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THE PARADOX OF FISCAL INDEPENDENCE: WHY DOES DECENTRALIZATION DECREASE CAPITAL EXPENDITURE ALLOCATION?

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ABSTRACT

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Purpose – This study seeks to examine the impact of local government financial performance on capital expenditure. **Design/methodology/approach** – Adopting a descriptive quantitative methodology, this study examines panel data from seven local governments in the former Pekalongan Residency during the 2020-2024 period. **Findings** – The results show that the effectiveness of Local Own-Source Revenue (LOSR) and local government financial efficiency positively influence capital expenditure. Meanwhile, the growth of LOSR did not show a significant impact. What needs to be noted is that this study reveals a paradoxical empirical finding: fiscal decentralization has a significant negative influence on capital expenditure. **Research limitations/implications** – Theoretically, these findings imply a misrepresentation in local budgeting priorities. To ensure fiscal independence positively impacts public infrastructure development, local governments need to exercise stricter controls over operational expenditure. **Originality/value** – This research contributes to the public finance literature by empirically demonstrating the "Fiscal Independence Paradox" in emerging economies.

INTRODUCTION

Post-reform implementation of regional autonomy has transformed the architecture of government and public finance in Indonesia, with the existence of a decentralization policy (Ningsih K.sh. et al., 2023) by handing over the mandate to local governments to manage resources and development independently (Canavire-Bacarreza et al., 2020). This policy aims to encourage local initiatives, accelerate equitable distribution of infrastructure and improve the quality of public services.

There is a mandate for local governments to use their revenues to deliver tangible outcomes, such as improved services and increased public welfare. This can be achieved, among other things, through the allocation of capital expenditures, which are long and medium-term investments essential for building adequate public service infrastructure (Andriyani et al., 2020; Fajriati et al., 2022), which in turn has the potential to attract investment to open up new job opportunities, and stimulate productivity and economic growth in the region (Ardelia et al., 2025).

Although capital expenditure is essential for regional development and the improving public services, the budget allocated to capital expenditure by most local governments in

Indonesia is suboptimal (Auliya & Hidajat, 2024; Fajriati et al., 2022). A similar phenomenon was also identified empirically among local governments in the former Pekalongan Residency area (a historical administrative grouping), as indicated by the ratio data in Table 1. This condition is inconsistent with the regulatory mandate that at least 40 % of a local government’s total budget be devoted to public-service infrastructure (Republik Indonesia, 2022). This low capital expenditure allocation can indicate agency problems, where the local government, as an agent, allegedly does not fully pursue the community’s interests, their principal.

Table 1 Ratio of Capital Expenditure Realization of Regencies/Cities in the Former Pekalongan Residency

Regency / City	Capital Expenditure Ratio (%)				
	2020	2021	2022	2023	2024
Pekalongan Regency	16.81	10.03	12.30	12.23	13.73
Pekalongan City	19.28	16.68	19.06	16.54	11.78
Tegal Regency	17.34	13.28	11.52	12.59	11.78
Tegal City	15.83	13.43	12.79	8.44	7.35
Brebes Regency	21.05	14.05	15.55	11.97	13.63
Pemalang Regency	13.05	8.68	6.01	8.55	6.47
Batang Regency	12.74	11.01	10.17	7.75	9.07

Source: Secondary data processed (2025)

Based on data on capital expenditure realization from 2020-2024, the ratio for the former Pekalongan Residency area has fluctuated, showing a downward trend. For example, Tegal City recorded a sharp decrease in the capital expenditure ratio from 15.83% in 2020 to only 7.35% in 2024. A similar decline also occurred in Pekalongan City, where the capital expenditure ratio fell from 19.28% in 2020 to 11.78% in 2024, although it had returned to 19.06% in 2022. This decline likely occurred as a result of the policy of refocusing the Transfer and local government budget to mitigate the effects of the 2020-2022 pandemic and the subsequent recovery in 2023-2024 (Kementerian Koordinator Bidang Perekonomian, 2021).

This phenomenon has become increasingly crucial amid the issue of Regional Transfer Funds (TKD) cuts in the 2026 State Budget Bill, which has dropped significantly to only IDR 649.9 trillion, compared to the previous year's IDR 919 trillion (Akbar, 2025). This could significantly affect infrastructure development and public services in the area.

Complementing these observations, a literature search also revealed a research gap in previous studies on the determinants of financial performance that influence capital expenditure allocation decisions. Some researchers found inconsistent results. For example, Tamawiy et al., (2016) report the impact of Local Own-Source Revenue (LOSR) Growth on capital expenditure, a finding that contradicts the findings of Oktavianti & Idayati (2020), which did not find a significant relationship between the two variables. Similarly, on the variable of fiscal decentralization, Devi et al. (2022) confirmed a negative effect, while Oktavianti & Idayati (2020) found a positive effect. The gap in the literature, coupled with the significant decrease in the capital expenditure ratio in the observation area, underscores the need to re-evaluate the correlation between related variables.

Given the background of the gap between incurred capital expenditure and the inconsistency of previous literature findings, this research seeks to evaluate how financial performance affects capital expenditure. The analysis considers the following variables tested: LOSR Growth, Decentralization Degree Ratio, LOSR Effectiveness Ratio, and Local Government

Financial Efficiency Ratio. The research locus covers all Regencies/Cities in the former Pekalongan Residency area for the 2020-2024 period.

LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT

Agency Theory

Jensen & Meckling (1976) contend that agency relationships are formed through the dynamics of contractual relationships between two parties, namely principals and agents. In the context of local government, the community serves as the principal who delegates responsibility for resource management to the local government as an agent.

The dynamics of this interaction between the principal and the agent pose an inherent conflict-of-interest risk. This is known as the *agency problem*. This phenomenon occurs mainly if the agent makes a decision or action that is not in line with the principal's expectations (Tamawiy et al., 2016). Furthermore, Zimmerman (1977) added that agency problems are not limited to the private sector but also occur in government organizations.

Capital Expenditure

According to the regulations governing regional financial management, capital expenditure refers to regional expenditure used to acquire fixed assets or other assets that generate economic benefits over more than one accounting period (Pemerintah Republik Indonesia, 2019). The capital expenditure budget post is considered productive expenditure (Digdowiseiso et al., 2022) as well as a medium and long-term investment instrument (Alfiani et al., 2024) and shows a long-term plan (Husain, 2021) with the main goal of optimizing the availability and quality of public facilities and infrastructure.

An analysis of regional expenditure structure can be carried out to determine whether a local government prioritizes its budget between routine operational expenditure and development expenditure (Capital Expenditure). The substantial portion of capital expenditure cannot be ignored, considering that Patarai (2017) underscores its role as a vital stimulus for the growth and acceleration of the regional economy, for the equitable distribution of community welfare, and for infrastructure development across sectors.

Local Government Financial Performance

Bastian (2006) defines performance as a parameter that describes the level of success in implementing a policy or work program to realize the organization's vision, mission, and strategic goals. A main prerequisite in assessing the success or failure of these achievements is that all activities carried out must be documented and measurable. In line with this, Patarai (2017) said that the measurement process not only focuses on inputs but also emphasizes the outputs produced.

According to Patarai (2017), local government financial performance is an indicator of the extent to which a region has successfully implemented autonomy. This performance reflects achievements in the financial sector that demonstrate compliance with good governance principles such as honesty, transparency, effectiveness, efficiency, and accountability. The measurement aims to assess the level of regional financial independence, evaluate the effectiveness and efficiency of budget execution (revenue and expenditure), and monitor the expansion and progress of regional revenue and expenditure sources.

Local government financial performance is assessed through a financial ratio analysis, with data sourced from the Budget Realization Report (LRA). The dimensions of local

government financial performance measurement specifically include the LOSR growth ratio, fiscal decentralization, LOSR effectiveness, and local government financial efficiency.

Local Own-Source Revenue Growth

In accordance with the regulatory framework, Regional Revenue is defined as the accumulation of regional financial rights that increase net worth during a budget cycle. Its components include Local Own-Source Revenue (LOSR), transfer revenue, and other legitimate regional revenues (Pemerintah Republik Indonesia, 2019). Among these components, LOSR occupies a strategic position as the main indicator of regional independence. According to Patarai (2017) LOSR optimization is key for local governments to substantially reduce dependence on the central government within their budget structure.

Local Own-Source Revenue (LOSR) comprises all revenue obtained directly from the economic potential of a region, with a structure that includes regional taxes, levies, earnings from distinct regional wealth management, and other legitimate revenues (Republik Indonesia, 2014). As an important element in supporting fiscal and regional independence, LOSR is a critical requirement for local governments to realize development programs within the framework of regional autonomy policies (Hartoto, 2025). Regional autonomy can leverage regional potential, expected to increase LOSR, to accelerate development and improve community welfare.

Theoretically, a higher LOSR signifies that the region possesses greater resources. This increase is anticipated to lessen the dependence on the central government and allow regions to finance their own investment needs, including capital expenditure to improve public service infrastructure, such as roads, buildings, land, and quality machinery. Previous studies by Tamawiy et al. (2016), Andriyani et al. (2020) and Devi et al. (2022) supports the significant influence of LOSR growth on capital expenditure.

H1: LOSR growth has a positive and significant influence on Capital Expenditure

Fiscal Decentralization

Fiscal decentralization refers to the process of shifting part of financial responsibility and authority from the central government to local governments. This policy aims to accelerate improvements in public welfare. The mechanisms implemented include the delegation of development mandates and public service functions, as well as the allocation of financial resources to local governments, to reduce bureaucratic distance and make government services more responsive to community needs.

To measure a region's financial capacity, the fiscal decentralization ratio is used, defined as the ratio of LOSR to total regional revenue (Ambarwati, 2025). This ratio is directly proportional to regional independence, namely, the condition of local governments that do not depend significantly on external funding sources (Kementerian Dalam Negeri, 2020). Previous research noted that fiscal decentralization is a significant predictor, where Arif & Arza (2018) and Oktaviani & Idayati (2020) stated that there is a positive influence between these variables in encouraging an increase in Capital Expenditure.

H2: Fiscal Decentralization has a positive and significant influence on Capital Expenditure

LOSR Effectiveness

Effectiveness is a measure that compares the output of a program with the previously set target (Majid, 2019). In this case, the effectiveness of LOSR reflects local governments' ability

to realize it in line with projected targets, given the region's potential. Operationally, the effectiveness ratio is calculated by comparing the realization of LOSR with the budget target (Ambarwati, 2025). Patarai (2017) stated that an area is categorized as effective if it reaches a minimum ratio of 100 percent, and the higher the value of the ratio, the better its ability to meet the revenue target.

Optimizing the effectiveness of LOSR with realizations that exceed the target is clear evidence that local governments have succeeded in providing maximum output by mobilizing available revenue resources as planned (Majid, 2019). This is crucial to ensure sufficient budget to finance the Capital Expenditure program. Support for this causality relationship is found in research by Tamawiy et al. (2016), Arif & Arza (2018), and Oktaviani & Idayati (2020) which affirms the influence of PAD Effectiveness on Capital Expenditure.

H3: The effectiveness of LOSR has a positive and significant influence on Capital Expenditure

Local Government Financial Efficiency

In the public sector, budgets are an important tool that underpins an organization's operations. Majid (2019) stated that the budget is a public policy statement and fiscal target written in a formal document. Therefore, the budget serves as a commitment to manage resources for the benefit of the community, as well as a tool for control and performance assessment (Husain, 2021; Majid, 2019).

The performance of public management in budget management is assessed through two main dimensions, namely target achievement and efficiency (Patarai, 2017). Then Majid (2019) explained that efficiency is the ratio between inputs and outputs to achieve previously set targets. These things put pressure on public resources to be managed optimally to provide results or benefits for the community. Therefore, the efficiency ratio in measuring regional financial use not only reflects cost savings but also reflects local governments' ability to manage limited resources to finance development, including capital expenditure allocations. And based on several previous studies by Arif & Arza (2018) Oktaviani and Idayati (2020)), and Devi et al. (2022) that regional financial efficiency has a significant positive influence on capital expenditure.

H4: Regional Financial Efficiency has a positive and significant effect on Capital Expenditure

RESEARCH METHODOLOGY

This study employs a quantitative methodology, which Creswell & Creswell (2023) described as a strategy for testing theories objectively by using numerical and statistical data. This study is explanatory, with the main objective of examining the causal links between the financial performance and capital expenditures.

The population coverage studied includes all local governments in Central Java that fall within the former Pekalongan Residency area. This area comprises 7 (seven) local governments: Pekalongan City and Tegal City, as well as Pekalongan Regency, Pemalang Regency, Batang Regency, Brebes Regency, Tegal Regency. The samples taken are saturated, i.e., censuses. Over a 5-year observation period from 2020 to 2024, a total of 35 observation units were analyzed.

This study utilizes secondary panel data gathered from Local Government Budget Reports and Budget Realization Reports over a five-year observation period (2020-2024). The

database is sourced from the repository of the Directorate General of Financial Balance (DJPK) within Indonesia’s Ministry of Finance (Direktorat Jenderal Perimbangan Keuangan, n.d.)

To avoid differences in interpretation, the variables in this study are operationally defined in Table 2.

Table 2 Operational Definition of Research Variables

Variable	Formula	Sources
LOSR Growth	$\frac{\text{LOSR}_t - \text{LOSR}_{t-1}}{\text{LOSR}_{t-1}}$	(Patarai, 2017)
Decentralized Degree Ratio	$\frac{\text{LOSR}}{\text{Total Revenue}} \times 100\%$	(Hartoto, 2025)
LOSR Effectiveness Ratio	$\frac{\text{LOSR Realization}}{\text{LOSR Budget}} \times 100\%$	(Patarai, 2017)
Local Government Financial Efficiency Ratio	$\frac{\text{Spending Realization}}{\text{Revenue Realization}} \times 100\%$	(Hartoto, 2025)

To solve the problem of non-linear relationships that may occur between variables, Capital Expenditure is converted to a natural logarithmic scale (ln).

To analyze the data, the study used multiple regression on panel data in EViews 13. The analysis stage began with descriptive statistics to provide a comprehensive picture of the data’s characteristics. This was followed by the main regression test to examine the causal influence of independent and dependent variables.

The multiple regression model equations in this study are:

$$\ln_Y = \alpha + \beta_1 X1_{it} + \beta_2 X2_{it} + \beta_3 X3_{it} + \beta_4 X4_{it} + \epsilon$$

where,

Ln_Y = Natural Logarithm of Capital Expenditure

α = Constant

β_{1-4} = Coefficients of independent variables

X1 = LOSR Growth

X2 = Decentralized Degree Ratio

X3 = LOSR Effectiveness Ratio

X4 = Financial Efficiency Ratio

i = Regency/City

t = Time period

ϵ = error terms

To identify the most suitable panel-data estimator among the three main modeling strategies, this research follows a structured, step-by-step testing protocol. First, a Chow test is performed to choose between the Common Effects Model (CEM) and the Fixed Effects Model (FEM), if the cross-sectional F-test yields a p-value below 0.05, the FEM is adopted. Next, a

Hausman test distinguishes the FEM from the Random Effects Model (REM). According to the decision rule, a cross-sectional random-effects p-value greater than 0.05 leads to retaining the FEM. Finally, when earlier tests produce conflicting outcomes, a Lagrange-Multiplier (LM) test is applied as a last resort—if the Breusch-Pagan p-value is less than 0.05, the REM is judged to provide the best fit for the data.

RESULTS AND DISCUSSION

Descriptive Statistical Test

Descriptive analysis provides an overview of the characteristics of the research variables. Based on the processing of panel data from seven regencies/cities in the former Pekalongan Residency during the 2020-2024 period, the following results were obtained:

Table 3 Descriptive Statistics

	X1	X2	X3	X4
Mean	7.09	19.92	103.08	100.01
Median	4.71	18.13	104.47	99.61
Maximum	55.99	33.73	148.33	108.81
Minimum	-19.11	12.16	69.43	79.65
Std.Dev	15.14	6.03	18.38	4.69
Observations	35	35	35	35

Based on Table 3, the descriptive analysis of data from 35 Regencies/Cities the former Pekalongan Residency captures the challenging regional financial dynamics during the 2020-2024 period. The LOSR growth (X1) recorded a positive average of 7.09%, but with high volatility (Min: -19.11; Max: 55.99), reflecting the impact of the COVID-19 pandemic contraction and the recovery's expansion. Meanwhile, the average degree of fiscal decentralization, which remains relatively low (19.92), indicates a high degree of fiscal dependence on the central government. The LOSR effectiveness (X3), which has a fairly high average (103.08), also shows a high level of uncertainty, as indicated by the standard deviation (18.38), the largest among the other variables. In contrast, the financial efficiency ratio (X4), with an average of 100.01% and the smallest standard deviation (4.69), indicates a highly efficient rate of budget absorption, reflecting budget discipline and rigidity.

Model Selection Test

To identify the most statistically robust estimator for the panel data, a sequential testing framework was implemented following the methodology of Napitupulu et al. (2021). The process began with the Chow test, which returned a cross-section F-probability of 0.0000; because this value is below the 0.05 significance level, the Fixed Effect Model (FEM) was initially favored over the Common Effect Model.

However, subsequent analysis using the Hausman test yielded a probability of 0.2793, suggesting that the Random Effects Model (REM) was more appropriate than the FEM, given that the result exceeded the 0.05 threshold. To definitively confirm the optimal fit, the Lagrange Multiplier (LM) test was applied as the final diagnostic. The resulting Breusch-Pagan cross-section value of 0.0000 (falling below 0.05) provided conclusive evidence that the Random Effects Model (REM) is the most suitable and efficient model for this study.

Table 4 Chow Test Results

Effect Test	Statistic	d.f	Prob.
Cross-section F	21.961602	(6,24)	0.0000
Cross-section Chi-square	65.461349	6	0.0000

Table 5 Hausman Test Results

Test Summary	Chi-Sq. Statistic	Chi-Sq. d.f.	Prob.
Cross-section random	5.078878	4	0.2793

Table 6 Lagrange Multiplier Test Results

	Cross-section	Time	Both
Breusch-Pagan	40.15547 (0.0000)	0.550131 (0.4583)	40.70560 (0.0000)

Classical Assumption Test

To assess the GLS-based Random Effects Model, this study conducted diagnostic checks recommended by Napitupulu et al. (2021). The normality assessment yielded a Jarque-Bera p-value of 0.21, which exceeds the 0.05 significance level, confirming that the error terms are normally distributed. Moreover, the correlation analysis shown in Table 7 demonstrates that multicollinearity is not a concern, as all independent variables have correlation coefficients below 0.85.

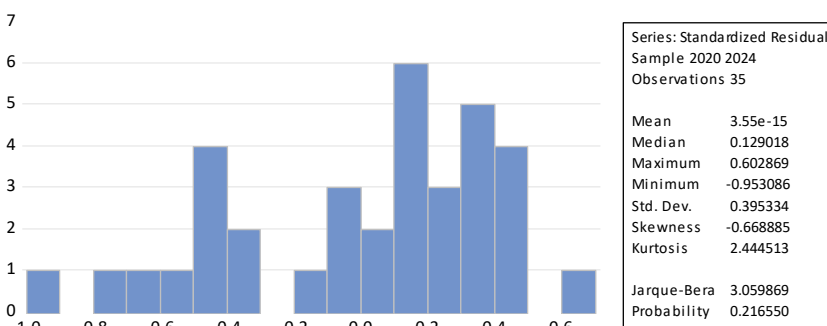


Figure 1 Normality Test Results

Table 7 Multicollinearity Test Results

	X1	X2	X3	X4
X1	1.000000	0.120508	0.409916	-0.150960
X2	0.120508	1.000000	-0.113421	0.332908
X3	0.409916	-0.113421	1.000000	-0.420814
X4	-0.150960	0.332908	-0.420814	1,000000

Hypothesis testing

The model’s feasibility was validated by a Prob(F-Statistic) of 0.000589, which indicates that it is below the 0.05 threshold, confirming that the regression model is robust and that independent variables together have a significant simultaneous effect on Capital Expenditure. Nonetheless, individual results varied; partial testing presented in Table 8 revealed that Fiscal Decentralization (p = 0.0001), LOSR Effectiveness (p = 0.0141), and Financial Efficiency (p = 0.0007) had a significant influence, as their p-values were below the conventional level of 0.05, so H2, H3, and H4 hypotheses were accepted. Conversely, H1 should be rejected because LOSR

Growth has a p-value of 0.0928, indicating the variable does not have a significant impact on the Capital Expenditure.

Table 8 Hypothesis Testing Results

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	23.99333	0.898424	26.70602	0.0000
X1	0.004300	0.002477	1.736045	0.0928
X2	-0.077429	0.017828	-4.343024	0.0001
X3	0.008083	0.003100	2.606908	0.0141
X4	0.028500	0.007532	3.783733	0.0007
F-statistic	6.650957			
Prob(F-statistic)	0.000589			

Discussion

The Effect of LOSR Growth on Capital Expenditure

With a regression coefficient of 0.0043 and a p-value of 0.0928, which exceeds 0.05, leading to the rejection of H1. This finding demonstrates that the growth rate of **Local Own-Source Revenue** is not a primary driver of **Capital Expenditure** allocation within the former Pekalongan Residency. Accordingly, fluctuations in LOSR from one period to the next do not automatically translate into shifts in capital expenditure.

During the 2020-2024 research period, these results can be explained by the economic uncertainty triggered by the COVID-19 pandemic and the subsequent recovery. In this period, local government budget priorities tend to be *refocused* on health care, social security programs, and economic recovery, most of which are included in operating expenditures or unexpected expenditures, rather than capital expenditures. As a result, despite LOSR growth in the recovery years, the funds are not directly converted into fixed assets or long-term infrastructure.

Empirically, these results correspond to of Oktavianti & Idayati (2020) study which found that the growth of LOSR does not significantly impact capital expenditure. The combination of these findings with the pandemic situation and its recovery suggests that local governments in the former Pekalongan Residency area tend to apply the principle of prudence, prioritizing other spending over fixed-asset investments when income fluctuates.

The Effect of Fiscal Decentralization on Capital Expenditure

The Fiscal Decentralization (X2) exhibits a negative regression coefficient of -0.0774 with a p-value of 0.0001, well below 0.05. These results show that Fiscal Decentralization has a negative and significant effect on Capital Expenditure.

These findings are interesting because they contradict the common assumption that financial independence will increase the capacity for infrastructure development. From the perspective of *Agency Theory*, this condition can indicate an inefficiency or shift in allocation priorities by agents (local governments). Increased LOSR provides more space for local governments to manage their resources; however, due to information asymmetry, agents have the potential to prioritize spending that has short-term benefits or for the benefit of the bureaucracy itself, such as operational costs (expenditure on employees and goods/services), thus *crowding out* the portion of the budget for capital expenditure. This low allocation indicates an *agency problem*, in which agents (local governments) are not optimal in prioritizing the public interest when developing fixed assets. Halim & Abdullah (2006) explained that public

representation in the budgeting process is not fully operational due to opportunistic behavior, a moral hazard, on the part of both the legislature and the executive.

The decline in capital expenditure allocation in the former Pekalongan Residency, along with the increase in decentralization, is consistent with the Leviathan Hypothesis proposed by Brenman and Buchanan (1980). Decentralization or fiscal independence, if not balanced by institutional control, can lead to an increase in government size (Moges, 2005). The study results support this; the negative relationship between the level of fiscal decentralization and capital expenditure shows that the resources obtained are absorbed by the bureaucratic machinery.

In addition, these results show the alleged dependence of capital expenditure on central transfer funds (the *flypaper effect*). Local governments may still rely on Special Allocation Funds (DAK) or central financial assistance for physical projects, while their own revenue (PAD) is used more for routine operations. Consequently, when transfer funds from the central government decrease or are cut, capital expenditure is directly affected, even though the regional PAD increases. These results support the findings of Devi et al., (2022) who likewise identified a significant negative effect.

The Effect of LOSR Effectiveness on Capital Expenditure

The LOSR Effectiveness (X3) has coefficient of 0.0080 with a probability of 0.0141. Since the probability value is below 0.05 ($0.0141 < 0.05$), H3 is accepted.

These results confirm that the certainty of budget revenue is the key to development planning. When the realization of PAD reaches or exceeds the target (effective), local governments have greater fiscal flexibility to implement infrastructure development programs planned in the local government budget. As an agent, the local government demonstrates its accountability to the community (principal) by achieving the revenue target and providing long-term public service infrastructure that benefits the community. These findings are in line with the research of Tamawiy et al., (2016) Arif & Arza (2018), and Oktavianti & Idayanti (2020)

The Effect of Regional Financial Efficiency on Capital Expenditure

The Regional Financial Efficiency variable (X4) has a positive coefficient of 0.0285 and a probability of 0.0007. The probability value is below 0.05, so H4 is accepted.

These findings provide an interesting perspective on regional spending behavior across the regencies and cities of the former Pekalongan Residency. The mean of this ratio, which is 100.01%, indicates that local governments in this region tend to optimize their budgetary potential for regional spending. The positive influence in this study means that the higher the rate of budget absorption, the higher the allocation of capital expenditure.

Based on the concept of *Value for Money* in the public sector, where efficiency means the achievement of maximum outputs with certain inputs and related to performance standards and targets that have been set (Majid, 2019), efficiency does not always have to mean savings by holding back spending but optimizing budget resources for development. When the budget can be absorbed to the maximum, local governments can execute public service infrastructure programs. On the other hand, if the ratio is low, it indicates budgetary constraints in execution that can delay public service infrastructure projects. This finding confirms that areas in the former Pekalongan Residency that can maintain their efficiency have a greater capacity to provide public infrastructure and facilities that support regional economic growth. This is consistent with the findings of Arif & Arza (2018), Oktaviani and Idayati (2020), and Devi et al. (2022), which indicate that financial management efficiency positively contributes to capital expenditure.

CONCLUSION

This research shows that the financial performance of the regencies and cities in the former Pekalongan Residency is colored by complex dynamics in the 2020-2024 period. Although LOSR effectiveness and expenditure efficiency positively influence capital expenditure, the main findings indicate a *crowding-out* phenomenon. This finding proves the paradox of fiscal independence in this region, which shows that higher fiscal independence is not automatically used for public service infrastructure but is absorbed by the expansion of operational spending.

This anomaly theoretically validates *the Agency Theory* and *Leviathan Hypothesis* in the context of regional autonomy in Indonesia. Fiscal flexibility arising from the increase in LOSR tends to be used by local governments to expand the bureaucracy. These findings confirm the need for adequate control mechanisms to ensure that fiscal independence truly contributes to the provision of quality public service infrastructure for the community.

Contributions

Given the negative and significant impact of Fiscal Decentralization, local governments need to evaluate their spending structures. Increasing regional independence through LOSR must be balanced by controlling employee expenditure and goods and services expenditure so that additional revenue can be truly channeled to public service infrastructure capital expenditure. Even though the growth of LOSR does not have a significant effect, it is recommended that local governments develop more consistent budget planning so that revenue increases in certain years can be directly converted into capital expenditure reserves. The performance of LOSR effectiveness and local government financial efficiency, which has proven to have a positive effect, must be maintained. This can be done through intensification of regional tax collection or digital-based levies to reduce collection costs and minimize budget leakage.

The central government also needs to tighten supervision of the minimum allocation standard for public service infrastructure expenditure of 40% in accordance with the mandate of Law Number 1 of 2022 concerning Financial Relations Between the Central Government and Regional Governments (Maula et al., 2023), especially for regions with high fiscal capacity, to ensure that regional autonomy not only benefits the bureaucracy, but also prospers the community through the development of public service infrastructure.

Limitation and Future Research

This study uses the time period from 2020 to 2024, which is influenced by the abnormal conditions of the COVID-19 pandemic. The budget refocusing that occurred during the pandemic may distort the relationship between financial performance and capital expenditures. In future studies, it is recommended to extend the observation period or compare the periods before and after the pandemic. Future research is suggested to add other relevant variables, such as the General Allocation Fund (DAU), the Special Allocation Fund (DAK), or SiLPA (Remaining Budget for Financing). Based on the results of this study on negative fiscal decentralization, researchers are advised to test the Flypaper Effect to determine whether capital expenditure is more responsive to transfer funds (DAU/DAK). Finally, the object of the research is limited to the Regency and City in the Former Pekalongan Residency area, so caution is necessary when generalizing these results to other areas outside the former Pekalongan

Residency. Future research can expand the sample to the level of Central Java Province or the coverage of Java Island.

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