lemeshow's Goodness of Fit Test**
**Hosmer and Lemeshow Test**

| Step | Chi-square | Df | Sig. |
|---|---|---|---|
| 1 | 7440 | 8 | .490 |

Source: Data processed in 2016

From the table above, it shows that the significance score obtained was 0.490 which was certainly greater than 0.05 and it means that the model was acceptable because it fit the data conducted by the researcher.

4.2.4. Classification Table

Table 4.5. shows the estimated financial distress and non financial distress scores; there were 76 regencies/cities governments predicted to experience financial distress, but the results of observation showed 75 experiencing financial distress and the only one which was incorrectly predicted as non financial distress. Therefore, the accuracy of prediction of financial distress was 75/76 (98.7%).

The regencies/cities governments which were predicted for not experiencing financial difficulties (non financial distress) were as many as eight, but the results of observation showed that only three which were not experiencing financial distress, meanwhile the remaining five were incorrectly predicted as the financial distress. Therefore, the non financial distress prediction accuracy was 3/8 (37.5%). Overall, the level of accuracy of the prediction was at 92.9%.

**Table 4.5**
**Classification Table**
**Classification Table [A]**

| | Observed | | Predicted | | |
|---|---|---|---|---|---|
| | | | FD | | Percentage Correct |
| | | | 0 | 1 | |
| Step 1 | FD | 0 | 75 | 1 | 98.7 |
| | | 1 | 5 | 3 | 37.5 |
| | Overall Percentage | | | | 92.9 |

a. The cut value is .500

Source: Data processed in 2016

4.2.5. Parameter Estimation and His interpretation

**Table 4.6**

**Results Classification Errors Type I and Type II**

| Classification | Amount | Percentage (%) |
|---|---|---|
| Estimated true | 78 | 92.9% |
| Type I error | 5 | 5.9% |
| Type II error | 1 | 1.2% |
| Total | 100 | 100 |

Source: Data processed in 2016

## 4.3. Discussion

4.3.1. The Effects of Financial Independence on Financial Distress

The testing results of financial independence variables were found significance score a0,201 and coefficient - 0.012. The significance score bigger than 0.05 indicated that financial independence did not significantly influence financial distress. Meanwhile, the negative coefficient indicated that the local governments had high financial independence and tended unlikely to experience financial distress. From these results, it showed that there were differences in the theory of resource dependency proposed by Peffer and Salancik, 1978 in Gudono, (2009). It was stated that not all local governments which were able to control resources would survive to the possibility of financial distress.

4.3.2. The Effects of Expenditure Conformity on Financial Distress

The testing results of the expenditure conformity variables were found significance score 0.007 and coefficient -0.069. The significance score was smaller than 0.05 indicating that the expenditure conformity gave significant effects on financial distress and was in accordance with the existing hypotheses. Whereas, for the coefficient score, it was found negative result, meaning that higher expenditure budget spending did not reflect a balance between personnel and capital expenditures and this result also showed that the realization of employees' expenditure spending still dominated the overall local governments' spending so that the realization of decentralization which has been planned was not in accordance with its purpose.

4.3.3. The Effects of Regional Revenue (PAD) Growth on Financial Distress

The testing results of PAD growth variable were found significance score 0.236 and coefficient score -0.564. The significance score bigger than 0.05 indicated the PAD growth did not significantly influence financial distress. Meanwhile, the coefficient score showed a negative number, which means that the increase of PAD in each region did not affect the likelihood of financial distress because of the amount of revenue that has been generated by the local governments did not result in direct implication on capital expenditures.

# 5. CLOSING

## 5.1. Conclusion

The results of data processing through SPSS on 84 local government regencies/cities in Central Java in 2013-2015 obtained the following conclusions:

1) From 84 samples processed, there were as many as 78 samples predicted to experience financial distress, this means that 92.9% of local governments experienced financial distress due to the large budget realization they had from 2013 to 2015 which tended to focus only on personnel expenditures and regional operational spending, yet minimum on infrastructure or capital expenditure spending.
2) From the three available hypotheses, there was only one same result obtained, which was on the expenditure conformity variable where the more balance the expenditure spending

done by the local governments was, the lesser the possibility of the regions experienced financial distress. Meanwhile, the financial independence variable did not give effects where the more independent regions did not show the better level of their financial distress. The PAD growth variable showed no effect results where the increased revenue was not associated with the level of financial distress in the local governments.

### 5.2. Limitations and Suggestions

Based on the research that has been done by the researcher, there are some limitations found as followings:

1) This study only takes samples of regencies/cities in Central Java; therefore, further research is expected to take a broader sampling.
2) The determination size of financial distress category in this study is limited only to quantitative data with a focus on a comparison of each local government spending.

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