THE IMPACT OF GOVERNMENT OVERSIGHT ON CORRUPTION IN PROCUREMENT ACTIVITIES OF LOCAL GOVERNMENTS IN INDONESIA

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Abstract—This study examines the impact of supervision on corruption in procurement activities of local governments in Indonesia. Procurement in this study is classified into two activities based on the type of expenditure: (1) capital expenditures and (2) operating expenditures. Thus, this study will also identify which types of expenditures are more involved in corruption. This study also examines the moderation effect of government oversight on the association between procurement and corruption. Using panel data analysis for all provinces in Indonesia from 2010 to 2013, we find that capital expenditures has a positive association with corruption cases, while operating expenditures have an impact on local government financial losses. This paper, however, does not qualify the impact of government oversight on the association between procurement and corruption.

Keywords—Local government procurement, capital expenditures, operating expenditures, government oversight, corruption

I. INTRODUCTION

Corruption in competitive public contracts is an issue in both developed and developing countries. The number of parties involved in the procurement of goods and services creates a ‘space’ of discretion to violate established procedures [1]. This discretion can be abused by suppliers and purchasers and corruption can have dire consequences and high costs [2, 3]. These consequences will be more serious in countries with low government accountability [1].

High value of public contracts makes the process of procurement in this area a prime situation for corruption [4-6]. The magnitude and volume of procurement activities cause bureaucracy, ambiguity in the market value of goods purchased, political discretion gaps in administration, and independence issues between political entities and business. This condition makes government procurement one of the centers of corruption activities [7-9].

The preventive efforts to corruption in the process of procurement have been done by several international institutions, such as the World Bank, have encouraged the development of corruption legislation in developing countries as preventive efforts against procurement corruption. Many countries have adopted new rules of procurement in accordance with international standards, such as public administration reforms, laws relating to conflicts of interest and so on. In the current environment, to fight corruption by relying only on the rule of law will be difficult [1]. In addition, the anti-corruption community has developed various mechanisms of commitment in an effort to limit corruption related to competitive procedures. Even the United Nations Convention Against Corruption has asked private companies to adopt standards of transparency to deter bribery.

A competitive procurement process is sometimes controlled by a party that is susceptible to bribery. Corruption is modeled as an auction game in which companies compete to bribe procurement managers to gain an advantage in the selection process. Bribery allows companies with worse qualifications to win the competition [1]. The Controller and Auditor-General of India has stated that malpractice in the bidding process and government tenders causes millions of dollars of losses in that relatively poor country. This is due to collusion between management and politicians. Corruption in the procurement process could occur regardless of the country’s condition; in developed countries, developing countries, and poor countries.

One of the detrimental effects of corruption is that it can hamper the State growth, development and public welfare. Corruption also impacts a community its distribution of wealth and it can distort the market [10, 11]. Corruption negatively impacts investments that will then hinder economic growth and employment. Mauro [3] found that corruption has a direct impact on investments and therefore, will hamper growth and development. This finding is consistent with Brunetti and Wedder [12]; Lambsdorff and Cornelius [13]; and Doh and Teegen [14]. Meanwhile, Lambsdorff [15] states that corruption affects capital inflows and investments.

The damaging impact of corruption requires continuous efforts to prevent it, so that citizens—as the ultimate principals of the State—would have their rights protected. In government procurement, the emphasis is on the role of internal controls and monitoring practices [5, 16]. Tasks division, rules of procurement, activity guides, ethical guidelines and trainings are some of the efforts to curb
corruption [6, 17]. In addition, the role of internal and external auditors is required as a control function [18-20]. These various elements are used to combat corruption [21].

Control can be interpreted as making decisions, defining limits or delegating authority. Meanwhile, governance has different meanings. Its rise to prominence stems from the difficulty in coordination between the business sector and the government [22]. Regarding governance in the public sector, OECD [23] defines public governance as the formal and informal settings that determine how public decisions are made and how public actions are overcome, from the perspective of maintaining the value of a country’s constitution.

Another effort to reduce the negative impact of procurement activities is to improve the ethical standards and integrity among personnel involved in procurement. For example, weak governance causes a very large project in Boston known as the Big Dig Project to experience soaring costs [24]. This is a proof that good governance of procurement activities is crucial even in developed countries.

This study is important for several reasons: First, (1) The community is a very important stakeholder in the public sector [25]. The supply of goods and services should be representing the government’s commitment to provide public facilities. If there is an element of corruption in the process of procurement, however, it indicates that the provision of goods and services aimed at the prosperity of the community is in fact brings losses to the State, meaning that the interests of the public agent and common people as the ultimate principals of the State are not aligned. (2) Second, procurement in public institutions can be a significant proportion of a of a country’s GDP. This volume increases corruption risk [4-6], (3) Third, procurement is a prominent area for corruption. The largest corruption cases handled by the Corruption Eradication Commission of Indonesia (KPK) was were a case of corruption in procurement [26]. In some cases, the losses from caused by corruption reach 40% to 50% of a contract’s value [27]. In Indonesia, 70% of corruption cases comes from procurement [28]. Fourth, there is a need to maximize intensify efforts to minimize limit the scope of corruption in procurement because there are still many cases of corruption keep happening in procurement. (5) Fifth, there is still very limited empirical research on corruption in procurement activities and efforts to reduce negative impact of procurement activities, especially in Indonesia. (6) Sixth, besides maximizing public services, procurement control is needed to protect the State's finances.

This study contributes to the literature in two ways, First, this study provides empirical evidence on the impact of procurement on corruption in Indonesia using quantitative methods, unlike previous research that used descriptive, experimental or case study methods. Second, in terms of variables measurement, this study introduces a new measurement that uses Capital expenditures and Operating expenditures for the procurement variable, also, the amount of local government financial losses as a proxy for potential-corruption variables.

This study did not use the Corruption Perception Index (CPI) to measure corruption because the CPI uses a variety of indicators that are beyond the issue of procurement. Therefore, the CPI does not isolate corruption in procurement activities. Moreover, there is criticism that CPI is subjective since it only measures perception, hence, it does not measure the real amount of corruption itself.

This study uses panel data analysis with a sample of provincial governments in Indonesia from 2010 to 2013. The results show that both capital expenditures and operating expenditures have an effect on corruption in local governments of Indonesia, although the results are highly dependent on the measurement of corruption that is applied. However, this research does not find the moderating role of supervisory functions to overcome corruption. Presumably, this is due to the weaknesses of internal-control measurement of this study.

II. LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

A. Procurement and Corruption

Procurement is one of business management function that includes the identification, sourcing, access and management of external resources needed by an organization to achieve organizational goals [29]. Goods and services must be procured in accordance with the company’s needs and purchased at the best cost, in terms of quality, quantity, time and location [30]. The procurement process must be transparent, effective and efficient [31].

Procurement is ‘fertile ground’ for corruption, both in terms of the abuse of power or the use of authority for personal gain [32]. It has a series of characteristics and unique participants can be ripe for corruption [33]. Procurement uses public funds derived from taxes [9] and is embedded in the political sphere where there is a symbiotic relationship between bureaucrats, businessmen, politicians and political parties [9, 34]. Procurement activity is expected to be profitable, so that businesses are willing to buy government influence in order to obtain favorable attention in procurement activity [33].

This interdependent relationship can begin when a business person supports a politician’s campaign [35-36]. The bureaucrat is compelled to repay the previous campaign and to raise funds for the next campaign program [37]. This drives bureaucrats to sell their influence in order to maintain their political career. Corruption in procurement also lead to the buying and selling of illegitimate government influence for personal gain [38-40]. In addition, the process of market mechanism would be difficult the corruption environment. A business partner has the opportunity to change the cost and quality of materials used [5, 8], making procurement activities prone to corruption. As has been mentioned, one of the biggest corruption cases handled by the KPK was in procurement [26], and procurement cases contribute to 70% of all cases of corruption in Indonesia [28]. In addition, losses due in government procurement can be around 10% to 25% of the contract value in normal cases and even 40% to 50% in particular cases [27].

The amount of procurement in public institutions occupies about 15% to 30% of a country’s GDP. Public projects high stakes lead to increased opportunities for corruption risk [4-6]. The relatively large nominal value of budgets and the power to use the budget make the capital expenditures has great potential for misuse. This proposition is in line with Salama [41], who states that the distribution of
financial resources to a region raises the opportunity to abuse it for personal gain. This argument is also supported by OECD [42] which states that the abuse of expenditures, especially in procurement is the greatest source of corruption in local government. This condition implies that the greater the procurement activities, the higher the corruption in local government. Thus, the first hypothesis is:

H1: Procurement has a positive association with corruption

B. Government Oversight and Corruption

Previous research found that corruption is always associated with the abuse of power, weak laws and inadequate supervision [43-44]. The public finance sector is especially prone to corruption, due to the power of this sector in terms of taxation, budgeting, procurement and management of state assets [45]. Therefore, the audit board is an important institution in modern governance; it has a fundamental objective to conduct surveillance, provide adequate confidence, and assess the accountability of a government [45]. Governance practices in various countries indicates that government auditing has a role in detecting fraud in financial statements, by making investigation of corruption effective and directly publishing the results of the audit [44, 46].

Liu and Lin [45] found that audit institutions could detect and report violations and irregularities in government revenue and spending. Violations and irregularities are positively associated with bureaucratic corruption. This argument is in line with the classical audit theory that defines audit quality as the auditor’s ability to discover and report violations of the accounting system of an entity [47]. Zhao [48] divides government audit quality into three characteristics: (i) technical factors (professional competence, auditor size, and audit hour); (ii) independence factors (audit fees, auditor reputation, organizational design of the audit institution; and (iii) administrative factors (finding misstatements and making recommendations and inspection for follow-up). Researchers on audit quality generally focus only one of these three characteristics. For example, time spent on the audit is used as a proxy for audit quality by Saito and Mcintosh [49], while Ma [50] used the educational background, experience and competence of the auditor. This study uses administrative factors: namely finding misstatements, making recommendations and inspecting follow-up examination results.

Olken [51] conducted a field experiment in Indonesia related to the impact of government oversight on corruption reduction and concluded that government auditing can reduce over-spending. In addition, internal controls and auditing activity are seen as a way to avoid corruption, in procurement practices [52]. Ferraz and Finan [53] found that the government audit reports can reveal corruption activities. This indicates that better quality government audits are expected to further reduce corruption. Thus, the second hypothesis proposed is:

H2: Government oversight weakens the positive relationship between procurement and corruption.

C. Capital Expenditures and Operating Expenditures.

Procurement in the Indonesian government is derived from two expenditures accounts: spending on goods and services for operating purposes and for capital purposes. These expenditures have the characteristics described in the following sections.

1) Operating Expenditure

Goods and services are purchased to produce marketed or not marketed products. This type of purchase can be classified into three categories [54]:

a) Procurement Expenditures

Procurement expenditures in the financial statements are categorized into operational goods expenditures and non-operating goods expenditures. Consultant fees are not in the services expenditures category.

b) Maintenance Expenditures

Expenditures incurred that do not extend the useful life and/or potentially bring future economic benefits in the form of capacity, quality of production or improvement of performance standards are categorized as maintenance expenditures in the financial statements.

c) Travel Expenditures

Travel Expenditures that are incurred not for the purpose of asset acquisition, plant and equipment are categorized as travel expenses in the financial statements.

2) Capital Expenditures

Capital expenditures are used for fixed assets and inventory that give benefit in more than one accounting period, including expenditures for maintenance to extend useful life, improve capacity and improve the quality of assets. Capital expenditure can be categorized into five main categories:

a) Land Expenditures

Land expenditures are used for procurement, exemption of settlement, ownership replacement and land leases; the emptying, sorting, smoothing, or maturation of land; and making of certificates and other expenses related to the acquisition of land rights.

Equipment and Machinery Expenditures

Equipment and Machinery Expenditures are expenditures used to procure/ replenish/replace, and upgrades of equipment and machinery and office inventories that provide more than 12 months of benefits and until such equipment and machinery are ready to use.

b) Building Expenditures

Building Expenditures are expenditures to procure, replenish or replace buildings and include expenditures for planning, supervision and building management and building construction that extends capacity until buildings are ready to use.

b) Road, Irrigation and Network Expenditures

Road, irrigation and network expenditures are expenditures used for procurement, addition, substitution, enhancement of development, manufacture or maintenance of roads, irrigations and networks. It include expenditures for planning, supervision and management of irrigation roads and networks that add capacity to current projects.

d) Other Fixed Assets Purchases
Other fixed asset expenditures are expenditures and expenses incurred for the procurement, addition/replacement, development, improvement, maintenance and other physical maintenance that cannot be categorized under capital expenditures’ criteria of land, equipment and machinery, buildings, and irrigation roads and networks. Included in this expenditure are capital expenditures of lease purchase contracts, purchase of art goods, antiquities and articles for museums, farm animals and plants, books, and scientific journals.

A capital expenditure is a request from local government in order to perform services to the community. Capital expenditures for local governments are long-term commitments that require analysis in a long-term perspective and should provide long-term benefits [55].

Capital expenditures represent expenditures made by a government in order to acquire fixed assets and other assets that provide benefits over more than one accounting period and exceed the minimum limit of the capitalization of fixed assets or other assets stipulated by the government. The asset is used for the daily operations of a unit work and is not for sale (PMK 91/PMK.06/2007). Meanwhile, according to Perdirjen Treasury Number PER-33 / PB / 2008, capital expenditure are used for capital formation and add fixed assets or other assets that provide benefits for more than one accounting period, including the expenses of maintenance that maintain or extend the useful life of a capital expense, increase the capacity and quality of assets.

One of the primary functions of a local government is to carry out development and sustain the development in a territory [55]. In the public sector, allocation of resources is a major problem in budgeting [56-57]. One such resource issue is related to resource constraints. The budgeting process and decision making is dynamic because governments have limited resources to spend. Spending becomes even more complex as more parties get involved in the budgeting process [58]. People who prioritize their personal interests or groups that disrupt the budgeting process will ultimately affect government activities. Nonetheless, the limited resources in the public sector can be addressed by the concept of public expenditure management [57]. This concept challenges the public sector to implement appropriate public expenditure management.

Large capital expenditures reflect the quality and quantity of the infrastructure built by local governments. A higher the level of capital investment in a region is expected to maximize the quality of public services because the fixed assets acquired through capital expenditure are part of the public services provided by local governments. Increased infrastructure development, especially in industry, has a significant impact on increasing revenue [59]. Infrastructure provides a sense of comfort to a community. Therefore, the quality of public services increases public participation in regional development [60].

In addition, capital expenditure improve the investment climate in an area and leads to regional economic growth. It also encourages local independence [61]. Therefore, an increase in capital expenditures implies that local governments have a strong commitment to improve the welfare of their citizens.

D. Corruption

Corruption is defined as an exploitation of public positions, resources and power for personal gain [62-63]. Corruption involved retaining power and increasing personal wealth in an illegal manner involving public spending and abuse of power. Meanwhile, Fjelstad and Isaken [64] and Ogundiya [65] define corruption as a betrayal of public trust for personal gain or groups. Corruption tends to distort the structure of public expenditure with increased spending on construction projects and lower expenditure on things like science, education, culture and health program [66-67].

In an academic context, “corruption” is discussed by various disciplines; therefore, the definition of corruption becomes very diverse and is applied in very complex contexts [68]. Bowles [69] classifies various definitions of corruption into a notion of corruption in a narrow and in a broad sense. Narrowly, Shleifer and Vishny [70] define corruption as the sale of government asset by public officials for personal purposes. Bouchaert [71] argues that corruption as a behavior—both legal and illegal that harms the state [68]. Among the two definitions, Bowles [69] views corruption as a deviant practice that harms a country that can involve bureaucrats and parties outside the bureaucracy.

There are several ways to measure the level of corruption in a country. First, the CPI, released by Transparency International is an aggregate of various surveys by independent agencies regarding the perception of corruption among government officials and politicians. Second, the Worldwide Governance Index-Control of Corruption issued by the World Bank measures six major components of governance: voice accountability, government effectiveness, political stability and absence of violence, rule of law, regulatory quality, and control of corruption. Third, the Bribe Payers Index also released by Transparency International measures the level of corruption of business people in a particular country. Fourth, the Global Integrity Index measures the existence, effectiveness and public access to anti-corruption mechanisms at the country level. Finally, the Political and Economic Risk Consultancy measures the perception of expatriates about corruption in various countries in Asia. State/Regional Loss.

According to Article 15, paragraph 1, of Law No. 15 of 2006 concerning the State Audit Board, the meaning of “State/Regional Losses” is “lack of money, securities and goods that are real and possess particular amount as a result of unlawful acts either intentionally or negligently.” This definition is exactly the same as Article 1, paragraph 22 of Law No. 1 of the Year 2004 concerning State Treasury. The explanation of Article 32 Paragraph (1) of Law No. 31 of 1999 concerning the Eradication of Corruption makes it clear that the meaning of “there is a real loss of state finances” is the amount of losses that can already be calculated based on the findings of the authorized institution or designated public accountant.
III. RESEARCH METHOD

A. Data and Sample

The data used are the Audit Report of the State Audit Board of the Republic of Indonesia between 2012 and 2013, for all provinces of Indonesia. The data of public complaints about corruption are sourced from the Central Bureau of Statistics.

B. Research Model

This research controls the effect of size (i.e., TB and TA) and also financial condition of the Local Government (i.e., LOR and LRD). Due to the multi-collinearity problem among TB and TA, also between LOR and LRD, the Model is split into two as follows:

\[ \text{COR}_i = \beta_0 + \beta_1 \text{CE}_i + \beta_2 \text{OE}_i + \beta_3 \text{CIIL}_i + \beta_4 \text{TCWSPI}_i + \beta_5 \text{CE}_i \times \text{CIIL}_i + \beta_6 \text{CE}_i \times \text{TCWSPI}_i + \beta_7 \text{OE}_i \times \text{CIIL}_i + \beta_8 \text{OE}_i \times \text{TCWSPI}_i + \beta_9 \text{TA}_i + \beta_{10} \text{LOR}_i + e \]  

\[ \text{COR}_i = \beta_0 + \beta_1 \text{CE}_i + \beta_2 \text{OE}_i + \beta_3 \text{CIIL}_i + \beta_4 \text{TCWSPI}_i + \beta_5 \text{CE}_i \times \text{CIIL}_i + \beta_6 \text{CE}_i \times \text{TCWSPI}_i + \beta_7 \text{OE}_i \times \text{CIIL}_i + \beta_8 \text{OE}_i \times \text{TCWSPI}_i + \beta_9 \text{TB}_i + \beta_{10} \text{LRD}_i + e \]

Where:
- Dependent Variables:
  - COR: Corruption
- Independent Variables:
  - CE: Capital Expenditure
  - OE: Operating Expenditure
- Moderating Variables:
  - CIIL: Cases of Ineffectiveness of the Implementation of Legislation
  - TCWSPI: Total Cases of Weakness of SPI

Control Variable:
- TB: Total Budget
- TA: Total Assets
- LRD: Level of Regional Dependency
- LOR: Local Original Revenue

C. Operationalization of Variables

1) Corruption (COR)

This study proposes a measurement of corruption that uses data on the number of special criminal cases of the Supreme Court for the main model and the local government financial losses as the audit findings of Supreme Audit Institution of the current year as a new measure of potential for corruption. This measure is used to describe the real loss of local government, besides due to some criticisms of CPI that is based on subjective perceptions.

2) Procurement (CE and OE)

Procurement in Indonesia is executed through the components of operating expenditures and capital expenditure. Capital expenditures are measured by the ratio of capital expenditures to total budget expenditures, while operating expenditures is measured by the ratio of goods and services expenditures for operating purposes to the total budget.

3) Government Oversight (CIIL and TCWSPI)

Government oversight is measured by its weaknesses and effectiveness. The ineffectiveness (CIIL) is measured by the number of regulatory incompliance cases identified during the current year audit by Indonesian Supreme Audit Board (BPK). While the oversight weaknesses (TCWSPI) are calculated by the number of cases of internal control system weakness found in BPK’s audit findings during the current year. This measurement is used with the assumption that a higher the number of cases indicates weaker internal controls in local government. The number of cases has no nominal value, so it is not related to the state or regional loss assessment value.

4) Local Original Revenue (LOR)

Several previous studies have found that capital expenditures are influenced by the local original revenue [72] therefore, local original revenue is the control variable in this study. Local original revenue is measured by the ratio of local original regional revenue to total revenue in the current year.

5) Level of Regional Dependency (LRD)

The level of regional dependence is a control variable measured by the ratio of Amount of Transfer Funds to Total Income [73].

6) Total Budget and Total Asset (TB and TA)

The amount of Total Budget and Total Asset for the Current year in billion Rupiah, transformed into Ln for the purpose of empirical test in the Model.

D. Sensitivity Analysis

Sensitivity analysis will be carried out, where the Data of corruption cases from the Supreme Court is replaced by the amount of local government financial losses

IV. RESULT AND DISCUSSION

A. Statistic Descriptive

Table I shows that the average of capital expenditures in each province is 17 percent of the total budget. Most of local government have 16 percent. This ratio is quite large, but there are even provinces with capital expenditure realization for 34 percent, more than a third of the total budget. In all cases, the value of capital expenditure is relatively large. While capital expenditure items are expensive, in some provinces, operational expenditures can be half of the total local budget. This indicates that the government and oversight body must give extra attention to the portion of this expenditure

For the size of local assets, there is no balance among provinces. There is huge difference between the maximum and minimum values of regional assets. Likewise, local revenues, which are sometimes used as a measure of the size of a region, have significant differences.
B. Regression Result

The results of the regression models, as shown in Table II indicate that CE has a positive effect on corruption in procurement. These results support the hypothesis that the higher the flow of funds in a procurement, the higher the likelihood of corruption [4-6]. Meanwhile, the OE is statistically insignificant which means that it does not associated with Corruption. Most likely, this is due to contrast nature of OE compared to CE, such as: OE covers only one year to spend, while CE usually covers multi years period. Therefore, although OE represent a large portion of the Total Budget, it is relatively less complex, hence easier to monitor and control. For that reason, OE is insignificantly associated with Corruption. As for control variable, both Total asset and Local Original Revenue has positive impact on corruption. This result confirms [74-75] that the larger the size of local government, the greater the opportunity perform political rent seeking behavior.

Both the total case of ineffectiveness of the implementation of legislation and the total case of internal control weaknesses have positive effect on the case of corruption. It confirms previous study that corruption is always associated with the abuse of power, weak laws and inadequate supervision [43-44].

The weaknesses of internal control and ineffectiveness of legislation implementation weakened the positive effect of OE and CE on corruption. It supports previous study that corruption is always associated with inadequate supervisions [43-44]

C. Sensitivity Test

Table III shows different results compared to the main test. This test shows that Capital Expenditure has a negative effect on local government financial losses. This indicates that local governments use capital budgets to improve their performance to signal to the public that the local government actually works to serve the community. Accordingly, the case of corruption does not always reflect the amount of financial loss. Meanwhile, the internal control only works in operating expenses, which is consistent with the main test.

Note: *** = p value ≤1%; ** = p value ≤5%; * = p value ≤10%

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<th>Actual Sign</th>
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<th>Prob</th>
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TABLE III. SENSITIVITY ANALYSIS REGRESSION RESULT (DEPENDENT VAR: FINANCIAL LOSS)

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</table>

V. CONCLUSION AND IMPLICATION

This study provides empirical evidence that Capital Expenditures have a positive association with corruption when corruption is measured by the number of corruption case of the Supreme Court. On the other hand, the opposite result was found in the Operating Expenditures. This might be due to its nature which are having clearer rules, shorter term period coverage and relatively less complex compared to Capital Expenditures. With regards to the moderating effect of oversight function, the condition of internal control and effectiveness of legislative implementation are suggested to weaken the association between Procurement Expenditures and Corruption.

The expected implications from this research is that the government, most particularly the oversight function, should provide more attention to the activities associated with Capital Expenditures compared to Operating Expenditure activities, even though their amount is far larger than Capital Expenditure. In addition, when the proportion of such expenditure are relatively large compared to the total budget, the mechanism of procurement may provide opportunities for corruption. Moreover, the audit institution should implement alternative inspection program more broadly on procurement activities, particularly for components of Capital Expenditures and Operating Expenditure.

VI. RESEARCH LIMITATIONS

This study uses one-year provincial government as a sample, which was very limited. Accordingly, the use of district and municipal governments as samples may show better results, because in addition to large sample quantities and high data variations, district and municipal governments would also better capture the oversight function as a consequence of the national policy of local government autonomy and decentralization. In addition, the measurement of internal control variables in this study still uses general surveillance measures. Suggested further research should use measurements of specific controls for the procurement of goods and services.

REFERENCES


[38] Transparency International, 2004

[39] Worldbank, 2005


