

Regional Financial Governance Reform in Indonesia Through the *Arthashastra* Perspective

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Abstract

Reforms in the New Public Management (NPM)-based financial governance are needed to improve the rules and standards for financial governance applied in the previous government system. NPM reforms in the public sector, in both developed and developing countries, are criticized due to their sub-optimum results. NPM is considered to foster capitalism and give rise to secularism, so fraud in the budget management accounting system is associated with the loss of ethics and morality. Based on this criticism, this research seeks to highlight the form of financial governance through the perspective of *Arthashastra*, an ‘economics science’ based on ethics and morality. This perspective contains methods for productive government

financial management in all aspects, including in the management of the state budget. The inclusion of *Arthashastra* is expected to foster a view concerning what kind of reforms should be made, which is based on *Dharma*, i.e., ethical, and moral strength.

Keywords: New Public Management, Fiscal Decentralization, Government, *Arthashastra*

1. Introduction

Financial reform has indeed brought about many changes in the financial activities of the central and local governments. The current financial governance reforms are responses to the 1998 monetary crisis. At that time, to obtain financial assistance from the IMF and the World Bank, Indonesia had to follow the direction of global reform, namely the implementation of New Public Management (NPM), starting with decentralization (Harun, Mir, Carter & An, 2019). Following the implementation of decentralization through an autonomy policy, Law number 17 of 2003 concerning state finances became one of the cornerstones of the government financial accountability era (Witono, Sukoharsono, Nurkholis & Roekhudin, 2021). Transparency and accountability of public financial governance is a form of government's responsibility to the community. Accountability is the basis of all financial reporting in government institutions (GASB, 1999). Accountability and transparency of the government's financial report cannot be separated from the role of accounting; both are highly related (Bovens, 2007). Accounting produces transparent and accountable government financial reports to improve government performance (Hood, 1995; Marwata & Alam, 2006; Hassan, 2015). Improvements in financial governance reforms have been carried out for good governance, which refers to attitudes, ethics, and values in society (Puspasari & Suwardi, 2016). Good governance is the main goal of government administration. Accountability is responsible for the success or failure of the government's mission, namely achieving the vision that has been set with

an orientation to the welfare of the community. One form of accountability from the government to its citizens is financial statements.

Apart from the facts above, several empirical studies have proven that NPM reforms in the public sector in both developing and developed countries have given unexpected results. NPM in Indonesia as a form of financial governance reform also contains the ideology of neoliberalism in the realm of regulation, particularly in the management of regional finances (Harun et al., 2019). It is believed to be responsible for the removal of government accountability's senses due to its orientation to profit. Christia and Ispriyarso (2019) have found an obstacle in fiscal decentralization: the utilization of local own-source revenue. Funds originating from local own-source revenue have not been used optimally, especially to increase the independence of local governments. The reason is that there are many local own-source revenues, particularly from local taxes and local levies, which have not been managed effectively and efficiently. Sylvia, Sukoharsono, Prihatiningtias, and Roekhuddin (2018) found that local government accountability does not prioritize public interest. Instead, it prioritizes accountability for managerial and political interests. That makes accountability according to the regulations only limited to political discourse, '*and jargon*'.

Harun et al. (2019) stated that the decentralization policy containing NPM has facilitated the re-emergence of authoritarian power held by local elites. It causes accounting fraud in the government's financial management. Sulastri (2014) revealed that accounting fraud often occurs in various governmental sectors due to policies that are difficult to understand, the lack of a cooperation system, miscommunication, poor supervision, and personal needs, for example, economic pressure that creates the intention to commit fraud. Ikbala, Irwansyah, Paminto, Ulfah, and Darma (2020) also Rinaldi, Purnomo, and Damayanti (2007) revealed that accounting fraud in the public sector takes the form of budget fraud e.g., goods and services procurements and purchases, financial reports, official travel expenses, company permits

granting natural resources usage, and fraud by law enforcers. Moreover, municipal leaders distribute the unused remaining balance to their group, elite supporters, and clients at the end of the year. Another example of manipulation in the procurement process of goods and services is when members of the local house of representatives increase line-item budgets for bribery and funds transferred to fictitious institutions; the reason is that local governments have full financial control. This makes it clear that corruption has decentralized significantly to the sub-national level following the delegation of powers concerning public service provision and finance (Hadiz, 2004). Saputra and Mahmudi (2012) argued that fiscal decentralization in Indonesia has decentralized corruption to local governments, in both district and city administrations. Harun et al. (2019) found that the framework of decentralization designed by the government was not able to prevent local politicians from designing local government budgeting processes and projects for their personal gain, so corruption continued. As a consequence, accounting and auditing reforms at local level cannot improve the quality of the internal audit function and do not reduce corruption. Filmer and Lindauer (2001) found that corruptive behavior at the sub-national level can be seen as a response to opportunity. The higher the local own-source revenue, the higher the corruption. This indicates that local own-source revenue is vulnerable to corruption in local governments. The authority given by the central government to develop its regions independently, for example, the construction of public facilities such as bridges, are misused, and that becomes a gap for mass corruption.

Fraud in accounting cannot be separated from ethical problems. Hernandez and Groot (2007) found that ethics and accounting control environment are vital variables related to a person's tendency to commit accounting fraud. Accounting fraud is illegal behavior that is generally part of unethical behavior. Therefore, there must be laws that serve as efforts to enforce moral standards. Albrecht and Albrecht (2004) stated that personal integrity in the fraud scale refers to an individual's code of ethics. Puspasari and Suwardi (2016) stated that governments with high morality tend not to

commit accounting fraud under any circumstances. The cause of local financial management problems lies in the commitment of the government, including government accountants and auditors, to consistently implement the rules of laws. These motives must be shifted to those that pay attention to essential ethical standards (Kadafi, 2012).

2. Research Methodology

Through conceptual methods, this research tries to explore, understand, integrate, and analyze the content of *Arthashastra* in studying and fostering thoughts on how reforms should be carried out and help solve issues that are criticized in the implementation of local government financial governance reforms.

3. Literature Review

3.1 Implementation of NPM in Indonesia

New Public Management was implemented to replace the Old Public Administration (OPA). Osborne (2006) explained that OPA is a management concept that relies on centralized control, which establishes rules and guidelines, makes policies separate from the implementation, and uses a hierarchical organizational structure. OPA prioritizes efficiency and effectiveness in budget management and human resources, which is characterized by the separation between politics and administration. Here the administration is continuous, predictable, and regulated, the personnel is appointed based on qualifications, the division of labor is functional and hierarchical, the resources belong to the organization – not to the individuals who work in it, and the officers serve the public interest – not their private interests (McCourt, 2013). However, the monetary crisis has sparked criticism toward OPA, in which the public requested that the market economy be allowed to resolve its problems without any active intervention from the government

(Larbi, 1999). In addition, neoliberal groups in the late 1970s increasingly criticized the size, cost, and role of governments, doubting their capacity to fix economic problems because of their monopolistic service delivery and inefficient operations. In addition, OPA is insufficiently community- and result-oriented. Adherents of neoliberalism assume that efficiency can only be achieved through market competition and that the public should choose service providers freely (Larbi, 1999). Therefore, public sector reform must be carried out, one of which is through NPM.

New Public Management (NPM) is a form of management reform, i.e., depoliticization of power or decentralization of authority that encourages democracy in the management of a country or region. Rethinking government is the first step of the reform, followed by reinventing government including reinventing local government that changes the role of government, especially in terms of the relationship between the government and the public. Reforms in almost all countries have led to the use of performance-based budgeting, outcome-based management, and the use of accrual accounting. Hood (1991) explained that there are seven aspects of NPM: professional management in the public sector, performance standards and performance measures, greater emphasis on output and outcome, division of work units in the public sector, competition in the public sector, adoption of business-sector management to public-sector management, and emphasis on discipline and greater savings in resource usage. The characteristics of NPM applied in Indonesia, according to Anindita (2009), are professional management in the public sector, i.e. managing the organization professionally, providing boundaries around main tasks and functions and clearer job descriptions, providing clarity of authority and responsibility, emphasizing output and outcome control using performance budgeting designed by the Directorate General of Treasury, dividing work units in the public sector, creating competition in the public sector with the mechanism of contracts and competitive tenders for cost savings and quality improvement as well as privatization, adopting business-style management to the public sector, promoting discipline, and saving resources.

NPM is the content of public management theory which assumes that management practice in the private sector is better than that in the public sector (Sayidah, Mulyaningtyas, & Winedar, 2015). Therefore, to improve the performance of the public sector, several management practices and techniques applied in the private sector such as market mechanisms, compulsory competitive tendering, and the privatization of public companies (Hughes, 1998) need to be adopted. Hood (1995) believes that this kind of changes in public management is called '*accountingization*', accepting the doctrine of public accountability and public administration. The philosophy of NPM is derived from two different sources (Sayidah et al. 2015), namely the idea of 'managerialism' and the thought of economists. Managerialism assumes that management is generic: a purely instrumental activity with a set of principles that can be applied to both public and private businesses. The theories from the thought by economists are public choice theory, agency theory, and transaction cost theory. The public choice theory sees that all human behaviors are dominated by self-interest and tend to maximize wealth. Hence, individuals choose individual satisfaction and efficiency reasons. Agency theory perceives that principals can control agents to create accountability for what they produce. Institutional economic theory, which is also known as transactional cost theory, sees that all individuals act in their interests and prefer to maximize benefits to their satisfaction.

The application of the NPM concept has led to a drastic change from the traditional management system, which was considered rigid, bureaucratic, and hierarchical, to a public sector management model that is flexible and more accommodating to the market. NPM is also seen as a form of modernization or reform in public management and administration, depoliticization of power, or decentralization of authority that promotes democracy. These changes have also changed the role of government, especially in terms of the relationship between government and society (Hughes, 1998). One of the NPM reforms in local financial governance is Decentralization. Decentralization, as opposed to centralization, is defined as

a process of political, fiscal, and decision-making revolution from the central government to local governments (Moisiu, 2013). Fiscal decentralization is a mechanism for transferring funds from the State Budget in relation to state financial policies, namely bringing forth fiscal sustainability and stimulating economic activity (Syahrudin, 2006). Mardiasmo (2009) stated that fiscal decentralization, which is a part of the NPM concept, has a direct impact on the management of the state budget, changing the budget system from the traditional model to a performance-based budgeting. Fiscal decentralization in Indonesia was started in 1979-1980. At that time, the Ministry of Finance started a study plan on the modernization of the government's accounting system. The government administration system in that era was still carried out manually, and the management of state finances was based on rules issued by the Dutch government in 1864. Financial transactions were recorded in single entry, which only resulted in a report on the calculation of income and budget (Fontanella & Rossieta, 2014).

The next period is the 1998 monetary crisis. The 1998 reforms had a significant impact on the management of state finances. Traditional budgeting was altered by performance-based budgeting, followed by the implementation of performance audit, the application of value-for-money concept, and changes in the government accounting system; all of them had been an important point in the reformation of state financial management (Mahmudi, 2007). In addition, asset recording, budget systems, and patterns of accountability for government spending have also been improved (Harun, 2009). It was also followed by the enactment of Law number 17 of 2003 concerning state finances and Government Regulation number 71 of 2010 concerning the Standard for Government Accounting (SAP), which has become the basis for the preparation government office's financial reports and the legal foundation for the reports until now. SAP has changed the basis of accounting, from moving cash toward accrual to accrual-based accounting, as seen in the Local Government's Financial Report (LKPD). This report is part of the development performance evaluation that will be used to project

the next year's planning. LKPD also serves as a source of information for stakeholders, so local government administration staff must be able to produce accurate financial reports in accordance with existing regulations, although administrator's understanding and knowledge play an important role in the presentation of the financial reports (Fontanella & Rossieta, 2014).

Following the enactment of Law number 17 of 2003, Law number 15 of 2006 concerning the Supreme Audit Agency was applied. This law describes audit function, which consists of problem identification, analysis, and evaluation that are carried out independently, objectively, and professionally based on standards to assess the truth, accuracy, credibility, and reliability of information regarding the management of state finances. This audit is conducted to ensure the reliability and accountability of government finance's management and reporting. This audit, conducted by the Audit Board of Indonesia (BPK), ensures the absence of authority breach in the management and reporting of the government's finances. It refers to the Standard for State Financial Audit (SPKN) to provide reasonable assurance that the financial reports have been presented fairly in all material respects according to the SAP.

3.2 *Arthashastra*: A Concept for Public Governance

Arthashastra is a classic work on politics and state administration, economics, leadership culture, and security and defense. As a great work of its time, this book also contains matters concerning intelligence, philosophy, and even medicine. It is often referred to as a compendium on how to manage a country and is regarded as a manual or handbook for leaders to manage their country. It was written by Kautilya or Canakya, also known as Vishnugupta, one of the ministers of state, political expert, and religious expert who lived around 321 to 296 BC (Sujana, 2011). Accounting experts started studying this book in 1988, when Bhattacharyya published a book entitled Modern Accounting Concepts in Kautilya's *Arthashastra*. Since then, *Arthashastra* has been attracting the interest of accounting experts. Researchers, especially Indians, discuss how to apply *Arthashastra* in managing recent-time

governments. Some of the researchers are Mattessich (2010), Balachandran (2011), Manrai (2017), and Debnath (2019). *Arthashastra* is designed for governance in the hands of strong leaders; it is relevant to be used in modern era. Kautilya strongly believes that strong institutions are a prerequisite for economic growth with the support of good governance, knowledge, and ethical behavior (Sihag, 2007).

3.3 Financial System Governance in *Arthashastra*: Accounting System

The concept of financial management systems according to *Arthashastra*, which was translated by Shamasastri (1915), Choudhury (1982), Bhattacharya (1989), Rangarajan (1992), and Mattessich (1992), is considered similar to the concept used in this modern era. Accounting in *Arthashastra* is accrual, which recognizes outstanding receivables, payables, and deferred income. Non-financial information is also recorded to measure performance. *Arthashastra* conducts periodic budgeting and makes classifications based on sources and objectives, emphasizing more on outputs and outcomes. The separation between sources of income and expenditure also the arrangement of an unused budget is carried out for expenditure and resource efficiency. *Arthashastra* also stipulates that accounting reports must be prepared systematically and logically based on prioritized activity reports, in real-time, based on relevant and clear facts, and user-friendly.

Arthashastra also implements a financial management audit system. The audit is carried out by examining the financial statements prepared by the officers, and the auditor ensures the absence of collusion. Information discrepancies due to misrepresentation and misappropriation will be investigated, and penalties will be given by the applicable regulations. *Arthashastra* does set a working system in financial management according to the definition in the accounting concept and applies uniform standards. However, *Arthashastra* also states that the work system is not sufficient to prevent misappropriation. *Arthashastra* realizes that irregularities were bound

to occur among the royal employees. Therefore, *Arthashastra* also discusses corruption by royal employees and creates systems to prevent it.

3.4 Arthashastra: A Concept of Ethics and Morality

The ethical and moral values contained in the teachings of *Dharma* are inseparable from the development of an individual's personal character. Kautilya stated that *Dharma* values in the Vedas have been universally recognized; they are *ahimsa* (not harming all living beings), *satyam* (truth); cleanliness; freedom from crime; compassion, and tolerance (Sihag, 2014). *Dharma* is highly respected by Kautilya, not only in the management of the country but also in daily life. *Dharma* is the source of joy and the attainment of eternal bliss (salvation from the cycle of birth-death-rebirth). However, when *Dharma* is violated, chaos leading to world destruction will arise. In connection with state governance, when *Adharma* controls *Dharma*, a leader will destroy his own country (Subramanian, 2000). Ethics and morality must always be upheld for the welfare of the country. Ethical and moral degradations are caused by the lack of knowledge. Kautilya believes that knowledge of ethics and morality is very helpful in developing discipline and logical ability to predict the consequences of criminal behavior (Shihag, 2014). The only objective of all branches of knowledge is to instill control over the 'self' (Subramanian, 2000). Self-control is the basis of knowledge and discipline; it is obtained by giving up lust, anger, greed, pride, and ignorance. Living according to the shastras means avoiding over-indulgence of pleasures in all senses, i.e., hearing, touch, sight, taste, and smell (Subramanian, 2000).

Kautilya expanded the role of ethics into the most effective encouragement to save oneself from poverty (Sihag, 2014). If the world is run according to the teachings of *Dharma*, the world will prosper (Subramanian, 2000). Hence, a leader will never allow his people to do things that deviate from *Dharma*. Kautilya believes that laws, regulations, and government policies guided by ethics and morality can enrich all walks of life (Sihag, 2014). Good institutions and governance always depend on the ethical

environment and behavior of decision makers. Kautilya argued that a leader must be aware of his choice of duties, fulfilling his moral obligations or following his personal interests (Sihag, 2014). Based on his argument in terms of moral obligation, a *rajarshi* (leader) will only take enough, even very little, from state revenue for his own consumption and uphold ethical attitudes such as using all tax revenues to provide public goods and welfare programs and follow the wisdom of promoting economic growth (Sihag, 2014). If a leader is motivated by his personal interests, for example advancing public interest to advance his own interests, in other words doing something that is not purely for the community and having other intentions in carrying out his duties of advancing the interests of the community, his country will be damaged.

In *Arthashastra*, the ideal kings or leaders are those who can control and fight the enemies that are within them, namely sight, sound, taste, smell, and touch. Those senses must be trained so that humans can avoid greed, arrogance, and ego (Kangle, 1972). Leaders who fail to control their senses will never achieve success and the goals of their government (Pillai, 2020). *Arthashastra* explains the values that a leader must have, are honesty, reliability, transparency, justice, gratefulness, visionary, and obeying elders (in this case a religious teacher) (Mukherji, 2009). Leaders who fulfill these values will bring happiness and spiritual and material well-being. Kautilya emphasized that the essence of leadership is the ethical foundation of that leadership. A leader must behave like *Rajarshi*, who prioritizes the achievement of the goals of government and the peaceful enjoyment of prosperity so that the people get material benefits, pleasure, and spiritual goodness. Kautilya emphasized that a leader must be aware of his choice of duties, between fulfilling his moral obligations and following his personal interests (Sihag, 2014). His argument in terms of moral obligation is that a *Rajarshi* (leader) will only take as needed, even very little, from state revenue for his own consumption and uphold ethical attitudes such as using all tax revenues for the provision of public goods and welfare programs and following wise

considerations to promote economic growth (Sihag, 2014). He also must not advance the public interest if it is only achieved for his own interests, for example doing something not only for the community, or having other intentions than his duty of advancing the interests of the community.

A king has the responsibility of administering punishment based on the *Dharma*, namely *Dandaniti*. Sihag (2007b) mentioned that there are several important guidelines of *Dandaniti* given by Kautilya, one of which is that the law must be fair. A king who keeps the law justly will go to heaven. *Dandaniti* is proportional to the level of the crime committed; the most important thing is being impartial. Fairly and well-considered *Dandaniti* makes people serve *Dharma*, *Artha*, and *Kama*, while unjust *Dandaniti* will cause anger and greed because the perpetrators of the crime are those in the realm of the kingdom. The absence of punishment causes chaos. Kautilya suggested that the king use *Danda* to make kingdom officials and the people submit themselves to the law, but it shall not be used to create fear to the ruling regime. Kautilya believed that law enforcement and public order are very important for growing knowledge, maintaining political stability, increasing economic growth, facilitating the formulation of laws, and creating sound policies (Sihag, 2014). In addition, political stability and independence are very important for economic growth, which in turn ensures national security. Therefore, sustainable growth requires stable, efficient, and ethical (honest and fair) governance (Sihag, 2014).

3.5 Arthashastra: Overcoming Fraud in Public Financial Governance

Fraud in financial management is discussed in the second book of *Arthashastra* in Chapter 8. In Sanskrit corruption is more broadly defined as '*bhrash*', which means failure, misguidance, deviation, separated, confiscated, expelled, turned around, rotten, lost, vicious, and depraved (Pohekar, 2014). Kautilya argued that human nature does give rise to corruption. If it happens in the government, failure in managing the state will be unavoidable (Sihag,

2004). This failure can occur at both peak and bureaucratic levels (Sihag 2014). He is quite aware of the possibilities and difficulties of detecting corruption at the bureaucratic level. Hiwargaonkar (1999) stated that it is very unlikely for government employees not to take the king's income, at least a little, secretly. It is metaphorized that it is impossible not to taste the honey found in the passage of the tongue (Hiwargaonkar 1999). Like a fish moving in water that we cannot know when it is drinking water (Sihag, 2004), leaders or government employees appointed to do the work are undetected when committing corruption. It is possible to see the plot of cheating, but it is like watching the flight path of birds in the sky (Sihag, 2004).

We do not know the methods used by government employees who have ulterior motives to do bad things. Corruption can lead to government failure. A leader who fails to protect his people from those who steal and rob is an analogy that government failure can occur due to inaction and inappropriate actions, i.e., a bad governance system (Sihag, 2014). Kautilya explained that corruption can be caused by intentional or unintentional accounting errors or irregularities, but, still, it can reduce government revenues. He believes that corruption in the public sector is caused by systemic and moral failures. He described forty ways of corruption in government, in which practices of fraud and misappropriation of funds or corruption cause state losses, misuse of government property, misappropriation of income, falsification of documents, inequality in employment, intentionally flawed budgeting, inequalities in price, weight, numbering, production quality, impediments in legal proceedings, public exploitation, embezzlement, acceptance of bribes, spending failure in works, wrong measurements, wrong allocation of expenses, fraud in weighting, etc. (Pohekar, 2014).

Kautilya also understands the need for transparency when investigating a corrupt government through whistleblowing practices. Public disclosure (*prachára*) must be made by stating that anyone who is affected by the perpetrators of corruption can submit a complaint to the head of the state

(Priyadarshni, 2012). Kautilya recommends that the working government should always be controlled. This is because the human mind is naturally fickle, as well as their emotions. Therefore, agents and tools they use, place and time of work, the proper form of work, work's expenditure and results, the realized income, and work expenses must always be ascertained, both in detail and in general (Priyadarshni, 2012). Kautilya is aware of the limitations of regulation and auditing in preventing corrupt practices (Sihag, 2014). Good bookkeeping systems and audits are indeed necessary, but they are not sufficient to ensure ethical practices. No matter how good accounting systems and standards are, 'Aggressive and creative accounting practices' are hard to beat. He believes that, although accounting principles are important, ethics also need to be practiced (Sihag, 2014). An independent audit is necessary but not enough to eliminate financial fraud. Hence, Kautilya has developed contract and property rules as well as a law of losses that do not undermine ethical behavior, i.e., a Dharma-based approach, to bring about peace and prosperity.

4. Findings

4.1 Old Public Management vs New Public Management vs *Arthashastra* in Financial Governance: The Difference

There are many Indian researchers who have studied financial governance according to *Arthashastra*, particularly in its relation to modern accounting, in which *Arthashastra* is translated as a combination of OPA and NPM. According to several studies and translated versions, *Arthashastra* is perceived to have a centralized system of government, just like OPA. However, for local financial management, it uses a decentralized system similar to NPM nowadays. This is because, during the era of the monarchy system, the decentralized system was not yet known (Yani, 2013). Regional leaders are given autonomy, but they still follow the rules made and supervised by the king as the central government. In the financial management system,

Arthashastra has implemented accrual accounting, where the recording is carried out using a double-entry system, income and expenditure budgets are prepared periodically, and non-financial accounts such as the number of workers, weight, and volume, quality of materials, container size etc. were made. In addition, audits of financial management were also implemented.

The authority to manage the finances of a region is given to the regional leader, but he still must report his activities to the central government. Therefore, until now there are still many thinkers and researchers who believe that *Arthashastra* is a government system that is suitable to be applied in the modern era. Indonesia also applies the same financial management, such as the application of accrual accounting records, audits by the central government to local governments, and decentralization of regional financial management. However, why are there so many irregularities in the country's financial governance? Why is the implementation of NPM still widely criticized? Why is the Kautilya government able to make the country highly developed in finance even though the financial governance system used is not much different from the system used now? What's the difference?

Cohen, Duberley, and McAuley (1999) revealed that, basically, the concept of NPM had been built on the basic idea that public sector organizations should work like market-oriented business organizations, namely focusing on performance, cost, efficiency, and auditing (Diefenbach, 2009). Thus, the main objective of NPM is to provide a new orientation for public-sector organizations and to replace their existing system. Chiapello and Fairclough (2002) considered that NPM fosters globalization and neoliberalism in public-sector organizations. In other words, they must have a 'new spirit of capitalism' which is seen in the implementation of fiscal decentralization frequently used as a competition arena by local governments to get more budgets in the following year. Hence, the budget is sometimes just planned without paying attention to the ideal outcome, i.e., public welfare. Particularly in Indonesia, decentralization is caused more by external factors, namely institutional forces, than the pure need of the public (Kamayanti, 2011).

Furthermore, decentralization cuts through the hierarchical structure of government. The control of the central government over the local government is ineffective because there are no more direct structural relationships that can force the local government to comply with the central government's requirements (Saldi, 2009). This is closely related to the impact of power abuse. Criticisms expressed in empirical research have proven that NPM is only seen as a technical concept that focuses on delegating authority of policy-making, both financial and administrative, from central government to local governments (Gunarso, 2015) without being accompanied by an emphasis on ethics and morality and without democratizing power for the people who should participate in supervising government administration. Since the 1998 monetary crisis and NPM reforms, Indonesia has been driven towards Western ideology, which supports capitalism. Capitalism is teaching to obey and submit to the combined values of egoism and materialism. Accounting must also be presented according to capitalism and liberalism, which are the manifestations of modernism with the characteristics of reductionistic, mechanistic, linearistic, dichotomous, and materialistic (Triyuwono 2012; Kamayanti 2016).

Indonesia today has even marginalized social and environmental elements as well as transcendental or spiritual values (Sukoharsono, 2010). This makes ethics and morality in the management of public-sector government reduced, resulting in the abuse of power in the financial governance of local governments. This is different from the view of *Arthashastra*, which is not a book containing wealth or money principles as prescribed by books written by Western economists (Rangarajan, 1992). *Arthashastra* holds ethics and morality contained in Dharma in carrying out public financial governance. The failure of the financial management system accompanied by the moral failure of the government has become the main factor of corruptive practices. This deviant behavior is the result of excessive greed. *Arthashastra* often mentions that a king should take care of the happiness of his people and should not make rules for his own sake. There are two goals emphasized by

Arthashastra: maximization of resources and optimal management of the state; both imply a method of gathering resources that can bring about maximum prosperity without killing economic incentives.

The government has an important role in maintaining their nation's and people's material welfare. The balance between the welfare of the people and the increase of state resources must be maintained (Rangarajan, 1992). *Arthashastra* emphasizes that the most comprehensive set of rules will not be sufficient to control greed and eliminate fraudulent practice potentials. Rules are considered complementary to an ethics-based approach. If most people are unethical, the system will collapse. The government must be ethical, high in morality, and must ensure that there is no corruption in their system because corrupt government employees will accustom corruptive practices. This is because once a government employee is corrupt, it will create a culture of corruption which will familiarize the practice of corruption in the government system. Therefore, the *Arthashastra* emphasizes that leaders must reform the administrative system first, by punishing officials who deviate according to the appropriate punishment as expected by society.

4.2 Critical Thoughts on *Arthashastra*

Arthashastra is indeed a work that provides knowledge about the management of state assets that cannot be separated from ethics and morality. However, Mulla & Vylder (2014) showed that ethics and morality in *Arthashastra* are different from ethics in Buddhism and Tamil. Normatively, *Arthashastra* refers to statements that are instrumental in nature, namely economic activities as guidelines and important needs in a country yet its management cannot be separated from moral and ethical teachings, while Buddhist and Tamil values teach good characteristics needed to build ethics. Mulla & Vylder (2014) also argued that the fundamentals of the *Arthashastra* are the ethical dimension, but Kautilya has several arguments that are considered to be pragmatic in maintaining leadership, namely that corruption is handled only from the government's point of view.

In addition to explaining that punishments are carried out based on ethical teachings and *Dharma*, punishment must provide a deterrent effect so that the government remains subservient to the king/leader, as stated by Kautilya in Rangarajan (1987) that punishment must be “sufficient to prevent them from succumbing to temptation or rising up in rebellion, sufficient to make them efficient in their work, sufficient to ensure that they remain loyal and become strong supporters of the king”. The written utterances above invite debates in the interpretation of the meaning and raise the assumption that the motivation of *Dharma* is misused for the benefit of the king. In fact, the thought of Kautilya that he wrote in *Arthashastra* is considered to be oriented to practical politics with a pragmatic approach similar to Machiavelli’s thinking. As a result, some Indian thinkers began to question the *Dharma* mentioned in the *Arthashastra* and juxtapose it with other books such as the Kural, which codified clear directions to mankind on how they should behave and act in social and political circles with religion as the foundation (Vylder & Mulla, 2014).

4.3 *Dharma* as A Law Concept in *Arthashastra*

Dharma is a code of ethics for inside individuals, i.e., conscience that compels individuals to apply the *Dharma*, and outside individuals, i.e., through law (Radhakrishnan & Muirhead, 1936). *Dharma* cannot be forced; it is a series of exercises to make a man a moral person. The ethical and moral values in the *Dharma* are efforts for the development of human character. Kautilya has stated the *Dharma* values in the Vedas, which are universally recognized; they are *ahimsa* (does not harm all living beings), *Satyam* (truth), cleanliness, freedom from crime, compassion, and tolerance (Sihag, 2014). Kautilya has also expanded the role of ethics to become the most effective driver in achieving safety from poverty (Sihag, 2000). If the world is run according to the teachings of the *Dharma*, then the world will prosper (Subramanian, 2000). Therefore, in order to achieve the desired social and political conditions, humans must have four interrelated goals

(*purusharthas*) consisting of ethical goodness (*Dharma*), wealth and power (*Artha*), pleasure (*Kama*), and spiritual transcendence (*Moksha*). *Arthashastra* states that governance for welfare cannot leave the balance between *Artha* (material gain or wealth), *Dharma* (morality), and *Kama* (pleasure). The most basic moral in human life is the absence of *ahimsa* (violence) and controlled senses (Gautam, 2016).

Dharma in the *Arthashastra* has three different meanings: *Dharma* in social obligations; *Dharma* in moral law based on truth; and *Dharma* in civil law (Vishwanath, 1959). Therefore, the concept of state governance in *Arthashastra* is a government driven by social obligations, ethical and moral law, and civil law. *Arthashastra* refers to *Rajdharma*, the one *Dharma* which is only applied to kings, not referring to *Dharma* in a religious sense. *Dharma* in a religious sense teaches morality as a human duty and teaches that misconducts are sinful. Gautam (2016) stated that Kautilya's *Dharma* is related to truth and ethics. The *Dharma* that is established in the *Arthashastra* is called *Dandaniti* (punishment), which is prioritized to solve moral problems. *Rajdharma* is the guarantor for the entire social structure in a country. Kautilya expanded the role of ethics into the most effective encouragement in achieving safety from poverty (Sihag, 2000). If the world is run according to the *Dharma*, then the world will prosper (Subramanian, 2000). *Dharma* has the highest-level underlying *Danda* because it is the means for applying *Dharma* (Drekmeier, 1962). *Raj Dharma* is a higher code of ethics or rule of law, that applies to rulers, governing all their actions. Kautilya believed that laws, regulations, and government policies that are based on ethics and morality can prosper at all levels of society (Sihag, 2014).

4.4 A Synthetic Study: Local Financial Governance Reforms Through *Arthashastra*

The concept of *Arthashastra* is technically no different from the government structure and rules in Indonesia, but Indonesia has lost its ethical and moral aspects. *Arthashastra* adheres to morality, ethics, and spirituality.

It uses the word '*Dharma*' (which generally means 'duty') and righteousness in personal and social behavior by describing ethical values (*Dharma*) as a shared duty for all through *ahimsa* (not harming all sentient beings), *Satyam* (truth), cleanliness, freedom from hatred, compassion, and tolerance (Priyadarshi, 2012). It also promotes ethical foundations such as developing the capacity to follow one's conscience, perceiving things beyond self-interest, and showing benevolence toward others; they are all as important as learning professional skills and should be incorporated in addressing fraud issues in the management of local government finances in Indonesia.

Concerning the issues of fraud in the management of regional finances in Indonesia, first, decentralization can be applied by selecting individuals of high integrity to cultivate an ethical culture in the local government system. Regulatory reforms that are carried out continuously will not work well if people involved in the government do not adhere to the principle of morality. The government which is given the authority to regulate its own region should uphold ethics and morality because regulations that have been reformed continuously will not work properly if the government that runs them does not adhere to moral principles. Leaders should be chosen not only because of their expertise in regional management but also because of their moral qualities. Moral quality according to *Arthashastra* is control over the five senses to attain strong leadership with justice, transparency, honesty, and commitment in regional management for the welfare of the community, followed by the application of *Dandaniti*. One of the financial governance systems in local government is budgeting planning processes. Budget planning processes must also be in accordance with the interests of the community. The focus of the government should be public welfare. The prepared budget contains public aspirations about, for example, much-needed facilities.

The expenditures must also be in accordance with the budget that has been set. Infrastructures that are high in quality and in accordance with the budget can bring people's welfare. In addition, the outcome of the

budgeting needs to be considered. Indonesia is currently implementing performance-based budgeting as one of the political reforms in financial management. The said budgeting is the relationship between funding allocation and the expected performance of the expenditure allocation, including efficiency in achieving performance. Hence, evaluations of the fiscal decentralization policy, which gives district and city governments the authority (power) in financial management, are still very much needed to minimize the potential of corruption. On their way to good governance, local governments must pay attention to the inputs, outputs, and outcomes of budget management. The transparency and accountability of financial reports must also be considered. The government must be transparent and accountable and must provide the public with broad access to financial reports.

Second, a whistle-blowing system also needs to be implemented. Indeed, the State has a financial management supervisory body tasked with overseeing and examining the financial management of the central and local governments. However, there is still a need for whistleblowers to be able to monitor and control more deeply and thoroughly how the government and its staff work. Corruption in Regional State Budgets is very much likely to be caused by opportunities supported by weak internal control, as mentioned by the Fraud Triangle Theory (Christia & Ispriyarno 2019). Corruption at the sub-national level has been formulated as ‘Corruption = monopoly power + discretion – accountability’, which means that corruption can occur if the power is monopolized by people who have the freedom to act. Accrual-based Governmental Accounting Standard (SAP), which has been considered appropriate and applicable, cannot be implemented perfectly due to the government’s high self-interest. Standards and policies certainly have loopholes that can be used for fraud. In *Arthashastra*, if the government adheres to ethics and moral principles, these loopholes will not be used. Officials who know about the holes will instead tell central government leaders about it for improvement.

Finally, implementation of a legal system based on 'dharma'. *Dharma* in the *Arthashastra* has three different meanings: *Dharma* in social obligations; *Dharma* in moral law based on truth; and *Dharma* in civil law (Vishwanath, 1959). The three meanings of *Dharma* in *Arthashastra* contain self-control to achieve individuals who have ethics, foster morality, and justice. *Dharma* in the legal system is a fair and impartial legal system that makes officials or other government employees uphold the law. The dharma law that can be implemented in Indonesia is imprisonment and moral sanctions that can prevent corrupt officials from getting privileges in prison. As is often the case, local leaders who commit irregularities in financial management get special facilities in prisons so that moral punishment is not felt by them. Therefore, good cooperation between the central government and policymakers in determining punishment, especially regarding moral punishment, is needed. Its realization is to provide moral guidance to corrupt employees and the abolition of privileged facilities. The moral punishment is to force them to learn to control their senses, such as when in prison they cannot enjoy what they used to enjoy before (wealth and excessive lust) so that finally they are able to realize their mistake by giving up lust, anger, greed, pride, and ignorance, and eventually become a new person who has high morality. Equality of treatment in punishment between ordinary people and government officials needs to be done because Kautilya said that, if the leader is not fair in his punishment, the people will hate him, and crimes will not be reduced. Leaders who are just in giving punishment will be respected, and crime rates will be reduced.

However, the critique of *Arthashastra* should not be ignored. *Arthashastra* indeed still implements a centralized government, so that, if the king was not wise, then he would be oppressive in managing his country. The weakness of the *Arthashastra* here is obvious, but the good point is that if the *Dharma* is held up, the king will not get caught up in the urges of his five senses that lead to perversion. Therefore, it is very important to choose a leader who holds the *Dharma* firmly, so that the country can be managed properly, and the welfare of the people will be prioritized.

5. Conclusion

NPM is a system designed to modernize governance. Technically, state management in *Arthashastra* is similar to the management prescribed by NPM. The difference is that *Arthashastra* still upholds *Dharma*, managing the country with ethics and morality. Fraud, which has become a critique for NPM, is an example of the loss of ethical and moral character. Governments must realize that, as 'leaders', they have an important role in maintaining the material welfare of their nation and people, must be aware of the *Dharma*, and must reduce materialistic traits. When the government adheres to the principles of ethics and morality, the management of finance and other sectors in the government will be in accordance with the vision and mission of the country, namely protecting all the people of Indonesia and all the independence and the land that has been struggled for, improving public welfare, educating the life of the people, and participating in the establishment of a world order based on freedom, perpetual peace, and social justice.

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