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A literature Review: Determinants of Financial Performance in Local Governments

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ABSTRACT

This study aims to review and synthesize the existing literature on the determinants of local government financial performance in Indonesia, with a particular focus on regions experiencing real fiscal deficits. Under the regional autonomy framework, local governments are required to manage their financial resources independently to support public services and regional development. However, many local governments continue to face fiscal challenges due to limited local revenue capacity and high dependence on central government transfers. Using a literature review approach, this study examines how Local Own-Source Revenue (PAD), capital expenditure, and audit opinion influence local government financial performance. Capital expenditure is also found to play a strategic role in enhancing financial performance through long-term investment in infrastructure, service quality, and economic productivity. Despite extensive empirical evidence, the literature reveals limited attention to the interaction of these factors within local governments experiencing real fiscal deficits. This review highlights the need for more focused analysis in fiscally constrained regions and provides a conceptual foundation for future empirical research aimed at improving sustainable regional financial management.

Keywords *Local Government Financial Performance, Local Own-Source Revenue (PAD), Capital Expenditure, Audit Opinion, Fiscal Deficit*

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INTRODUCTION

Regional autonomy in Indonesia was established to grant local governments greater authority and responsibility in managing their own governmental affairs and administrative apparatus. Law No. 23 of 2014 on Regional Government defines regional autonomy as the rights, authority, and obligations of autonomous regions to regulate and manage their own governmental affairs and the interests of local communities within the framework of the Unitary State of the Republic of Indonesia. This policy aims to improve public services and community welfare by enabling local governments to respond more effectively to regional needs and priorities.

The delegation of governmental authority to local governments is accompanied by the transfer of financial resources, including local taxes, regional retributions, and intergovernmental fiscal transfers. This fiscal decentralization is a logical consequence of autonomy, as local governments require adequate financial capacity to carry out their responsibilities. A balance between transferred responsibilities and financial resources is essential to ensure the effective implementation of decentralized governance. Without sufficient and proportionate funding, local governments may struggle to provide quality public services and sustain development programs.

One critical aspect of regional governance that requires careful regulation is regional financial management. Government Regulation No. 12 of 2019 defines regional finance as all rights and obligations of local governments that can be valued in monetary terms, including all assets related to the execution of regional governmental duties. Regional financial management involves planning, organizing, and controlling financial resources to achieve development objectives (Halim & Kusufi, 2018). Sound financial management is fundamental, as it serves as the backbone of annual governmental operations and development efforts aimed at enhancing public welfare.

To accurately assess the financial condition of local governments, it is necessary to examine real fiscal surplus or real fiscal deficit. Real fiscal deficit refers to a situation in which actual expenditures exceed revenues after considering outstanding liabilities, resulting in no remaining cash balance at the end of the fiscal year. This condition reflects more severe financial distress than a conventional budget deficit. Empirical evidence indicates that several local governments in Lampung Province have experienced significant increases in real fiscal deficits. For instance, the Provincial Government of Lampung recorded a rise in real deficit from IDR 273.5 billion in 2020 to IDR 1.41 trillion in 2023, with similar patterns observed in Pesawaran, North Lampung, and West Tulang Bawang. High dependence on central government transfers exacerbates fiscal vulnerability and limits budgetary flexibility.

Regional financial performance serves as a key indicator for monitoring and evaluating the effectiveness of regional financial management (Mahmudi, 2019). Financial performance reflects the extent to which budgetary resources are utilized efficiently and effectively to achieve predetermined objectives. According to Government Regulation No. 12 of 2019, performance is defined as measurable outcomes achieved through budget utilization in terms of quantity and quality. Financial performance is often assessed using effectiveness ratios, particularly the effectiveness of Local Own-Source Revenue (PAD) realization compared to targeted revenue levels (Susanto, 2019).

Previous studies suggest that regional financial performance is influenced by several factors, including Local Own-Source Revenue, capital expenditure, and audit opinion. PAD represents revenues generated locally through taxes, retributions, regionally owned enterprises, and other legitimate sources. Higher PAD reflects stronger fiscal independence and is associated with improved financial performance. Capital expenditure plays a strategic role in enhancing public infrastructure, attracting investment, and stimulating local economic growth (Dwigantara & Handayani, 2020). Meanwhile, audit opinion reflects the fairness and compliance of financial reporting with applicable accounting standards, signaling accountability and transparency in financial management (Halim, 2015). These factors collectively motivate further investigation into their roles in shaping the financial performance of local governments, particularly those experiencing real fiscal deficits.

Overall, the existing literature highlights the importance of local revenue capacity, expenditure allocation, and financial accountability in determining regional financial performance under decentralized governance. However, empirical findings remain limited in explaining how these factors interact within local governments experiencing real fiscal deficits, where financial pressures are more pronounced and policy trade-offs are unavoidable. The persistence of real fiscal deficits, particularly in regions with high dependence on central government transfers, suggests structural weaknesses in revenue generation and expenditure effectiveness. Therefore, this study seeks to contribute to the literature by examining the influence of Local Own-Source Revenue, capital expenditure, and audit opinion on the financial performance of deficit local governments, offering insights that may support more sustainable fiscal management and evidence-based policymaking.

RESEARCH METHODE

This study adopts a literature review approach to examine the influence of Local Own-Source Revenue (PAD), capital expenditure, and audit opinion on local government financial performance, particularly in regions experiencing real fiscal deficits. The literature review method is used to synthesize theoretical perspectives, empirical findings, and regulatory frameworks related to regional financial management under decentralization. Relevant academic articles, government regulations, and institutional reports are collected from reputable sources, including peer-reviewed journals, official government publications, and previous empirical studies in the field of public sector accounting and regional finance.

The literature selection process follows several stages. First, keywords such as local government financial performance, local own-source revenue, capital expenditure, and audit opinion are used to identify relevant studies. Second, inclusion criteria are applied, including publication relevance, methodological clarity, and alignment with the research variables. Third, selected studies are analyzed and categorized based on their focus on PAD, capital expenditure, audit opinion, and financial performance. The analysis is conducted through qualitative content analysis to identify patterns, consistencies, and gaps in previous findings. By systematically comparing and synthesizing prior research, this study develops a comprehensive understanding of how financial capacity, expenditure allocation, and accountability mechanisms influence local government financial performance. The findings of this literature review provide a conceptual foundation and research justification for future empirical studies, particularly those focusing on local governments facing real fiscal deficits.

RESULT AND DISCUSSION

Article Descriptive

Based on the prior studies summarized above, the literature consistently indicates that local government financial performance is closely linked to the ability of regions to generate and manage their own financial resources. Local Own-Source Revenue (PAD) emerges as a key determinant, as higher PAD reflects stronger fiscal capacity and reduced dependence on central government transfers. Empirical evidence from Ningrat and Supadmi (2019) as well as Andaresta et al. (2021) confirms that PAD has a positive and significant effect on local government financial performance. These findings suggest that regions with greater success in mobilizing local revenue are better positioned to finance public services, support regional development, and maintain sustainable fiscal management.

In addition to revenue capacity, expenditure allocation and financial accountability play crucial roles in shaping financial performance. Several studies demonstrate that capital expenditure positively influences financial performance by increasing long-term assets, improving public infrastructure, and stimulating economic productivity (Sari & Mustanda, 2019; Sukma et al., 2021; Lestari & Hapsari, 2020). Furthermore, audit opinion serves as an important indicator of transparency and compliance with accounting standards. Positive audit opinions enhance public trust and signal sound financial governance, which in turn contributes to improved financial performance (Satria & Sari, 2018; Suandani & Banu, 2021). Collectively, these studies provide a strong empirical foundation for examining the combined effects of PAD, capital expenditure, and audit opinion on local government financial performance.

Table 1.
Article Descriptive

No	Author(s) & Year	Research Variable(s)	Main Findings
1	Dali et al. (2021)	Local Government Financial Performance	Local government financial performance reflects the ability of regions to collect and manage financial resources independently to support governance, public services, and regional development.
2	Ningrat & Supadmi (2019)	Local Own-Source Revenue (PAD), Financial Performance	PAD has a positive and significant effect on local government financial performance. Higher PAD improves financial performance.
3	Andaresta et al. (2021)	Local Own-Source Revenue (PAD), Financial Performance	PAD significantly influences local government financial performance, indicating stronger fiscal capacity leads to better performance.
4	Sari & Mustanda (2019)	Capital Expenditure, Financial Performance	Capital expenditure has a positive effect on financial performance. Increased capital spending improves facilities and regional potential, contributing to higher performance.
5	Sukma et al. (2021)	Capital Expenditure, Financial Performance	Effective allocation of capital expenditure enhances long-term assets and contributes positively to overall financial performance.
6	Lestari & Hapsari (2020)	Capital Expenditure, Financial Performance	Capital expenditure positively affects local government financial performance by increasing productivity and revenue generation across sectors.
7	Satria & Sari (2018)	Audit Opinion, Financial Performance	Audit opinion has a positive influence on local government financial performance, reflecting accountability and transparency.
8	Suandani & Banu (2021)	Audit Opinion, Financial Performance	Better audit opinions increase public trust and positively affect local government financial performance.

Local Own-Source Revenue (PAD) on Financial Performance

Local Own-Source Revenue (PAD) is a fundamental indicator of fiscal capacity and regional financial independence. The positive relationship between PAD and local government financial performance suggests that regions with higher PAD are more capable of financing public services and development programs independently. Increased PAD reduces reliance on central government transfers, allowing local governments greater flexibility in budget planning and allocation. This autonomy enhances efficiency in financial management and supports sustainable governance. Prior empirical studies, such as those conducted by Ningrat and Supadmi (2019) and Andaresta et al. (2021), confirm that PAD has a positive and significant effect on financial performance. Higher realization of PAD relative to targets improves effectiveness ratios, which are widely used to measure local government financial performance. Moreover, strong PAD performance reflects the government's ability to explore and optimize regional economic potential through taxes, retributions, and regionally owned enterprises. Consequently, local governments with stronger PAD tend to exhibit better budget control, improved service delivery, and enhanced financial sustainability. These findings underscore the importance of strengthening local revenue sources as a strategic effort to improve financial performance, particularly in regions facing fiscal pressure or real financial deficits.

Capital Expenditure on Financial Performance

Capital expenditure plays a strategic role in enhancing local government financial performance by supporting long-term development and public infrastructure improvement. Allocations for capital expenditure are intended to create assets that provide benefits beyond a single accounting period, such as roads, public facilities, and government buildings. Effective capital spending improves service quality, increases regional productivity, and creates an environment conducive to economic growth. Empirical evidence from Sari and Mustanda (2019), Sukma et al. (2021), and Lestari and Hapsari (2020) demonstrates that higher capital expenditure is positively associated with improved financial performance. This relationship indicates that investment-oriented spending contributes not only to physical development but also to future revenue generation. When capital expenditures are planned and executed efficiently, they can stimulate local economic activity, attract investment, and expand the tax base. However, the effectiveness of capital expenditure depends on proper planning, prioritization, and monitoring. Poorly managed capital projects may increase fiscal burdens without delivering expected benefits. Therefore, capital expenditure should be aligned with

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regional development goals to ensure that it contributes meaningfully to improved financial performance and long-term fiscal sustainability.

Audit Opinion on Financial Performance

Audit opinion serves as an important indicator of accountability, transparency, and compliance in local government financial management. A favorable audit opinion reflects that financial statements are prepared in accordance with applicable accounting standards and are free from material misstatements. This condition strengthens public trust and enhances the credibility of local governments in managing public funds. Studies by Satria and Sari (2018) and Suandani and Banu (2021) provide empirical evidence that audit opinion has a positive effect on local government financial performance. Local governments that receive unqualified audit opinions tend to have stronger internal controls, better financial discipline, and more effective budget execution. These factors contribute to improved financial efficiency and effectiveness. Furthermore, good audit outcomes can encourage better governance practices, as local governments are motivated to maintain compliance and transparency. This accountability mechanism supports improved decision-making and resource allocation, ultimately enhancing financial performance. In the context of fiscal deficits, audit opinion becomes increasingly important as it signals the government's commitment to responsible financial management. Therefore, improving audit quality and compliance is essential for strengthening local government financial performance and public confidence.

CONCLUSION

This study adopts a literature review approach to examine the influence of Local Own-Source Revenue (PAD), capital expenditure, and audit opinion on local government financial performance, particularly in regions experiencing real fiscal deficits. The literature review method is used to synthesize theoretical perspectives, empirical findings, and regulatory frameworks related to regional financial management under decentralization. Relevant academic articles, government regulations, and institutional reports are collected from reputable sources, including peer-reviewed journals, official government publications, and previous empirical studies in the field of public sector accounting and regional finance.

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