

## **ANALYSIS OF FINANCIAL PERFORMANCE OF NEWLY CREATED REGENCIES/CITIES IN NORTH SUMATERA**

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### **Abstract**

*This research attempts to analyze the implementation of the regional autonomy in the newly-created regencies/cities in North Sumatra. It focuses on the financial performance of the original regional income (PAD) after the fiscal decentralization and the regional financial independence. The result shows that the regional autonomy has a positive impact on the growth of the PAD. However, the share of the PAD in regional budget is still inadequately small. The newly-created regencies/cities in North Sumatra are not ready to face the regional autonomy policy. Most of the newly-created regencies/municipalities are dependent on the balancing fund through the General Allocation Fund (DAU) and the Special Allocation Fund (DAK).*

**Keywords:** *regional autonomy, original regional income, fiscal decentralization.*

### **PENDAHULUAN**

The governance of provincial and regencies'/mayoral governments has entered a new era as new laws No. 32/2004 and No. 33/2004 were enacted. These two laws revise the laws No. 22 and 25 the year 1999 that provide rulings on the local autonomy and fiscal decentralization. The enactment of these laws obligates the central government to hand over some of its authorities to the local governments so that the governance of local governments runs more effectively and efficiently.

The enhanced function and authority of the local government undoubtedly needs sufficient financing supports. However, it is a known fact that the financing capacity of

each region is not uniform. While some regions will likely run the autonomy and fiscal authority smoothly because they are rich with natural resources, some others might suffer from financial difficulties due to limited resources.

The law No. 33/2004 article 10 rules that the sources of financing for local (regional) development (capital investment) include the Balancing Funds that come from the central government and the Original Local Income (PAD), which is generated by the local government from local resources. The Balancing Funds consist of Income Sharing Fund, Special Allocation Fund (DAK) and General Allocation Fund (DAU). In contrast, the Original Local

Income is mobilized from such sources as local taxes, excises (retribution), profits of Local-Government-Owned Companies (BUMD) and other legal sources of income. This PAD will arguably serve as the main yardstick by which we measure the success of the local autonomy implementation. That is, the degree of independence or autonomy of a local administration is largely determined by the share of the PAD in its budget; the greater the share the greater the autonomy.

The new laws also give more responsibilities to local governments in the fiscal management. This means that local governments will have to deal with developments within their own regions, especially in the sectors of infrastructure and public services, by relying on their own resources in planning, implementation and financing.

This implies that the creativity and initiative by a local government in tapping financial resources will largely depend on the policy it makes. On the one hand, the performance of the local government in fulfilling all its functions greatly depends on its success in mobilizing potential financial resources. On the other, mobilizing and tapping potential resources excessively will have adverse long-term effects, thereby disturbing its fiscal sustainability.

This paper aims to analyze and investigate thoroughly the financial capacity of the newly-created regencies/cities in North Sumatra from the point of view of their Original Regional Income (PAD) after the enactment of the autonomy laws. The analysis makes use of a map of financial capacity constructed using the Quadrant Method (Bappenas, 2003).

This research addresses the following questions. (1) What is the financial capacity of the newly-created regencies/cities in North Sumatra in terms of their PAD after the autonomy laws were enacted? (2) How

does the map of the financial capacity of the newly-created regencies/cities in North Sumatra that uses the Quadrant method look like?

## LITERATURE REVIEW

One of the main factors determining the success of regional development is the adequacy of financial capacity of the region. The greater the financial capacity the greater is the ability of the region to improve the wellbeing of its people through development. According to Tjokroamidjojo (1993) a regional government is likely able to carry out its autonomy and decentralization responsibilities successfully if it has adequate sources of finance.

A research conducted by Astuti and Joko (2005) discloses some sad facts that the ratio of the DAU to total regional income is more than 50 percent in nearly all regions in Indonesia. Likewise, most regions with relatively large PAD ratio to total regional income are concentrated in Java, while regions in the outer islands, with the exception of North Sumatra and Lampung, show no improvement in their capacity to generate PAD.

In their investigation of the autonomy in Malang City, Halim and Jamal (2006) find that the autonomy has not achieved an optimum level, because the share of the PAD in the local budget (APBD) is merely 13.23 percent on average during the period of 2000 - 2004. Similarly the capacity of the PAD to finance the local government expenditure is also very small, only 15.51 percent during the same period. Accordingly, the dependency of the Malang City government on other sources of income is still significantly high. This is despite the fact that on average the realization of the PAD in the same period exceeded the target, namely achieving 103.97 percent of the

target, with the average growth rate of 29.73 percent, albeit declining every year.

The study by Sumiyarti and Akhmad (2005) reveals that the PAD of Depok City has a positive, but not statistically significant, effect on the regional gross domestic product (RGDP). The relatively small share of the PAD in the local budget income most likely becomes the main reason for this statistical insignificance. In contrast, the Balancing Funds variable is found to have a positive and statistically significant effect on the RDGP. This arguably reflects a relatively strong dependence of the Depok City government on the financial support from the central government.

In addition, a research by Insukindro *et.al* (1994) also confirms that the share of the PAD in the local budget income is relatively small. One of the main reasons is that the realization of the PAD does not rely on the potentials of the regions for income generation; instead, the current year realization is targetted based on the previous year realization. These results are corroborated by Mulyono (2005), which finds that the degree of fiscal autonomy of regencies/cities in the North Sumatera province is at the very low range (0.00 – 10.00 percent). Further, the estimation of a panel data that covers the period before and after the autonomy using the GLS method shows that both the PAD and the balancing funds have positive and statistically significant effects on the economic growth in the regencies/cities of the North Sumatera province. However, in the period after the autonomy the PAD shows no effect on the economic growth.

Nevertheless, Hidayat and Sirojuzilam (2006) find that the PAD of Medan City is on the constant rise, although its growth declines significantly by 43.14 percent on average. And local taxes and retributions account for the largest portion in the PAD. As for the degree of fiscal

autonomy and routine capacity index (IKR) for Medan City, they are on average at the middle range. The positive side is the PAD and the Balancing Funds have positive and statistically significant effect on the economic growth, although the estimated coefficients clearly reflect that the Balancing Funds still play a more dominant role in the the Medan City government finance.

## **RESEARCH METHOD**

This research examines the financial capacity of the newly-created regencies/cities in North Sumatera in generating the PAD during the period of 2001-2006. The newly-created regencies/cities in North Sumatera that are investigated include Mandailing Natal Regency, Toba Samosir Regency, Humbang Hasundutan Regency, Phakpak Bharat Regency, Samosir Regency, Serdang Bedagai Regency, and Padang Sidempuan City. The data used are time series published by the Central Bureau of Statistics (BPS) and the Department of Finance (Directorate General PKPD). The data span from 2001 to 2006.

Various parameters are employed to measure the capacity of each newly-created regency/city in generating the PAD. These parameters are as follows.

1. To measure the performance of the PAD in a regency/city, we use, among others:
  - a. Growth analysis, which looks at the annual growth rate of the PAD in each newly-created regency/city.
  - b. Share Analysis, which examines the PAD-to-local-budget ratio that serves as an indicator of the financial capacity of each newly-created regency/city to finance its both routine and development (investment) activities.

2. Analysis of map of financial capacity of each regency/city by employing the Quadrant method.
- a. The Quadrant method is an analytical tool that maps the financial capacity of each region in four quadrants in which the magnitude of each quadrant is determined by the growth and share of the PAD.

**Table 1:** Classification of Region Financial Capacity Based on Quadrant Method

Quadrant	Condition
I	The most ideal condition where the PAD plays a dominant role in the local budget (APBD), indicating that the respective region has the capacity to mobilize its own local potentials. This condition is reflected in both high growth rate and share of the PAD.
II	Near ideal condition where the region has abundant local potentials for income generation that potentially enable the PAD to play a dominant role in the budget. But these potentials are not yet fully mobilized and as a result although the growth of PAD is high its share in the budget is low.
III	Below ideal condition in which the share of the PAD in the budget is high but potentially declining due to its significantly low growth. So here we have a high share of the PAD in the budget in the face of low growth of the PAD.
IV	The worst condition where the PAD has both low growth and low share in the budget. The region may have small capacity to mobilize its abundant potentials or it may equally have limited potentials for generating income regardless of its mobilization capacity.

Source: Bappenas (2003)

**RESULTS AND DISCUSSION**

**Overview of Regency/City Finance**

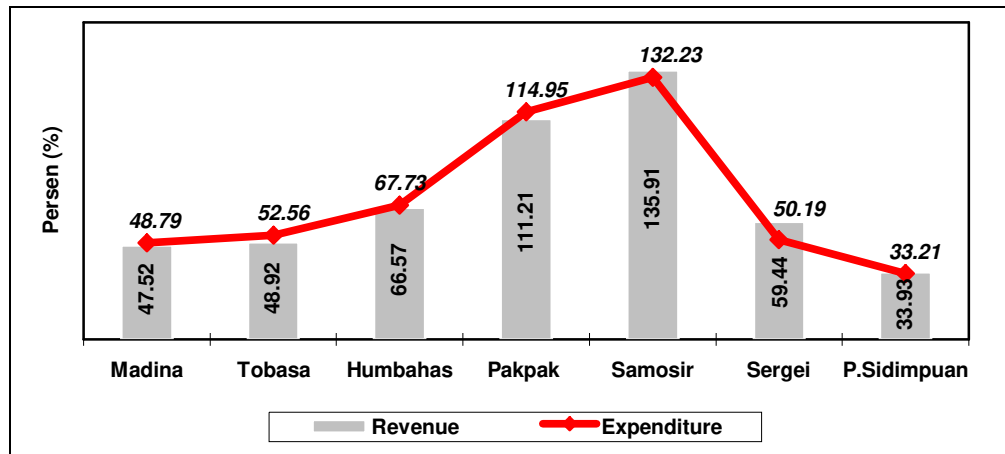
The independence of a region in implementing the autonomy depends on the capacity of the financial resources for that region to finance its development. In an autonomous region, the running of the activities of both the executive and the legislative branches of government is financed by the local budget (APBD). The following is the development of the APBD of each newly-created regency/city in North Sumatera, which is summarized in Table 2.

Table 2 shows that in general the APBD of the newly-created regencies/cities shows a constant upward trend, except for Toba Samosir regency and Mandailing Natal regency, which experienced a decline in the APBD in 2004 and 2005. However, in 2006 Mandailing Natal regency, along with Serdang Bedagai regency, had the highest APBD, while Pakpak Bharat regency scored the lowest APBD, only Rp. 189.4 billion.

**Table 2:** The APBD of Newly-created Regencies/cities in North Sumatera (in Rp billion)

No	Regency/City	2001	2002	2003	2004	2005	2006
1	Mandailing Natal	180.1	187.9	233.2	229.1	238.2	388.3
2	Toba Samosir	173.5	202.5	317.1	226.1	171.2	291.7
3	Humbang Hasundutan	-	-	-	106.2	123.3	267.6
4	Pakpak Bharat	-	-	-	43.3	78.7	189.4
5	Samosir	-	-	-	-	107.5	253.6
6	Serdang Bedagai	-	-	-	-	258.6	412.3
7	Padang Sidempuan	-	83.0	139.0	170.7	177.0	250.9

Source: North Sumatera in Numbers 2001 - 2006



**Figure 1:** Average Growth Rate of Revenue and Expenditure of Newly-created Regencies/cities in North Sumatera

As for the growth of expenditure relative to income, Mandailing Natal regency, Toba Samosir regency, Humbang Hasundutan regency and Pakpak Bharat regency all have an average growth rate of expenditure exceeding that of income. In contrast, other regencies such as Samosir, Serdang Bedagai, and Padang Sidempuan City have a greater average growth rate of income than expenditure.

**The PAD Growth**

The financial performance of a region is determined by its capacity to increase its financial resources to generate its original regional income (PAD) and mobilize all the PAD generation potentials from its own territory. Therefore, one of the main features of an autonomous region is its ability to run its own affairs independently by relying on its own financial capacity. In turn, a regional autonomy is equivalent with a financial autonomy measured with the degree of fiscal autonomy of that region.

Table 3 shows that on average the PAD of the newly-created regencies/cities in North Sumatera grow at 55.47 percent annually. The PAD of all six regencies and one city has experienced a positive growth rate. While the PAD of Pakpak Bharat regency experiences the highest growth rate, reaching 192.81 percent, Humbang Hasundutan regency records the lowest positive growth rate of its PAD, only 12.77 percent.

This finding is inline with the finding of Bappenas (2003) that concludes that the PAD of all provinces throughout Indonesia has grown positively during the regional autonomy period. This positive growth results from the increase in both regional tax and retribution income. This also indicates that the regional governments have made serious attempts to optimize the mobilization of their regional potentials.

**Table 3:** Development of PAD of Newly-created Regencies/cities in North Sumatera (in Rp. billion)

No	Regency/City	2001	2002	2003	2004	2005	2006	Average Growth (%)
1.	Mandailing Natal	1.94	6.53	5.32	9.11	5.80	8.25	59.04
2.	Toba Samosir	4.34	8.88	12.57	12.01	6.28	10.38	31.86
3.	Humbang Hasundutan	-	-	-	2.76	3.09	3.51	12.77
4.	Pakpak Bharat	-	-	-	0.28	1.38	1.28	192.81
5.	Samosir	-	-	-	-	5.21	6.57	26.10
6.	Serdang Bedagai	-	-	-	-	12.90	17.16	33.02
7.	Padang Sidempuan	-	2.18	3.48	5.24	4.68	6.14	32.68

Source: North Sumatera in Numbers

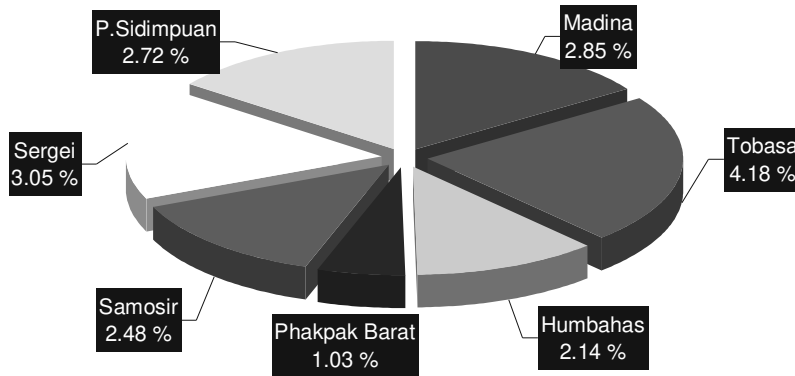
**The PAD Share in the APBD.**

The fiscal decentralization (in the regional autonomy) is intended to create regional independence. Sidik (2002) argues that in the era of regional autonomy each regional government has to be able to mobilize and optimize its local financial potentials, especially sources of the PAD. Accordingly, the local government can reduce its dependence on the central government.

To measure the capacity of a region to finance its expenditure we can use the ratio of the PAD to the total routine expenditure and development expenditure (APBD) of that region. Figure 2 shows that in general the PAD in all newly-created six regencies and one city in North Sumatera is far below adequate to finance the expenditure. This is reflected in the relatively low share of the PAD in the APBD in all those regions, averaging 2.36 percent. This means that the PAD only

covers 2.36 percent of the total routine and development expenditure, and the remaining 97.64 percent is covered by the subsidy from the central government in the form of the Balancing Funds (Income Sharing Fund, DAU and DAK).

This finding echoes the finding of Insukindro *et al.* (1994) that reveals that the contribution of the PAD to the total regional income and expenditure (APBD) is relatively low. Similarly, Mulyono (2005) finds that regencies/cities in North Sumatera are still greatly dependent on the transfer from the central government, with the degree of fiscal autonomy below 10 percent. Further, Hidayat and Sirozujilam (2006) disclose that the share of Medan City's PAD in the APBD is less than 30 percent. Again this indicates that the role of financial transfer from the central government is still dominant in the APBD of Medan City.



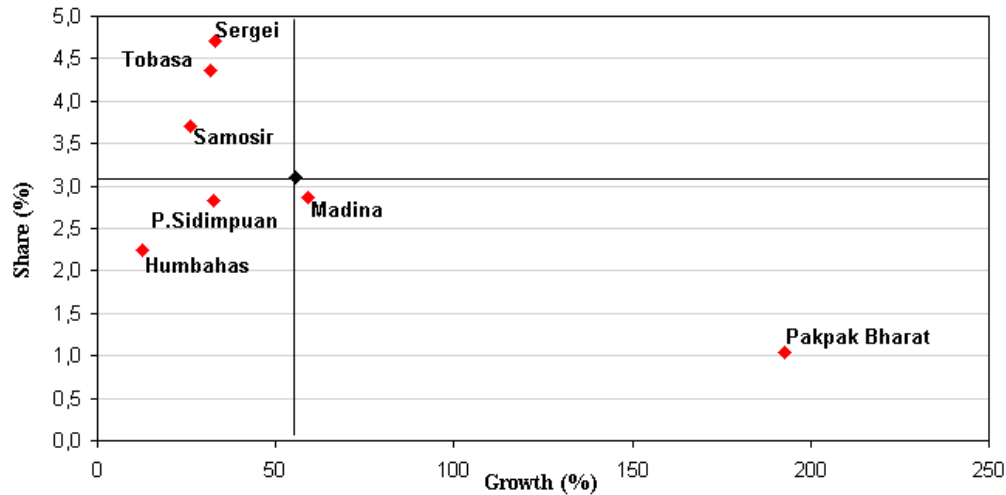
**Figure 2:** Ratio of PAD to APBD in Newly-created Regencies/cities in North Sumatera

**The map of Regional Financial Capacity Using Quadrant Method**

To draw a map of the financial capacity of each newly-created regency/city in North Sumatera requires two financial capacity variables, namely: the share of the PAD in the APBD and the PAD growth. A combination of these two variables, using the quadrant method (Bappenas, 2003), forms a coordinate that determines the financial position of a region in the quadrant. Figure 3 depicts the map of financial positions of the newly-created

regencies/cities in North Sumatera in the quadrant.

The map shows that the 7 regions under study occupy only three quadrants. While 2, 3 and 2 regencies/cities are located in quadrant II, III and VI respectively, no region occupies quadrant I, despite the fact that this quadrant represents the most ideal condition for an autonomous region. This clearly indicates that none of the newly-created regencies/cities in North Sumatera has achieved an ideal level of financial independence and autonomy.



**Figure 3:** Map of Financial Capacity of Newly-Created Regencies/cities in North Sumatera Using Quadrant Method



A deeper examination reveals the 2 regencies located in quadrant II are Mandailing Natal and Pakpak Bharat regencies. Although their financial position is not yet ideal, but their PADs grow quite rapidly so that their share in the respective APBDs keeps increasing. This is because these regencies have the ability to create and mobilize local potentials for generating local income. The fact that the share of their PADs in their respective APBDs is still low shows that the growth of their total expenditure exceeds the growth of their PADs.

In quadrant III are Serdang Bedagai, Toba Samosir, and Samosir regencies. This quadrant represents a below ideal financial position where a relatively big share of the PAD in the APBD has a likelihood to shrink due to a small growth of the PAD.

Finally the regions that occupy quadrant IV are Humbang Hasundutan regency and Padang Sidempuan City. These two regions have the worst financial condition. Both the share of the PAD in the APBD and the PAD growth are significantly low. This shows that both regions have small ability to create and mobilize local potentials for generating local income.

This finding implies that there is a tendency for these regions to maintain their financial dependency on the central government through the transfer of the general allocation fund (DAU) whose amount keeps increasing. According to BPS

(2004) there are several factors that are responsible for the declining share of the PAD in the APBD, namely: (1) many regions have abundant potentials of income resources but they are beyond their authority to mobilize and earn, (2) People in these regions have low standard of living and level of economy as reflected in their low percapita income, and (3) many regions have inadequate capacity to create and mobilize local sources of income.

### **CONCLUSION**

Based on the above analysis and discussion we draw the following concluding notes:

1. The regencies of Mandailing Natal, Toba Samosir, Humbang Hasundutan, and Pakpak Bharat have on average a total expenditure that grows faster than their income. In contrast, Samosir and Serdang Bedagai regencies and Padang Sidempuan City have the growth of their income exceeding the growth of their total expenditure.
2. The newly-created regencies/cities in North Sumatera enjoy a positive growth rate of the PAD but its share in the APBD is still inadequately small.
3. The financial capacity map shows that each newly-created regency/city in North Sumatera shows a low level of financial preparedness and readiness for decentralization and regional autonomy.

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