


**INTERNAL CONTROL WEAKNESS AND CORRUPTION: EMPIRICAL EVIDENCE FROM
INDONESIAN LOCAL GOVERNMENTS**

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ARTICLE INFO	ABSTRACT
<p>Article history:</p> <p>Received 20 February 2023</p> <p>Accepted 26 May 2023</p>	<p>Purpose: Corruption still becomes a serious problem in Indonesia in the decentralization era. This paper aims at providing a comprehensive empirical examination regarding the effect of internal control system weaknesses on corruption in Indonesian local governments (LGs).</p>
<p>Keywords:</p> <p>Indonesia; Local Government; Corruption; Internal Control System Weakness.</p>	<p>Theoretical framework: By drawing the concept from the fraud theories and agency theory, the study explores the internal control weaknesses as corruption determinants in LGs.</p>
	<p>Design/methodology/approach: We use secondary data from the related regulating bodies in Indonesia during 2010-2018 fiscal period from 508 LGs with total of 4530 observations, analyzed with panel data regression.</p> <p>Findings: Our findings suggest that the corruption in Indonesian LGs has not experienced significant decrease during the observation period. The internal control system implementation also still has significant weaknesses that has not improved from 2010-2018. Our analysis demonstrates that internal control weakness positively affects corruption. Further analysis also reveals that all internal control weakness element also has positive effect on corruption, both the weaknesses in the budget, revenue, and expenditure administration, the weaknesses in accounting and financial reporting, and the structure weaknesses.</p> <p>Research, Practical & Social implications: Based on the research findings, our study emphasizes that the internal control system implementation in Indonesian LGs needs urgent improvement to support the prevention of corruption in local level. The policymakers are required to take strategic efforts for internal control system reform in the LGs to reduce the likelihood of corruption by irresponsible local authorities.</p> <p>Originality/value: The study fills the limitation in Indonesian corruption literature by providing one of the earliest empirical investigation that comprehensive covers the whole Indonesian regions.</p> <p>Doi: https://doi.org/10.26668/businessreview/2023.v8i6.1278</p>

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FRAQUEZA DO CONTROLE INTERNO E CORRUPÇÃO: EVIDÊNCIAS EMPÍRICAS DOS GOVERNOS LOCAIS DA INDONÉSIA

RESUMO

Objetivo: A corrupção ainda se torna um problema sério na Indonésia na era da descentralização. Este artigo visa fornecer um exame empírico abrangente sobre o efeito das deficiências do sistema de controle interno sobre a corrupção nos governos locais indonésios (GLs).

Referencial teórico: Ao extrair o conceito das teorias da fraude e da teoria da agência, o estudo explora as fraquezas do controle interno como determinantes da corrupção nos LGs.

Desenho/metodologia/abordagem: Usamos dados secundários dos órgãos reguladores relacionados na Indonésia durante o período fiscal de 2010-2018 de 508 GLs com um total de 4.530 observações, analisados com regressão de dados em painel.

Resultados: Nossas descobertas sugerem que a corrupção nos GLs indonésios não experimentou diminuição significativa durante o período de observação. A implementação do sistema de controle interno também ainda apresenta deficiências significativas que não melhoraram em relação a 2010-2018. Nossa análise demonstra que a fragilidade dos controles internos afeta positivamente a corrupção. Uma análise mais aprofundada também revela que todo elemento de fraqueza do controle interno também tem efeito positivo sobre a corrupção, tanto as fraquezas no orçamento, receitas e administração de despesas, as fraquezas na contabilidade e relatórios financeiros, quanto as fraquezas da estrutura.

Pesquisa, implicações práticas e sociais: Com base nos resultados da pesquisa, nosso estudo enfatiza que a implementação do sistema de controle interno nos GLs da Indonésia precisa de melhorias urgentes para apoiar a prevenção da corrupção no nível local. Os formuladores de políticas são obrigados a realizar esforços estratégicos para a reforma do sistema de controle interno nos GLs para reduzir a probabilidade de corrupção por parte de autoridades locais irresponsáveis.

Originalidade/valor: O estudo preenche a limitação na literatura de corrupção da Indonésia, fornecendo uma das primeiras investigações empíricas que cobrem todas as regiões da Indonésia.

Palavras-chave: Indonésia, Governo local, Corrupção, Fraqueza do Sistema de Controle Interno.

DEBILIDAD DEL CONTROL INTERNO Y CORRUPCIÓN: EVIDENCIA EMPÍRICA DE LOS GOBIERNOS LOCALES DE INDONESIA

RESUMEN

Propósito: La corrupción sigue siendo un problema grave en Indonesia en la era de la descentralización. Este documento tiene como objetivo proporcionar un examen empírico integral sobre el efecto de las debilidades del sistema de control interno sobre la corrupción en los gobiernos locales (LG) de Indonesia.

Marco teórico: Tomando el concepto de las teorías del fraude y la teoría de la agencia, el estudio explora las debilidades de control interno como determinantes de la corrupción en los GL.

Diseño/metodología/enfoque: Utilizamos datos secundarios de los organismos reguladores relacionados en Indonesia durante el período fiscal 2010-2018 de 508 LG con un total de 4530 observaciones, analizados con regresión de datos de panel.

Hallazgos: Nuestros hallazgos sugieren que la corrupción en los GL de Indonesia no ha experimentado una disminución significativa durante el período de observación. La implementación del sistema de control interno también tiene debilidades significativas que no han mejorado desde 2010-2018. Nuestro análisis demuestra que la debilidad del control interno afecta positivamente a la corrupción. Un análisis más detallado también revela que todo elemento de debilidad del control interno también tiene un efecto positivo sobre la corrupción, tanto las debilidades en la administración del presupuesto, los ingresos y los gastos, las debilidades en la contabilidad y los informes financieros, como las debilidades estructurales.

Implicaciones de investigación, prácticas y sociales: en base a los hallazgos de la investigación, nuestro estudio enfatiza que la implementación del sistema de control interno en los GL de Indonesia necesita una mejora urgente para apoyar la prevención de la corrupción a nivel local. Los formuladores de políticas deben realizar esfuerzos estratégicos para la reforma del sistema de control interno en los GL para reducir la probabilidad de corrupción por parte de autoridades locales irresponsables.

Originalidad/valor: el estudio llena la limitación en la literatura de corrupción de Indonesia al proporcionar una de las primeras investigaciones empíricas que cubre de manera integral todas las regiones de Indonesia.

Palabras clave: Indonesia, Gobierno Local, Corrupción, Debilidad del Sistema de Control Interno.

INTRODUCTION

The 1998 reform has brought massive changes in Indonesian government as it ended President Suharto's New Order regime that was highly criticized for its iron-fist leadership and rampant corruption (Harun et al., 2019). Corruption is indeed one of the biggest issues in the New Order era as the public believes that the regime is full of corrupt people who would use public fund massively for their own interest (Henderson & Kuncoro, 2004; King, 2000). As a result of the 1998 reform, the country switches from the centralized government to decentralized government by implementing the regional autonomy (Harun et al., 2019; Holzacker et al., 2016). One of the purposes is for tackling corruption issue that becomes one of the main priorities (Umam et al., 2020), considering that corruption is a dangerous global phenomenon that has brought down many countries (Al-Rubaye, 2022). It is believed that regional autonomy will increase public accountability and reduce corruption as the local public can have better monitoring on the LGs.

Two decades have now passed since the 1998 reform. In fact, however, corruption is still becoming a serious issue in Indonesian government until now (Mietzner, 2015; Pertiwi & Ainsworth, 2020). ACFE documented that the corruption has brought massive loss to the government (ACFE Indonesia, 2020). Prabowo (2014) mentions that the number of financial losses burdened by the Indonesian government caused by corruption is very substantial. In line with that, Indonesia is also ranked 96 out of 180 by the Transparency International in 2021 with considerably slow improvement for the past decade in which the score is still only at 38 points. Thus, Indonesia is still sitting in the category of countries with high corruption level (Pradiptyo et al., 2016). For worse, the LGs dominate the corruption by having many serious cases by local public leaders. Corruption in LGs also dominates in public press with a lot of news spreading through media. There are many LG heads that were arrested by the Commission for Corruption eradication (KPK) as they were proven to be corrupt in managing local financial resources. This fact is undeniably disappointing and is not in line with the goals of regional autonomy and surely impede the local development and public welfare (Lewis, 2017).

From the regulation point of view, the central government has already established a foundation for fighting against corruption post 1998 reformation, especially during the first five years (Schütte, 2016). Several more regulations also followed for strengthening the good governance practice and policies such as the continuous development of government accounting standards and government internal control system (Harun et al., 2019). It is expected that the implementation of good governance can support the realization of public accountability,

one of which is by having clean government without corruption (Rubasundram & Rasiah, 2019). However, the fact that the corruption in Indonesia is still high prove that the fight against corruption in Indonesia has not been effective (Gong et al., 2016), especially in LGs with numerous corruption cases. This underlies the need for further empirical studies in corruption issue especially in the LGs. The existence of further studies will not only enrich the literature but also provide recommendations for fighting against corruption in Indonesia.

Corruption can be viewed from fraud theories that have developed from the fraud triangle theory (Cressey, 1953) to fraud diamond (Wolfe & Hermanson, 2004) and further to fraud pentagon theory. Within the framework of these fraud theories, the opportunity becomes the most significant element and is always mentioned. In dealing with the opportunity, an organization normally implements an internal control system (Abdullahi & Mansor, 2018; Zimbelman et al., 2014) that becomes the main determinant investigated in this research. Indonesian government has started the development of the government internal control system since 2008 from the central to local government level (Winarna et al., 2021). However, the implementation of internal control system still has a lot of weaknesses (Harun et al., 2019). Nevertheless, there is limited studies investigating the impact of internal control weaknesses on corruption, especially in Indonesia. The existing study in the literature lacks empirical evidence such as the studies by Sundari & Retnowati (2021). Also, the studies in Indonesia still have a lot of limitations that cause low generalizability of research findings particularly due to the low observation coverage (Purnomo, 2017); (Eriyana, 2019); (Shohihah, Djamhuri, & Purwanti, 2018)). Therefore, this study contributes significantly to the development of the literature by providing a comprehensive empirical examination of internal control weakness and corruption that covers all Indonesian LGs for the past decade. The study also contributes to the regulating bodies in Indonesian government by providing practical recommendations in optimizing the internal control system for fighting against corruption. The remainder of the paper is presented as follows: literature review and hypothesis development, research method, results and discussion, and conclusion.

LITERATURE REVIEW

Corruption in Indonesian LGs

Corruption in LGs is a serious problem that requires strong action (Schütte, 2016) and it still happens in many countries (Masters & Graycar, 2016). In large scale, corruption brings negative consequences on economic development (Rose-Ackerman, 2016) and surely harms

public welfare as it degrades government's capacity in managing the resources (Lee & Liu, 2022) (Lee & Liu, 2021). Indonesia's local autonomy that allows LGs to manage their own resources often end up in corruption cases as the resources intended for public spending is corrupted (Valsecchi, 2013). There are still many irresponsible local officials that manipulate the state funds and use it for their own advantages and personal benefits (Yates & Graycar, 2020). Therefore, the management of public funds by the government often failed to meet the target in improving public welfare and local development agenda (Wardhani et al., 2017). Corruption can be viewed from fraud theories that have developed from the fraud triangle theory (Cressey, 1953) to fraud diamond (Wolfe & Hermanson, 2004) and further to fraud pentagon theory. Within the framework of these fraud theories, the opportunity becomes the most significant element and is always mentioned (Montesdeoca et al., 2019). In dealing with the opportunity, an organization normally implements an internal control system (Abdullahi & Mansor, 2018; Zimbelman et al., 2014). This internal control system is an interesting factor as the Indonesian government put a great attention in the development of government internal control system for the sake of accomplishing public accountability and transparency.

Internal Control System Weakness in Indonesian LGs

The internal control in Indonesian government has been given a serious concern by the scholars and practitioners. (Baltaci & Yilmaz, 2006) states that the internal control in Indonesian government is still weak that impedes the LG financial management and public sector accounting reform in Indonesia. Thus, Indonesia has put a great concern on government internal control system, both in the central and local level since the issuance of Government Regulation Number 60 of 2008 concerning Government Internal Control System. Indeed, the internal control system reform is regarded as one of the most crucial steps towards realizing the accountability of government institution (Aziz et al., 2015). The development of internal control must be taken seriously and even deserved to be one of the priorities in governance reform (Urbanik, 2016).

Government internal control system in Indonesia is developed following the COSO concept. The development of internal control system is important in attempt to accomplish organizational goals (Ismail et al., 2023) by having operational effectiveness and efficiency, assets safety, financial statement reliability, and compliance with the laws and regulations (Winarna et al., 2021). Every year, the Supreme Audit Board (BPK) as the external auditor of Indonesian LGs identify the internal control weaknesses in LG financial management that are

classified into: a) internal control weakness in budget, revenue, and expenditure administration, b) internal control weakness in accounting and financial reporting, and c) internal control structure weakness.

Internal Control Weakness and Corruption

The implementation of internal control systems has impact on LG financial management implementation. When the internal control system is weak, it will result in poor management (Rácz & Tóth, 2021). This study overall predicts that internal control system weaknesses will increase corruption. Previous studies states that Indonesian LGs still face difficulties to realize good financial management due to the weaknesses of internal control system (Yaya & Suprobo, 2019; Yurniwati & Rizaldi, 2015). These internal control weaknesses can result in administrative weaknesses, inefficiencies and ineffectiveness that lead to financial losses of LGs funds that are not in line with the objectives of government internal control system implementation (Sari et al., 2017). In addition, Pamungkas et al. (2018) documented that internal control system weaknesses in Indonesian LGs become a threat in fulfilling the public accountability. Based on the explanation above, we formulate the following hypothesis:

H1. LG internal control weakness positively affect LG corruption

Internal Control Weakness in Budget, Revenue, and Expenditure Administration and Corruption

Internal control system weaknesses in budget, revenue, and expenditure are related to the financial management processes in Indonesian LGs. Unfortunately, it still becomes one of the most dominant issues (Kewo, 2017). Indonesian public sector still has various deficiencies in financial management processes, especially in the operational procedures due to the lack of management policies. The lack of management policies often makes the corruption disappear in LGs (Masters & Graycar, 2016). Further, the lack of e-Government implementation in Indonesian LGs makes the administration of government activities ineffective and inefficient (Fernández et al., 2023; Sabani, 2020). The human resource factor, specifically in financial management positions, also become a significant issue that becomes a barrier in Indonesian public sector reform due to the lack of competency in government financial management knowledge (Mcleod & Harun, 2014). As a result, the administration of LG budget, revenue, and expenditure is not carried out properly. Due to this weakness, there exists many maladministration in financial management that becomes an integral part of corruption (Guslan,

2018; Kurniawan, 2021). The funds that should be allocated for the sake of fulfilling public service functions end up being corrupted by irresponsible government executives. Therefore, we formulate the following hypothesis:

H1a. LG internal control weakness in budget, revenue, and expenditure administration positively affect LG corruption

Internal Control Weakness in Accounting and Financial Reporting and Corruption

Internal control weakness in accounting and financial reporting is strongly related to the accounting policy along with its practice that manifest the accountability mechanism of LGs to the public (Pamungkas et al., 2018). Accounting practice is highly associated to compliance with the accounting standards (Muhtar et al., 2020). However, the internal control in accounting and financial reporting in Indonesian LGs still has significant weaknesses (Pamungkas et al., 2018) as there are still numerous cases of non-compliance with the government accounting standards (Muhtar et al., 2020). The cases of non-compliance with accounting standards that occurred in the LGs financial reporting may also be indications of corruption as previous study by Jeppesen (2019) who states that corruption creates misstatements in the financial statements. Xu et al. (2020) also reveals that lower financial reporting quality is related to higher corruption. In the context of Indonesian LGs, the existence of accounting non-compliance illustrates that the LG is not able to conduct proper accounting practice for their activities either related to revenue, expenditure, or assets (Yuliati et al., 2019). The condition threatens the safety of LG assets due to corruption activities. Hence, the more internal control weakness in accounting and financial reporting will increase the possibility of corruption in the Indonesian LGs. Based on the explanation above, the hypothesis is formulated as follows:

H1b. LG internal control weakness in accounting and financial reporting positively affect LG corruption

Internal Control Structure Weakness and Corruption

Internal control structure weakness has a great potential to affect corruption in LGs. The weakness in the internal control structure can be the one that opens the opportunity for fraudulent activities in the LG financial management processes (Lele, 2020). An LG with adequate internal control structure will build a conducive control environment. Thus, it has specific units and individuals assigned to conduct control activities and risk assessment on the LG activities. In addition, the information and communication within the internal control

system implementation will be timelier and more accurate. The weaknesses in the internal control structure will weaken the control mechanism. Thus, the effectiveness of control environment, risk assessment, control activities, information and communication, and monitoring implementation will decrease. These deficiencies will open the opportunity for corruption. Even worse, this weakness will create structural opportunity that makes corruption can spread out through all governance structure level (Lele, 2020). Further, it also creates corruption patterns that makes it difficult to eradicate (Yusoff & Hamdi, 2018). Therefore, we formulate the following hypothesis:

H1c. LG internal control structure weakness positively affect LG corruption

MATERIAL AND METHODOLOGY

Research Design

The study is a causality study that comprehensively investigate the impact of internal control system weakness on corruption in Indonesian LGs. The study employs all LGs in Indonesia in the district/city level during 2010-2018 as the research population. As for the data, the study uses secondary data obtained from the governing bodies in Indonesia such as the Supreme Audit Board of the Republic of Indonesia (BPK-RI), the Central Statistics Bureau (BPS), and the respective LG's website. Finally, the study generates a set of panel data with a total of 4,528 observations from 508 LGs during the 2010-2018 fiscal year.

Variable Measurement

We use the LG corruption as our dependent variable. It is measured with the total corruption cases that occurred in a LG during a fiscal year. Alternatively, we use the actual number of LG financial loss for further analysis in the robustness test. Both of the data are obtained from the BPK-RI. The independent variable of the study is the LG internal control weaknesses that are measured using total number of audit findings in internal control system provided by the BPK-RI. Our study controls for several external factors such as LG human development, population, wealth, head characteristics, and legislative characteristics. We provide the details of our variable operationalization in the following table:

Table 1 – Summary of Research Variables

Variable	Notation	Measurement	Data Source
<u>Dependent</u>			
LG corruption	LG_CORR _{it}	a. Total number of corruption cases	BPK-RI

Variable	Notation	Measurement	Data Source
b. Total actual LG financial loss in million rupiah			
<u>Independent</u>			
Internal control weakness	ICW_TOTAL _{it}	Total number of internal control weaknesses – aggregate	BPK-RI
Internal control weakness in budget, revenue, and expenditure administration	ICW_ADM _{it}	Total number of internal control weaknesses in budget, revenue, and expenditure administration	BPK-RI
Internal control weakness in accounting and financial reporting	ICW_REPORT _{it}	Total number of internal control weaknesses in accounting and financial reporting	BPK-RI
Internal control structure weaknesses	ICW-STRUCT _{it}	Total number of internal control structure weaknesses	BPK-RI
<u>Control</u>			
LG human development	LG_HDI _{it}	LG human development index	BPS
LG population	LG_POP _{it}	Natural logarithm of LG total population	BPS
LG wealth	LG_WEALTH _{it}	Natural logarithm of LG total assets	BPK-RI
LG head education level	HEAD_EDU _{it}	Dummy: 1: Undergraduate or above 2: Below undergraduate	LG website
LG head tenure	HEAD_TENURE _{it}	Total number of years of LG head reign since the inauguration	LG website
LG legislative coalition	LEGIS_CO _{it}	Proportion of legislative members supporting the executive	LG website
LG legislative size	LEGIS_SIZE _{it}	Total number of legislative members	LG website

Source: Elaborated by the authors (2022)

Data Analysis

We conduct initial analysis to generate the general summary of our research data using descriptive statistics analysis. We also test for the correlation amongst our variables. The main analysis is conducted with panel data regression analysis. Firstly, we perform our main analysis to test the hypothesis by using the total number of corruption cases in LGs within a fiscal year as the measurement of our dependent variable. Subsample analysis is further performed by classifying the LGs based on the type of the LGs that consist of district and city LGs. Further, a robustness test is performed by using variable proxy change to test the consistency of our research findings. The regression equation is stated as follows:

$$LG_CORR_{it} = a + \beta_1 ICW_TOTAL_{it} + \beta_2 LG_HDI_{it} + \beta_3 LG_POP_{it} + \beta_4 LG_WEALTH_{it} + \beta_5 HEAD_EDU_{it} + \beta_6 HEAD_TENURE_{it} + \beta_7 LEGIS_CO_{it} + \beta_8 LEGIS_SIZE_{it} + e \dots\dots\dots(1)$$

$$LG_CORR_{it} = a + \beta_1 ICW_ADM_{it} + \beta_2 ICW_REPORT_{it} + \beta_3 ICW_STRUCT_{it} + \beta_4 LG_HDI_{it} + \beta_5 LG_POP_{it} + \beta_6 LG_WEALTH_{it} + \beta_7 HEAD_EDU_{it} + \beta_8 HEAD_TENURE_{it} + \beta_9 LEGIS_CO_{it} + \beta_{10} LEGIS_SIZE_{it} + e \dots\dots\dots(2)$$

Information

LG_CORR _{it}	: LG corruption
ICW_TOTAL _{it}	: Internal control weakness - total
ICW_ADM _{it}	: Internal control weakness in budget, revenue, and expenditure administration
ICW_REPORT _{it}	: Internal control weakness in accounting and financial reporting
ICW_STRUCT _{it}	: Internal control structure weakness
LG_HDI _{it}	: LG human development
LG_POP _{it}	: LG population
LG_WEALTH _{it}	: LG wealth
HEAD_EDU _{it}	: LG head education
HEAD_TENURE _{it}	: LG head tenure
LEGIS_CO _{it}	: LG legislative coalition
LEGIS_SIZE _{it}	: LG legislative size

RESULTS AND DISCUSSION

Descriptive Statistics

Our analysis begins with descriptive statistics to generate the summary of research data. Overall, we find that there is still considerable amount of corruption cases in Indonesian LGs with average value of 12 cases. The lowest number is 1 case while the highest number reaches 98 cases. As for the internal control weakness variable, the average total number of internal control weaknesses is around 10 weakness cases with the highest total cases of 48 and the lowest one at 0. Internal control weaknesses in budget, revenue, and expenditure administration have the highest contribution with average value of 4.675, followed by the weaknesses in accounting and financial reporting with average value of 4.052, and internal control structure weaknesses with average value of 2.227. Internal control weaknesses in accounting and financial reporting have the highest maximum value of 48 cases, followed by the weaknesses in budget, revenue, and expenditure administration with 34 cases and internal control structure weaknesses with 23 cases.

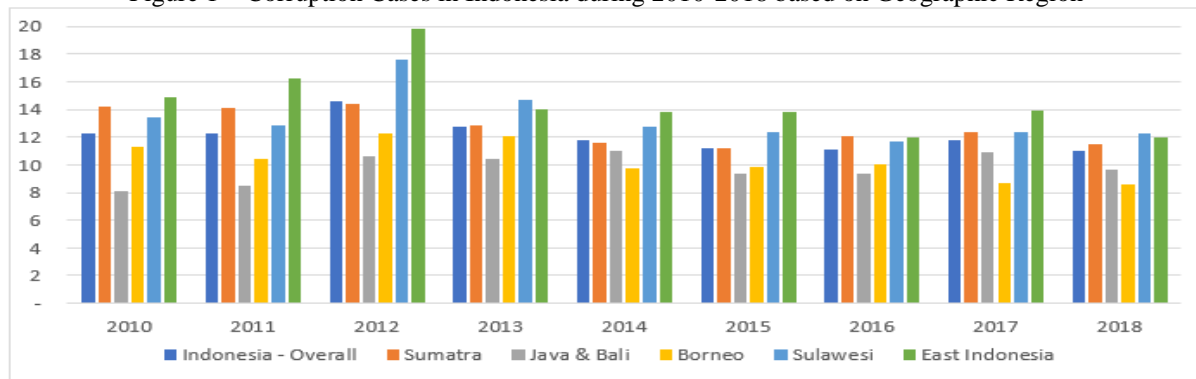
Table 2 – Descriptive Statistics

Variable	Obs	Mean	Std. Dev.	Min	Max
LG_CORR _{it}	4530	12.092	6.017	1	98
ICW_TOTAL _{it}	4529	10.896	5.133	0	48
ICW_ADM _{it}	4510	4.675	2.813	0	23
ICW_REPORT _{it}	4510	4.052	2.415	0	34
ICW_STRUCT _{it}	4488	2.227	2.001	0	21
LG_HDI _{it}	4530	66.718	6.884	21.12	86.11
LG_POP _{it}	4530	12.583	1.016	8.763	15.376
LG_WEALTH _{it}	4530	28.238	0.723	24.483	31.387
HEAD_EDU _{it}	4529	0.267	0.462	0	5
HEAD_TENURE _{it}	4529	2.889	1.45	0	6
LEGIS_CO _{it}	4530	0.336	0.194	0	1
LEGIS_SIZE _{it}	4530	33.819	10.176	19	55

Source: Elaborated by the authors

We further investigate the trend of our dependent and independent variables. We also categorize the LGs based on the geographic region that consist of Sumatra, Java and Bali, Borneo, Sulawesi, and East Indonesia. We find that the average corruption cases in Indonesian LGs during our observation period still ranges between 10 to 15 cases. Thus, the corruption eradication in Indonesia may actually has not experienced significant improvement, specifically in LGs. Based on geographic region, we evidence that LGs in East Indonesia and Sulawesi regions have the highest average of corruption cases. Meanwhile, LGs in Java and Bali as well as Borneo regions have the lower average of corruption cases throughout the examination period.

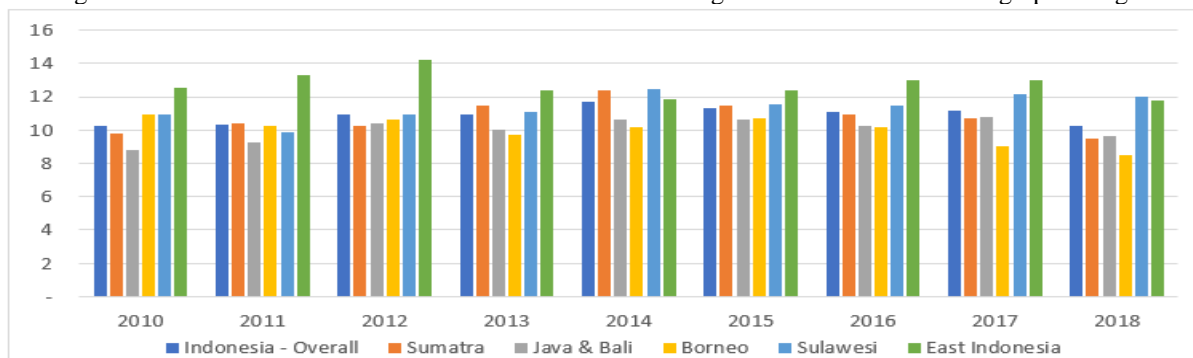
Figure 1 – Corruption Cases in Indonesia during 2010-2018 based on Geographic Region



Source: Elaborated by the authors based on data from BPK-RI

Further, the development of internal control weaknesses variable is also examined based on the geographic regions. In terms of the trend throughout the examination period, there is no significant improvement of internal control system implementation. The average total number of internal control weakness cases in Indonesian LGs ranges around 10 to 12 cases throughout the examination period. In terms of distribution, the average total internal control weakness cases during 2010-2018 considerably does not show significant variations in Java and Bali, Sumatra, and Borneo regions while the Sulawesi and East Indonesia regions have higher average internal control weakness cases.

Figure – Internal control weaknesses in Indonesian LGs during 2010-2018 based on Geographic Region



Source: Elaborated by the authors based on data from BPK-RI

Panel Data Regression Analysis

The main analysis is conducted using panel data regression following the nature of our research data. Subsample analyses are also performed by categorizing the LGs based on the type in accordance with Indonesian context, namely the district and city LGs. The best estimation in our regression models use fixed effect approach. The first regression model is performed to test the effect of total LG internal control system weaknesses on corruption. Overall, we find that the internal control weaknesses have positive impact on corruption in terms of total corruption cases occurred. The more internal control weaknesses, the more likely corruption cases will occur in the local government. This finding is also consistent in the district and city local government regression scenario. The result is presented as follows:

Table 3 – Panel data regression analysis result using total internal control system weaknesses – corruption measured with total cases

VARIABLES	All LGs	District LGs	City LGs
ICW_TOTAL _{it}	0.326*** (0.0160)	0.329*** (0.0177)	0.311*** (0.0377)
LG_HDI _{it}	0.00470 (0.0197)	0.0174 (0.0249)	-0.0576 (0.0745)
LG_POP _{it}	-0.0367 (0.267)	-0.0781 (0.289)	0.238 (0.705)
LG_WEALTH _{it}	-0.993*** (0.172)	-1.226*** (0.193)	-0.356 (0.410)
HEAD_EDU _{it}	0.265 (0.215)	0.247 (0.231)	0.454 (0.597)
HEAD_TENURE _{it}	-0.0758 (0.0518)	-0.0566 (0.0576)	-0.142 (0.119)
LEGIS_CO _{it}	-0.114 (0.495)	0.239 (0.535)	-1.303 (1.324)
LEGIS_SIZE _{it}	-0.0254 (0.0254)	-0.0346 (0.0280)	0.00558 (0.0634)
Constant	37.76*** (4.776)	44.15*** (5.530)	20.41* (11.43)
Observations	4,528	3,691	837

VARIABLES	All LGs	District LGs	City LGs
Number of LGs	508	415	93

Source: Elaborated by the authors

The subsequent analysis is performed based on the second regression model to test the effect of internal control system weaknesses per dimension. The analysis result demonstrates that both internal control system weaknesses in accounting and financial reporting, internal control weaknesses in budget, revenue, and expenditure administration as well as internal control structure weaknesses exhibit positive influence on LG corruption. These findings confirm all of the research hypotheses that we propose. The effect remains consistent in the district LGs observation. Meanwhile, in the city LGs observation, the effect of internal control structure weaknesses has no significant effect. The panel data regression analysis result is presented in the following table:

Table 4 – Panel data regression analysis result using internal control system weaknesses dimensions – corruption measured with total cases

VARIABLES	All LGs	District LGs	City LGs
ICW_ADM _{it}	0.441*** (0.0303)	0.431*** (0.0339)	0.489*** (0.0674)
ICW_REPORT _{it}	0.370*** (0.0357)	0.361*** (0.0394)	0.381*** (0.0853)
ICW_STRUCT _{it}	0.107** (0.0427)	0.151*** (0.0486)	-0.0462 (0.0887)
LG_HDI _{it}	0.00740 (0.0198)	0.0216 (0.0251)	-0.0924 (0.0751)
LG_POP _{it}	-0.0216 (0.267)	-0.0774 (0.289)	0.410 (0.703)
LG_WEALTH _{it}	-0.990*** (0.172)	-1.224*** (0.195)	-0.371 (0.409)
HEAD_EDU _{it}	0.199 (0.219)	0.183 (0.236)	0.333 (0.595)
HEAD_TENURE _{it}	-0.0655 (0.0520)	-0.0472 (0.0579)	-0.134 (0.118)
LEGIS_CO _{it}	-0.107 (0.496)	0.189 (0.537)	-0.776 (1.330)
LEGIS_SIZE _{it}	-0.0268 (0.0254)	-0.0350 (0.0280)	-0.000642 (0.0633)
Constant	37.09*** (4.793)	43.60*** (5.559)	21.08* (11.44)
Observations	4,487	3,658	829
Number of LGs	508	415	93

Source: Elaborated by the authors

Our findings basically emphasize that all the internal control system dimensions are crucial for the LG financial management activities. All of them are important to create an accountable public governance mechanism (Pamungkas, 2018). Internal control system

weaknesses in budget, revenue, and expenditure administration have the strongest effect, meaning that it causes most of the corruption cases that happen in the Indonesian LGs. In practice, maladministration is dangerous, especially due to the lack of management policies, as it often makes the corruption disappear in LGs (Masters & Graycar, 2016). In addition, the lack of competent human resources in the financial department also becomes barrier (McLeod & Harun, 2014) that makes the corruption potential even worse. This empirical evidence confirms the previous studies stated in our hypothesis that the financial management in Indonesian public sector still has various deficiencies (Kewo, 2017) that causes maladministration cases in LG financial management as a part of corruption (Guslan, 2018; Kurniawan, 2021). This result implies that the LG financial management reform becomes urgent agenda to ensure the enforcement of laws, policies, procedures, and rules to build local authorities' behavior in managing the state fund properly (Allen, 2013).

Internal control weakness in accounting and financial reporting is strongly related to corruption as there are still many weaknesses in this aspect (Pamungkas et al., 2018) and there are numerous cases of non-compliance with the accounting standards (Muhtar et al., 2020). Our result is in line with Jeppesen (2019) and Xu et al. (2020) that evidence the relationship between poor financial reporting practice and corruption. Further, this finding supports Lewis & Hendrawan (2020) who state that the public sector accounting reform in Indonesia has not been effective in reducing corruption. Indeed, Indonesia practices government accrual-based accounting with a detailed and rigid regulations that is intended to prevent corruption (Prabowo et al., 2017). In practice, the lack of coordination between central government and the LGs, along with inadequate number of qualified accountants become a significant barrier (Harun et al., 2013). As a result, the local governments still have confusions in meeting the standards and regulations required by the central government (Pamungkas, 2018). Thus, the quality of public sector accounting practices needs urgent reform so that it can assist in reducing corruption in LGs in future.

Finally, internal control structure weakness has positive effect on corruption as it is the one that opens the opportunity for fraudulent activities. Lele (2020) mentions that corruption in Indonesia has become more rampant because of structural opportunities which incentivize corrupt practices. Indeed, the organizational structure of government bureaucracy in Indonesia is still ineffective and inefficient (Labolo & Indrayani, 2017), including in the implementation of government internal control system. This condition still causes various white-collar crimes in many government institutions (Maulidi, 2020). This result implies that the government

internal control structure needs significant reform as a part of government bureaucratic structure reform as a whole (Turner et al., 2022). In addition to the bureaucratic structure, the organizational commitment of the employees should also be reformed as it is very important in local governance and management (Alberca et al., 2023).

Robustness Test

We perform robustness test by changing the proxy of LG corruption as our dependent variable from the total number of cases into the total amount of state financial losses (in million rupiahs). For the first regression model, it is evidenced that total internal control weaknesses have positive effect on LG corruption and thus the effect is consistent. The more internal control weaknesses, the more the state financial loss occurred because of fraudulent activities in the LG financial management. Therefore, it can be concluded that the result we obtained for the first regression model is robust. The result is presented as follows:

Table 5 – Robustness test result using total internal control system weaknesses – corruption measured with state financial loss (in million rupiahs)

VARIABLES	All LGs	District LGs	City LGs
ICW_TOTAL _{it}	164.6*** (26.30)	165.8*** (30.73)	150.9*** (43.81)
LG_HDI _{it}	-68.49*** (24.78)	-73.89** (33.97)	-18.90 (67.46)
LG_POP _{it}	-694.2* (378.5)	-937.4** (431.4)	1,187 (732.3)
LG_WEALTH _{it}	426.9* (253.4)	418.1 (304.9)	-220.5 (430.0)
HEAD_EDU _{it}	299.8 (322.5)	217.4 (370.6)	700.4 (584.2)
HEAD_TENURE _{it}	87.23 (88.86)	60.73 (103.9)	227.6 (146.5)
LEGIS_CO _{it}	-495.9 (752.7)	-293.0 (859.2)	-809.2 (1,443)
LEGIS_SIZE _{it}	-4.869 (36.34)	6.458 (42.17)	-81.97 (65.50)
Constant	3,358 (6,914)	6,636 (8,548)	-3,343 (11,172)
Observations	4,528	3,691	837
Number of LGs	508	415	93

Source: Elaborated by the authors

The robustness test performed for the second regression model shows the significant positive effect of internal control weaknesses in accounting and financial reporting as well as the weakness in budget, revenue, and expenditure on LG corruption in all LGs, district LGs, and city LGs. Based on the result, it can be concluded that the more internal control weaknesses

in these two dimensions will increase the amount of state fund loss due to corruption. Meanwhile, the internal control structure weaknesses have no significant effect on LG corruption. This internal control structure weaknesses opens opportunity for fraud as evidenced in the previous result while using the total number of corruption cases. However, the effect does not significantly affect the number of financial losses suffered by the LGs due to corruption.

Table 6 – Robustness test result using internal control system weaknesses dimensions – corruption measured with state financial loss (in million rupiahs)

VARIABLES	All LGs	District LGs	City LGs
ICW_ADM _{it}	130.4*** (50.40)	102.9* (59.42)	234.0*** (80.05)
ICW_REPORT _{it}	340.7*** (58.80)	345.2*** (68.29)	301.3*** (100.2)
ICW_STRUCT _{it}	-6.190 (71.49)	23.46 (85.95)	-124.5 (106.2)
LG_HDI _{it}	-71.63*** (24.75)	-80.12** (34.06)	-35.50 (67.64)
LG_POP _{it}	-707.7* (378.0)	-965.5** (430.6)	1,318* (731.7)
LG_WEALTH _{it}	506.2** (254.2)	509.1* (306.2)	-218.1 (428.8)
HEAD_EDU _{it}	310.7 (328.3)	238.7 (378.6)	616.3 (581.6)
HEAD_TENURE _{it}	78.96 (89.84)	49.58 (105.1)	224.3 (147.5)
LEGIS_CO _{it}	-422.6 (755.9)	-234.5 (861.8)	-494.2 (1,458)
LEGIS_SIZE _{it}	-6.243 (36.30)	6.774 (42.09)	-88.58 (65.60)
Constant	1,374 (6,929)	4,706 (8,571)	-4,001 (11,172)
Observations	4,487	3,658	829
Number of LGs	508	415	93

Source: Elaborated by the authors

CONCLUSION

The study provides an illustration of corruption in Indonesian LGs and the impact that the internal control weakness has on it. We find that the corruption eradication in Indonesian LGs has not experienced significant improvement during 2010 to 2018 as the amount of corruption cases occurred still ranges around 10 to 12 cases during the examination period. Meanwhile the implementation of government internal control system in Indonesian LGs still also need considerable attention as there are still a significant number of internal control weaknesses both in accounting and financial reporting, budget, revenue, and expenditure administration, and the internal control structure. Further, we obtain robust empirical evidence that internal control weakness positively affects LG corruption both in terms of total number of

cases and total amount of state financial losses. All internal control system weakness dimensions also provide positive effect on LG corruption. Based on our results, our study provides suggestions for LG internal control system implementation in which LGs should continuously improve its implementation. The role of internal control system as the first mechanism of corruption prevention must be optimized. LGs can examine the internal control system weaknesses findings by the BPK-RI and follow-up the audit recommendations. The LGs and Financial and Development Supervisory Agency (BPKP) that has the coordinating function of LGs internal control system implementation in Indonesia should also set a specific strategy to continuously improve the internal control system implementation followed by proper monitoring. This must be followed by significant reform in governance structure effectiveness and accounting practice with the assistance of information technology. Therefore, the government internal control system implementation in all LGs in Indonesia can be optimized for the sake of enhancing public accountability, one of which is by having less corruption.

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