

The implications of fiscal decentralization and budget governance on economic capacity and community welfare

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Abstract

Purpose – *The purpose of this study is to investigate the relationship between government and Balinese society in tax decentralization through budgeting seem to insignificantly improve the welfare of Balinese society.*

Design methodology/approach – *This research was conducted in Bali Province involving eight regencies and one city. The data used in this study were secondary data, derived from relevant institutions or from websites through internet browsing and other documentations in the form of official reports/publications, such as regional budget, accountability reports, regional regulations and documents on budget and development of the regional economy. The present research used the partial least squares analysis technique.*

Findings – *Fiscal decentralization does not necessarily lead to better budget management. The success of fiscal decentralization can be found in the quality of the regional budget and the quality of budget management. The allocation of the regional budget for public service improvement and the development of infrastructure will increase the economic capacity of the regions. Improvement in regional economic capacity encourages the improvement of community welfare.*

Originality/value – *This income inequality points to the issue of fiscal capacity. The development of the financial role of district/city regions in the Province of Bali remains at a level gap with the development level of community welfare. During this period, the financial role of the government as estimated from the ratio of the national budget to the regional budget is higher than that of the society development. The acceleration role of the government is not proportional to the development of Human Development Index outcomes.*

Keywords *Fiscal decentralization, Community welfare, Budget governance, Economic capacity*

Paper type *Research paper*

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1. Introduction

The definition of decentralization according to Law no. 33 of 2004 on the financial balance between the central government and the regional government is the authority given by the central government to autonomous regions for regulating and administering government affairs in the Republic of Indonesia. The definition of the financial equity between the central government and the regional government is an integral system for the funding under the principles of decentralization, deconcentration and duty assistance. In essence, this definition demonstrates a clear separation in financial affairs between the central government and the regional government (Isdijoso and Wibowo, 2002).

The implementation of fiscal decentralization, based on the first rule of fiscal decentralization according to Bahl (2008), is that fiscal decentralization should be seen as a comprehensive system. Minimum condition is required by the regions in implementing fiscal decentralization, for instance the regional government has sufficient authority to mobilize acceptance and is given sufficient accountability in expenditure. On the other hand, ideal

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conditions for the region are as follows: it should be free from excessive expenditure control from the central government, the transfer should be done without much attachment to the centrality requirements and the region should be given the authority to make loan.

In the opinion of [Akai and Sakata \(2002\)](#), the decentralization theorem by Oates argues that the decentralized system is always more efficient than the centralized system in terms of providing service for increased public demand, but in some cases in several areas, [Akai and Sakata \(2002\)](#) suggest that the decentralized system sometimes is less efficient compared with the centralized system.

The regional income and expenditure budget allocation is seen from the main budget categories, consisting of the following items: health, education, administrative administration, and other infrastructure and postal services, all of which come from Dana Alokasi Umum (DAU) for the purpose of achieving the regional development goals. The data from the Ministry of Finance in [Basri and Munandar \(2009\)](#) point out that the budget efficiency and effectiveness remain low for activities that can stimulate regional economic activities and improve the welfare of the society. According to Mauro in [Syukriy and Halim \(2006\)](#), the budget allocation seems to be related to corrupt behavior of politicians and bureaucracy, where the expenditure process that gives higher lucrative opportunities for corruption is more preferable.

A finding on study regarding Indonesia's public expenditure in 2007 shows important issues related to decentralization:

- The main challenge in Indonesia's development is no longer fund provision for poorer regions, rather the ways of ensuring that these areas will use the funds distributed as best as possible.
- The largest expenditure item for the regional government is found in the administration, absorbing 32 per cent of all regional government expenditures.
- More than half of the increase in allocations of DAU that should have been used for service improvement of the society turn out to be used for financing the provincial and the regional government's staff expenditure (World Bank).

One objective of fiscal usage that comes from regional income and the central government's transfer is to increase the growth of the regional economy. In Keynes' eco-theory, it is mentioned that economic growth has a linkage to inflation and unemployment. One savior of the Indonesian economy from unemployment problems is that many working-age residents who initially work in the formal sector eventually move on to the informal sector over economic crisis and work termination havoc. In principle, the smaller the informal sector in the economy and the bigger the formal sector, then the better the economy will be ([Basri and Munandar, 2009](#)).

The role of good governance in the regional governance is very important, given that a weak governance regime will result in the following:

- Poor communities will find difficulties to get access to public services, as the consequence of having dirty public officials.
- Investors will be afraid to make investments because of the absence of legal certainty in terms of contracts and security factors.
- Many government resources are lost owing to non-transparency, manipulation and holes in the management system and procurement ([Kuncoro, 2004](#)).

Regional governments cannot simply depend on how much income they have, whereas in the era of regional autonomy, it must be supported by good quality human resources who are able to interact and adapt to the real conditions of society, while building partnerships with outsiders. Good governance is supported by three main pillars: the government, the

private sector and society. Regional governments should be able to provide good public services to the society, and the society should be involved in the planning of regional development.

There is an urgency to improve the abilities of local officials in conducting service duty for the society. The phenomenon occurring today shows there are still many people who have not felt the benefits of regional autonomy. The biggest fruit of regional autonomy is limited to being perceived among the regional elites but has not directly improved the welfare that can be received by the society – despite the essence that the ultimate goal of regional autonomy is the improvement of people's welfare (Basri and Munandar, 2009).

Regional autonomy is also expected to provide an excess of interregional disparities. Inequality in regional development at the level of infrastructure and facilities and human resources will affect the achievement of decentralization goals in the regions. Regional financial problems are not the only cause of this disparity, demographic factors actually have contributions, too. The population pressure can be a snowball phenomenon because it has implications on unemployment, health and poverty issues.

The average ratio of regency/municipal income in Indonesia to total regency/municipal income in Indonesia is 0.23 per cent. If regency/municipal income in Bali Province is compared with national's average income ratio, it turns out that in 2008, there are four regencies rated under the national average ratio. These four regencies are Bangli (0.06 per cent), Jembrana (0.11 per cent), Karangasem (0.22 per cent) and Klungkung (0.15 per cent). As for other regencies/municipalities, they are already above the national range, and specifically for Badung Regency, it is far above them, at 3.86 per cent.

The ratio of regency/municipal income in Bali when compared with Badung Regency shows a fairly high gap, where in 2008, Jembrana has an income ratio of 2.79 per cent, Buleleng of 6.93 per cent, Tabanan of 7.20 per cent, Denpasar of 23.2 per cent, Gianyar of 12.76 per cent, Klungkung of 3.82 per cent, Bangli of 1.67 per cent and Karangasem of 5.66 per cent. On the other hand, one of the regencies in Bali Province, Jembrana Regency, which has an income far below the Badung Regency, gets many awards and recognition for its good public service to the society, although this regency has limited source of funds. In 2005, Jembrana Regency's income was only about 3 per cent of the total budget, and was not rich in natural resources, but with its budget limitations, this regency could provide good public services and reached out to poor communities (Hirawan, 2007).

This income inequality points to the issue of fiscal capacity. The development of the district / city regional financial roles in the Province of Bali in 2012-2016 remains in the gap with the level of community welfare development. During this period, the financial role of the government as estimated from the ratio of the national budget to the regional budget is higher than that of the society development. It is measured from the Human Development Index (HDI). Despite both of them showing an upwardly moving direction, the HDI movement remains below the government's financial role. The acceleration role of the government is not proportional to the development of HDI outcomes.

Although in the regional autonomy, each city/regency receives fiscal transfers in the form of balancing funds; regencies/municipalities in Bali Province receive fiscal targets, such as cross subsidies from Badung Regency. This phenomenon is very interesting because such a condition seems to only occur in Bali Province with relatively small natural resources. The reason for this transfer is because the tourism industry in Bali has inter-regency links in promoting the tourism industry in Bali. Foreign and domestic tourists tend to stay in the area of Kuta and Nusa Dua (Badung Regency), but tourists tend to move to various tourism objects in Bali.

The thing to take into our consideration related to the growth of economy in Bali after the regional autonomy is the relatively below-average economy compared with the national economic growth. The facts show that the economic growth in Bali, which is largely

supported by the tourism service industry, has not been optimal, meaning that public welfare is still not optimal as well.

In 2012, the economic growth of Bali was 4.62 per cent, which then increased to 5.56 per cent in 2013. Although it plunged to 5.29 per cent in 2014, the economic growth in Bali in 2015 and 2016 increased to 5.92 per cent and 5.97 per cent, respectively. The trend of Bali's economic growth in 2012 to 2016 was relatively below the national economic growth at 5.03 per cent, and the national economic growth also dropped in 2014 to 5.50 per cent but rose to 6.10 per cent in 2016. The data reflect fluctuations in the relationship between the economic growth of Bali Province and the growth of national economy.

This study aims to examine the implications of fiscal decentralization in relation to good governance in budgeting against economic capacity and community welfare in Bali. Several previous studies have examined partially the relationship between fiscal decentralization, good governance, economic capacity and community welfare. Researchers indicate a direct relationship between fiscal decentralization to good governance, such as [Regmi *et al.* \(2010\)](#); [Bahl and Wallace \(2006\)](#) and [McCluskey and Bevc \(2007\)](#) showing no significant influence of fiscal decentralization on good governance. A set of studies showed fiscal decentralization has an effect on economic capacity, such as by [Pitsvada and LoStracco \(2002\)](#) and [Elmassri *et al.* \(2016\)](#); yet, different findings are expressed by [Ebdon *et al.* \(2016\)](#); [Luehlfing \(1996\)](#) and [Bracci *et al.* \(2014\)](#), who indicated a non-significant relationship. The next research gap is the impact of fiscal decentralization against public welfare, for which [Singh and Mahajan \(2015\)](#) show significant and positive relationships, whereas [Zulkhibri *et al.* \(2015\)](#); [Raimi and Adeleke \(2009\)](#); [Salih \(2003\)](#) and [Doessel and Williams \(2014\)](#) show contradicting results. This present study aims to fill the gap of previous studies, as well as to comprehensively examine the impact of fiscal decentralization toward good governance, economic capacity, and welfare.

The good governance in the implementation of local governance is crucial, given a weak governance regime will lead to the following:

- Poor people having difficulties to access good public services because of corrupt apparatus.
- Investors feeling hesitant to invest because of no legal certainty concerning contracts and security factors.
- Many lost government resources owing to non-transparent, manipulative and numerous leakage in the management systems and procurement.

The implementation of the local government cannot only rely on PAD (Pendapatan Asli Daerah)[1]; in a regional autonomy, the administration must be supported by quality human resources that can interact and adapt to the real condition of society, and at the same time be able to build partnership with many parties. Good governance is supported by three main pillars, namely, the government, the private sector and society. Local governments should be able to provide good public services to communities and involve them in local development planning. In addition, local governments are also expected to provide ease in investment activities and business opportunities for the private sector.

In such a pattern, the administration of a particular service or governmental function is no longer dominated by one party (i.e. the government). This means that the process of partnership and cooperation should be further encouraged by reducing the role of the government, on the one hand, and strengthening the role of the private sector and the community, on the other hand. The need to improve the capacity of the regional apparatus is increasingly urgent because during the period of this regional autonomy (2001-2015), the central government increases transfers to the regions, averaging on an increase of 20.2 per cent per year, which accounts for about 30 per cent of total state expenditure. In 2008, the realization of transfer to the region is estimated at IDR 293.6tn, increasing the ability of local

officials to fulfill the task of providing good services to the community. The thing of concern is that many people have not felt the benefits of the so-called regional autonomy; the benefits are still limited to the local elite and not directly to the improvement of welfare of the community. At its climax, this can deteriorate the purpose of regional autonomy and the community will doubt the benefits of regional autonomy on public welfare (Cruz, 2015).

Regional autonomy, besides being expected to improve public welfare, is also expected to affect regional disparity. Inequality in infrastructure development regionally, as well as in human resources, will affect the achievement of the main objectives of decentralization to the regions. Inequality between regions in Indonesia after the introduction of regional autonomy is owing to the high interregional financial capability, in addition to the allocation of local budget expenditures lacking the direct effect on community welfare. This is pathetic, as the noble goal of decentralization is to improve equity. In addition to local financial capacity as the cause of this disparity, demographic factors are another factor to consider. The issue of population pressure is a snowball because it will lead to unemployment, health problems and poverty.

Regions with abundant resources must quickly develop the brain power or the empowerment of human resources and skills, so the potential will not be wasted over time. Natural resources are non-renewable factors of production and regions rich in natural wealth must have high administrative skills and a willingness to advance their region in various fields.

In the context of fiscal decentralization, the underlying factor of inequality in interregional financial capability lies in the Dana Bagi Hasil Sumber Daya Alam (DBH SDA)[2]. Areas rich in natural resources are entitled to receive large amounts of DBH SDA, yet the goal of decentralization is on equity and welfare of all regions. Then, the different amount of DBH SDA received represents inequality and breaks the mandate of the 1945 Constitution, which states that the earth, water and natural resources are controlled by the state and used for the greatest prosperity of the people.

There have been efforts to fight for the issue of special autonomy discussed in Bali, the central government in Jakarta. Regardless of the name and form of the effort to obtain the autonomy, it is necessary to study the autonomy format that really has a positive impact on Bali now and in the future. It seems there are differences in understanding (asymmetric information) about the status of autonomy itself. It is important to have the same perception on the definition of autonomy before preparing an autonomy format, including the status, the services to the community, the quality of human resources, the economic sector, the demography and the ability to manage and develop the financial potential of the region.

The implementation of fiscal decentralization within the framework of regional autonomy to date has been going on in two periods; the first was 2001 to 2003 and the second was 2004 to the present. There are several noble goals from decentralization; one of which is an increase in fiscal capability for the regions. Furthermore, with increasing fiscal independence, the regional economy is expected to increase, which in turn can improve public welfare in each region. Decentralization, in addition to the authority for the regions to manage their own budgets, also means better public services within the framework of good governance especially in the economic field.

Based on the empirical explanation, the objective of decentralization implementation in Bali Province has not been achieved. Referring to some empirical evidence of the financial and economic conditions in Bali, it was found that the ratio of the province's fiscal autonomy in the second era of decentralization implies a relatively declining condition, or a decrease of fiscal independence in the form of the ratio of PAD to budget. At the national level, the average ratio of the regencies/cities PAD in Bali to the regencies/cities PAD in Indonesia shows that almost half of Bali's regencies/cities generate PAD below the average. Data on PAD between regencies/cities in Bali show high income inequality – in which the ratio of

regencies/cities' PAD compared with those of Badung Regency does not exceed 24 per cent in 2008.

Other empirical evidence related to decentralization is the shift of the regional economic structure from the agricultural sector to the tourism sector, although the economic growth of Bali in 2004 to 2008 was under the national economic growth. The budget and expenditure in Bali until 2008 since the implementation of fiscal decentralization was dominated by routine expenditure by the government; this suggests the need for more intensive efforts for regions to implement good governance, especially in the management of local budgets.

2. Conceptual framework and research hypothesis

The conceptual framework constructed in this study is based on theoretical studies and supported by previous research results – this is in accordance with the topic of this study on regional economics, where studies of previous research results show that the welfare of the community is influenced by several variables such as fiscal decentralization, budget governance, budget allocation and regional economic capacity. This study is expected to answer the research questions.

The goal of fiscal decentralization in Indonesia is to provide more space for the regions to regulate their economies by optimizing local revenue sources outside of sources from the central government; thus, the opportunity to increase the regional economy is wide open (Rahim and Shirazi, 2018). Fiscal decentralization in Indonesia has generally had a positive impact on regional development from 1999 to 2004, and a new era of fiscal decentralization has a relatively better impact on regional development (Wibowo, 2008). There has been, however, an ambiguity of the impact of fiscal decentralization on economic growth (Thornton, 2007), and the most well-informed of local needs and long-term regional aspirations is the local government and communities. Fiscal decentralization is worth considering developing local innovation in the framework of regional development (Seo, 2009). Decentralization needs to change high taxation and reduce expenditures not leading to prosperity, as this can reduce regional economic growth (Mourmouras and Rangazas, 2009). Government transfers in the form of government expenditures increase; regions that still rely on budgetary resources from DAU[3] and DAK (Dana Alokasi Khusus)[4] will be able to increase expenditure items to improve local infrastructure.

Fiscal transfers from the central government to the local governments greatly affect local budget structures, especially for regions that do not have many natural resources (Alisjahbana, 2000; Affandi and Astuti, 2014). Increased allocation of transfers is followed by higher spending on regional budgets. There is an indication that the high increase in expenditure is owing to inefficiency of local government expenditures, especially routine expenditures (Kuncoro, 2004). The high fiscal stress shows the higher regional effort to increase its PAD; the expectation of continuing to increase its own revenue will be difficult if the allocation of spending on capital or development is not improved (Adi, 2008). Fiscal constraints need to be done over the long term; this condition implies that local governments should be more active when there is a need for fiscal reform (Schaltegger and Feld, 2009).

The public services of the local governments in Indonesia still need to be improved because the governance score in Indonesia for the six main indicators is still below 50 per cent. This is pitiful, but the strong will from the local government elite surely will help to achieve better public service. Good governance, especially in the economic field, is a central pillar to face competition in a globalized world. In addition, Indonesia must also reform the civil service to achieve clean and efficient bureaucracy to maintain confidence in the government (Tjiptoherijanto, 2008). Some local governments have provided efficient and responsive services, whereas others have burdened the local economy with administrative uncertainty, inefficiency and extortion. The delegation of authority from

central to local governments is aimed not merely for financial affairs but also for the realization of quality apparatus and good service (Gauteplass and Hopland, 2017).

Based on the theoretical explanations and empirical studies, hypotheses related to the implications of fiscal decentralization on budgetary governance, budget allocation, economic capacity and public welfare are presented as follows:

- H1. Fiscal decentralization affects local budgetary governance.
- H2. Fiscal decentralization affects local budget allocation.
- H3. Fiscal decentralization affects local economic capacity.
- H4. Fiscal decentralization affects public welfare in the region.

In conditions where the level of taxation affects the level of public saving, then available resources are used for capital formation. Likewise, tax incentives and penalty systems may be designed to influence the efficient use of resources, and tax patterns on imports and exports relative to taxes on domestic products will affect the balance of foreign trade (Nwaobi, 2009). Optimizing local fiscal resources is a must for local governments without relying on fiscal transfers from the central government. Local fiscal optimization can be done by arranging expenditure on items that can encourage increased production and economic activities.

Research conducted by Cappelen *et al.* (2007) shows two important interregional transfers schemes, basic funding schemes and power equity funding scheme – in this case, two different interpretations of equal opportunity ethics can be found using liberal egalitarian principles. Both the basic funding schemes and power equity funding scheme use specific reference levels. The first relies on the idea of a reference tax rate and the latter on the notion of reference jurisdiction. There is a difference between the ideal of local autonomy and the interregional equation, where two interregional transfer schemes can be seen as two different ways of solving problems. The research, conducted by Cappelen and Tungodden, uses a different interpretation of the principles of fiscal capacity equality and fiscal responsibility, characterized as balanced basic funding scheme and balanced power equity funding scheme.

We cannot deny that the potential of each differs, especially in the case of local revenue sources. This difference in revenue sources has created differences in budget allocation priorities. Each region will face different problems; high population and the low quality of human resources can worsen the income gap of society. There is always a possibility to prioritize the interests of regional elites at the expense of the welfare and rights of the people – this will make the elites lose their value. Letting people become apathetic is certainly not an unavoidable solution. There must be a strong will of all parties, including the elites, for the realization of good governance. Improving the quality of service is based on not only the performance of the apparatus but also the reform of institutional formation in the regions.

Better management of the budget will improve financial performance, and in the end will lead to increasing economic activities. Regional financial performance has a significant effect on economic growth in the regional autonomy (Rahmiyati, 2007). However, the greater discretion to explore the potential of local revenue through local taxes or levies has not shown significant increase in revenues (Isdijoso and Wibowo, 2002). Regional disparities in Indonesia are mostly caused by non-oil revenues; a new problem arises when it comes to the number of population (Sakamoto, 2006).

The fiscal decentralization policy in China leads to a significant increase in inequalities in geographic distribution or fiscal resource transfer (Qiao *et al.*, 2008). Decentralization can lead to an increasingly sharp gap between regions owing to high levels of corruption and weak local government capacity in resource management and public services (Lessmann, 2006).

Based on the theoretical explanations and empirical studies, hypotheses related to the implications of budgetary governance, budget allocation, economic capacity and public welfare are presented as follows:

H5. Budgetary governance affects local budget allocations.

H6. Budgetary governance affects local economic capacity.

H7. Budgetary governance affects public welfare in the region.

Good economic results come from good economic governance. Good economic governance is defined as the existence of government institutions that have the capacity to manage resources efficiently, are able to formulate and implement sound policies and regulations, can be supervised and carry out responsibilities, show respect for the rules and norms of economic interaction and work well to maintain public trust. Core elements that contribute to an environment with good economic governance are transparency, accountability and participation enabling the creation of an environment for the development and growth of the private sector, as well as institutional development and effectiveness (Hope, 2009).

In terms of increasing economic growth, the quality of resources must rely on not only the natural resources but also the quality of human resources. A qualified human is a very important production factor. If economic growth increases, then everyone must feel the benefits. Abundant natural wealth means nothing if it does not provide direct benefits to people in the region. The high regional wealth is not significantly followed by the high level of community welfare. Thus, there is a failure to reflect the wealth of the region into improving the welfare of the community (Tadjoeddin *et al.*, 2001).

The improvement of social infrastructure is also an important consideration for the welfare of society. Equity in infrastructure development makes an easier access on development results. The educational and health factors are two fundamental things to be a priority of local budget allocation. The smaller the problems arising from these two factors, the better the development benefits the community feels.

Gender disparity, especially in terms of real access to resources, accountability and participation in an active life, social inclusion in politics and employment, makes inequality increase. Gender disparity in the socio-economic context goes hand in hand with the lack of women's participation in the political and economic system (Costantini and Monni, 2009).

Based on the theoretical explanations and empirical studies, another hypothesis can be formulated related to the implications of budget allocation to economic capacity as follows:

H8. Budget allocation affects economic capacity.

The initial findings by A.W. Phillips describe a trade-off between output and price stability. The economic mechanisms using the Phillips curve as a study of wage level and unemployment linkages are a long-term phenomenon (Fanti and Manfredi, 2007).

Economic growth involves two important things, i.e. price stability and declining unemployment. Economic growth, on the one hand, can trigger an increase in the rate of inflation when growth itself has not been able to meet the high domestic needs. Another trigger appears when production factors and finished products are imported. Therefore, policies in achieving optimal economic growth should pay attention to various economic variables that serve as a reference to accelerate the process of economic growth.

Growth of labor absorption is the change in the total working population over a specified period (within a certain year to the next year) calculated in percent. Labor variable is one indicator to see the development and condition of the economy. The labor factor refers to the role of man in the production process; in this sense, the definition of labor is all people

who are willing and able to work. The amount of labor is only meaningful and empowering when the workforce has the ingenuity, intelligence and expertise to perform certain productions in various fields of economic activities. The workforce is also included in the definition of the labor force; workforce is the number of working-age population who are looking for work and are working, included in this group is the productive age seeking work (Abel and Bernanke, 2005).

A government that runs good governance will encourage the creation of public confidence, so people have the opportunity to improve their quality and ability. A quality government is a government that has a commitment and certainty of rules and credibility. Certainty aspect contributes to the interest to invest. High investment will provide economic benefits for the government and society.

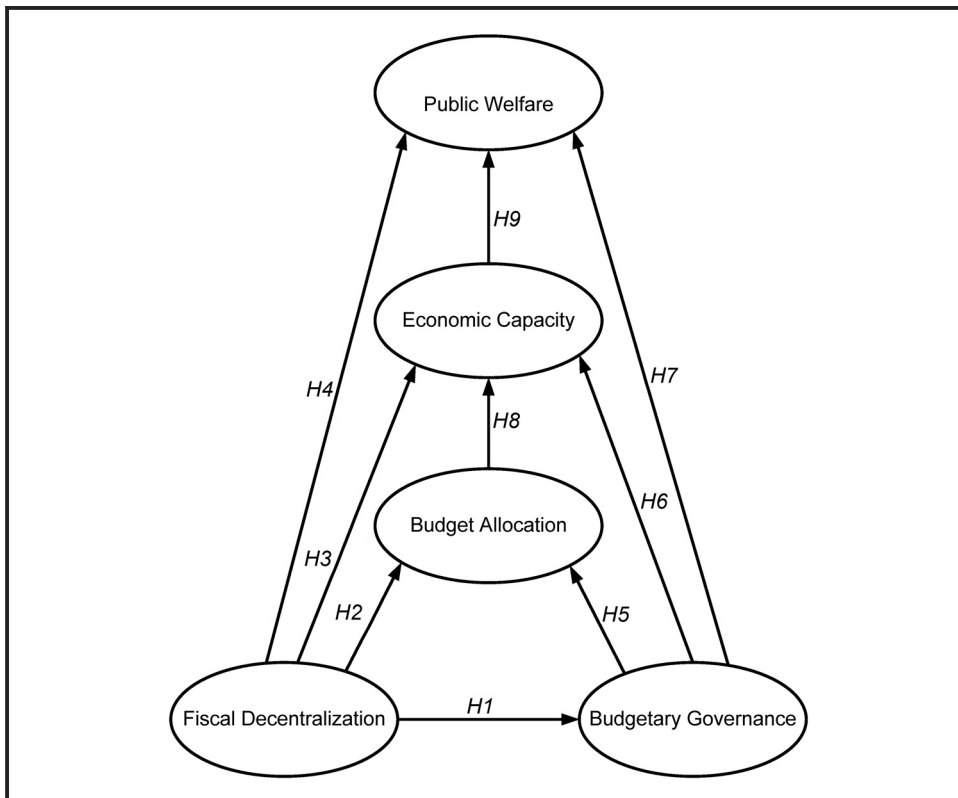
Based on the theoretical explanations and empirical studies, the last hypothesis can be formulated related to the implications of economic capacity on public welfare as follows (Figure 1):

H9. Economic capacity affects public welfare.

3. Methods

This research was conducted in Bali Province including eight regencies and one city. This location was chosen, considering that Bali Province is one of the provinces with relatively high economic growth rate and regional income in Indonesia. The object of

Figure 1 Conceptual framework



the study was the implications of fiscal decentralization related to budget governance, budget allocation and economic capacity in the effort of improving the community welfare, taking the period from 2012 to 2016. The data used in this study were secondary data, derived from relevant institutions or from the websites through internet browsing and other documentations in the form of official reports/publications, such as regional budget, accountability reports, regional regulations and documents on budget and development of regional economy. The present research used the partial least squares (PLS) analysis technique.

Two things to do in PLS. First, assessing the outer model or measurement model is an assessment on the reliability and validity of research variables. Three criteria to assess the outer model are convergent validity, discriminant validity and composite reliability. Second, we have to assess the inner model or structural model. An inner model or structural model testing is done to see the relationship between construct, significance value and *R*-square of the research model.

The PLS approach does not assume certain distributed data. The estimated parameters obtained with PLS are categorized into three, namely:

1. weight estimate used to create the latent variable score;
2. path estimate connecting latent variables and between latent variables with their indicator blocks (loading); and
3. means and location of parameters (regression constant values) for latent variables and indicators (Solimun *et al.*, 2017).

PLS is a powerful analytical method because it is not based on many assumptions. Data do not have to be multivariate normal distribution (indicators by a category scale, ordinal, interval to ratio can be used on the same model). PLS can confirm the theory and explain relationships between latent variables. It can be used as a confirmation of theory (hypothesis testing) and also to build relationships that have no theoretical basis or for prepositional testing. PLS has been developed as an alternative to situations where the theory is weak and the available indicators do not meet the reflexive measurement model (Hair *et al.*, 1992).

PLS can analyze latent variables by using both reflexive and formative indicators, which cannot be done by covariance based on structural equation modeling.

The study involves four exogenous variables as follows:

1. Fiscal decentralization (X1) with three indicators, namely:
 - X_{1.1}. Ratio of fiscal decentralization degree;
 - X_{1.2}. Ratio of fiscal independence degree; and
 - X_{1.3}. Ratio of DAU.
2. Budgetary governance (X2) with three indicators, namely:
 - X_{2.1}. Ratio SILPA;
 - X_{2.2}. Opinion of BPK; and
 - X_{2.3}. Ration of funds returned.
3. Budget allocation (X3) with four indicators, namely:
 - X_{3.1}. Ratio of basic need expenditure;
 - X_{3.2}. Ratio of government administrative expenditure; and
 - X_{3.3}. Ratio of infrastructure expenditure.

4. Economic capacity (X_4) with three indicators, namely:

- $X_{4.1}$. Income per capita;
- $X_{4.2}$. Theil Entropy Index; and
- $X_{4.3}$. Real GDP rate.

The endogenous variable or the dependent variable is:

1. Public welfare (Y_1) with three indicators, namely:

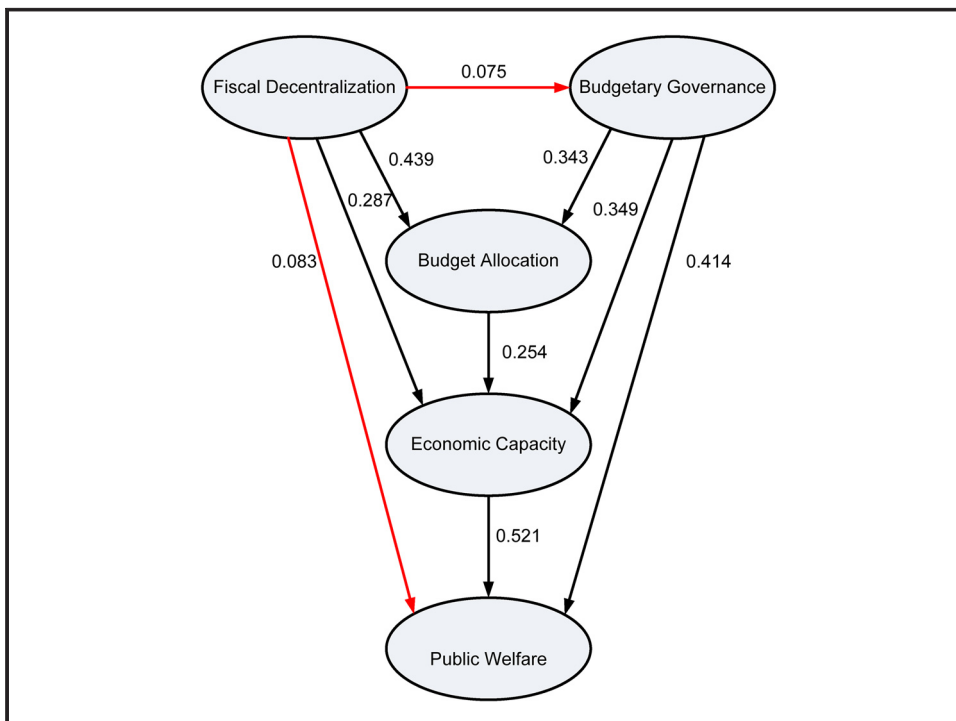
- $Y_{1.1}$. HDI; and
- $Y_{1.2}$. Ratio of the poor people.

4. Results and discussion

The goodness-of-fit test of structural model in the inner model uses the predictive-relevance (Q2) value. The result shows that the predictive-relevance value is 0.8858 or 88.58 per cent. A predictive relevance score of 88.58 per cent also indicates that the diversity of data explained by the model is 88.58 per cent, or in other words, the information contained in the 88.58 per cent data can be explained by the model. Meanwhile, the remaining 11.42 per cent is explained by other variables (those not contained in the model) and error. Therefore, the structural model established is appropriate.

The result of PLS analysis is presented in [Figure 2](#) (significant relationship if p -value < 0.05). Of the nine hypotheses, two hypotheses were rejected, namely, the effect of fiscal decentralization on budgetary governance ($H1$) and the effect of fiscal decentralization on public welfare ($H4$), whereas the other seven hypotheses were accepted ($H2$, $H3$, $H5$, $H6$, $H7$, $H8$ and $H9$). The study finds that fiscal decentralization directly affects budget allocation and economic capacity, but it has no effect on budgetary governance. The test of

Figure 2 Analysis result



indirect influence shows that fiscal decentralization has an indirect effect on public welfare with budget allocation and economic capacity as the mediating variables.

The study also confirms that budgetary governance affects budget allocation for economic capacity and community awareness. Finally, budget allocations also affect economic capacity and economic capacity affects public welfare.

4.1 The relationship between fiscal decentralization and budget governance

The results of this research indicate that there is no significant effect of fiscal decentralization on budget governance. It supports the research results conducted by [Davidson and Lookwood \(2008\)](#), stating the need for arrangements for partnership-based governance, including the ways to handle complex problems related to coordination and integration with the framework between the central and regional governments. Thereby, it will create good intention in addressing the emerging problems and enable the accountability of budget management. The result of this study also influences the opinion of [Tjiptoherijanto \(2008\)](#), saying the role of good governance is highly important, and when it is related to budget management, it is necessary to reform the civil service to achieve clean and efficient bureaucracy, thus maintaining trust in the government. This research also supports the opinion of [Luebke \(2009\)](#), stating that the governance in Indonesia has seen regional governments that provide efficient and responsive services, whereas others are burdensome to the economy because of their administrative uncertainty, inefficiency and abuse of authority. The results corroborate the research findings conducted by [McCulloch and Malesky \(2010\)](#) in 243 regencies throughout Indonesia, which find relatively little evidence of a strong relationship between governance management's quality and the performance of regional economy. The governance quality has a direct economic relationship with the economic size, the wealth of natural resources and the population.

The increasing DAU in fiscal decentralization shows high dependence of the regional government on fiscal transfer from the central government. The use of budgets that rely on DAU as the main source of financing makes the role of fiscal decentralization with linkage to the regional capability have weaker execution. It can be caused by the occurrence of the flypaper effect – a situation where the regional government wastes too much budget finance (DAU) received from the central government, rather than using its own income (PAD). When we view the ratio of the average growth rate of Bali Province from 2004 to 2008, which amounted to 19.38 per cent, then it is smaller than the average growth rate of funds per hectare (DAK, DAU and DBH) in the same period, at 26.49 per cent. This shows that there was no flypaper effect in Bali Province during that time. According to [Kuncoro \(2004\)](#), in an economic repertoire, the study on the flypaper effect can be grouped into two schools of thought: bureaucratic model and fiscal illusion model. The bureaucratic model examines the flypaper effect from the bureaucrat's point of view, whereas the fiscal illusion model bases its study from the perspective of the society with limited information on its regional government budget. According to Niskanen in [Kuncoro \(2004\)](#), implicitly, the bureaucratic model asserts the flypaper effect because of the superiority of the bureaucrat's knowledge on transfers, whereas Oates in [Kuncoro \(2004\)](#) states that the phenomenon of flypaper effect is a result of the society's ignorance about regional government budgets.

Budget governance in fiscal decentralization reflects the accountability for fiscal use addressed to the public. In the fiscal decentralization, the rules found by [Bahl and McMullen \(2000\)](#) state that the regional governments are often incapable of handling complex fiscal arrangements. The same goes to the systems required to evaluate and monitor these fiscal arrangements. Regional governments have different capabilities in providing and financing public services. Therefore, for the maintenance of accountability in the budget flows, assessment standard for budget use is set. Annual evaluations by BPK on the use of local budgets often find many things incompatible with those already established. The principle of money follows function as proposed by [Bahl \(2008\)](#) has

implications that the government's jurisdiction should be accompanied by the budget amount corresponding to the delegated authority.

4.2 The relationship between fiscal decentralization and budget allocation

Regional financial capability sourced from high income provides a better "space" for the regional government to develop and allocate the budgets according to the conditions and needs of the society in regions. The formulation of budgetary allocation can be done by giving greater attention and portion to the public service, thus arbitering budgetary can be avoided solely for the government, and even more it can increase fund for allocation posts which provide stimulus to development in regions, thus absorbing the aspirations of the society needs.

This research also supports the results of research conducted by [Alisjahbana \(2000\)](#), pointing out that the implementation of fiscal decentralization based on Law No. 25 of 1999 provides greater autonomy in the form of fiscal benefits to regency/city's budgets. When budget allocations are in deficit state, and whenever the fiscal transfers of the central government are relatively fixed, the regional governments can apply adjustments to budget allocation posts, one of which is by reducing government's expenditure as wisely as possible. In this regard, the results of this research favor the research conducted by [Schaltegger and Feld \(2009\)](#), stating that if high budget deficits in the preceding years are followed by weak growth of GDP, it implies that the regional government should be more active in increasing income sources whenever there is a need for fiscal reform.

The fiscal pressure faced by regions in the development owing to the high fiscal gap can be handled by adjusting the budget through an increase in local revenue. On the other hand, the benefits of fiscal decentralization for the society can be further enhanced by evaluating the size of the government's spending. Efficiency in government's administrative spending can be done by adapting to the incentive given to the regional apparatus through the reward and punishment mechanism. The incentives should no longer be done in a "flat-out way" without considering the work performance. The implementation of reward and punishment mechanisms for the performance of the regional government can be considered in the adjustment of budget allocation for the regional government. Efficiency to these spending allocations can reflect a passion for improving the performance and motivation of the officials while improving the regional spending allocation on basic needs, such as education, health and local infrastructure. Increasing budget allocations in these two areas is expected to improve public services and promote regional economic activities. Another apparent thing is the regional spending allocations that still provide the largest share in government's administrative needs, leading to counterproductive effects on regional economic capacity.

4.3 The relationship between fiscal decentralization and economic capacity

Fiscal decentralization has goals, one of which is to encourage the acceleration of regional economic growth, thus increasing regional economic capacity. Increase in regional economic capacity is expected to provide direct benefits to local communities. The government's efforts to increase its economic capacity depend on the political will of the government. Fiscal decentralization in the form of authority in local financial management implies that the regions should take advantage of their potential income and accuracy in the use of fiscal pillar given by the central government. An increase in the fiscal granting from the central government to the regional government is conceptually capable of increasing regional economic growth.

The budget allocation is highly determined by the size of income per region. The fact shows that there is a relatively high income inequality between regencies/municipalities in Bali, where Badung Regency has income far above the other regencies/municipalities' average income. Such very different income source makes the difference in local spending allocations which are adapted to the development priorities in each regency. The average

ratio of APBD to gross regional domestic revenue (GRDP) of Bali Province over the period of 2012-2016 is 5.54 per cent, which means that the private sector is stakeholders with great roles in increasing the economic capacity in Bali. Fiscal decentralization should not only focus on enhancing regional growth through fiscal transfer, instead one of the targets of regional economic improvement should be done through the continuous increase of the private sector's role in regional economic development.

The element of bureaucratic ease in fiscal transfers implies the effectiveness and simplification of requirements for fiscal transfer to the regions. The more the aid provision requirements and the attachment of interests that should be met by the region over the received transfers, the greater the limited space will be for the improvement of economic capacity in the regions. Impression of centralistic decentralization can also lead to undesired regional economic growth. Regional economic growth may also be caused by heavy legislation that tends to be inconsistent. On the other hand, fiscal decentralization with consistent administrative clearance and legal certainty can encourage the acceleration of regional economic growth.

4.4 The relationship between fiscal decentralization and public welfare

Fiscal decentralization has no direct impact on public welfare, but when viewed from indirect effect, there is a significant indirect effect between fiscal decentralization on public welfare through economic capacity, due to a significant direct correlation between fiscal decentralization and economic capacity, and a significant direct effect of economic capacity on public welfare. Therefore, economic capacity here is not regarded as an intervention that bridges fiscal decentralization and public welfare, and fiscal decentralization arguably has an indirect significant effect through the fiscal decentralization significant effect on economic capacity, and a significant effect of economic capacity on public welfare.

Fiscal decentralization in the form of authority to explore and manage regional resources allows the regions to determine the development program appropriate with its condition, through a clear budget structure in preparing more direct budget posts for local society. If regional finance capabilities are limited and dependent on the central government's aid, it is almost certain that substantial regional budget is spent on administration as a top priority. What should be noted in the implications of fiscal decentralization on the welfare of society is the variable of economic capacity which applies as an intervening variable. The implication of fiscal decentralization is that its implementation will not be able to directly improve the public welfare if the regional government ignores the regional economic capacity. Economic capacity can be improved by increasing economic growth. Local macroeconomic policy in this condition is oriented to growth and not merely pursues an increase in regional income.

Further implications related to growth-oriented policies in regional development are to increase investment, improve the public life quality in the fields of education and health and increase employment opportunities. Improving economic growth with investments can be done by asking for cooperation with private parties, and not necessarily done by increasing government spending. Investment effectiveness also should be reconsidered when the investment goes up but not on productive sectors, as it will give a relatively less significant impact on economic growth.

The condition of the government's financial role in improving the economic capacity of regencies located in Bali Province needs some improvement. This refers to the average ratio of regional budget to GRDP in Bali Province, which is still below 10 per cent. This ratio implies that the financial role of regional government is still relatively small, but other facts indicate that Bali's economic growth is relatively continuous; hence, it is estimated that the increase in economic growth is caused by one of them because of the high role or contribution of the private sector in economic activities. Such a condition is a potential

source for the government in getting revenue distribution via local taxes and duties, thus raising the regional budgeting. However, on the other hand, if this condition persists, it may indicate the government's non-optimal financial role in economic growth. The more aggravating impact is that it may give rise to poverty, and the public service will be left out in the regional development. Although the HDI (integrated pest management) of regencies/municipalities in Bali is significantly improved, the role of the regency/municipality government in Bali Province in the context of fiscal decentralization still shows a relatively non-optimal condition, as appears in the level of community welfare measured by HDI.

4.5 The relationship between budget governance and budget allocation

Budgetary governance in the accountability aspect can be used to address efficiency in budget allocation for financing regional development. The SILPA indicator shows the level of budget absorption in the development. Areas with high SILPA indicate non-optimally allocated budget imply ineffective budget allocation. Besides ineffectiveness of budget allocations, high SILPA may also indicate regulatory changes or regulatory inconsistencies related to the use of regional budgets. This condition will obviously result in slower development activities.

Good budget governance provides proportional attention to education and health issues as the basis for regional development to accelerate the improvement process of community welfare. The field of education and health in regional development is a fundamental need related to human resource development. In addition to governance and infrastructure (physical), budgets must also pay attention to the human resource development. Accountable management will accelerate efforts to improve quality of human resources. Empirical evidence concerning the significant relationship between budgetary governance and budget allocation in this research supports the results by [Fleisher et al. \(2009\)](#), pointing out that human capital positively affects the output of educated workers and contributes directly to production. The positive impact of education is more consistent in growth. Good budget governance also indicates the readiness and attention to public services in regions. It supports the research conducted by [Tjiptoherijanto \(2008\)](#) stating the importance to the good governance role, especially in economy (budget governance) as a central pillar to face competition in a globalized world. The delegation of authority from central to regional is aimed for not only financial affairs but also the realization of clean and good service quality.

This research has a different finding from [Jaweng's \(2011\)](#): the type and essence of regional investment problems in Indonesia, especially in 10-year decentralization, remains in the economic governance embodied in the regional government's weak role policies and business services in facilitating the economy. In fact, this research finds that public services in regencies/municipalities in Bali are relatively well proven from the effects of allocation indicators for basic needs and infrastructure, which have a positive effect on budget allocation. On the other hand, the allocation for government administration has a negative impact on budget allocations.

The findings of this research also provide description, especially in the regencies/municipalities in Bali which have materialized relatively good budget allocation for public service, and it resulted from more accountable budget governance. According to [Bahl \(2008\)](#), fiscal decentralization involves more than just fiscal problems. The election system and the civil service are undoubtedly as important as the fiscal components of fiscal decentralization. A one-step reform, including only one element of the system (e.g. only on the issue of fiscal transfers), is unlikely to lead to a change to a better direction, especially in the approach to governance. In the budget governance, in addition to aspects of good accountability, good planning is also required for its allocation. The allocation of regional budgets, especially those coming from the transfer funds, requires more authority without the inclusion of excess liabilities and requirements. What is necessary is to control the use

of funds and budget allocation, emphasized on improving public services and regional economic capacity.

4.6 The relationship between budget governance and economic capacity

The basic objective of the budget management is to improve the public service and the welfare of society. Budget management in the context of good governance is a pillar to achieve development goals both in public services and infrastructure development. Good budget management, especially in the economic field, gives impact on economic capacity building. Economic capacity covers not only economic growth but also economic development. Economic growth is defined as the changes in output values of economic goods and services over periods, whereas economic development has a broader meaning involving economic activities of production, distribution and economic structure.

The empirical facts of this research indicate a significant relationship between budget governance and economic capacity, that is good budget governance contributes to economic capacity. A further implication of this relationship is that the economic activities from regional budgets concern not only the amount of the budget managed but also the ways to manage the budget well. According to Culloch and Malesky (2010), although the role of good governance on economic capacity is relatively small, the accountability aspect as one of the pillars of good governance plays an important role in increasing the regional economic capacity. Budget management without good accountability is difficult to be held accountable for the public, thus in this case, budget management accountability is one of the necessary conditions in budget management.

4.7 The relationship between budget governance and community welfare

Good budget management directly affects the welfare of the society, given the principle of building a prosperous society that requires budget management that can be accounted for. The empirical studies of this research show different circumstances from research conducted by [Hernandez-Trillo and Jarillo-Rabling \(2008\)](#), which presents evidence of the condition in Mexico related to the effectiveness of weak transfer and low absorption capacity of the regional government, eliciting opportunistic political behavior. Such a condition will tend to ignore public services, and if this happens, it will be difficult to achieve the improvement of community welfare. High fiscal absorption of high regional government indicates that in the regional management, the regions still need funds to implement various development programs. Implementation of development programs based on good budget management has proven to increase the level of community welfare in Bali. The average assessment of the regional government's financial statement (LKPD) for regencies and municipalities in Bali receives the status qualified (WTP), showing that regencies/municipalities in Bali have conducted relatively accountable financial management.

The research found that budget governance in regencies/municipalities in Bali Province indicates the efficiency in budget management. The assessment of the regional government financial accountability performed by Bali BPK's representative indicates good condition (mostly receives qualified status). Accountable budget management can provide legal certainty to the budgetary for the development. The accountability of budget management is important to provide certainty to the private sector to invest in Bali and to give benefits to the society. The success of budget governance on improving community welfare is not found in the size of regional budget; instead, it is found in accountable budget governance. Fiscal transfers can indeed increase the source of financing for the regions, but it will not certainly increase the community welfare if the governance quality and human resources quality in the budget management are relatively low. Thus, in this case, more emphasis is put onto aspects of governance quality, not merely on fiscal matters.

4.8 The relationship between budget allocation and economic capacity

The budget allocation related to public service in this research includes the allocation of sub-national spending on basic needs areas, such as health and education, governmental administration and infrastructure allocation. Besides providing stimulus, budget allocation also provides acceleration of economic growth. On the other hand, it is also expected to give real impacts on the society needs. Society, in this case, can be individuals and entrepreneurs. As an individual, the society is in great need of health care and education. On the other hand, the society as the entrepreneur is providing facilities in the form of infrastructures and facilities to smoothen the business world.

The results of this research provide the empirical fact that budget allocation implemented by regencies/municipalities' government in Bali has a direct and significant relationship with economic capacity. The noteworthy indicator is inequality in income among regions. Not all regencies/cities in Bali have great potential in income; there are only two areas which have an income higher than the average income of other regencies in Bali, Badung Regency and Denpasar City. These two even relatively have a higher income than the average national income. Such a condition tends to increase the regional disparity in Bali. The results support the research conducted by [Sakamoto \(2006\)](#), suggesting the regional disparities between provinces in Indonesia using the distribution approach. It demonstrates a very uneven distribution of income. Regional disparities in Indonesia will be caused more by non-oil revenues.

This result also supports the research conducted by [Qiao et al. \(2008\)](#), declaring policy decentralization in China that leads to significant increase in inequalities in the geographic distribution or transfer of fiscal resources. Increasing economic capacity in fiscal decentralization is expected to give an impact on regional disparity. It is reinforced by the study conducted by [Lessmann \(2006\)](#), saying that for developing and poor countries, decentralization will probably lead to a sharper increase of disparities between regions. It resulted from high level of corruption and low capacity of regional government in managing public resources and services.

The implication of the relationship between budget allocation and economic capacity in fiscal decentralization policy is if it is not accompanied by equitable distribution of income, it tends to enlarge the disparity rate between regencies/municipalities. Regional inequality affects the greatest contribution to the economic capacity of regencies in Bali Province, indicating that equity issues are something important to consider. It is reinforced by the fact that only Badung Regency and Denpasar City have an income over regencies' income nationally. And when compared with these two Level 2 regions, other regencies in Bali seem to be lagging behind. The planning for eco-regional development in regencies/municipalities in Bali Province needs to reconsider the inequality issue, not merely to encourage economic growth alone, but rather to reduce the impacts of regional income inequality. Further review about it indeed needs to be done. At least, it is expected to distribute the industrial pockets, not to be concentrated in one particular area (Badung Regency). This concept is in accordance with the mission contained in fiscal decentralization according to Barzelay in [Sasana \(2009\)](#):

- creating efficiency and effectiveness of local resource management;
- improving the quality of public services and the community welfare; and
- empowering and creating space for the society to participate (participation in the development process).

A comprehensive policy is thereby required to reduce this regional disparity. The role of the provincial government is important in coordinating the decentralization, so that inter-regencies/municipalities have a vision and a mission that refer to the improvement of

community welfare as a whole. The synergies of development between regencies become a very significant matter in development sustainability in Bali.

4.9 The relationship between economic capacity and community welfare

The interests of the community are related to their livelihoods, which according to the United Nations Development Programme perspective, includes several components of basic needs, such as education, health and other primary needs. From his perspective, fiscal decentralization is aimed at the welfare of regional communities. From its point of view, fiscal decentralization is aimed for regional community welfare. However, the real situation can be seen in areas where people live below the poverty line. An interesting phenomenon in poverty is the declining number of rural poor people, which cannot be interpreted as an increase in the quality of people's lives; rather, the real thing happening is the poverty migration from village to urban areas owing to urbanization. For Bali Province, what occurred is not only the poverty movement from rural to urban areas; rather, there is also a movement of productive labors from the agricultural sector to the tourism sector. Nowadays, there are only very few working-age people in rural areas willing to work in the agricultural sector. In this regard, the understanding of fiscal decentralization for regional elites should be extended, not only to the delegation of local financial management authority, but also to the understanding of community welfare issues. If such a condition continues, it is feared that not only the objectives of fiscal decentralization drifting further away from the welfare but also the disparity of regional welfare will be getting bigger.

One criterion for the development of regional economic capacity is at the rate of real GRDP. Increasing GRDP indicates an increase in regional economic capacity. In fact, there is often an increase in economic capacity accompanied by higher unemployment and poverty. If this condition persists, then efforts to achieve welfare improvement will be difficult to achieve. However, in this study, the poverty indicator, calculated from the ratio of the poor, does not significantly affect the welfare of society.

This research finds an empirical fact that the economic capacity has relevance to the level of community welfare. The results do not support the research conducted by [Tadjoeddin et al. \(2001\)](#), stating that the relation between the output level in an area and the level of community welfare is very weak. The high regional wealth is not significantly followed by high welfare level of the society. Therefore, there is a failure to reflect on the region's assets in improving the welfare of society.

The implications of positive impacts of economic capacity on the community welfare indicate that in the effort of increasing the regional economic capacity, it should be focused not only on the original income of the region but also the economic growth of the region. It is because the increase in regional income tends not to encourage growth if reduced to non-productive sectors; instead, it will only increase regional disparity.

Increase in regional economic capacity is expected to provide stimulus to the private sectors for investment in regions, and become the most favorable in terms of increasing income and creating conducive dynamic effect for the local economy. The improvement of regional economic capacity does not only strengthen the dynamic effect of fiscal decentralization on community welfare improvement, but economic capacity in this research actually gives direct impacts on the improvement of community welfare.

4.10 Theoretical contribution

- Fiscal decentralization does not provide certainty in the absence of good budget management quality. The implementation of fiscal decentralization does not only cover the problems of fiscal transfers, but what is equally important is the transfer of skills, in the form of transfer of knowledge about good local budget management for areas with

relatively low human resources quality. Transfer of skills is expected to be a driver of community welfare improvement in the region. Theoretically, the transfer of skills in fiscal decentralization is expected to “bridge” the perspective of fiscal decentralization from the traditional into new perspective theories.

- The success of fiscal decentralization does not merely depend on fiscal quantity, but also depends on budget governance quality. Fiscal decentralization is a comprehensive policy. The role of good governance element is relatively small to the regional economy. However, the good governance aspect is a necessary condition for budget governance.
- The efficiency and effectiveness of budget allocation to improve public service require a clear budget structure. In the budget allocation, the improvement for regional economy that is still relatively low can be done through society’s role in the regional economic capacity. The role of society in enhancing local economic capacity reflects a new perspective theory view in implementing fiscal decentralization.

4.11 Practical contributions

- The policy that can be taken by the government in the fiscal decentralization framework is to do a combination of policies in the form of fiscal transfer, accompanied by “transfer of skills policy” to improve the management quality, especially for regions with relatively bad budget governance. Budget management also requires a clear budget structure – as without a clear budgetary structure restriction, it will likely result in ineffective budget allocation. The current budget structure does not focus on definite boundaries. Therefore, good budget governance in fiscal decentralization is not necessarily followed by a good budget structure as well.
- The combination of fiscal decentralization policy for the region must be balanced with efforts to increase revenue from its own sources, to increase spending in regional capital expenditure. Implementation of this policy is expected to reduce the dependence of regional development funding from central government assistance.

Good budget governance brings consequences in the quality improvement of regional government officials and provision of services to the public, and it is expected to give greater benefits for the public and the private sectors. A well-managed budget allocation provides the opportunity and certainty to strive for the private sector. It is hoped that the private sector can contribute more to the regions in the form of employment expansion and acts as a source for local revenue.

4.12 Limitations of research

The present research only relates the accountability aspect in evaluating the good governance effects in the budget governance which is only related to the welfare of the society. Further research should consider the involvement of other aspects of good governance. The budget allocation involved in this research only concern the allocation of four areas thought to be in direct contact with public services. Another limitation of this research is the use of research variables and indicators that are quite restricted, such as five latent variables with a total of 15 indicators. Further research is expected to be conducted with a broader range of variables and indicators.

5. Conclusions and suggestions

Based on the results, we can conclude the following:

- Fiscal decentralization does not necessarily lead to a better budget management. It is owing to the fact that the transfer of knowledge/skills has not been fully implemented in the form of skills or expertise for fiscal decentralization policy. And there is no clear definition of local budget structure. A good budget management requires good governance element as a necessary condition. Fiscal decentralization affects the budget allocation in the regions, and fiscal independence is needed to improve regional economic capacity. The fiscal decentralization does not directly improve the community welfare. It is because fiscal decentralization is comprehensive, and the fiscal's goal is to stimulate the economy for the improvement of regional economic capacity. Therefore, it is expected to achieve the improvement of community welfare.
- The success of fiscal decentralization is not merely found in the regional budget quality, but also in the quality of budget management. Good budget management quality will increase the budget allocation, especially for services to the public. Good budget management is a basic rule in an effort of increasing regional economic capacity because good local budget management will dismiss the doubts of the business world (investors). Accountable budget management can also avoid poor budget practices in the improvement of community welfare. Improvement of management quality of local budgets thereby will encourage the improvement of community welfare.
- The allocation of regional budget for public service improvement and the development of infrastructure will increase the economic capacity of the regions. Efforts to further increase regional economic capacity can also be done by more effectively allocating budget for administrative expenditures.
- Improvement in regional economic capacity encourages the improvement of community welfare. Increased economic capacity can be realized by increasing local capital expenditures and private sector roles, especially private/local communities in the regional economy – as the role of the private sector is clearly capable of boosting regional economic growth.

Here are the recommendations for local governments. The study finds that fiscal decentralization affects budget allocation, economic capacity and community welfare. Thus, the local government of Bali must consider combining the fiscal decentralization with efforts to increase accountability of budget management. The local government should not only focus on increasing PAD alone; it must also focus on increasing regional economic capacity through economic growth, as increasing the achievement of PAD alone has no direct contribution to efforts to improve the welfare of the community. The local government at the city/regency level needs to intensify coordination in the implementation of regional development with the provincial and interregional governments; this is necessary given the differences in the regional economic potential. The local government of Bali is expected to improve and maintain the accountability level of their budget management to provide adequate public services and to maintain the confidence of investors in the region.

Notes

1. Locally generated revenue.
2. Natural Resources Sharing Fund.
3. General Allocation of Funds.
4. Special Allocation of Funds.

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