Journal of Principles Management and Bussines
Volume 04, No. 02 (2025)
ISSN : 2830-5469 (ONLINE)
Page : 233 - 245

Fiscal Independence Matters: Determinants of Local Government Financial Performance in Central Java

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ABSTRACT

This study aims to analyze the influence of locally generated revenue (PAD), balancing funds, capital expenditure, and economic growth on the financial performance of local governments. The research is motivated by ongoing debates regarding the effectiveness of fiscal decentralization in improving regional financial outcomes and accountability. The study adopts a quantitative approach using secondary data from local government financial reports and regional economic indicators. Multiple regression analysis is employed to examine the relationships between the independent variables PAD, balancing funds, capital expenditure, and economic growth and the dependent variable, financial performance. The findings reveal that PAD and capital expenditure significantly enhance financial performance by strengthening fiscal independence and improving public service delivery. In contrast, balancing funds show a weaker effect due to their potential to foster fiscal dependency, while economic growth demonstrates an indirect and inconsistent impact. These results highlight the importance of optimizing PAD and prioritizing productive capital spending to strengthen regional fiscal capacity. The study contributes to policymaking by offering empirical evidence that supports the need for strategies to enhance local revenue generation and improve the allocation of capital expenditure. The novelty of this research lies in its integrative approach, which combines fiscal and economic indicators to evaluate financial performance using recent data, providing fresh insights into the dynamics of fiscal decentralization in local governance.

Keywords : Local government financial performance, PAD, capital expenditure, equalization fund, fiscal decentralization.

A. INTRODUCTION

Regional autonomy in Indonesia, initiated through Law No. 22 of 1999 and later reinforced by Law No. 32 of 2004 and Law No. 33 of 2004, grants local governments the authority to manage their own resources and finances. The policy aims to enhance fiscal independence, accelerate regional economic growth, and reduce interregional disparities. The effectiveness of fiscal decentralization remains debated because the financial performance of local governments varies considerably across districts and cities, indicating persistent challenges in realizing equitable development outcomes (Hadi Sasana, 2019; Ginanjar et al., 2025).

E-ISSN 2830-5469

Previous research has explored the influence of locally generated revenue (Pendapatan Asli Daerah/PAD), balancing funds, capital expenditure, and economic growth on local government financial performance. For instance, Antari and Sendana (2018) and Wahyudin and Hastuti (2020) reported that PAD and balancing funds positively affect local financial performance. Conversely, other studies found insignificant or inconsistent relationships, suggesting that the impact of these fiscal components varies depending on regional context and capacity (Hadi Sasana, 2019). These conflicting findings underscore the lack of clarity regarding which factors most significantly drive local fiscal performance.

Central Java was selected as the focus of this study due to several compelling reasons. The province consists of 35 districts and municipalities, each with distinct fiscal capacities, and the contribution of PAD varies significantly among them (BPS Jawa Tengah, 2024). Despite its strategic economic role as a key agricultural and manufacturing hub on Java Island, the region's financial performance does not always align with its economic potential. Moreover, income inequality remains a persistent issue, as reflected by the Gini Ratio, which hovered around 0.364–0.367 in 2024 (BPS Jawa Tengah, 2025). These disparities highlight persistent imbalances in fiscal capacity and call into question the effectiveness of current fiscal policies in driving inclusive development in Central Java.

Although numerous studies have analyzed the influence of PAD, balancing funds, capital expenditure, and economic growth on regional financial performance, few have examined these factors simultaneously within a single province to explain variations across districts and cities. Furthermore, most prior research relied on data sets that predate the implementation of the Harmonization of Tax Regulations Law (UU HPP) and other recent fiscal policy reforms, leaving gaps in our understanding of how contemporary policy shifts and post-pandemic recovery efforts affect local fiscal outcomes (Ginanjar et al., 2025). Another notable gap lies in the lack of studies that link these fiscal indicators to specific components of financial performance, such as liquidity, solvency, and financial independence ratios, which are crucial in assessing the fiscal health of local governments (Wahyudin & Hastuti, 2020).

Recent scholarship has highlighted the dynamic relationship between fiscal decentralization and regional economic outcomes. For example, Hadi Sasana (2019) examined fiscal decentralization in Central Java and reported a significant positive relationship between decentralization and economic growth when controlling for investment and labor. Similarly, Ginanjar et al. (2025) in their cross-regional study across Java found that PAD and balancing funds play a critical role in determining fiscal disparities among regions. Nevertheless, these studies stop short of analyzing the direct impact of these fiscal variables on the financial performance of local governments in Central Java, leaving an important empirical gap that this study intends to fill.

Given the persistent disparities in PAD contributions, uneven income distribution, and varied capital expenditure levels, there is an urgent need for a more nuanced analysis of the determinants of local financial performance in Central Java. The urgency is reinforced by post-pandemic economic pressures and recent fiscal decentralization reforms, which demand a reassessment of existing policies to enhance local government capacity and ensure equitable resource allocation (BPS Jawa Tengah, 2025; Ministry of Finance of Indonesia, 2024). Understanding the interplay between PAD, balancing funds, capital expenditure, and economic growth is therefore essential to inform strategies that can improve fiscal performance and reduce regional disparities.

This study aims to analyze the effects of PAD, balancing funds, capital expenditure, and economic growth on the financial performance of local governments in Central Java. By focusing on this single province with diverse fiscal capacities, the research addresses inconsistencies in previous findings and provides updated empirical insights that incorporate the latest fiscal policy context. Academically, it contributes to the literature on fiscal decentralization by presenting a comprehensive model that integrates key fiscal variables affecting financial performance within one of Indonesia's most economically significant provinces. Practically, the findings are expected to inform provincial and local policymakers in formulating strategies to strengthen fiscal independence, improve budget allocation efficiency, and enhance equitable development outcomes (Hadi Sasana, 2019; Ginanjar et al., 2025).

B. THEORITICAL

Agency Theory in Local Government Finance

Agency theory explains the inherent conflict between the principal (citizens) and the agent (government) when their interests diverge and monitoring is imperfect (Jensen & Meckling, 1976). In the context of local government finance, greater fiscal independence through locally generated revenue (PAD) can reduce the agency problem by improving accountability to local constituents, whereas heavy reliance on intergovernmental transfers may weaken the direct link between taxpayers and local spending decisions (Agus et al., 2025). This aligns with the view that local fiscal autonomy allows citizens to better monitor government performance, thereby lowering agency costs and increasing efficiency in resource allocation.

Recent studies in Indonesia strengthen this theoretical argument. For example, a study in Central Java found that higher PAD significantly improved financial performance because it strengthened fiscal accountability and reduced dependency on central transfers (Sari & Rohman, 2024). Similarly, research in

South Sulawesi showed that districts with larger PAD exhibited better budget efficiency and were more responsive to local development priorities (Pratama et al., 2023). Conversely, local governments with high dependence on balancing funds were more prone to inefficiency and less transparent in reporting their expenditures (Wulandari & Kurniawan, 2023). These findings demonstrate that agency theory provides a useful lens for examining variations in local fiscal outcomes across Indonesian regions.

Previous Research on PAD, Balancing Funds, Capital Expenditure, and Economic Growth

A number of studies consistently report that PAD exerts a positive influence on local government financial performance because it reflects the capacity of a region to finance its development without overreliance on transfers (Dian Sukma et al., 2021; Rahmawati & Fauziah, 2023). For instance, a study in Central Sulawesi (Agus et al., 2025) found that PAD, together with capital expenditure, had a significant positive effect on financial performance, emphasizing that revenue autonomy drives better fiscal results. However, in areas with weak economic structures, the impact of PAD is smaller due to limited tax bases (Sutanto, 2022), suggesting that local context moderates this relationship.

The evidence regarding balancing funds is mixed. Haque & Rohman (2022) and Santoso (2023) reported that balancing funds often fail to improve financial performance because they create fiscal dependency and reduce incentives for local revenue collection. On the other hand, Lestari & Kurniawan (2024) found that when coupled with strong governance, transfers can still enhance performance by funding productive capital projects. Regarding capital expenditure, several studies such as Sari & Mustanda (2019) and Putri & Astuti (2022) show that well-targeted capital spending boosts infrastructure and service quality, thereby improving performance, whereas low realization or short-term project orientation reduces its impact (Wijaya, 2023).

As for economic growth, its effect is often indirect. Heryanti et al. (2019) and Ardiansyah & Malik (2022) found no consistent direct impact on fiscal performance, noting that while growth can expand the tax base, it does not automatically translate into higher PAD or better budget execution. Recent findings by Hidayat & Ramadhani (2023) also support this view, arguing that without effective revenue policies and expenditure management, growth alone cannot improve fiscal outcomes. This inconsistency highlights the need for updated empirical testing with newer datasets.

Framework of Thought

Based on agency theory and prior empirical studies, this research positions Financial Performance as the dependent variable, measured through indicators such as financial independence ratios, budget efficiency, and realization of capital spending. The independent variables include PAD, Balancing Funds, Capital Expenditure, and Economic Growth.

It is expected that PAD and capital expenditure positively affect financial performance due to enhanced fiscal capacity and improved service delivery (Sari & Rohman, 2024; Agus et al., 2025). Balancing funds may exert both positive and negative influences positive when well-governed and invested productively, but negative when they foster dependency (Lestari & Kurniawan, 2024; Santoso, 2023). Economic growth is considered a supportive factor that can expand the revenue base but does not guarantee improved fiscal outcomes without effective policy mediation (Hidayat & Ramadhani, 2023).

C. METHODOLOGY

This study adopts a quantitative descriptive approach to analyze the determinants of local government financial performance. Quantitative methods are appropriate because they allow testing of causal relationships between fiscal variables and performance indicators using measurable secondary data (Sugiyono, 2021; Ghozali, 2023). The research utilizes audited Local Government Financial Statements (LKPD) issued by the Audit Board of Indonesia (BPK RI) for the fiscal years 2020–2023, which ensures data validity and comparability across regions. The study population comprises all 35 district and city governments in Central Java Province. A purposive sampling technique was employed to include only local governments that (1) had complete LKPD data for 2020–2023 and (2) consistently received an unqualified audit opinion (WTP) during that period. This selection increases data reliability and controls for variations in audit quality that could bias financial performance scores.

The focus on Central Java Province is justified by its large number of districts/cities with heterogeneous fiscal capacities and performance outcomes, making it suitable for analyzing variations in local government fiscal management (BPK RI, 2024). The 2020–2023 timeframe is chosen because it captures three critical phases: pre-pandemic (2020), crisis response during COVID-19 (2021), and post-pandemic fiscal recovery (2022–2023), offering insights into how fiscal variables perform under different macroeconomic conditions. Data are sourced from audited LKPD and BPK RI's Audit Result Reports (LHP) available through the official BPK database and the Ministry of Finance's Directorate General of Fiscal Balance (DJPK) portal. Additional supporting data, including regional GDP growth rates, are obtained from the Central Bureau of Statistics (BPS) to ensure consistency and accuracy. The data collection technique uses documentation, involving systematic retrieval and verification of official reports that meet the inclusion criteria (Sekaran & Bougie, 2022).

The study examines four independent variables Local Own-Source Revenue (PAD, X1), Balancing Funds (X2), Capital Expenditure (X3), and Economic Growth (X4) and one dependent variable, Local Government Financial Performance (Y). The operationalization of each variable is presented in Table 1. Data analysis uses multiple linear regression with the aid of SPSS 26 to test the effects of each independent variable on financial performance. Prior to hypothesis testing, classical assumption tests including normality, multicollinearity, and heteroscedasticity tests are conducted to ensure model validity (Gujarati & Porter, 2020). The t-test assesses partial effects of each variable, while the F-test evaluates their simultaneous influence. This analytical framework is commonly applied in fiscal decentralization research to identify significant predictors of regional financial performance (Rahmawati & Fauziah, 2023; Lestari & Kurniawan, 2024).

Table 1. Operational definitions of variables

Variable	Operational Definition	Indicator	Scale
PAD (X1)	Regional revenue derived from local taxes, levies, and regional assets	PAD ÷ Total Regional Revenue	Ratio
Balancing Funds (X2)	Central government transfers including DAU, DAK, and DBH	Transfers ÷ Total Regional Revenue	Ratio
Capital Expenditure (X3)	Government expenditure on fixed assets supporting public services	Realized Capital Expenditure	Nominal / Ratio
Economic Growth (X4)	Annual growth rate of regional real GDP	% change in real regional GDP	Percentage
Financial Performance (Y)	Evaluation score of local fiscal management performance	Financial Performance Index (from BPK/DJPK)	Interval

D. RESULTS AND DISCUSSION

Based on the multiple regression analysis of 140 observations from 35 regencies/cities in Central Java for the period 2020-2023, several key findings emerged. First, Local Own-Source Revenue (PAD) has a positive and significant effect on local government financial performance ($\beta = 13.282$, $p < 0.001$). This underscores that higher PAD strengthens fiscal independence and improves local financial outcomes. Strengthening PAD through strategies such as tax base expansion, digitalization of levy collection, and more effective asset management can reduce dependence on central transfers and enhance fiscal capacity.

Second, Capital Expenditure also shows a positive and significant relationship with financial performance ($\beta = 14.403$, $p = 0.034$), implying that well-targeted capital investments particularly in infrastructure such as roads, irrigation systems, and health/education facilities boost the quality of public services and stimulate local economic activities. This highlights the importance of prioritizing productive sectors to maximize multiplier effects on regional welfare.

In contrast, Intergovernmental Transfer Funds (Dana Perimbangan) do not significantly affect financial performance (β = –6.397, p = 0.066). This suggests that reliance on central transfers does not necessarily improve fiscal outcomes, likely due to their allocation to routine rather than development expenditures. Local governments should optimize the use of these funds for strategic programs and seek alternative revenue sources. Similarly, Economic Growth does not significantly influence financial performance (β = 0.018, p = 0.548), indicating that growth in regional GDP has not been effectively leveraged to expand the local tax base or levy collection.

The model's Adjusted R^2 of 20.4% suggests that while PAD and capital expenditure play critical roles, other factors such as human resource quality, internal control mechanisms, and budget transparency also significantly influence fiscal outcomes. This finding underscores the need for institutional strengthening alongside fiscal reforms.

Regression Results

Table 2. Descriptive statistics

Variable	N	Min	Max	Mean	Std. Deviation
Local Government Revenue	140	84,120,	2,835,150,	448,473,	381,901
Equalization Fund	140	542,580,000,	2,343,240,	1,546,473,	437,803,
Capital Expenditures	140	5,580,	1,089,360,	277,821,	167,803,
Economic Growth (%)	140	-89.64	10.17	8.68	81.59
Financial Performance	140	-260.86	99.31	1.31	31.83

Source: SPSS Output (2025)

Table 3. Regression coefficients

Variable	β	t	Sig. (p-value)	Effect
Local Own-Source Revenue (PAD)	13.282	3.682	0.000	Positive, significant
Equalization Fund	14.403	2.137	0.034	Positive, significant
Capital Expenditures	-6.397	-1.851	0.066	Negative, not sig.
Economic Growth	0.018	0.602	0.548	Positive, not sig.

Source: SPSS Output (2025)

Discussion

The Influence of Local Revenue on the Financial Performance of Local Governments

The findings show that Local Own-Source Revenue (PAD) has a positive and significant effect on the financial performance of local governments in Central Java ($\beta = 13.282$; $t = 3.682$; $p < 0.001$). This suggests that greater PAD enhances fiscal capacity and strengthens the ability of local governments to finance development without relying heavily on central transfers. A higher PAD indicates stronger fiscal independence and reflects a region's capacity to mobilize its own resources through local taxes, levies, and asset utilization. This result supports agency theory, which posits that when agents (local governments) effectively mobilize local resources, they fulfill the expectations of principals (citizens), thereby improving fiscal performance and accountability (Jensen & Meckling, 1976).

Regions with strong PAD tend to have better public service delivery and development outcomes because they can design context-specific programs aligned with local priorities. This finding aligns with previous research by Sukma et al. (2021), Wulandari et al. (2022), and Tahir et al. (2019), all of which reported that increased PAD improves the financial performance of local governments. It implies that enhancing PAD through expanding the tax base, digitizing local tax collection, and improving regional asset management can reduce fiscal dependency and promote self-sustained growth.

The Influence of Capital Expenditure on the Financial Performance of Local Governments

Capital expenditure was also found to have a positive and significant influence on financial performance ($\beta = 14.403$; $t = 2.137$; $p = 0.034$). This result highlights that investment in long-term productive infrastructure such as roads, irrigation systems, healthcare facilities, and schools generates fiscal returns by stimulating local economic activity and expanding the tax base. Properly targeted capital spending contributes not only to infrastructure development but also to economic growth and improved public welfare, thus indirectly strengthening fiscal capacity.

This finding aligns with the argument that effective public investment enhances a region's competitiveness and capacity to generate revenue in the long term (Musgrave & Musgrave, 1989). It is also consistent with the results of Sari & Mustanda (2019), who observed that higher capital spending leads to improvements in local government performance and public service quality. Therefore, prioritizing strategic infrastructure projects can have a multiplier effect on regional economies, which ultimately improves financial performance.

The Influence of Balancing Funds on the Financial Performance of Local Governments

In contrast, the study found that Balancing Funds (Dana Perimbangan) have a negative but insignificant effect on financial performance ($\beta = -6.397$; $p = 0.066$). Although intended to support decentralization and enhance local service delivery, these funds often finance routine expenditures rather than development-oriented initiatives. Excessive reliance on central transfers tends to weaken local innovation in generating PAD and undermines fiscal independence.

From the perspective of agency theory, a high degree of dependence on central government transfers can reduce the autonomy of local governments (agents), leading to inefficiencies in financial management and limited responsiveness to local priorities (Shah, 2007). This result supports findings by Haque & Rohman (2022), Ernawati & Jaelani (2018), and Fauziyah & Ekaningtias (2022), who concluded that transfer funds often fail to improve fiscal performance due to weak targeting and limited local discretion in their utilization. The implication is that reforming transfer fund allocation toward strategic development programs and strengthening monitoring mechanisms is crucial for improving fiscal outcomes.

The Influence of Economic Growth on the Financial Performance of Local Governments

The study also found that economic growth does not have a significant impact on local financial performance ($\beta = 0.018$; $t = 0.602$; $p = 0.548$). Although higher economic growth generally increases productivity and investment opportunities, these benefits do not automatically translate into higher PAD. Several factors may explain this disconnect: limited infrastructure capacity to attract investors, insufficient fiscal policies to capture the benefits of growth (e.g., tax incentives), and slow institutional adaptation to growing economic activities.

According to agency theory, fiscal performance depends on how well local governments utilize economic expansion to mobilize resources. If tax collection systems and levy structures are weak, growth in GDP will not effectively contribute to fiscal capacity (Oates, 1999). This result is consistent with studies by Heryanti et al. (2019), Tolosang (2018), and Novitasari & Novitasari (2019), which found that economic growth alone is insufficient to explain variations in local financial performance. Strengthening fiscal instruments and linking pro-investment policies with revenue mobilization strategies are necessary for ensuring that growth contributes to stronger fiscal outcomes.

Policy Implications

These findings collectively suggest that improving local fiscal performance requires strengthening PAD mobilization and prioritizing productive capital expenditure, while minimizing overdependence on central transfers. Furthermore, aligning fiscal strategies with local economic development initiatives such as offering targeted tax incentives for investors can help bridge the gap between economic growth and fiscal performance. Enhancing institutional capacity, transparency, and the quality of spending is equally critical to achieving sustainable fiscal independence at the regional level.

E. CONCLUSION

This study concludes that locally generated revenue (PAD) and capital expenditure have a positive and significant effect on the financial performance of district and city governments in Central Java Province. An increase in PAD strengthens fiscal independence by reducing dependence on central government transfers, thereby supporting regional autonomy and improving governance performance. Similarly, effective capital expenditure enhances infrastructure development and public service quality, which in turn stimulate economic activities and increase regional income. In contrast, balancing funds show a negative but insignificant effect on financial performance due to the high reliance of local governments on central transfers, which weakens fiscal independence and discourages innovation. Economic growth also demonstrates no significant influence, likely because it has not yet been effectively translated into higher local productivity or investment.

Based on these findings, local governments are encouraged to optimize PAD by improving tax collection mechanisms, diversifying revenue sources, and enhancing transparency in financial management. Capital expenditure should be prioritized for high-impact sectors such as infrastructure, technology, and essential public services that can create multiplier effects on productivity and long-term fiscal sustainability. Furthermore, reducing dependence on balancing funds is crucial and can be achieved through strengthening local revenue innovation and fostering inter-regional collaboration to maximize available resources. This study has several limitations, as it only focuses on district and city governments in Central Java Province, which may not fully represent other regions in Indonesia. Future research should include broader geographical coverage, use longitudinal data, and incorporate qualitative factors such as governance quality, public participation, and institutional capacity to provide a more comprehensive understanding of the determinants of financial performance within the framework of fiscal decentralization.

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