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## **The influence of the ethic culture and intellectual capital on local government performance: Evidence from Indonesia**

**Buntoro Heri Prasetya<sup>1</sup>, Yvone Agustine Sudiby<sup>2</sup>, Juniati Gunawan<sup>3</sup>, Khomsiyah<sup>4</sup>**

<sup>1 2 3 4</sup>Trisakti University, Jakarta Indonesia

buntoro\_heriprasetyo@yahoo.com<sup>1</sup>, yvoneeags57@gmail.com<sup>2</sup>,  
juniatigunawan@trisakti.ac.id<sup>3</sup>, khomsitah@trisakti.ac.id<sup>4</sup>

**Abstract.** The provision of public services by local governments in Indonesia is considered unsatisfactory. By theoretically ethical culture and intellectual capital play an important role on organization performance. This study aims to analyze the effect of ethical culture, and intellectual capital on Indonesian local government performance. The research sample was 53 districts / cities in Indonesia which were selected using cluster sampling method. This study uses ethical regulations and reporting on allegations of unethical behavior as a proxy for ethical culture, while intellectual capital and performance of local governments are measured by indicators used in assessing the performance of local government administration. The study results conclude that ethical culture and intellectuals have a positive effect on local government performance. That conclusion has an impact on the importance for local governments to induce and disseminate ethical culture and manage intellectual capital effectively. The results of this study also support the mindset of bureaucratic reform that is currently running in Indonesia.

**Keywords.** ethical culture, intellectual capital, local government performance, Indonesia

### **1. Introduction**

Law Number 23/ 2004 of Regional Government mandates regional governments to carry out development to increase and equalise community income, increasing employment opportunities, business fields, access and quality of public services, and competitiveness. The successful performance of public sector organisations are measure by the effectiveness and efficiency of public service provisio [7].

Referring to Government Regulation Number 6/ 2008 of Guidelines for the Evaluation of Local Government Implementation, evaluation of local governments is carried out on (a) the performance of local government administration based on the principles of good governance at the level of policymaking and implementation and (b) the ability to carry out regional autonomy.

According [36] to provide public services and maintain the community's trust, professionalism and high professional standard reflected in ethics are required. In terms of public services, the ethic is moral principles leading to behavior of all parties involved in public services. The behavior include commitment to maintain the community's trust, public service provision, and protection to the vulnerable community [17]. Ethics of government apparatus

are required because unethical behavior potentially leads to corruption in the public service area [31] and interference in the government legitimacy [34]. Unethical behavior of government apparatus makes the community have negative perceptions about important roles of government apparatus [1]. According to report on supervision and enforcement of code of ethics and code of conduct of state civil apparatus, ethical breaches in civil servant environment still happens (KASN, 2019). The report shows that there are 2674 state civil apparatus who were involved in corruption cases in which 11.9% of them were temporarily dismissed while the rest, 85.1% of them are still active state civil apparatus. In addition to ethical behaviour, the quality of public services is also influenced by intellectual capital [41]. Intellectual capital plays an important role to optimize the relation between resources, services, and community, as well as connects the achievement of accountability performances [19]. [16] prove that intellectual capital positively influences performances.

In addition to ethical culture, the quality of public services is also influence by intellectual capital [41]. Intellectual capital plays an essential role in optimizing the relationship between resources, services, and society and linking it to the achievement of performance accountability [19]. [16] prove that intellectual capital has a positive impact on performance. Other research concludes that the ethical culture of organizations plays a vital role in creating organizational integrity [40]. Based on this literature, it can conclude that ethical and intellectual capital plays an essential role in achieving local government goals in providing public services. But it can disrupt due to unethical behavior. The purpose of this study is to identify the influence of ethical culture and intellectual capital on local government performance

Scientific researches on ethics in public sectors in Indonesia are infrequent [33]. In general, research on ethical culture is not directly related to organizational performance. The research by Idris et al., (2015) and Nugraha et al., (2015) conclude that ethics of bureaucratic in the permit issuance are still poor. Mahfud (2017) concludes that ethics in the form of local wisdom acts to optimize corruption prevention.

This research also adds spiritual capital to enrich intellectual capital dimensions. Spiritual capital addition is considered relevant to phenomena of ethics and corruption in this research in which practical contributions are provided in the form of factor identification influencing the achievement of the regional government's performances. Identification of ethical cultural influences on performances are beneficial seeing that unethical behaviour phenomena in state civil apparatus' environment are relatively high. In addition, this research also provides understanding of the importance of intellectual capital management by the regional government

## **2. Literature review and hypothesis**

### **2.1. *Planned behavior theory (PBT)***

According to planned behavior theory, the intention or will to behave in a certain way is influenced by attitudes toward behavior, subjective norms, and perceived behavioral control. Attitude refer to an individual's considerations of behavioral consequences. Subjective norms are an individual's perceptions on social norms and pressures to behave or not behave in a certain way. Meanwhile, perceived behavioral control is an individual's perceptions on convenience and difficulty in realizing the intention or will and the intention with behavior. the intention or will is influenced by attitudes on toward behavior, belief and it become a behavior predictor. Planned Behavior Theory consider an individual's intention as the determining factor of certain behaviors. In general, the stronger the intention, the greater the possibility to realize certain behaviors [4].

Intention as a behavior expression applies only if a person has an ability to decide whether or not to manifest certain behaviors. However, a decision to behave or not behave in a certain way is not only influenced by a motivation but also a perception on opportunities and available resources called perceived behavioral control. In general, factors other than motivations driving a person to behave or not behave in a certain way reflect real behavioral control. Therefore, the realization of certain behavior depends on motivations reflected in the intention and ability as behavioral control [4].

### 2.2. *Resources based value theory (RBVT)*

RBVT stated that a sustainable competitive advantage could achieve effectively and efficiently through resource management [27]. The main key of this theory is sustainable competitive excellence that can be achieved efficiently and effectively through resources management [29]. The theoretical framework for RBVT is devolving from the premise that resource attributes that create a competitive advantage are unique [32]. According to [11], the role of intellectual capital in realizing a sustainable competitive advantage can do through performance measurement and implementation of strategies that mix internal strengths with responses to external opportunities and prevent internal weaknesses and neutralize external threats. The assumptions used in analyzing the sources of excellence in competitiveness are the control of various strategic resources. Those resources are not easy to move, so that they have long-term impacts.

### 2.3. *Local government performance (LGP)*

In accordance with Government Regulation Number 6 of 2008 on Evaluation Guidelines of Regional Government Implementation, the regional government evaluation is conducted in terms of (a) the regional government's performances, (b) abilities to implement regional autonomy and (c) new regional autonomy. One of aspects assessed in the regional government implementation is the achievement of Minimum Service Standards (MSS).

According to Regional Government Number 2 of 2018 on MSS is provisions regarding the type and quality of basic services are mandatory government affairs in which every citizen is intitled to obtain to a minimum. Meanwhile, basic services are public services to fulfill citizens' basic needs. The government regulation also stipulates mandatory functions and scopes of MSS that include: (a) education, (b) health, (c) public works and spatial planning, (d) public housing and residential areas, peace and protection of the community, and (f) social.

### 2.4. *Ethical culture (EC)*

Ethical culture of organizations is the same faith of organization members about moral principles and behavioural guidelines that individual must carry out in a community. Ethical culture of organizations triggers organization members' ethical behaviours as well as whistleblowing reports on unethical behaviours [26]. Ethical culture is a system controlling behaviour, both formal and informal, that influence each other, encourage ethical and unethical behaviours. Formal behaviour control includes policies such as code of ethics, leadership, authorization mechanism, reward system, and training program, meanwhile, peer behaviours and norms are informal control [40]. Ethics are important strategies to increase organizational productivity [10]. [12] conclude that positive influences of ethical cultures in the form of job satisfaction and commitment to the organization affecting employee absence and turnover that are reducing. High absence decreases productivity and morality, while high employee turnover affects high human resources management costs. Commitment and productivity are the key of organizational performance (Kawara, 2014).

Positive influences of ethical culture on organizational performances are realized through a conducive environment formation in building trust [18] and integrity [9]. Bardy (2015) states that activities or business based on ethics have positive influences on performance, through responsiveness to issues of concern to stakeholders. [2] state that organizational culture positively correlated to organizational performances. Ethical environment positively influences organizational performances in public sector [35]. The research also defines ethical environment as an environment that is able to maintain and secure ethical failures.

From those various literatures, ethical culture contributes to creating the environment with mutual trust, integrity, and considering stakeholders' interest so that it positively influences organizational performances. According to the conclusion, the first research hypothesis (H1) is: ethical culture positively influences the regional government's performances

## **2.5. Intellectual capital (IC)**

According to [41] the public sector's performance influenced by intellectual capital. The effect is even more significant than that of the private sector because the outcomes and management of the public sector are more intangible. Intellectual capital is a valuable collection of knowledge and includes human capital, customer capital, and structural capital (Stewart, 1997). Bontis (1999) proposes intellectual capital construction which provides for human capital, structural capital, and relational capital.

### *2.5.1. Human capital*

Human capital is knowledge, experience, competence, and expertise individually and collectively possessed by the workforce, including creativity and innovation [14]. Therefore, ownership of human capital is in individuals, not organizations [38]. Organizations can benefit from human capital by investing in individual members' knowledge, skills, and abilities [28]. Human capital is the component of intellectual capital that has the most influence on organizational performance through its innovative ability to deal with environmental changes. This innovation results from a combination of employee knowledge, experience, and capabilities [39]. The quality of the human resources has significant effect on job satisfaction [15].

### *2.5.2. Structural capital*

Structural capital includes intangible infrastructure in an organization, including, among others, processes, software, and trademarks. According to [8] structural capital is a collection of knowledge located in an organization, including databases, organizational charts, standard procedures, strategies, mechanisms, and policies. Structural capital plays an essential role in forming corporate culture [8]. According to [8] structural capital is knowledge created by organizations and cannot separate from an organization [25]. The role of structural capital in performance realised by providing organizational infrastructure to store and develop intellectual knowledge and rights, such as trademarks and patents [37].

### *2.5.3. Relational capital*

According to Bontis (1999), relational capital is knowledge about marketing channels, relationships with suppliers and consumers, and an understanding of the environment, including industry and government associations. The substance of relational capital is the knowledge inherent in the relationship between the organization and external parties, manifested in customer orientation. Relational capital plays a role in increasing organizational responsibility

to consumer needs, structuring, disseminating knowledge and transferring knowledge into corporate principles. According to [24] relational capital includes relationships with consumers and associations with other external people.

Khalique et al. (2018) synthesised various studies on intellectual capital. They proposed a model called Integrated Intellectual Capital Model (IICM), which includes six components: human capital, structural capital, customer capital, social capital, and technological capital. And spiritual capital. Spiritual capital is a combination of power, influence, enthusiasm, and knowledge derived from religiosity (Berger and Hefner, 2003).

According to [22] spiritual capital is knowledge, beliefs, and emotions integrated with individuals and organizations that manifested in the vision, mission, direction, guidelines, principles, and organizational culture and are proven to affect organizational performance positively [29]. [30] concluded that spiritual capital positively correlated with job satisfaction. Job satisfaction creates organizational citizenship behaviour, namely voluntary and not part of their work, and is not formally regulated but provides benefits for the organization.

According to Cabrita and Vaz (2006), intellectual capital is an important trigger and an indicator of national and international economic development. Intellectual capital is an intangible asset perceived as a cornerstone to gain a competitive advantage [20]. Intellectual capital plays a vital role in creating regional competitiveness and is the foundation for long-term growth and regional welfare [23]. [3] concluded that intellectual capital positively affects workforce capabilities, system effectiveness, and good relations with stakeholders. According to [16] intellectual capital has a positive impact on the performance of public organizations. This literature concluded that intellectual capital contributes to organizational performance by providing creative and innovative human capital, the condition of structures, mechanisms, and processes that support innovation and responsiveness to consumer needs. Therefore, the second research hypothesis is H2: Intellectual Capital has a positive effect on local government performance.

#### *2.5.4. Follow-up on the recommendation of BPK*

According to the Indonesia Basic Law, Supreme Audit Agency, in the future abbreviated as BPK, is an institution state responsible for checking management and responsibility state finances. Minister of State Apparatus Empowerment & Birocratic Reform Decree Number 4/2004 defines follow-up as actions taken by government agencies that the BPK examines to implement suggestions or recommendations on the results of the BPK examination. The follow-up on requests for BPK audit results is mandated by Law Number 15 /2004 of State Financial Management and Accountability Audit.

Azhar et al. (2015) concluded that the follow-up to BPK's recommendations had an impact on strengthening the internal control system and harmed corruption. Furqan et al. (2020) also found empirical evidence that the follow-up to BPK recommendations positively affected the quality of financial reporting and the quality of public services.

### **3. Research method**

#### *3.2 Sample and data collection*

The clustering process is using to pick a sample of 53 districts/cities [13] (Cooper and Shindler, 2001). The clustering resulted in 64 samples, 11 of which did not meet the data availability criteria, so that the final sample was 53 districts/cities.

This study uses secondary data with the dimensions of the 2016-2019 observation time. The data we obtained from publications and requests for data through district/city PPIDs. Sources of research data include the Ministry of Finance, Ministry of Home Affairs, Central

Bureau of Statistics, the National Legal Documentation and Information Network Website, Ministry of Empowerment of State Apparatus and Bureaucratic Reform, district/city government portals, Development Finance Supervisory Agency, and the Supreme Audit Institution (BPK).

### 3.3 Variable Measurement

This study uses local government performance (LGP) as an exogenous variable and ethical culture (E.C.) and intellectual capital (I.C.) as an endogenous variable. The follow-up of the BPK recommendation was used as the control variable to get an absolute power of influence of E.C. and I.C.

#### 3.3.1 Local Governance Performance

Based on Government Regulation No. 6/ 2008, delivering public service is evaluated by achieving minimum service standards. The indicators used are indicators used in the evaluation of the performance of local government administration as shown in table 3.1 as follows:

**Table 3.1**  
**LGP Indicators**

Dimension	Indicators
Performance on providing public service	
Educational	<ol style="list-style-type: none"> <li>1. The ratio of teachers who meet Bachelor/Academy qualifications</li> <li>2. The ratio of literate population over 15 years</li> <li>3. Ratio number of students continuing their level educational to junior secondary school</li> <li>4. Ratio number of students continuing their level education from junior secondary school to senior high school</li> </ol>
Health	<ol style="list-style-type: none"> <li>1. Coverage of referral health services for the poor</li> <li>2. Coverage of vaccination for children</li> <li>3. Coverage of care for infants with malnutrition</li> <li>4. Coverage of treated obstetric complications</li> </ol>
Infrastructure and	<ol style="list-style-type: none"> <li>1. The ratio of the liveable houses</li> <li>2. The ratio of household using clean water</li> <li>3. The ratio of sanitized household</li> <li>4. The ratio of a road in good condition</li> </ol>
Economic Performance	
Contribution to product domestic, regional bruto (PDRB)	<ol style="list-style-type: none"> <li>1. Contribution of the industry sector to PDRB</li> <li>2. Contribution of energy, oil, and gas sector to PDRB</li> <li>3. Contribution of the trading sector to PDRB</li> <li>4. Contribution of the agriculture sector to PDRB</li> </ol>

### 3.3.2 Ethical Culture

Robin and Judge (2009) state that efforts to build E.C. require various steps: role model, clear messages on desired ethical behaviour, reward and punishment systems, protection of information providers, and training. This study uses the whistleblowing system (WBS) and unethical behaviour to proxy for organizational ethical culture. Kaptein (2009) states that WBS is an organizational ethical system that integrates ethical values into practical action. The indicator of E.C. is as follows:

**Table 3.2**  
**EC Indicators**

Dimension	Indicators
Ethical regulation	<ol style="list-style-type: none"> <li>1. Existence of ethic regulation</li> <li>2. Existence of regulation for handling conflicts of interest</li> <li>3. Existence of whistleblowing regulation</li> </ol>
Reporting facility & incentive	<ol style="list-style-type: none"> <li>1. Availability of facility for reporting suspected unethical behaviour through the WBS online</li> <li>2. Protection to whistleblowers</li> <li>3. Incentives to whistleblowers</li> </ol>
Unethical behaviour	<ol style="list-style-type: none"> <li>1. Fraud in travel cost</li> <li>2. Fraud in payment of honoraria</li> <li>3. Un-need expenditures</li> <li>4. Overpayment</li> </ol>

### 3.3.3 Intellectual Capital (I.C.)

The indicator of intellectual capital is shown in table 3.3 as follows:

**Table 3.3**  
**IC Indicators**

Dimension	Indicators
Human Capital	<ol style="list-style-type: none"> <li>1. % of officials who have attended leadership training</li> <li>2. The suitability between position and rank</li> <li>3. The ratio of the state's civilian apparatus to the total population</li> <li>4. Frequency of acceptance of awards/innovations</li> </ol>
Structural Capital	<ol style="list-style-type: none"> <li>1. Filling positions and echeloning</li> <li>2. institutional suitability to Government Regulation No. 41/2006</li> <li>3. Number of standard operating procedures</li> <li>4. The utilization of information technology on personnel management system</li> </ol>
Relational Capital	<ol style="list-style-type: none"> <li>1. Frequency of cooperation with other regional/central government</li> <li>2. Frequency of community involvement</li> <li>3. Frequency of events/promotions</li> </ol>



Spiritual Capital	4.	Provision of interaction facilities
	1.	Existence of religious education regulation
	2.	Appointment of a work unit as the person in charge of mental development
	3.	Honesty in exploring potential sources of regional income
	4.	Honesty in realizing potential sources of regional income

### 3.3.4 Follow-up on recommendation of BPK

The follow-up recommendations of the BPK. The examination measured by the ratio of the follow-up to the number of findings

### 3.4 Methodology

The relationship between the variable of this study is tested using Structural Equation Model-Partial Least Square and utilizing Smart-PLS statistical program, version 3.0, based on the following model:

$$LGP = \beta_0 + \beta_1EC + \beta_2IC + \beta_3FBPK + e$$

Notes: LGP = Local government performance; EC = Ethical culture of the organization; FBPK = Follow-up recommendation of BPK; e = Error

## 4. Statistical summary, analysis and result

### 4.1 Statistic descriptive

The descriptive statistic is displayed in Table 4.1 as follows:

Table 4.1

Statistic Descriptive

Variable	N	Min	Max	Mean	S.D.	
Exogenous variable						
Local Government Performance (LGP)	Education	212	6.00	23.00	17.79	2.24
	Health	212	12.00	25.00	21.38	3.09
	Infrastructure	212	6.00	25.00	17.77	4.12
	Economic	212	1.00	13.00	6.57	1.98
Endogenous variable						
Ethical Culture (EC)	Ethical regulation	212	0.00	30.00	10.89	10.14
	Reporting facility & Incentive	212	0.00	30.00	8.91	10.40
	Unethical behaviour	212	0.00	40.00	26.17	10.53
Intellectual Capital (IC)	Human capital	212	748.00	2218.00	1529.70	262.13
	Structural capital	212	866.00	2174.00	1604.10	235.61
	Relation capital	212	38.00	1877.00	562.24	376.11
	Spiritual capital	212	115.00	1646.00	950.33	288.26
Control Variable						
Follow-up on recommendation of BPK (FBPK)	212	1429.00	10000.00	8096.31	1735.89	

Source: SPSS statistical Ver. 22 output, processing by author

#### 4.2 Analysis and result

The result of statistical testing is presented in table 4.2 as follows:

Table 4.2  
Statistical Result

	Original Sample (O)	Sample Mean (M)	Standard Deviation (STDEV)	T Statistics ( O/STDEV )	P Values
X1 (EC) -> Y (LGP)	0.181	0.183	0.054	3.365	0.000** *
X2 (IC) -> Y (LGP)	0.542	0.546	0.049	11.133	0.000** *
C (FBPK) -> Y (LPG)	0.113	0.112	0.050	2.256	0.012**

Source: Smart-PLS 3.0 output, processing by author

The symbols: \*\*\*, \*\*, \* denote significance level 1%, 5% and 10% respectively.

Notes: LGP = Local government performance; EC = Ethical culture; IC = Intellectual capital; FBPK = Follow-up on recommendation of BPK

Table 4.2 shows that E.C. and I.C. have a positive effect on LGP. Thus, the research hypothesis H1, namely E.C. has a positive impact on LGP, and H2, I.C. has a positive effect on LGP is acceptable. Furthermore, FBPK as a control variable also has a positive correlation with I.C. Therefore, the conclusion concerning the effects of the two exogenous variables on the endogenous variable is more robust because it has overlooked one of the other factors that affect LGP.

### 4.3 Discussion

#### 4.2.1 Ethic Culture and Local Government Performance

The positive correlation between ethical culture and local government performance is consistent with [2] and [35]. This study proves that a work environment based on ethics is beneficial in improving performance. It is possible because the work environment encourages commitment, integrity, mutual trust among organizational members, and responsiveness. This study also shows that management needs to provide a clear message about the desired ethical behaviour through various internal processes and mechanisms, and facilities for reporting suspected unethical behaviour. From the perspective of Planned Behavioural Theory, the clarity of the message creates subjective norms and perceived behavioural control that encourage ethical behaviour and avoid unethical conduct.

In the context of bureaucratic reform that the Indonesian government is implementing, officials must have high ethics in carrying out their duties as the mission and objectives of bureaucratic reform following Presidential Regulation Number 81/2010 of Grand Design of Bureaucratic Reform 2001-2025. This study supports the mindset of bureaucratic reform policies that encourage the formation of integrity zones through various stages to develop individual and organizational integrity.

#### 4.2.2 *Intellectual Capital and Local Government Performance*

The conclusion that I.C. positively affects performance is consistent with [3] and [16] and confirms the resources-based value theory. Table 4.1 shows that the components of intellectual capital, namely human capital, structural capital, and spiritual capital contribute to creating intellectual capital that can boost performance. The study conclusions indicate that the local government has succeeded in combining and directing the competence of human resources with internal mechanisms and processes and spiritual capital to support organizational performance. Table 4.1 also indicates relations between government of regency/municipality and the regional government or the central government and the community still need to be increased

This study also supports the mindset of achieving the vision of bureaucratic reform, including realizing the effective management of apparatus resources. The grand design of Indonesian bureaucratic reform requires knowledge management to disseminate knowledge and experience both internally and externally. The learning process through knowledge management involves collaboration with other work units within the district/city government and external parties. That way, effective relational capital management must realize.

### 5. Conclusion

The study concludes that the intangible assets in E.C. and I.C. capital play an essential role in LGP. The influence of the E.C. realized by building the integrity of individuals and organizations, I.C. acts as a means and infrastructure for E.C. induction and a managerial tool that supports LGP. The alignment between the E.C. with internal mechanisms, procedures, and processes and competent and innovative human resources positively impacts LGP. However, the results of this study cannot be generalized to other levels of local government, that is, the province. The conclusion of this research confirms the vital role of E.C. and I.C.

Therefore, it recommended to regulators, in this case, the Ministry of State Apparatus Empowerment and Bureaucratic Reform, to accelerate the establishment of an integrity zone among district/city governments. Following the Regulation of the Minister of State Apparatus Empowerment and Bureaucratic Reform Number 10/2019, the development of an integrity zone that begins with the declaration of an integrity zone is still voluntary. Also, the WBS reporting mechanism needs to reorganized to facilitate and encourage reporting of suspected unethical behaviour. The results of this study open up opportunities for retesting by adding samples, using primary data, and adding other control variables.

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