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Determinants of Local Government Financial Performance in Indonesia

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Abstract

Regional autonomy is expected to promote financial performance and people's welfare. This study investigates factors that affect local governments' financial performance in Indonesia, where performance is defined as the ability to generate local revenues. To test our hypothesis, we used panel data regression analysis. From 2012 to 2019, this study collected 3,747 observations on municipal governments. The dependent variable is local government financial performance, while the independent variables include region size, capital spending, financial reporting quality, audit recommendations, and the horizon problem. We find that the size of the local government, financial reporting quality, and the follow-up on audit recommendations positively affect financial performance. Larger local governments have more resources to generate revenues. High financial reporting quality and accountability are supposed to improve public trust and increase their willingness to make contributions through local tax payments. Capital expenditure, on the other hand, is associated with lower financial performance. This study contributes to the literature on financial performance, especially in the public sector, by providing empirical evidence on factors affecting local government financial performance. This study provides insight to stakeholders by providing evidence on the role of size, capital spending, audit opinion, and follow-up of audit recommendations in accelerating the improvement of financial performance.

Keywords: *financial performance; local government; regional autonomy; decentralization; public sector*

1. Introduction

The financial performance of local governments in developing countries is a critical issue in the public finance literature (Kapidani, 2018). Governments across various countries are engaged in public sector reform to promote the privatization of the public sector through increasing financial autonomy (Thoa & Nhi, 2021). Regional autonomy is granted to local governments to provide flexibility in delivering better public services, improve responsiveness and efficiency, and strengthen roles in the economy and intergovernmental systems (Ebel et al., 2002; Oates, 1974; Musgrave & Musgrave, 1973; Tiebout et al., 1956; Wolman et al., 2008). Regional autonomy, particularly in the financial aspect, will help public organizations promote the quality of public services, financial responsibility, and sustainability (Hartley et al., 2016). In a decentralized economy, it is critical that local governments can optimally generate their local revenues, which is one key indicator of local governments' performance. This study examines the determinants of financial performance under regional autonomy among local governments in Indonesia.[1]

After nearly two decades of regional autonomy, the financial capacity of local administrations in Indonesia continues to rely on transfer revenues and profit sharing from the central government. Table 1 shows the proportion of regional income compared to total income in 1999 (before the decentralization), 2014, and 2019. In Indonesia, the share of local governments with a local revenue ratio of less than 10% was 151 (51.7%) in 1999, 311 (62.8%) in 2014, and 256 (50.5%) in 2019.[2] The data shows that regional autonomy to local governments has not been optimal in promoting the degree of regional decentralization. Therefore, it is in the interest of stakeholders to learn about the determinants of the local revenue ratio or the ability of local governments to generate their revenue locally. A higher degree of local revenue ratios certainly provides executive discretion in providing competent human resources in financial management, infrastructure provision, and information technology development. Furqan et al. (2021) state that to improve the quality of public services, the Indonesian government has carried out reforms such as strengthening decentralization and increasing public and private participation (including state-owned enterprises) in the context of providing public facilities and services.

Table 1. The degree of regional decentralization in regency and city governments

Number of Local Governments						
Percentage of local revenues	1999		2014		2019	
	Total	%	Total	%	Total	%
< 10%	151	51.7	311	62.8	256	50.5
10 – 19%	82	28.1	146	29.5	190	37.5
20 – 29%	38	13.0	20	4.0	36	7.1
30 – 39 %	13	4.5	13	2.6	10	2.0
40 – 49%	7	2.4	3	0.6	12	2.4
> 50%	1	0.3	2	0.4	3	0.6
Total Regencies/Cities	292	100%	495	100%	507	100%

Regarding the factors affecting local administrations' financial performance, previous studies have also produced inconclusive results. Putu and Harta (2016) and Leki et al. (2018) discovered that capital expenditure positively affects local governments' performance. Different results from Darwanis and Saputra (2014) and Suryingsih and Sisdyani (2016) indicate that capital expenditures have no effect on the efficacy of local governments. Furthermore, a number of studies indicate that the size of local administrations has a positive effect on their financial performance (Kusumawardani, 2012; Masdiantini & Erawati, 2016). However, Noviyanti and Kiswanto (2016) and Setyaningrum and Martani (2018) discover that neither local government size nor regional assets influence local

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[1] *Indonesia has 98 municipal governments, 416 regency governments, and 38 provincial governments. The central government gives broad authority to local governments with regional autonomy by implementing Law No. 32 of 2004 concerning regional governance and Law No. 33 of 2004, which regulates financial balances in budgeting.*
[2] *A local revenue ratio of 10% means that 90% of revenues is transferred from the central government.*

government performance. Previous studies also demonstrate that audit opinions have a positive impact on local government performance (Udirizqi et al., 2016; Sutopo et al., 2017; Ahyaruddin & Amrillah, 2018). However, Susanti (2018) argues that audit opinion has no effect on local government performance.

This study distinguishes itself from previous studies by utilizing more comprehensive data encompassing nearly all regencies and cities across Indonesia. The level of decentralization is gauged through the ratio of locally generated revenues to the total revenues received by local governments. A higher proportion of local revenues indicates an enhanced capacity of local governments to implement regional decentralization. Given the inconclusive outcomes of preceding studies, this study re-evaluates the variables of audit opinions, capital expenditure, and the scale of local governments. Consequently, there is room for expanding investigations in this domain to encompass additional variables beyond the current model. Moreover, this study introduces novel factors like audit opinions and the follow-up on audit recommendations. It also addresses the horizon problem among regional heads, conducting tests within the public sector context. Meanwhile, Murphy (1985), Jensen and Murphy (1990), Rose and Shepard (1997), Matta and Beamish (2008), Ali and Zhang (2015), and Fang et al. (2018) argue that incoming CEOs who are on the brink of retirement or the conclusion of their tenure exhibit different behavior, affecting the levels of performance in steering their organizations.

This study finds that local government size is positively associated with financial performance. The result suggests that local governments with more assets have a greater ability and capacity to generate more local revenues. We further find that a clean audit opinion on the financial report is associated with more local revenues. A clean audit opinion indicates that a local government performs its financial management with strong accountability and transparency, increasing the public trust and their willingness to contribute financially to the local government through payments for taxes and services. Similarly, we find that follow-up on prior years' audit findings is associated with increased local revenues.

This study contributes to the literature on the determinants of local government performance. It provides insights to practitioners and policymakers by providing information on important factors to achieve financial performance by implementing strategic and necessary policies. Accordingly, the central government and local governments are expected to make the right decisions to support people's welfare with predetermined programs based on the input given.

2. Literature Review and Hypothesis Development

2.1 Local Government Financial Performance

The financial performance of the local government is measured through financial ratios as in the private sector. Carmeli (2002) evaluated financial performance using four categories of financial variables: short-term liquidity, budget solvency, long-term solvency, and service development. Atan et al. (2010) measured local authorities' performance in Malaysia with categories of fiscal year balance, short-term liquidity, and long-term solvency. Ritonga (2014) modeled local governments' financial condition in Indonesia by considering six dimensions to measure the financial situation: budget solvency, financial flexibility, short-term solvency, service solvency, long-term solvency, and financial independence.

The framework in Table 2 refers to a modification of the framework proposed by Carmeli (2002) and Atan et al. (2010). Several studies used regional financial performance proxies, as presented in the following table:

Table 2. Proxies of Financial Performance

Proxy	Categories	Researcher
Income surplus/deficit	Fiscal-year balance	Carmeli (2002), Local Government Association, (2006)
Cash quick ratio	Short-term liquidity	Ryan et al. (2000), Carmeli (2002), Kamnikar et al. (2006)
Decentralization degree ratio /Self-income ratio	Short-term liquidity	Ahyaruddin & Amrillah (2018), Puspitaningrum (2014), Industry Commission (1997), Ryan et al. (2000), Carmeli (2002)
Average collection period	Short-term liquidity	Atan et al. (2010)
Collecting efficiency ratio	Long-run solvency	Carmeli (2002), Atan et al. (2010)
Indebtedness ratio	Long-run solvency	Ryan et al. (2000), Atan et al. (2010)

The financial performance in this study is defined as the ability to generate local revenues. The degree of decentralization indicates the transfer of authority to local governments in exploring various sources of regional revenues. The degree of decentralization is used as a proxy in this study to measure the financial performance of local governments. It refers to the ratio resulting from dividing the total locally generated revenues by the total regional revenues. The greater this ratio, the greater the capacity of local governments to implement regional decentralization (Eckardt, 2008; Liu & Li, 2015; Purbasari et al., 2017). The formula is calculated by dividing the ratio of total locally generated revenues by total regional revenue (Carmeli, 2002; Atan et al., 2010).

2.2 Factors Affecting Financial Performance

A few studies have examined factors that affect local governments' financial performance at the international level. Numerous studies are conducted at the national level, though only a few regions are involved. According to Kusumawardani (2012), the scale of a local government positively impacts its financial performance. Sesotyaningtyas (2012) reveals that local tax revenues have a negative impact on the financial performance of local governments as measured by performance efficiency ratios. Additionally, Darwanis and Saputra (2014) confirm that capital expenditures positively influence financial performance.

Previous studies found factors that contribute to local government performance in a small percentage. Therefore, it is necessary to involve new variables beyond the current ones. Sesotyaningtyas (2012) suggests that the independent variables reach 33.30%, while 66.70% are outside the independent variables. Kusumawardani (2012) states that the independent variables are 31.50%, and 68.50% are other variables beyond the independent variables. Darwanis and Saputra (2014) reveal that the independent variables are 31%, and 68.80% are other variables outside the independent variables. Andirfa et al. (2016) contend that the independent variables are 13.60%, and 86.40% are other variables outside the independent variables. Suryaningsih and Sisdyani (2016) argue that the independent variables are 19%, and 81.00% are other variables outside the independent variables. Udirizqi et al. (2016) explain that the independent variables are 22.20%, and 77.80% are other variables outside the independent variables. Setyaningrum and Martani (2018) admit that the independent variables are 37.88%, and 62.12% are other variables outside the independent variables. Therefore, this study examines new variables consisting of follow-up on audit recommendations and horizon problems.

2.3 Hypothesis Development

This study empirically investigates the factors that influence the financial performance of local administrations by referencing previous studies from the business and government sectors. This study was designed specifically to investigate the effects of variables such as region size, regional expenditure, and audit opinion, with unconfirmed findings to date. Previous studies on this topic in Indonesia only used data from specific islands or provinces. This study, on the other hand, includes all local governments in Indonesia that have complete data.

2.4 Local Government Size

Local government size is proxied by by the total assets controlled and utilized by these organizations. Local governments gain the capacity to enhance both financial performance and public services, in accordance with key regulatory frameworks, when they have efficient management and a larger asset base. These include Minister of Home Affairs Regulation No. 17 of 2007 pertaining to regional property management, Minister of Home Affairs Regulation No. 19 of 2016 concerning regional property management, Minister of Home Affairs Regulation No. 19 of 2016 outlining Guidelines for Regional Property Management, and Article 304 of Law 23/2014 addressing investment or regional equity involvement. These regulations collectively express an institutional framework characterized by normative isomorphism, which assures that regional assets support local governments' efforts to deliver efficient and effective public services. Finally, this synergy serves to increase societal productivity, resulting in improved financial performance within local governments. In terms of augmented locally generated revenue, a significant increase is expected.

Chi (2005) finds that organizational size has a significant effect on performance and shareholder rights in private organizations. Gedajlovic and Shapiro (1998) state that the relationship between size and financial performance is favorable for the profitability of an organization. Lin (2006) and Wright et al. (2009) discover that the size of a company influences its financial performance positively. These results indicate that large organizations are likely to attain favorable performance. A similar relationship between size and performance is also expected in government organizations. Kusumawardani (2012) and Masdiantini and Erawati (2016) find that the size of the local government affects financial performance. The proxy used refers to Furqan et al. (2020), Setyaningrum (2017), and Din et al. (2017), which is the natural logarithmic value of total assets as a measure of local government size.

Researchers argue that the size of local governments provides better service efficiency and effectiveness. As a result, public services become more optimal in increasing the productivity of local revenue, which is inseparable from the normative isomorphism in improving financial performance through local revenue. Based on the above arguments, we propose the following hypothesis:

H1. Local government size is associated with higher local government financial performance.

2.5 Capital Spending

Local governments carry out capital spending in public facility development, information technology, and infrastructure to improve public services, raising public awareness about paying local taxes and levies. Increased capital spending promotes the performance of local governments. Several government regulations ensure that capital spending will greatly assist regions in obtaining financial sources to contribute to local revenue growth to improve local government performance. The drive becomes the evidence of implemented institutional theory through normative isomorphism. Putu and Harta (2016) and Leki et al. (2018) find that local government capital spending contributes to financial performance. Furqan et al. (2021) view that the provision of public service infrastructure will have a greater positive effect when compared to operational spending, especially on the role of non-financial performance information, such as the provision of public services, which has an impact on economic and political decisions among stakeholders.

Furthermore, this study believes that improvements in infrastructure, information technology, and facilities will result in a more stable level of services. In other words, capital expenditure will either directly or indirectly contribute to the payment of regional taxes and levies to increase local revenues because the potential for regional revenues and investment is greater with improved infrastructure, technology, facilities, and infrastructure. The above arguments lead to the following hypothesis:

H2. Local government capital spending is associated with improved local government financial performance.

2.6 Audit Opinion

Auditors comply with the auditing standards for state finance to determine an opinion. The audit opinion in this study refers to the Supreme Audit Agency's (BPK) opinion as the government body that conducts an independent and objective audit of local government financial reports based on predetermined criteria.

Local governments are audited for their annual financial report and given an audit opinion by BPK. Local governments are expected to be highly motivated to improve financial performance through an audit opinion. If the audit opinion obtains a clean result, the public's perception of the local government's legitimacy will increase. This view shows that coercive isomorphism arises from political pressure on local governments to gain legitimacy. The public will trust the local government if it shows evidence of good regional financial management and accountability. The effect will encourage people to voluntarily contribute to generating revenues for local governments, primarily through local taxes and levies that promote the local government's performance.

Sutopo et al. (2017) reveal a positive relationship between audit opinion and performance. Udirizqi et al. (2016) and Suryaningsih and Sisdyani (2016) also suggest that financial report opinion significantly affects financial performance. Furthermore, researchers argue that local government legitimacy arises because of the status quo through audit opinions, which provides sufficient legitimacy to carry out credible programs and activities to increase local revenues. Audit opinion provides institutional skills in compliance with supervisory policies and financial fairness, leading to coercive isomorphism. Based on the above arguments, we propose the following hypothesis:

H3. The clean audit opinion is associated with the higher financial performance of local governments.

2.7 Follow-up on Audit Recommendations

BPK Regulation No. 2 of 2017 specifies that an audit recommendation is a suggestion made by the auditor based on the inspection results presented to officers and agencies authorized to conduct audits. Eckersley et al. (2014) also define audit recommendation as a form of independent assessment of errors that arise during the audit process to be followed up by auditees. In this case, giving audit recommendations is under the auditor's authority, while follow-up on audit recommendations is under the responsibility and control of the local government as the auditee, including audit recommendations if involving third parties.

The Regional Inspectorate, as the internal supervisory apparatus, is tasked with monitoring and ensuring the suitability of the follow-up implementation of audit recommendations as clarified through the duties of the internal supervisory apparatus embodied in Article 4 of BPK Regulation No. 2 of 2017. In this regulation, the task of the Regional Inspectorate is to verify the adequacy, accuracy, and relevance of supporting documents for implementing follow-up on audit recommendations before submission to BPK.

Follow-up on the recommendations of the inspection output carried out by the local government shows that the local government strives to carry out the recommendations to improve its performance. The government's efforts will undoubtedly have an impact on public services to materialize people's welfare, which implies that more followed-up recommendations indicate better performance of the local government.

Several studies have found that following up on the results of audit recommendations increases financial accountability and reduces corrupt practices. Liu and Lin (2012) argue that the application of sanctions and other audit recommendations has a deterrent effect, so follow-up audit recommendations will lead to lower corruption in the following period. In Indonesia, a similar study was also conducted by Setyaningrum (2017), which confirms that, in general, following-up on audit recommendations is how local governments improve public financial accountability. Furqanet al. (2020) argue that follow-up on audit recommendations has an indirect positive role in improving the performance of public service quality. Meanwhile, Kiswanto and Fatmawati (2019) report that regional size and follow-up on audit recommendations positively affect local government performance.

Based on the explanation, the local government conducts follow-up audits to comply with the recommendations. This effort increases compliance with laws and regulations and the implementation of internal control systems in local governments for higher effectiveness. Furthermore, the public will trust the financial accountability of the local government, which will lead to a higher degree of regional decentralization. The above arguments result in the hypothesis below:

H4: Follow-up on audit recommendations is associated with higher financial performance.

2.8 The Horizon Problem

The horizon problem can be defined as actions taken by motivated managers who have enough time to grow the company, resulting in them receiving increased compensation and prestige. Conversely, managers lose motivation if they are about to retire or leave the company soon, making them reluctant to grow the company at the end of their tenure, as the successor will enjoy the success (Murphy, 1985; Jensen & Murphy, 1990; Rose & Shepard, 1997).

Many studies have been done on the horizon problem in the business sector. Bebchuk (1999) reported that there were efforts to reduce long-term research and development (R&D) spending. Dechow and Sloan (1991) published that managers in the final term of office will reduce R&D costs, as R&D is considered a long-term spend. Huson et al. (2012) found a relationship between abnormal changes in sales, administrative and general expenses, and cash compensation changes in the final term of office. Furthermore, Matta and Beamish (2008) suggested that the career horizon problem occurs between the newly appointed chief executive officers (CEOs) and the CEOs about to retire. The latter are likely to make decisions to meet short-term interests only. Ali and Zhang (2015) also revealed that newly appointed leaders increase market penetration based on the desire for long-term benefits such as increased compensation, appointments, and managerial autonomy. Yul and Kyun (2017) observed that companies with CEOs with short-horizon careers tend to make fewer breakthroughs in innovation. Fang et al. (2018) also reported that managerial slack increased in the last two years of CEO tenure compared to previous years.

In the public sector context, several studies were conducted. In Brazil, mayors who qualify for re-election are those with low corruption levels (Ferraz & Finan, 2011). In Italy, Alesina and Paradisi (2017) report that politicians use their discretion before re-election by setting a low property tax to make them popular and open more chances to win the election for the second term. The studies conducted in Indonesia confirm that incumbent regional heads take popular actions before an election to promote a positive image. Setiawan and Setyorini (2018) disclose that the contesting incumbent in the second term's election will be more aggressive in lowering the budget for goods and services spending.

In the context of the horizon problem, a leader who is about to retire or whose term of office is about to expire may be hesitant to make long-term decisions and take substantial risks that could jeopardize the success of their tenure. Prospect theory demonstrates that leaders as decision-makers will avoid risk as they approach closer to analyzing their options. Regional heads in their second terms are likely to do worse. In contrast, freshly elected regional heads perform better since they hope to be re-elected for a second term. Based on the above arguments, we propose the following hypothesis:

H5. First-term regional heads show better financial performance than second-term regional heads.

3. Research Design

3.1 Data and Samples

This study used as a sample all local governments in Indonesia from 2012 to 2019. We examined financial reports covering balance sheets, budget realization reports, statements of operations, statements of cash flows, and notes on financial statements. Purposive sampling was used to collect data by determining the complete data provided by local governments. The data came from audited financial reports and included total assets, capital spending, audit opinion, follow-up audit recommendations, gender, age, and the horizon problem. The reports also present data on locally-generated and total revenues to calculate the decentralization ratio.

The population of this study consisted of local governments in Indonesia, particularly regency and city governments, in accordance with the Rules of the Ministry of Home Affairs Number 56 of 2015, which states that Indonesia has 514 local governments, of which 416 are regencies and 98 are cities. An overview of the samples for the main test in this study can be seen in Table 2 below.

Table 3. General Description of the Research Samples

Description	**Sample**	
	Total	**Percentage (%)**
Panel A. Determination of the number of samples		
Number of Regencies/Cities in 2012-2019	**514**	**100%**
Administrative Regencies and Cities of DKI Jakarta Province	6	1.17%
Unavailability of Badung Regency Sample Data 2012-2019	1	0.19%
Number of Samples	**507**	**98.6%**
Panel B. Sample Description		
Based on Local Government Status		
Regencies	414	81.66%
Cities	93	18.34%
Number of Samples	**507**	**100**
Based on the Geographical Location of the Local Government		
Java Island	114	22.49%
Outside Java Island	393	77.51%
Total Samples	**507**	**100%**

Table 3 shows 514 regencies/cities in Indonesia from 2015 to 2019. However, six regencies/cities in the Province of the Special Capital Region of Jakarta (DKI) were excluded because they do not have their financial reports and are part of the reporting entity for DKI Jakarta Province. In addition, no data on follow-up variables were found in the Badung Regency sample from 2012 to 2019, so Badung Regency was also excluded. The final sample size was set at 507 observations, corresponding to approximately 98.6% of Indonesia's total regencies/cities between 2012 and 2019.

Meanwhile, Table 3 Panel B shows that areas with regency status outside Java Island dominate the sample.[3] There are 414 areas with regency status, or approximately 81.66%, and only 93 areas with city status, or about 18.34%, of which only 114 areas, or about 22.49%, are on Java Island, while the remaining 393 areas, or approximately 77.51%, are elsewhere.

Several regencies/cities have no variable data in specific years among the samples determined.

[3] *Java is an exception because it contains the capital city of Jakarta. As a result, local governments on the island of Java are geographically close to the central government, which serves as the "supervisor" of the local governments.*

Therefore, the observation data was discarded. Consequently, this study uses unbalanced panel data with a total cross-section of 507 over 8 years (2012-2019) and 3,747 observations as the observational data. Table 4 below describes an overview of the observations used.

Table 4. General Description of Research Observations

Year	Regency/City Research Samples for 2012-2019	Data Unavailability	Total Observations
2012	507	37	470
	100%	7.30%	93%
2013	507	40	467
	100%	7.89%	92.1%
2014	507	33	474
	100%	6.51%	93.5%
2015	507	54	453
	100%	10.65%	89.3%
2016	507	56	451
	100%	11.05%	89.0%
2017	507	38	469
	100%	7.50%	92.5%
2018	507	23	484
	100%	4.54%	95.5%
2019	507	28	479
	100%	5.52%	94.5%
Total Observations	**4056**	**309**	**3747**
	100%	**7.71%**	**92.3%**

3.2 *Research Model*

This study used panel data regression analyses to test the hypotheses. The empirical model is stated below:

$KPD_{it} = \mu o + \mu_1 ASSET_{it} + \mu_2 CS_{it} + \mu_3 OPINI_{it} + \mu_4 FLW_{it-i} + \mu_5 TERM_{it} + \mu_6 GEN_{it} + e$ (1)

The details are as follows:

KPD_{it}= Local government financial performance is measured by the degree of decentralization, calculated as the total locally generated revenues divided by the total local revenues.

$ASSET_{it}$ = Natural log of total assets of local government i in year t.

CS_{it} = Natural log of capital spending in local government i in year t.

$OPINI_{it}$ = A variable set to 1 if the financial report of local government i in year t receives a disclaimer of opinion, 2 for adverse opinion, 3 for qualified opinion, 4 for unqualified opinion.

$FLW_{i,t-1}$ = Follow-up audit recommendations in local government i in year t-1.

GEN_{it} = A dummy variable set to 1 if the gender of the head of local government i in year t is male, and 0 otherwise.

$TERM_{it}$ = the horizon problem measured as the term in which the head of local government i at year t served (i.e., first or second term).

e = error term

The above model controls for the gender of the regional head. Gender is expected to affect the financial performance of local governments. Dankwano (2018) suggested that, in the corporate setting, an increase in the number of female directors positively affects return on expenditure (ROE). In the public sector, Park (2012) concluded that women's presence in South Korea's bureaucracy leads to improved government performance. The same finding was also stated by Hur (2020) that female managers show the same level of job satisfaction as men, but they have different work orientations.

4. Empirical Result

4.1 Descriptive Statistics

Table 5. Descriptive Statistics

Variable	Mean	Median	Maximum	Minimum	Std. Dev.
KPD	0.0982	0.0763	0.4919	0.0014	0.0783
ASSET	14.6744	14.5829	17.9352	12.5223	0.6371
CS	12.4464	12.4379	15.4399	1.7261	0.7995
OPINI	3.81238	4	4	1	0.7165
FLW	0.6471	0.7276	9.6838	0	0.3690
TERM	1.3528	1	2	1	0.4779
GEN	0.9423	1	1	0	0.2331
Total unique local government = 507; sample Year= 2012-2019 Total Observations = 3,747					

The descriptive statistics in Table 5 suggest that local government financial performance (KPD) has a mean of 0.0982 and a standard deviation of 0.0783. The maximum value obtained is 0.4919, which refers to the fiscal decentralization ratio of the City of Surabaya in 2012, and the minimum value is 0.0014, which is the fiscal decentralization ratio of Deiyai Regency in 2018. The local government size has a mean of 14.6744 and a standard deviation of 0.6371. The maximum value is 17.9352, referring to the local government size value of Makassar City in 2017, and the minimum value is 12.5223, which is the value of the local government size of North Nias Regency in 2016. The capital expenditure has a mean of 12.4464 and a standard deviation of 0.7995. The maximum value is 15,439, which refers to the value of capital expenditure in Kutai Kartanegara Regency in 2013, and the minimum value obtained is 1.7261, referring to the value of capital expenditure in Biak Numfor Regency in 2017.

The BPK opinion (OPINI) variable is on an ordinal scale from 1-4, with category 1 representing the quality of financial reports as "disclaimer of opinion" or the worst category, category 2 representing "adverse opinion", category 3 representing "qualified opinion", and category 4 representing the quality status "unqualified opinion" or the best category. The OPINI variable has a mean of 3.8123, which means that the average observation has a qualified opinion because the mean value is close to 4. The standard deviation of the OPINI variable is 0.7165. The maximum value obtained is four, whereas the minimum value is one.

The follow-up variable (FLW) is a calculation of the ratio of the number of audit follow-ups divided by the number of recommendations from the previous year. This variable has a mean of 0.647 and a standard deviation of 0.3690. The mean value of 0.647 means that the average percentage of cases followed up by regencies/cities in Indonesia in the period of 2011-2018 was 64.7% of the audit recommendations. The maximum value is 9.683857, which is the follow-up value of Puncak Regency in 2011, and the minimum value is 0.

Furthermore, the gender variable (GEN) is a dummy variable with a value of 1 as "male" and 0 as "female". The gender variable has a mean of 0.942354 with a standard deviation of 0.2331. The mean obtained from the gender variable is close to a value of 1, which means that most local governments have male regional heads. The minimum value is 0, and the maximum value is 1. The variable TERM indicates the period in which the regional head serves in the local government. This variable has a mean of 1.352 and a standard deviation of 0.47791. The maximum value of the period variable is two, and the minimum value is 1.

Observations with incomplete data are eliminated so that the regression uses unbalanced panel data with total unique local governments of 507 and a period of 8 years (2012-2019) and 3,747 observations. The Hausman test indicates that the Fixed Effect Model is the most suitable for our dataset.

5. Results and Discussion

Table 6. Test Results

Variable	Coefficient	Prob.	Description
CONS (Constant)	-0.8200	0.0000***	Negative
Asset (Government size)	0.0644	0.0000***	Positive
CS (Capital Expenditures)	-0.0037	0.0123**	Negative
$OPINI$ (Audit Opinion)	0.0106	0.0000***	Positive
FLW (Audit Follow up)	0.0139	0.0000***	Positive
TERM (Horizon Problem)	-0.0015	0.4822	Insignificant
GEN (Gender)	-0.0295	0.0000***	Negative
R-squared			0.3482
F statistics			153.4411
Total Unique Local Government = 507; Sample Year= 2012-2019; Total Observations = 3746			
***, **, * = **significant P-value 1%, 5%, 10%**			

The results in Table 6 show that the adjusted R-square was 0.3482, indicating that 34.82 percent of the variance in dependent variables can be explained by the independent variables, while the remaining 65.18 percent was explained by other variables outside the model. The results indicate a reasonably strong model. The independent variable of financial performance involves six independent variables, with five variables demonstrating significant effects and one variable with no significant effect.

The result shows that local government size or total assets owned by local governments positively affect their financial performance, and it is significant at a 1 percent level. Therefore, we reject H_0. The size or total assets owned by local governments influence the achievement of financial performance. When providing services to the public, local governments should not only focus on operational spending but also increase assets, especially government-owned fixed assets and investments, such as wide and free road access and community facilities. This study is consistent with Chi (2005), Lin (2006), Wright et al. (2009), Kusumawardani (2012), Mustikarini and Fitriasari (2012), and Kiswanto and Fatmawati (2019), who report that local governments with more assets generate better performance. Some evidence from the field supports our findings. For example, from 2011–2019 the City of Surabaya has succeeded in increasing local revenue through managing government assets such as office buildings. The City of Bandung has also succeeded in increasing local own-source revenue through the optimizing the use of assets for revenue generating activities such as for parking. Another example is Tangerang Regency, which succeeded in increasing local revenue through developing traditional markets and improving facilities, which then cooperates with the private sector to build larger modern markets to increase local revenues.

We find that capital spending has a negative effect on financial performance. This finding contradicts the findings of Furqan et al. (2021), Normalita and Mahmud (2017), and Leki et al. (2018), who all find that capital spending has a positive effect on financial performance. We argue that capital projects, such as building hospitals, schools, and public transportation, take several years to complete and cannot provide economic benefits in the same year, compared to operational expenditures that can have an immediate effect on the economy. In fact, in the short run, capital expenditures could have a temporary negative effect on financial performance, as shown in this study. Another possibility is that capital spending has always been a problem when it is associated with fraudulent practices, especially procuring goods and services within the scope of local government. The most frequent findings identified by the auditors are the procurement of goods and services that are not in accordance with the provisions. What usually happens is that the winning bidders or auctions in the government reduce the quality of the goods as specified in the contracts (BPK, 2019). The results of the Corruption Eradication Commission's study show that the potential for corruption occurs in procuring goods and services

(Movanita, 2017). According to the findings of Neu et al. (2015) and Sikka and Lehman (2015), this condition is exacerbated by the fact that capital expenditures typically entail construction and the procurement of goods, which increases the likelihood of corruption and bribery. Capital expenditures, particularly when accompanied by corrupt practices, are anticipated to have a negative impact on financial performance. From 2004 to 2022, 21 percent of corruption cases in the nation were associated with capital expenditures or the procurement of goods/services. Numerous local government heads were implicated in corruption in the procurement of products and services, resulting in a decline in public confidence in local government heads. This will, at least temporarily, reduce the capacity of local governments to generate revenue.

We find that the audit opinion positively affects financial performance and is significant at a 1 percent level. The audit opinion on the financial report has four types: an unqualified opinion, a qualified opinion, an adverse opinion, and a disclaimer of opinion. If the local government obtains an unqualified or the highest quality opinion, it indicates better financial performance. The findings are consistent with those of Udirizqi et al. (2016), Masdiantini and Erawati (2016), and Sutopo et al. (2017), who found that audit opinion had a positive effect on local government financial performance. These findings confirm that local governments who get a clean opinion on the financial report demonstrate to the public that revenues obtained from the public are used properly in accordance with applicable regulations. Consequently, public trust and obedience to pay levies and taxes will increase. Local governments continue to improve the quality of their financial reports from year to year. For example, the Sleman local government and the Banyumas local government were able to maintain a clean audit opinion from 2011 to 2019 and also experienced a steady rise in regional financial performance during the same period. This shows that the local government is truly accountable for financial reports to the community and as a result the community will voluntarily pay regional taxes and regional levies.

Finally, the audit follow-up also positively affects financial performance, and the coefficient is significant at a 1 percent level, rejecting H_0. This result suggests that audit follow-up has a positive impact on fiscal decentralization. This finding is consistent with the findings of Furqan et al. (2020) and Kiswanto and Fatmawati (2019), who found that follow-up audit recommendations have an indirect positive effect on public service quality performance. Local governments that respond quickly to follow up on any audit findings relating to internal control and compliance with laws and legislation demonstrate that they take the central government's role seriously. For instance, between 2011 and 2019, the City of Semarang consistently responded to nearly one hundred percent of audit findings and experienced consistent regional capacity development. This demonstrates the commitment of local government management to make continuous improvements so that the public's trust in local governments to manage regional taxes and levies in a transparent and accountable manner is maintained.

Our results suggest that the financial performance of local governments is not statistically different when the head of local government is in the first or the second period. This means that horizon problems do not affect financial performance. The results of this study do not support previous studies conducted by Murphy (1985), Jensen and Murphy (1990), and Rose and Shepard (1997), who report that managers lose motivation when they are about to end their tenure. However, this study's results concur with Matta and Beamish (2008), Ali and Zhang (2015), and Fang et al. (2018), who state that newly appointed CEOs have long-term motivation. However, CEOs about to retire or end their tenure are more likely to focus on short-term decision-making and have low innovation. Thus, the performance is expected to decline. This horizon problem variable is not supported, possibly because a regional head's motivation differs from that of an executive in a company. In the public sector, a regional head is required to provide public services, whereas in the private sector, an executive must increase revenue for the company owner or shareholders. Given various environmental factors and goals, the term of office does not apply to local government.

We find that Gender as a control variable has a negative effect on financial performance. Given the negative coefficient, the study finds that the performance of areas led by male regional heads tends to be lower than those led by female regional heads. This is consistent with the findings of Park (2012), which indicate that the presence of women in South Korean bureaucracies results in enhanced government performance. In private sector research, Kılıç and Kuzey (2016), discovered that the presence of female directors in Turkish companies enhanced financial performance (as measured by return on assets, return on equity, and return on sales). Then, Luh and Kusi (2023) found that women who hold top corporate executive positions such as chief executive officer, chair of the board, and female board members have an impact on improving performance. The results of a study conducted on the Palestine Stock Exchange from 2010 to 2020 by Awwad et al. (2023) revealed that the presence of women on the board of directors positively impacted company performance.

Furthermore, Arora (2022), with a sample from the Bombay Stock Exchange of 500 companies from India, found that the presence of female directors has a significant relationship with company performance. Finally, Harakeh et al. (2019), who examined data on public companies in England (between 2007 and 2015), discovered a negative relationship between female directors and earnings management. In other words, the female directors are associated with improved quality of financial reports. Therefore, female regional heads outperform male regional heads in terms of performance. Most of the regional heads in Indonesia are men. Consequently, there should be a consideration for encouraging female regional heads so that local governments can explore their potential to improve regional financial performance.

6. Conclusion and Limitations

Indonesia, one of the world's largest democracies with a population of 270 million, began regional decentralization in 2004. However, after nearly two decades, development in regional financial performance, particularly in terms of generating local income, appears to be somewhat gradual. On average, the locally generated revenues account for only 10 percent of total regional revenues. This study investigates the determinants of the degree of regional decentralization. This study used data from local government financial reports and BPK audit reports for the fiscal years 2012 to 2019, with 3,746 observations from local governments across Indonesia.

Consistent with previous research, we find that local government size, audit opinion on financial reports, and the level of audit follow-up have a positive impact, whereas capital expenditures have a negative impact on local government financial performance.

This study contributes to the literature on factors influencing the performance of financial autonomy. This study offers policymakers insight into the factors that contribute to the ability of local governments to generate local revenues and become less dependent on transfer revenues from the central government. Future researchers may be inspired by our findings to investigate the factors that contribute to rising financial performance in other countries.

This study has several limitations. The financial performance variable used in this study is only the degree of decentralization ratio. Subsequent examinations can use other performance measures such as local government performance evaluation, human development indices, effectiveness ratios, efficiency ratios, and other more precise financial ratios. Furthermore, the control variable of regional head attributes in this study covers gender only. Future studies might use attributes of regional heads, such as educational background and previous occupations (e.g., professionals, businessmen, or politicians), as a new variable.

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