# DOES FLYPAPER EFFECT REALLY EXIST? EVIDENCE FROM GOVERNMENT BUDGET IN EAST INDONESIA

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**Abstract**

Regional autonomy is one form of policy from the Indonesian central government to encourage independence from every existing local government, but at the same time, it also creates economic inequality. To make it balanced, the central government provides transfer funds for every local government that needs it. However, the dependence of the local government on the central government transfer funds has led to the phenomenon called the Flypaper Effect. This study aims to see the effect and the existence of a flypaper towards Local Own-Source Revenue (*Pendapatan Asli Daerah*), General Allocation Fund (*Dana Alokasi Umum*), Special Allocation Fund (*Dana Alokasi Khusus*), Revenue Sharing Fund (*Dana Bagi Hasil*) and Local Expenditure. This study relays on audited financial statements of local governments in 11 provincial governments located in Eastern Indonesia from 2012-2017. It uses E-views to test the hypothesis. The results show that only the Special Allocation Fund does not affect Local Expenditure. Furthermore, in Eastern Indonesia, there is an existing flypaper effect phenomenon. The regional autonomy policy implementation still needs to be improved. The central government needs to motivate the local government potencies to maximize their original revenue and consider for adjust the policy itself.

**Keywords:** Flypaper Effect, Local Expenditure, Revenue Sharing Fund, Local Own-Source Revenue, Regional Autonomy

## I. INTRODUCTION

Centralized policies raise various problems, such as the incompatibility of development with the needs of local communities in certain areas or centralized growth (centralization). To overcome this, the Indonesian people implemented regional autonomy as a form of reform to establish better governance. Regional autonomy is the right, authority, and obligation of autonomous regions to regulate and manage their government affairs and the interests of local communities following statutory regulations [1].

Regional autonomy also affects government financial management. Changes in financial management from the implementation of regional autonomy policies are stated in Law no. 22, the Year 1999 about Local Government [2], and Law no. 25, the year 1999, about Fiscal Balance between Central and Local Governments [3]. These two laws came into force in January 2001. Then with the changing conditions in Indonesia, both in terms of politics and economics, the government reviewed the regulations that had been implemented. It is marked by the emergence of Law no. 32 Year 2004[4] and Law No. 33 Year 2004 [4]. These Laws and Government Regulation No. 55 Year 2005 about the Balanced Fund [5] are tools for local governments to manage their local finances by maximizing their potential.

Regional autonomy is one form for the state to encourage each existing local government's independence by maximizing each region's potential. As a form of decentralization, the positive value that emerges from this policy is that each region will be required to become more independent. Another implication directly impacting the implementation of regional autonomy is the expenditure as initial capital for local governments to become more independent so that the funds needed are also not small [6]. However, in practice, local governments still need to do everything themselves fully, but there is still interference from the central government. It is because there is a fairly high fiscal imbalance between regions it will indirectly affect the level of disparity in the economic growth of each region [7].

Adequate regional infrastructure is one of the keys to good economic growth. With adequate infrastructure, community productivity will also improve. The increase in high community productivity will increase Local Own-Source Revenue (PAD), and an increase in Local Own-Source Revenue will improve the quality of services to the public [7]. Adequate infrastructure development will indirectly encourage the regional economy, so an adequate budget is needed. The budget and its realization will depend on the level of revenue received by the local government.

The high level of infrastructure development that is not evenly distributed between regions of Indonesia is one of the many factors for the emergence of inequality in economic growth in Indonesia. The islands of Java and Sumatra still dominate with a percentage of 80% of national economic growth. Meanwhile, national economic growth has yet to receive a maximum contribution from the eastern region of Indonesia [8], [9]. Thus, the central government needs support and encouragement regarding the inequitable distribution of infrastructure development in Indonesia to reach the maximum economic growth point in each Indonesia region.

There are various types of local government expenditure, including physical expenditures such as the development and improvement of health, education, transportation, and other sectors. The purpose of this local expenditure is that the community can enjoy the benefits of the development carried out by the local government. Local expenditure is important for each region because it relates to the readiness of the local infrastructure for efficiency and effectiveness for various sectors of community activities to increase community productivity [7], [10]. An increase in community productivity will indirectly increase economic growth in the area itself.

Local expenditures required by a local government are not small, so the income received by the local government is often insufficient. Therefore, the central government helped by providing transfers to local areas. These transfer funds or balancing funds are divided into several types: General Allocation Funds (DAU), Special Allocation Funds (DAK), and Revenue Sharing Funds and Special Autonomy Funds (DOK), which are given to certain regions. In addition, every local government has a source of funding from their respective regions, namely Local Own-Source Revenue (PAD). Thus, regional autonomy directs that each region is expected to be able to increase its Local Own-Source Revenue with balancing funds as additional income or become assistance from the central government for the regions.

Regional autonomy also gives freedom to each local government to decide for itself the allocation of its resources for budgeted expenditure needs. In conducting local expenditure budgeting, an in-depth study is required. The element of political interest is also sometimes considered very closely related to this. In addition to the amount or value that is not small, the budget for each region is related to the specifications and sources of long-term financing [7], [11].

According to Maimunah [10], the current practice is that local governments tend to use transfer funds from the central government as the main funding for local expenditure operations. It is contrary to the objective of the regional autonomy policy, which is to increase the independence of each region by maximizing its potential. The purpose of the transfer or balancing fund itself is used to mitigate or reduce the fiscal imbalances that exist in each government. It leads to dependence on local governments to use balancing funds or transfers rather than maximizing their local revenue. With this dependence, a phenomenon called the flypaper effect appears.

The purpose of this study is to see the effect between Local Own-Source Revenue (PAD) and balancing funds or transfer funds consisting of General Allocation Funds (DAU), Special Allocation Funds (DAK), and Revenue Sharing Funds (DBH) on local expenditures. Furthermore, we want to see if there is a flypaper effect phenomenon on expenditure made by local governments in the eastern part of Indonesia.

## II. LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

The First Research on the flypaper effect anomaly began with the research of James R Hines and Richard H. Thaler [12]. Both revealed that the surplus distributed to the states to be used for the public interest, in the end, has caused the flypaper effect in America. Research conducted using the literature of similar studies from 1971-1993 provides evidence that state governments increase their revenues with federal government assistance compared to tax revenues.

Acar [13] conducted a study related to the possibility of the emergence of the flypaper effect phenomenon in Turkey. The policy of the central government of Turkey is to provide transfer funds of about 2% of GNP (Gross National Product) to local governments and is carried out through three mechanisms: adjusted to the population level of each region, the distribution is centered on the city government and channeled through special government programs. Researchers prove that the phenomenon of the flypaper effect in Turkey still dominates.

In addition, other studies related to transferring funds have been carried out in various countries. For example, the percentage transfer policy for local government expenditure in South Africa is 85%, 67%-95%, and 70%-90% in Mexico. At the same time, the United States, especially the state of Wisconsin, receives transfer funds from the central government to local governments of 47% [14]. Another study related to the transfer of funds from the central government was conducted by Legrenzi and Milas [15]. Both find that long-term central government transfers to local governments in Italy strongly influence local expenditure. It can be caused by the existence of policies within the local government adjusted to the number of transfer funds received.

Several researchers have also carried out research in Indonesia related to this phenomenon. Maimunah [10] has proven that there is a flypaper effect phenomenon in city/district governments on the island of Sumatra. Pentury [16] also proves that this phenomenon occurs in the West Papua region. Furthermore, the researcher also emphasized that West Papua is an area that receives special autonomy funds, and the results found further strengthen the evidence regarding the phenomenon of the flypaper effect in West Papua. Research on the island of Java-Bali has been carried out by Halim and Sukriy [17]. Both found that Local Own-Source Revenue (PAD) and General Allocation Funds (DAU) significantly and positively affected local government expenditure. However, both of them did not find that there was a flypaper effect phenomenon in Java-Bali. According to Halim [18], the financial capacity of local governments not belonging to the Java-Bali area is considered different from that of local governments in Java-Bali.

The central government will transfer a sum of money known as the Balancing Fund, which consists of the General Allocation Fund (DAU), the Special Allocation Fund (DAK), and the Revenue Sharing Fund, which consists of taxes and natural resources. In addition, local governments have a source of funds obtained from their regions, namely Regional Original Revenue. Thus, each region is expected to be able to increase its own Local Own-Source Revenue with an additional contribution from the central government, namely the balancing fund.

Based on Law No. 23 Year 2014 about Local government [1] in article 285, it is stated that regional income comes from 3 main elements: (1) Local Own-Source Revenue, which includes regional taxes, regional levies, results of separated regional wealth management and others legitimate local revenue; (2) transfer income from the central government which includes balancing funds, special autonomy funds, privilege funds, village funds and inter-regional transfers consisting of revenue sharing and financial assistance; (3) other legitimate income.

Furthermore, the balancing fund or transfer fund consists of several parts. Based on Government Regulation No. 5 Year 2005 [5], some of these sections are;

1. The General Allocation Fund aims to equalize financial capacity among regions by applying a formula that considers personnel expenditure needs, fiscal needs, and regional potential.
2. The Special Allocation Fund is intended to fund special activities that are regional affairs and are national priorities following the functions that embody government duties in certain fields, especially to fulfill the needs of basic public service facilities and infrastructure.
3. Revenue Sharing Funds are funds from the APBN, distributed to regions based on certain percentage figures considering the potential of producing regions.

Local expenditure consists of operating expenditure, capital expenditure, and unexpected expenditure. Local expenditure is intended to provide services to the public. Local governments implement the implementation, such as the construction and improvement of infrastructures, such as roads and health facilities, education, transportation for personnel expenditures, and others. It means that expenditure is a form of local government effort in the implementation of mandatory affairs which aims to improve basic services to the community so that the formation of a good quality of community life as well as a form of a social security system provided by the government. The achievement of minimum service standards is one of the standards to improve the quality of life by implementing local government affairs following applicable laws and regulations.

Hamilton [19] defines the independence of local governments towards the provision of transfer funds from the center rather than using their Local Own-Source Revenue as a flypaper effect. The flypaper effect is a behavior that is difficult to rationalize, so it is considered an oddity, an increase in local government expenditure by using regional transfers from the central government [20]. If the transfer between governments is more than 50%, then the local government is more likely to stimulate local public expenditure rather than increase Local Own-Source Revenue. It indicates a high probability of a flypaper effect occurring [16]. Pramuka [6] revealed that the implication arising from the flypaper effect is an increase in local expenditure, which is greater than the transfer receipt itself. The bureaucratic model and the fiscal illusion model are two schools of thought proposed by economic observers from the emergence of the flypaper effect phenomenon.

Efforts to maximize the budget in public decision-making as a form of bureaucratic power is a proposal put forward by bureaucratic thinking. Another thing that this bureaucratic model emphasizes is that tax increases are not the main focus of bureaucratic behavior but the flexibility in expenditure transfers. In addition, the bureaucratic model also carries other important implications, namely, with the existence of fiscal decentralization, the growth of the public sector is also accelerated. The decentralized system allows the provision of public goods to be achieved properly due to the participation of the community so that local governments can distinguish the priorities their residents need based on the information obtained [21], [22].

Fiscal illusion is also one way to maximize local government revenue. This model illustrates the impetus for the central government to allocate large amounts of transfer funds due to budget engineering to encourage the public to make greater contributions in terms of paying taxes [6]. If the government maximizes the revenue it receives, then the government does a fiscal illusion.

With the government's desire to improve the quality of people's lives, which is manifested in services to the community, it will encourage the government to increase revenues from both Local Own-Source Revenue and transfer funds (DAU, DAK, and DBH) to improve the implementation of both infrastructure and government operations that have been budgeted in the APBD as a form of embodiment and of the vision and mission of each region itself. On the other hand, the dependence on local governments is increasing with an increased transfer of funds from the central government [23]. Thus, the hypotheses tested in this study are:

**H1**: Local Own-Source Revenue (PAD) positively affects local expenditure.

**H2**: General Allocation Funds (DAU) positively affect local expenditure.

**H3**: Special Allocation Funds (DAK) positively affect local expenditure.

**H4**: Revenue Sharing Funds (DBH) positively affect local expenditure.
**H5**: There is a flypaper effect between Local Own-Source Revenue (PAD), General Allocation Funds (DAU), Special Allocation Funds (DAK), and Revenue Sharing Funds (DBH) on Local Expenditure.

## III. METHOD

This study is a quantitative study using secondary data from financial statements. This study uses pooled research data, a combination of time series (using the time dimension), and cross-sections (using several research objects). The data in this study are Local Government Financial Reports published through the official website of the Supreme Audit Agency of the Republic of Indonesia (obtained by downloading from the website) [24]. The data period is 2012-2017. We use non-probability sampling, Saturation Sampling Because we use all populations as the sample. The sample used is the Provincial Government in the eastern part of Indonesia which consists of 11 provinces: Gorontalo, Maluku, North Maluku, NTT, Papua, West Papua, West Sulawesi, South Sulawesi, Central Sulawesi, Southeast Sulawesi and North Sulawesi [25]. The provincial government serves as the central government's representative in supervising and fostering local governments. To carry out the affairs and programs related to this matter, the provincial government will tend to have a larger budget than the local government, so the provincial government will also need large funds. This study uses the amount of Local Expenditure, Local Own-Source Revenue (PAD), General Allocation Funds (DAU), Special Allocation Funds (DAK) and Revenue Sharing Funds (DBH) from Local Government Financial Reports (LKPD).

The research model proposed in this study is:

$$BD = \beta 0 + \beta 1\ PAD + \beta 2\ DAU + \beta 3\ DAK + \beta 4\ DBH + e \quad (1)$$

| | |
|---|---|
| BD | = Local Expenditure |
| $\beta 0$ | = Constant |
| $\beta 1,2,3,4$ | = Regression Coefficient of Each Variable |
| PAD | = Local Own-Source Revenue |
| DAU | = General Allocation Fund |
| DAK | = Special Allocation Fund |
| DBH | = Revenue Sharing Fund |

This study uses E-views 10. For model selection, this study will choose one of the three-panel data models: Pooled Least Square, Fixed Effect, or Random Effect. The panel data model selection can be done by performing the Chow and the Hausman Test. After selecting the appropriate research model, the next step is testing the hypothesis. The chow test is used to select the Pooled Least Square (PLS) test with the Fixed Effect Model (FEM) test. The results of the chow test in this study indicate that the probability value of 0.0000 is smaller than 0.05, so in the chow test, the Fixed Effect Model (FEM) is an ideal model for researchers to use.

After doing the Chow test, the next test is the Hausman test, which is used to choose whether to use the Fixed Effect Model (FEM) or Random Effect Model (REM). The results of the Hausman test in this study indicate that the probability value is 0.0000 less than 0.05, so the Hausman test is the Random Effect Model (REM), which is an ideal model for researchers. The value of r-squared in this study is 0.681, which is greater than 0.55, so the variables in this study are considered capable of explaining the dependent variable by 68%, and other variables outside the model explain the remaining 32%.

## IV. RESULTS AND DISCUSSION

### A. *Result*

The results of hypothesis testing are presented in the table 1. Hypothesis 1 shows that 0.0079 is smaller than 0.01, so hypothesis 1 is supported. For testing hypothesis 2, the number 0.0000 is smaller than 0.01, so hypothesis 2 is also supported. Testing hypothesis 3 shows the number 0.1413 is greater than 0.01, so hypothesis 3 is not supported. Testing hypothesis 4 shows that 0.0000 is smaller than 0.01, so hypothesis 4 is supported.

### B. *Discussion*

Hypothesis one examines the relationship between Local Own-Source Revenue (PAD) and local expenditure. The results show a positive relationship between the two variables. It illustrates that regions that want to provide services with good standards in their regions will try to increase PAD so that the budgeted state expenditure needs can be met. If the Local Own-Source Revenue (PAD) obtained by the local government is high, it will increase the amount of local expenditure. Thus, Local Own-Source Revenue (PAD) positively affects local expenditure. The results of this study are in line with research by Maimunah [10], Inayati and Setiawan [20], and Solichin [7].

Testing hypothesis 2 shows a positive relationship between General Allocation Funds (DAU) and local expenditures. General allocation funds provided by the central government increase the desire of local governments to increase the amount of state expenditure for operational needs for their regions. Local governments that receive high General Allocation Funds (DAU) will also increase the amount of local expenditure. The results of this study are also supported by research by Maimunah [10], Inayati and Setiawan [20], and Solichin [7]. Hypothesis 2 General Allocation Funds (DAU) positively affect local expenditure.

TABLE 1. HYPOTHESIS TEST RESULTS

| **Pooled EGLS (Cross-Section Random Effects)** | | | | |
|---|---|---|---|---|
| Total pool (balanced) observations: 66 | | | | |
| **Variabel** | **Koefisien** | **Std. Error** | **t-Statistic** | **Prob.** |
| C | 171000000000 | 280000000000 | 0.60993 | 0.5442 |
| Local Own-Source Revenue (PAD) | 0.460717 | 0.167604 | 2.74884 | 0.0079 |
| General Allocation Funds (DAU) | 1.720498 | 0.210086 | 8.18951 | 0.0000 |
| Special Allocation Funds (DAK) | 0.211626 | 0.141994 | 1.49038 | 0.1413 |
| Revenue Sharing Funds (DBH) | 1.192453 | 0.152315 | 7.82889 | 0.0000 |

Source: Processed data

TABLE 2. COEFFICIENT VALUE

| **Variable** | **Koefisien** |
|---|---|
| Local Own-Source Revenue (PAD) | 0.460717 |
| General Allocation Funds (DAU) | 1.720498 |
| Revenue Sharing Funds (DBH) | 1.192453 |

Source: Processed data

Testing hypothesis 3 shows the number 0.1413 is greater than 0.01, so hypothesis 3 is not supported. Special Allocation Fund (DAK) provided by the government does not affect the amount of local expenditure. A special Allocation Fund (DAK) is a balancing fund with a value or amount that tends to be smaller than the general allocation fund (DAU) and Revenue Sharing Funds (DBH). In addition, Special Allocation Fund (DAK) is used to fund work programs that are special and programs that become national priorities and become regional affairs in certain fields [26]. This study's results are similar to Inayati and Setiawan's [20].

Testing hypothesis 4 shows that the Revenue Sharing Funds (DBH) significantly affect local expenditure. The higher the Revenue Sharing Funds (DBH) obtained by the local government will increase the amount of local expenditure. It is in line with the research of Inayati and Setiawan [20]. Thus, hypothesis 4, Revenue Sharing Funds (DBH), positively affects local expenditure.

Additional analysis is needed to test the existence of the flypaper effect phenomenon. The results of the study that indicate the possibility of a flypaper effect phenomenon on local expenditure behavior owned by local governments must meet the following requirements: (a) The coefficient values of General Allocation Funds (DAU), Special Allocation Funds (DAK), and Revenue Sharing Funds (DBH) are greater than the Local Own-Source Revenue (PAD) coefficient value, and the variable is significant, or (b) Local Own-Source Revenue (PAD) is not significant [10].

In this study, the results show that Local Own-Source Revenue (PAD), General Allocation Funds (DAU), and Revenue Sharing Funds (DBH) have a significant influence on local expenditure, so it is necessary to compare the coefficient values of the three variables. The coefficient values of the three are as follows in the table 2.

The table above shows that both the General Allocation Funds (DAU) and Revenue Sharing Funds (DBH) coefficient values are greater than the Local Own-Source Revenue (PAD) coefficients. Both meet the requirements that have been proposed by Maimunah [10]. Thus, the results of this study provide evidence that in the eastern part of Indonesia, the expenditure behavior of local governments implies the existence of a flypaper effect phenomenon.

The flypaper effect impacts increasing local government expenditure, greater than the regional revenue itself, and the tendency to expect assistance from the central government rather than managing Local Own-Source Revenue (PAD) [20]. Furthermore, another study by Lalvani [27] showed local governments' increased tax revenue to manage local expenditures during the reduction of transfer funds. Thus, the researcher assumes that the receipt of transfer funds only sometimes positively affects local governments because local governments tend to give little effort, so they cannot maximize the potential of the area they have [20], [27].

## V. CONCLUSIONS, IMPLICATIONS, AND LIMITATIONS

This study provides results showing that Local Own-Source Revenue (PAD), General Allocation Funds (DAU), and Revenue Sharing Funds (DBH) have a positive influence on local expenditure. This study also provides evidence of the flypaper effect phenomenon in eastern Indonesia. It is consistent with Hamilton [19], which states that local governments tend to rely more on Revenue Sharing Funds (DBH) than using Local Own-Source Revenue (PAD). Ndadari and Adi [23] also said the same thing, revealing that the General Allocation Funds (DAU) were used as an instrument of horizontal imbalance for equity or to fill the fiscal gap. Local governments use General

Allocation Funds (DAU) to support sufficiency. It shows that local governments are sufficient for local expenditures by seeking DAU from the central government.

The same thing happened to Revenue Sharing Funds (DBH). By maximizing Revenue Sharing Funds (DBH), local governments will have large Revenue Sharing Funds (DBH), so, in their use, PAD will be the second choice to be used. On the other hand, local governments manipulate the budget [6]. The local government did it to encourage the community to make a greater contribution in paying taxes and encouraging the central government to allocate larger funds [6]. Thus, the government performs a fiscal illusion to maximize the revenue received.

The impact of this flypaper effect is that the local government budgets its expenditure as high as possible and does not try to optimize its Local Own-Source Revenue (PAD). It indicates that this is done so local governments receive assistance in the form of Revenue Sharing Funds (DBH) from the central government. It is different when an increase in the Revenue Sharing Funds (DBH) to the regions results in the superior quality of local expenditure; of course, it is not a problem [20], [28].

This study is based only on data from provinces in eastern Indonesia, so the results cannot be generalized. This study uses the Local Government Financial Report (LKPD) published by the Supreme Audit Agency (BPK) from 2012 to 2017. This study uses Local Own-Source Revenue (PAD), General Allocation Funds (DAU), Special Allocation Fund (DAK), and Revenue Sharing Funds (DBH) as the independent variable and local expenditure as the dependent variable or the dependent variable. The results of this study become additional literature for research related to the phenomenon of the flypaper effect. However, this study also has some limitations, so future research is expected to make some changes. Some suggestions put forward by researchers for future research are:

- Expanding the coverage area for the sample, both provinces, cities/districts in Indonesia.
- Look at local expenditure by sector of expenditure, such as education, health, transportation, food, housing, and other sectors, to see more details related to this phenomenon.
- Take into account control variables for samples such as the Human Development Index (HDI) and the expansion area to reduce the possibility of bias.
- Extend the research period, for example, 10 years.
- Take into account other factors that may affect income, such as how to calculate income to see the behavior of local governments more clearly.
- Analyzing the possibility of a flypaper effect between regions or islands in Indonesia.

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