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Fiscal Decentralization and Financial Performance: The Mediating Role of Capital Expenditure

Raden Budi Hendaris[1], Rahmat Siraz[2]*

[1,2]Accounting Department, Faculty of Economics and Business, Jenderal Ahmad Yani University, Cimahi, Indonesia

*Correspondence: budi.hendaris@lecture.unjani.ac.id

ABSTRACT

This study aims to analyze the influence of fiscal decentralization on the financial health of local governments by placing capital expenditure as a mediation variable. This study uses a quantitative approach based on secondary data from 482 Indonesian local governments during 2019–2023. The hypotheses were tested using panel regression and path analysis to examine the mediating role of capital expenditure. The findings show that the efficiency of the transformation of funds into public investment is the main determinant of the success of fiscal decentralization. Targeted capital expenditure allocation has been proven to be able to improve regional accountability and financial reporting standards automatically. Regional financial stability is highly dependent on the ability of local governments to manage development budgets to optimize existing resources. This study strengthens the accounting literature on the important role of productive assets in maintaining the sustainability of public sector financial performance. Practically, local governments are encouraged to be more selective in spending policies so that central funds have a long-term impact on fiscal stability. The novelty of this research lies in the use of an accounting perspective that positions capital expenditure as an intermediate factor in determining sustainable regional financial performance.

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1. INTRODUCTION

Fiscal decentralization is present so that local governments are more independent and efficient in managing their own finances. However, in Indonesia, this progress has not been even due to the strong dependence on central funds and the lack of local revenue optimization, as noted by (B. D. Lewis, 2023) and (Wiryawan and Otchia, 2022). Globally, (Alves and Araujo, 2024) and (Andonova and Trenovski, 2023) emphasize that the success of regions actually depends more on how they allocate their budgets than just the amount of their income. Indeed, central transfer funds aim to close the inequality gap and expand spending capacity to boost financial performance (Fitrianti et al., 2025; Masaki, 2018). Even so, too high a dependency risks backfiring on the region. According to (Alves and Araujo, 2024; Andonova and Trenovski, 2023; Setiawan, 2021), this condition can pamper regions until fiscal discipline weakens and motivation to spend efficiently decreases. The challenge now is how to ensure that the fund spurs independence, not making the regions lose enthusiasm to continue to innovate in managing their resources.

Local own-source revenue is commonly viewed as a reflection of fiscal independence and the capacity of local governments to manage their financial resources. A number of studies have found a positive relationship between own-source revenue and financial performance (Dick-Sagoe et al., 2025; Anggraini and Diah Widajantie, 2024; Tahu et al., 2024). However, this relationship is not always consistent. In some cases, higher levels of own-source revenue do not necessarily translate into improved performance, particularly when revenue growth is not supported by effective expenditure allocation and sound governance practices (Chaerani and Firmansyah, 2024; Andjarwati et al., 2021).

Despite the growing body of literature, several important gaps remain. First, prior studies have primarily focused on the direct effects of intergovernmental transfers and local own-source revenue on financial performance. However, the findings have been inconsistent, and limited attention has been given to the theoretical mechanisms that explain these mixed results. In addition, relatively few studies have examined the role of capital expenditure as a mechanism linking funding sources to financial performance, particularly in decentralized settings characterized by variations in fiscal capacity and governance quality. Most existing research tends to treat capital expenditure as an outcome variable. In contrast, it can also be understood as a strategic allocation channel through which revenue is transformed into long-term fiscal and economic benefits (Pavlov and Kostov, 2023; Zamzami and Rakhman, 2023; Zamzami and Rakhman, 2023; Putra et al., 2021).

This study contributes to the literature by positioning capital expenditure as a mediating mechanism through which intergovernmental transfers and local own-source revenue influence local government financial performance. Unlike previous studies that mainly focus on direct fiscal relationships, this research adopts stewardship theory to explain how public officials, as stewards, are expected to allocate financial resources responsibly toward productive capital investment that supports fiscal sustainability and performance.

By empirically testing a mediation framework, this study offers a more comprehensive explanation for the mixed findings reported in prior research (Dallas and Lubrano, 2023; Pavlov and Kostov, 2023). This approach highlights the importance of understanding financial performance not only from a revenue perspective, but also from how financial resources are allocated and managed within an accounting framework.

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Accordingly, this study has three main objectives. First, to examine the effect of local own-source revenue and intergovernmental transfers on capital expenditure. Second, to analyze the influence of these fiscal variables on local government financial performance. Third, to assess the mediating role of capital expenditure in linking sources of funding to financial performance. The findings are expected to provide insights for improving local fiscal performance and strengthening public sector accounting practices in developing country contexts.

2. METHODS

The study adopts a quantitative research approach with an explanatory design to examine the relationship between intergovernmental transfers, local own-source revenue, capital expenditure, and the financial performance of local government. In this regard, a panel data framework is considered essential in order to capture cross-sectional differences among local governments, as well as temporal differences over the observation period. This guarantees the estimates will be more powerful and efficient. The analytical design is structured to examine direct and indirect relationships through a mediating mechanism in accordance with the objectives of the study.

The population in the study is all the Provincial Governments in Indonesia. The study collected secondary data on the financial statements from local governments, specifically the Budget Realization Reports from 2019 to 2023. The sample was taken from a population of 514 districts and municipalities. The final sample consisted of 482 local governments, taking into account 5 years of financial data that were available and consistent. This selection process provided a balanced panel data set that includes 2410 observations. The data came from the Directorate of Regional Financial Balance's database. The procedure for selecting samples is shown in **Table 1**. It is worth mentioning that research findings are more reliable when the sampling strategy is purposive and matches local governments with complete data and comparable data to be included in the research.

Table 1. Research population and sample selection

Citeria	2019	2020	2021	2022	2023
Total districts/cities in Indonesia	514	514	514	514	514
Incomplete or inconsistent financial data	-32	-32	-32	-32	-32
Final sample	482	482	482	482	482

Source: processed secondary data, 2026

The operationalization of all research variables was achieved by using financial ratios derived from actual budget figures, thereby ensuring data comparability across local governments and over time. Funds allotted from the federal budget to local governments to promote decentralisation and the delivery of public services are known as intergovernmental transfers. Local own-source local governments get their revenue from local taxes, user fees, income from separate regional assets, and other legal local sources. Government Regulation No. 71 of 2010 defines capital expenditure as funds used by the government to purchase fixed or other long-term assets that will be valuable for multiple accounting periods. The fiscal independence ratio measures the extent to which local governments can fund themselves with sources that they generate themselves. The definitions and measurements of all variables are presented in **Table 2.**

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Table 2. Operational definitions of research variables

No	Variabel	Type	Definition	Measurement	Reference source
1	Intergovernmental Transfers (IT)	Independent	Money from the central government's budget is given to local governments to help in decentralization and provide public services	Realization of intergovernmental transfers	(Canare, 2023; Aritenang, 2020; Ogweno and Semedo, 2025)
2	Local Own-Source Revenue (LOSR)	Independent	Revenue generated from local taxes, user charges, income from separated regional assets, and other legitimate local sources	Realization of Local Own-Source Revenue	(Andonova and Trenovski, 2023; Noor et al., 2022)
3	Capital Expenditure (CapEx)	Mediating	Government spending on buying fixed assets or other assets that give benefits that last more than one accounting period	Realization of Capital expenditure	(Adarov and Panizza, 2024; Kwistianus and Juniarti, 2022; Aschauer, 2000)
4	Local Government Financial Performance (LGFP)	Dependent	The capacity of local authorities to fund developmental initiatives and public services autonomously	Fiscal independence ratio (Realization of Local Own-Source Revenue / Total local government revenue)	(Zamzami and Rakhman, 2023; Andjarwati et al., 2021; Nurhayati et al., 2021)

Source: processed secondary data, 2025

Data analysis proceeded in several steps. We initially utilized descriptive statistics to show how the research variables were spread out, and then we performed panel regression analysis to see if the claimed associations were true. To choose the model, Chow, Hausman and Lagrange Multiplier tests were used. The test results were consistently supportive of the fixed-effects specification that suggest time invariant unobserved heterogeneity across local governments. Subsequently, we performed diagnostic tests for autocorrelation, multicollinearity, and heteroskedasticity and applied estimates using robust standard error. The empirical models to investigate the effects of regional own-source revenue and government transfers on capital expenditure, their direct effects on financial performance, and the mediating role of capital expenditure were estimated sequentially.

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To examine the indirect effects among the research variables, mediation analysis was performed using the Goodman test. This test was employed to assess whether Capital Expenditure significantly mediates the relationship between Intergovernmental Transfers, Local Own-Source Revenue, and Local Government Financial Performance. The significance of the mediation effect was evaluated based on the probability value generated by the Goodman test, where a p-value below 0.05 indicates a statistically significant indirect effect.

3. RESULTS AND DISCUSSION

Table 3. presents the descriptive statistics of the variables examined in this study. The statistics provide an overview of the characteristics of local governments in Indonesia in terms of transfer revenues, locally generated revenues, capital expenditure, and financial performance.

Intergovernmental Transfers (DT) have an average value of Rp1.22 trillion, indicating that transfers from the central government remain a major source of funding for local governments. The large gap between the minimum value of Rp392.24 billion and the maximum value of Rp7.68 trillion reflects substantial differences in the amount of transfers received by each region. This variation may be attributed to differences in population size, regional needs, fiscal capacity, and government policies related to fiscal equalization.

Local Own-Source Revenue (PAD) records an average value of Rp234.11 billion. However, the relatively high standard deviation compared to the mean suggests considerable disparities in the ability of local governments to generate revenue independently. While some regions are able to collect PAD exceeding Rp5.77 trillion, others generate only around Rp3.25 billion. These figures indicate that the economic potential and revenue-generating capacity of local governments remain uneven across regions.

Capital Expenditure (BM) shows an average value of Rp282.45 billion, with values ranging from Rp32.74 billion to Rp2.75 trillion. This finding suggests that local governments allocate different proportions of their budgets to long-term investments such as infrastructure, public facilities, and other development projects. Regions with stronger fiscal capacity generally have greater opportunities to increase capital spending in support of public service improvement and regional development.

Meanwhile, Local Government Financial Performance (KKD) has an average value of 14.84 percent, with a standard deviation of 14.59 percent. The minimum value of 0 percent and the maximum value of 268.92 percent indicate a wide variation in financial performance among local governments. This condition suggests that while some local governments have achieved relatively high levels of fiscal independence, others continue to rely heavily on transfer funds from the central government.

Table 3. Descriptive statistics of research variables

Variabel	Mean	St. Dev.	Min	Max
Intergovernmental Transfers (IT)	Rp1.222.869.506.951,49	Rp694.284.758.091,16	Rp392.235.153.648,00	Rp7.676.010.272.909,00
Local Own-Source Revenue (LOSR)	Rp234.105.409.072,99	Rp353.324.540.752,61	Rp3.254.425.181,00	Rp5.771.818.530.453,00
Capital Expenditure (CapEx)	Rp282.446.292.674,54	Rp232.036.545.609,04	Rp32.739.382.912,01	Rp2.754.304.824.082,00
Local Government Financial Performance (LGFP)	14,84%	14,59%	0,00%	268,92%

Source: Results from data processing, 2025

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As reported in **Table 4**, the normality test for Model 1 was conducted to evaluate whether the residuals of the regression model follow a normal distribution. The results show an adjusted Chi-square value of 5.31 with a probability value of 0.0702. Since the probability value is higher than the 0.05 significance level, the residuals can be regarded as normally distributed. Although the skewness test indicates a slight departure from symmetry, the overall evidence suggests that the deviation is relatively minor. Therefore, the normality assumption for Model 1 is considered to be adequately satisfied, allowing the regression analysis to proceed.

Table 4. Normality test results using the skewness and kurtosis test model 1

Variable	Obs	Pr(skewness)	Pr (kurtosis)	Adj chi2 (2)	Prob>chi2
Resid	2,410	0,0446	0,2541	5,31	0,0702

Source: Results from data processing, 2025

As shown in **Table 5**, the residuals of Model 2 exhibit some departures from the normal distribution, as reflected by the probability values of 0.0000 for both the skewness and kurtosis tests. This indicates that the distribution of residuals is influenced by asymmetry and the presence of extreme values. However, considering the relatively large sample size used in this study, such deviations are unlikely to materially affect the reliability of the estimation results. Accordingly, the model remains suitable for subsequent analysis.

Table 5. Normality test results using the skewness and kurtosis test model 2

Variable	Obs	Pr(skewness)	Pr (kurtosis)	Adj chi2 (2)	Prob>chi2
Resid	2,410	0,0000	0,0000	-	-

Source: Results from data processing, 2025

The results reported in **Table 7** indicate that both Model 1 and Model 2 show signs of autocorrelation. This can be seen from the probability values of 0.0255 and 0.0253, respectively, which are below the 5 percent significance level. These findings suggest that the residuals are not entirely independent and may still be influenced by patterns from previous observations.

Although this condition is detected in both models, it does not necessarily undermine the validity of the analysis. To improve the reliability of the estimation results, robust standard errors were employed in the regression procedure. By applying this adjustment, the estimated coefficients and statistical tests remain sufficiently reliable to support further analysis and hypothesis evaluation. **Table 6** shows sutocorrelation test results using bresusch-godfrey LM test.

Table 6. Autocorrelation test results using bresusch-godfrey LM test

Model	Lags (p)	Chi2	df	Prob>chi2
1	1	4,991	1	0,0255
2	1	5,000	1	0,0253

Source: Results from data processing, 2025

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The multicollinearity test results presented in **Table 7.** show that the VIF values for all explanatory variables remain at relatively low levels. In Model 1, both Intergovernmental Transfers (IT) and Local Own-Source Revenue (LOSR) record VIF values of 1.87. Meanwhile, in Model 2, the VIF values range from 1.94 to 2.69. These figures indicate that the independent variables are not excessively correlated with one another.

This finding suggests that each variable captures a different aspect of local government financial conditions and contributes unique information to the model. As a result, the estimated coefficients can be interpreted with greater confidence, as the relationships observed are less likely to be influenced by overlapping information among the explanatory variables. Overall, the results indicate that multicollinearity is not a concern in either regression model.

Table 7. Multicollinearity test results

Model	Variable	VIF	1/VIF
Model 1	IT	1,87	0,535800
	LOSR	1,87	0,535800
	Mean VIF	1,87	
Model 2	IT	2,69	0,371360
	Capex	2,25	0,44270
	LOSR	1,94	0,514267
	Mean VIF	2,30	

Source: Results from data processing, 2025

The heteroskedasticity test results presented in **Table 8** suggest that both regression models satisfy the assumption of constant error variance. Model 1 produces a probability value of 0.9330, while Model 2 records a probability value of 0.4879. Since both values are well above the 5 percent significance level, there is no indication that the variability of the residuals changes systematically across observations.

This finding implies that the models are able to capture the relationship among the variables without being affected by unequal error variation. As a result, the estimated coefficients are expected to provide a stable representation of the underlying relationships, supporting the reliability of the subsequent regression analysis.

Table 8. Results of the breusch–pagan/cook–weisberg heteroskedasticity test

Model	Chi2(1)	Prob > chi2
Model 1	0,01	0,9330
Model 2	0,48	0,4879

Source: Results from data processing, 2025

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The result indicates that 55.26% of the total variation in local government capital expenditures is explained by intergovernmental transfers and locally owned source revenue. In contrast, the leftover variation in capital expenditure is a result of something beyond the scope of this study. **Table 9** shows the results of testing the Model 1 hypothesis.

Table 9. Shows the results of testing model 1

Hypothesis	Coefficient	Robust Std Err	t	Prob.	Results
IT → CapEx	0.3087102	0,0498362		0,000	H1 Accepted
LOSR → CapEx	0.0615267	0,508015		0.226	H2 Rejected

Source: Results from data processing, 2025

Additionally, Model 2's coefficient of determination (R^2) value is 0.4377, according to the test findings. This result shows that 43.77% of the variation in local government financial performance can be attributed to intergovernmental transfers, locally owned source revenue, and capital expenditures taken together. The remaining variation in financial performance is due to factors that are not covered by this research methodology. **Table 4** shows the results of testing Model 2. The remaining variance in financial results is due to factors not recognized by the research model. **Table 4** provides a summary of testing of model 2. **Table 10** shows results of hypothesis testing for Model 2.

Table 10. Results of hypothesis testing for model 2

Hypothesis	Coefficient	Prob.	Results
IT →LGFP	-0.2121852	0.000	H3 Accepted
LOSR→ LGFP	0.1596819	0.016	H4 Accepted
CapEx → LGFP	0.0512085	0.200	H5 Rejected

Source: Results from data processing, 2025

The results of the indirect impact test, which examined the relationships among capital spending, intergovernmental transfers, local-owned source revenue, and local government financial performance, are displayed in **Table 5**. **Table 11** shows meditation test results.

Table 11. Mediation test results

Hypothesis	T statistic *Goodman Test*	Std. Error	*Prob.*	Result
IT → CapEx → LGFP	1.9781	0.0000	0.04791	H6 Accepted
LOSR → CapEx → LGFP	2.3302	0.0000	0.01979	H7 Accepted

Source: Sobel Test output results, 2025

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3.1 The Effect of Intergovernmental Transfers on Capital Expenditures

Table 3 shows that intergovernmental transfers positively and significantly impact capital spending.This result implies that transfer funds remain the main source of funding for long-term investments, especially for the provision of public assets and infrastructure development. In practice, more extensive capital expenditures are likely to occur in localities receiving more substantial transfers, an indication of the central government's incentive to expand local fiscal capacity.

According to stewardship theory, the local government is responsible for managing public goods for the benefit of the community. Public officials as stewards should use what has been entrusted to them in a manner to the long-term development objectives. In this sense, intergovernmental transfers can be seen as a form of fiscal trust that encourages local governments to engage in better and more effective spending rather than merely financing.

The aforementioned outcome can also be interpreted within the framework of fiscal decentralization, which encourages the transfer mechanisms envisaged to generate a level playing field for public service delivery across regions and difference in fiscal capacity (Oates, 1999). One explanation for this is that transfers create additional fiscal space and that local governments, especially those with limited own-source revenue, undertake capital investment difficult to fund otherwise. Consequently, transfer funds are a strategic tool that converts external financial assistance into development expenditure choices.

These findings confirm that transfer funds are indeed effective in triggering an increase in capital expenditure, in line with what has been discussed by (Rukmini et al., 2025; (Aritenang, 2020; Purniati and Heryana, 2016; B. Lewis, 2013; Sodikin and Widiawaty 2009). This phenomenon is not new in the international arena; areas with fiscal constraints are usually highly dependent on these transfers to fund their public investments (Lago et al., 2024; Coral et al., 2019; Litschig and Morrison, 2013). However, from an accounting perspective, transfer funds are not just a matter of spending figures, but a determinant of the quality of reporting and valuation of state assets. If these funds are converted into productive assets, the financial health of the region in the long term will be guaranteed. On the contrary, careless allocation will only give birth to unfulfilled assets that actually damage the credibility of the government's financial statements. Therefore, public sector accounting emphasizes that the success of transfers cannot only be measured by the amount absorbed, but must be seen from the quality of asset management and fiscal sustainability. To achieve this, local governments are obliged to strengthen project budgeting and evaluation practices so that every rupiah transferred really has a real impact on the community and increases overall public accountability.

Stewardship theory also makes us understand that the effectiveness of fund transfer also depends on governance capacity. An upsurge in capital spending however sizable or essential will not, by itself, lead to meaningful economic or fiscal gains, unless there is adequate planning, careful project selection, and effective management of funds. According to (Zamzami and Rakhman, 2023), this phenomenon increases the potential for inefficient expenditure and inadequate asset use. Thus, intergovernmental transfers have the potential for development. However, what matters ultimately is the way local level governments operate and account.

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3.2 The Effect of Local Own-Source Revenue on Capital Expenditure

The empirical findings reveal that Local Own-Source Revenue (LOSR) does not have a significant effect on Capital Expenditure. As shown in **Table 9**, LOSR has a coefficient of 0.0615 with a probability value of 0.226, which exceeds the 0.05 significance level. This result indicates that changes in locally generated revenue are not necessarily followed by changes in capital expenditure allocation.

One possible explanation is that additional local revenue is often absorbed by various expenditure needs beyond capital investment. Local governments are required to finance a wide range of public services, administrative activities, personnel expenditures, and other mandatory spending. Consequently, an increase in local revenue may not automatically translate into higher infrastructure investment or development expenditure.

From the perspective of Stewardship Theory, local governments are expected to manage public resources in a manner that best serves the interests of society. This responsibility requires balancing multiple development priorities rather than focusing solely on capital expenditure. As a result, local revenue may be directed toward programs considered more urgent or directly related to public service delivery, depending on the specific needs of each region.

The insignificant effect of LOSR on Capital Expenditure also suggests that many local governments continue to rely on intergovernmental transfers as the primary source of development financing. This interpretation is supported by the significant positive effect of Intergovernmental Transfers on Capital Expenditure found in this study. Therefore, the capacity of local governments to increase capital expenditure appears to be influenced more by transfer funds than by locally generated revenues.

This finding is consistent with several previous studies that reported an insignificant relationship between local own-source revenue and capital expenditure. For example (Meliawati et al., 2022; Bangun Pratama (2023) documented that local own-source revenue had no significant effect on capital expenditure. Likewise, (Komarek and Wagner, 2021) and (Muja et al., 2026) concluded that increases in local revenue do not automatically translate into higher capital expenditure, as local governments tend to allocate a substantial portion of their revenues to operational and administrative expenditures rather than long-term investment spending. These studies support the view that the availability of local revenue alone is insufficient to explain variations in capital expenditure across local governments.

3.3 The Effect of Intergovernmental Transfers on Government Financial Performance

According to the analysis done in **Table 4**, the financial performance of the local government is adversely affected by a statistically significant effect of intergovernmental transfers.
The use of external funding by the central government and also use of superior financial performance at the local level is undermined by this finding. In reality, local administrations may possess less incentive to improve their fiscal capability on excessive dependency on transfers.

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Through a stewardship lens, a better understanding of this finding is gained from how reliance on external resources dictates managerial behavior. As managers in the public interest, local government officials are functionaries who are expected to manage public funds geared to the sustainability and performance of the organization. With a major share of revenue coming from intergovernmental transfers, the role may gradually change from actively improving financial management practice to ensuring administrative compliance. Under these conditions, decisions are frequently driven by budget requirements and absorption, rather than generating a real and sustainable impact on financial performance.

Stewardship theory argues that effectiveness of the steward is not only determined by individual intention but also by the organizational context, especially the control structure and resources available to the steward. In this instance, local officials' financial independence may be constrained by the predominance of intergovernmental transfers as a funding source. Several local governments tends to have more focus on budget execution and administrative compliance when the federal government is their major funder than on the actual development of plan to enhance their financial capacity. Consequently, financial management may be more reactive than proactive.

This may be so because dependency on transfers undermines fiscal autonomy and constrains the flexibility of local governments to design and implement revenue-enhancing strategies. When financial resources are largely predetermined by central government allocations, local officials may have fewer incentives to optimize revenue generation or improve efficiency in resource utilization. This state of affairs may cause a dependency where the practices become routine and compliance oriented and not performance oriented.

The results obtained corroborate the findings of previous studies (Alves and Araujo, 2024) suggesting that intergovernmental transfers can weaken the local fiscal incentives against which they are targeted, particularly against attempts to strengthen local own-source revenue. In this sense, the negative association between transfers and financial performance does not mean that inefficiency is present in every case, but rather it shows how transferring transfers is somehow structured local fiscal issues generator.

Analysis of the said outcome from an accounting perspective helps in the ascertainment of the importance of the revenue source in the determination of financial performance and reporting quality. Relying too much on intergovernmental transfers may reduce the pressure for revenue accountability, since these receipts are external funds that are less tied to local economic activity. As a result, fiscal independence ratios are weaker than they should be, even though total revenue levels are relatively high.

Moreover, this is not only about the volume of resources, but also about the financial autonomy and accountability reflected by the volume of resources and participation in their distribution through various channels. In the public sector accounting, this is closely related to the recognition, management and reporting in financial statements of a revenue source. Regions with high dependency on transfers may have limited financial autonomy, which affects the way their financial performance is understood.

Moreover, the predominance of transfer funds can affect budgeting behavior where local budgeters comply with the central government rather than optimize their budget. It can affect the quality of financial reporting, especially concerning the transparency as well as the correspondence between performance outcomes and budget realization. For financial performance to really improve, it needs funding; however, more importantly, it requires financial management which has a much stronger emphasis on accountability and efficiency.

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From a stewardship view, optimal financial performance is achievable if trust, autonomy and responsibility are balanced. Intergovernmental transfers are crucial for fostering regional development. However, they may make local governments incapable of performing effectively. Thus, the local government strengthening fiscal independence will improve both financial performance and the credibility of financial reporting of local governments.

3.4 The Effect of Local Own-Source Revenue on Local Government Performance

Table 4 shows a significant positive correlation between local own-source Revenue and the local government's financial performance. The results show that municipalities' ability to manage and leverage local sources of revenue is a key factor in becoming more financially independent and improving their financial performance. From the perspective of stewardship theory, these results reflect the success of local government officials as stewards in managing public resources under their direct authority.

The stewardship theory argues that public officers are inherently and fundamentally pro-social, organisation committed and intrinsically motivated to perform their best for the benefit of the community (Joseph Seun et al, 2025). In regional finance, local own-source revenue offers greater fiscal autonomy compared to external funding sources. Consequently, local government officials are empowered to adopt a more proactive, responsible, and innovative stance in budget planning and allocation. At the same time, local own-source Revenue increase gives custodians of stewardship greater leeway to formulate their fiscal policy to suit local needs. As a result, the regional financial performance improved.

The analysis indicates that an increase in local-source revenue improves regional financial performance. A higher level of locally raised funds may enhance accountability and promote better fiscal management. The amount of money gathered directly from residents and businesses is known as local own-source revenue. Officials are required to manage this Revenue in a manner which is both transparent and efficient. The principle of stewardship suggests that stewards and principals have a trustworthy relationship. Public officials are expected to display optimal performance to maintain legitimacy and public confidence. Consequently, local own-source revenue not only helps with financing but also acts as a tool to strengthen financial management behaviours that exhibit accountability.

From an accounting viewpoint, the results show that the composition of revenue sources are associated with the financial performance and quality of accounting reporting. Intergovernmental transfers are basically externally sourced resources and are less related with local economy. Consequently, financial indicators such as fiscal independence ratios may appear weaker even if total revenue is sufficiently high. The financial performance of an organization should not solely be observed from the extent to which revenue is earned but from the degree of autonomy represented in the revenue structure itself.

Furthermore, the impact of transfer funds may also influence how local government financial statements are prepared and interpreted. When revenue is largely transfer-based, the emphasis on revenue accountability and performance measurement may be reduced. The overall quality of financial reporting may be affected, with possible implications for comparability, transparency and the congruence between results and budget outcomes.

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It also means that enhanced funding alone does not enhance or improve financial performance. More emphasis needs to be placed from a public sector accounting view of how resources are managed, reported, and evaluated. To ensure that financial performance does not only comply but also reflect effective and sustainable financial management, it is essential to strengthen internal revenue capacity, budget practices and accountability mechanisms.

The results of this research are strengthened by the findings of Anggraini and Diah Widajantie (2024) which states that local own source revenue has a strong influence on local government financial performance. The consistency of these findings bolsters the existing empirical evidence that localities with higher regional own-source revenue generally have greater fiscal autonomy and better financial performance. The performance of local officials in raising municipal own-source revenue is a manifestation of their ability, in the context of stewardship, to undertake public service functions, impose taxes and levies, and oversee financing. As a result, fiscal Performance enhancement.

Moreover, research on public finance shows that areas with a strong local property tax base show more resilience to shocks and are less dependent on transfers from the centre. This provides greater fiscal stability and allows local government officials to focus on achieving the organization's long-term goals. The condition aids the realization of the role of stewardship. Consequently, the improving regional own-source income is considered an essential step to improve the sustainability of local governments.

The results of the study showed that improvement of public administration and management (PAM) is one strategy that is considered important to improve the financial performance of local governments through tightening the stewardship role of the apparatus. Efforts aimed to enhancing local own-source Revenue through revenue administration improvement, digitization of collections and increase in local asset management should be seen as a long-term investment to strengthen fiscal autonomy and ensure sustainable local fiscal performance.

3.5 The Effect of Capital Expenditure on Local Government Financial Performance

Based on the information presented in **Table 5**, capital expenditure does not significantly affect the financial performance of local governments. The finding indicates that improvements in capital expenditure may not necessarily lead to superior financial outcomes when assessed using fiscal independence indicators. In fact, this may well reflect capital expenditures' potential long-term focus instead of short-term economic gains.

According to stewardship theory, this result shows how local government officials manage resources that are inherently long-term and service-oriented. As custodians, the officials are expected to allocate resources to enhance public welfare that enhances public welfare through infrastructural development and provision of public assets. Nevertheless, being a good steward is not always synonymous with enhancing financial returns within the same time horizon or in the interval immediately following a period of investment.

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One possible explanation is that capital expenditure has economic and social consequences that follow gradually and not instantaneously. Local governments may spend their money in the right way on the right assets but the impact will not get reported in the same year. Consequently, financial performance metrics centred on short-term outcomes may not entirely take into account the worth generated by capital expenditure. In other words, a time lag between the recognition of benefits and the realization of expenditures distorts the relationship between capital expenditures and financial performance.

The result is consistent with previous research (Zein et al., 2024; Amyulianthy et al., 2016) that indicates capital expenditure does not have significant impacts on financial performance. The results reinforce the view that capital expenditure is a long-term development and service enhancement instrument, as opposed to one for improving fiscal performance in the shorter term. When viewed through a stewardship lens, it indicates that local public servants may focus their attention on public service outcomes even if they do not see them being represented in financial terms.

According to the accounting angle, these findings demonstrate the need to know the recognition, measurement and reporting of these capital expenditures in the local government financial statements. Capital expenditure leads to the recognition of fixed assets, which are subsequently subject to depreciation and long-term valuation processes. As a result, its effect on financial performance, tends to be indirect and spread over many reporting periods. Therefore, the rise in different capital expenditure may not result in an immediate improvement in the indicators of financial performance.

Also, this finding contributes to a growing body of evidence that standard financial measures do not adequately represent capital investment's economic reality. Should you require public sector accounting performance to also interpret improvement in asset quality, capacity to serve and sustainability of finances in the long run, along with results. As such, it is necessary to develop a more comprehensive assessment framework that aligns financial reporting with the long-term nature of capital expenditure.

Furthermore, manager capitalization on asset and their effective management ensure the effectiveness of capital expenditure and also ensures managers' success in making timely production and inventory decisions. If there is poor planning, weak project selection, and inadequate monitoring then low or underutilized assets may be created that will result in a reduced economic benefit. The improper use of assets may affect their valuation and depreciation with resulting implications for financial reporting and a loss of credibility of financial statements.

The results indicate that merely raising capital expenditure cannot lead to improved financial performance. Ensuring that the capital investment is affordable and viable is equally important in public sector accounting as asset management and accountability. It should be backed by good-budgeting systems. Systems for measuring performance should be aligned to long-term development outcomes so that capital expenditure reflects stewardship commitments and contributes to sustained financial performance.

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3.6 The Mediating Role of Capital Expenditure in the Relationship between Intergovernmental Transfers and Local Government Financial Performance

Through capital expenditure, intergovernmental transfers have an indirect impact on the financial performance of local governments, according to **Table 5**'s mediation analysis. This result suggests that, rather than having a direct impact on the fiscal sector, intergovernmental transfers improve financial performance by encouraging investments focused on development. These findings suggest that capital expenditures function as a strategic channel that translates transferred resources into fiscal outcomes.

According to stewardship theory, it illustrates local government officials' role as stewards of public resources entrusted to them. The tendency of these officials to use economic indicators to obtain resources is suspected to be linked to long-term collective benefit rather than short-term(Joseph Seun et al., 2025). In this sense, intergovernmental transfer provides fiscal capacity, capital expenditure offers the managerial decision through which stewards convert that capacity to productive public assets. The results of the study as shown in **Table 5** suggest a significant indirect effect which means that when intergovernmental transfers are intentionally targeted to capital investment stewardship behavior emerges.

The stewardship-oriented governance makes a difference on an organizational level when managers are empowered with the discretion and responsibility to convert policy inputs to valuable outputs according to the recent literature of public management (Ramazanli, 2025). In accordance with this perspective, this study suggests that managers' judicious allocation of intergovernmental transfers toward capital projects that enhance service capacity and future fiscal capacity is what leads to improved financial performance. However, transfers that are mostly absorbed into routine expenditures may not trigger this mechanism of stewardship.

This explanation is further supported by evidence from fiscal decentralization. According to (Sean Dougherty et al., 2025), Studies have shown that intergovernmental transfers tend to have both direct impact and influence on fiscal performance, often with mixed or negative consequences in the absence of productive investment choices. Nevertheless, when used for financing infrastructure and long-term assets, a transfer can broaden the local tax base and enhance long-term fiscal sustainability (Masaki, 2018). Consequently, the mediation effect elucidated in **Table 5** clarifies the previously inconclusive findings on the impact of transfers; the effect is contingent on the spending pathway selected by local stewards.

Support for this argument comes from Indonesia. Recent national research yielded evidence that capital expenditures serve to correlate cash with regional financial performance, in particular areas that already have planning and regional capacity (Asmarawati and Randos, 2025). The current literature indicates that the stewardship capacity of local governments, through project selection, implementation and asset management, determines whether capital expenditures financed by transfers can lead to measurable benefits.

According to an accounting viewpoint, these findings highlight the role of the capital expenditure that links the budgetary inputs and the accounting outputs. Capital expenditure leads to the recognition of fixed assets, which are then reflected in the statement of financial position and influence future depreciation and expense recognition. Consequently, it does not cause an immediate impact on financial performance but happens over a period with the release of reports. Consequently, intergovernmental transfers may not have a direct effect which looks ineffective. However, indirect effect through capital expenditure looks significant.

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In addition, the mediating effect shows that calculating the financial performance can different in public sector accounting. Conventional indicators, especially those based on short-term fiscal ratios, cannot capture all the benefits of capital spending. A broader evaluation of an asset's quality, capacity to provide service and long-term fiscal sustainability is dependent on the asset's capital expenditure decisions.

This finding also highlights the need for good asset management and financial reporting practice. The valuation of assets as well as the reliability of the financial statements may be impaired because of ineffective project selection or weak implementation monitoring which may lead to assets that do not offer the expected benefits. Consequently, the quality of accounting processes, especially related to the recognition, measurement, and disclosure of assets, is reflected in the capital expenditure role as a mediating variable.

The result suggests that intergovernmental transfers affect the financial performance of local governments through capital expenditures only when the stewards allocate for productive well governed type asset. This shows that transfer policies must be complemented with improved stewardship capacity to ensure sustainable finances from fiscal decentralization.

3.7 The Mediating Role of Capital Expenditure in the Relationship between Local Own-Source Revenue and Local Government Financial Performance

Table 5. demonstrates a positive and significant influence of own-source revenue on capital investment, as well as the mediation influence of own-source revenue. The above conclusion implies that local own-source revenue enhances financial performance not only through direct revenue-raising capacity but through a possibility for local government to internally fund capital expenditure for enhanced service delivery and fiscal sustainability in the longer run.

According to stewardship theory, local government officers are stewards of public resources, which they manage for the benefit of the community. According to stewardship theory, public managers have an intrinsic motivation to achieve goals related to their organization and society in general, especially when afforded discretion and authority over resources they control (Salomonsen et al., 2024). In this regard, regional own-source revenue is a sort of fiscal autonomy that allows stewards to have discretion on the allocation of resources going into productive capital expenditure instead of merely absorbing budgets.

As the strong indirect effect shown in **Table 5** implies that a rise in local own-source Revenue enhances the capacity of local governments to fund capital expenditure, which improves infrastructure, service capacity and economic activity. These investments contribute to superior financial performance as they expand the local tax base and improve efficiency of expenditures over time. Recent empirical evidence corroborates this route whereby capital spending financed by strong internal revenue is likely to yield additional fiscal benefit (Masaki, 2018).

Evidence from Indonesia supports this stewardship view. New Findings have shown that there is a strong relation to regional own-source revenue and financial performance when used for non-routine expenditures, especially capital expenditres for public facilities or service quality improvement (Anggraini and Diah Widajantie, 2024). According to the literature, the extent of the local government stewardship capacity reflected in the quality of planning, selection of projects, and management of assets determine whether capital expenditure serves as a potent channel that connects local own-source Revenue with financial performance.

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Nevertheless, stewardship theory argues that autonomy is not enough. The mediation effect in a positive direction observed in **Table 5** depends on the quality of institutional capacity and governance quality. Without proper planning, monitoring, and evaluation mechanisms, increased local own-source Revenue may not translate into productive capital assets, therefore compromising its contribution to financial performance (Ernst, 2025) . In order to achieve long-term improvement in local government financial performance, results indicate the enhancement of the internal revenue capacity and stewardship-oriented governance.

Findings from an accounting perspective give important insights into how internally generated revenue translates into financial statement expressions through capital expenditure. The degree of fiscal autonomy and revenue accountability is referred to as local own-source revenue, while capital expenditure means the process through which these financial resources are turned into an asset recognized in the statement of financial position. This means that revenue does not guarantee a level of financial performance but the treatment of revenue in the accounting system matters a lot.

Furthermore, the mediation effect underscores the need for harmonizing budgeting choices with asset recognition and measurement methods. Expenditure invested in long-term assets is not reflected in the financials immediately because long-term assets are not valued in the books immediately nor do they contribute to profits immediately. This creates a potential gap between short-term financial indicators and the long-term economic benefits of public investment.

Moreover, it is essential to bolster accounting practices around the administration of assets, planning, supervision, and communication. Capital expenditures that yield outcomes of less than potential value may result in under-utilized assets. This will affect the valuation of the concerned assets and also have a negative effect on the reliability of the audited financial statements or results. Thus, the enhancement of the city's financial performance, in addition to the increase of local own-source revenue, must also improve the quality of accounting-based governance in terms of asset recognition and measurement as well as transparency.

4. CONCLUSION

The objective of the present study is to determine whether there are regional own-source revenues and intergovernmental transfers related to the financial performance of local governments both directly and indirectly through capital investment. According to the findings, it unfailingly enhances financial performance, with intergovernmental transfers showing mixed effects dependent on usage. The results of mediation specifically reveal capital expenditure to be an important transmission mechanism. The implementation of Public Administration Development is proven to create better financial performance when converted into investment that is development-oriented. Moreover, analysis suggests that the intergovernmental transfers are helpful only when spent on productive capital expenditure. The findings support previous evidence that have identified the importance of internally generated Revenue and investment quality. Also, it extends prior studies show how fiscal resources become fiscally meaningful through the spending pathway and not through the volume only.

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One of the main contributions of this study is the use of a stewardship-based mediation model to explain the link between fiscal decentralisation and financial performance. The main conclusion is clear, regional financial performance will improve if fiscal capacity is responsibly directed to productive investment. However, this study still has gaps because it only relies on quantitative figures within Indonesia, so that complex behavioral factors and legal rules are not fully represented. The quality of governance and internal control has not yet been on the observation radar. For this reason, further research needs to be more daring to explore governance variables, perhaps through qualitative or mixed methods so that the field picture feels more real. By expanding the scope to various institutional contexts, we can see more clearly how accounting and financial processes are interlocking in influencing regional financial health. The hope is that our understanding is no longer just about data, but also touches the essence of true governance.

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