

The Effect of Regional Original Revenue (Pad) and Transfer Funds on the Financial Efficiency of Local Governments in Indonesia

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Abstract. This study analyzes the impact of Regional Original Revenue (PAD) and Transfer Funds on the financial efficiency of local governments in Indonesia. This study uses panel data from 548 Provinces/cities/regencies per year during the 2019-2023 period. The data used was 542 per year of observations or 99.85%, so that the final total of data used in this study was 2,710 observations, showing that PAD has a significant positive effect on the efficiency of regional financial management, which reflects fiscal independence. on the other hand, excessive dependence on transfer fund from the central government has a negative effect on financial efficiency. The study emphasizes the importance of optimizing PAD to improve fiscal independence and efficiency, while reducing dependence on fund transfers from the central government. Data collection in determining samples in this study uses purposive sampling. These findings are important for policy recommendations aimed at strengthening regional fiscal management and sustainable development. further research should explore the broader regional context and additional factors that affect regional financial efficiency.

Keywords: Fund Transfers; Financial Efficiency; Original Revenue

INTRODUCTION

Fiscal decentralization through Law Number 33 of 2004 gives broad authority to local governments to manage finances independently, with the aim of increasing the efficiency and effectiveness of fiscal governance at the local level (Ivanova et al., 2019). The implementation of this policy is expected to be able to encourage local governments to be more accountable, transparent, and responsive to the needs of the community (Fachri et al., 2024). However, after almost two decades of running, the fiscal efficiency gap between regions is still a serious problem in Indonesia (Siburian, 2020). Regional Original Revenue (PAD) plays an important role as an indicator of fiscal independence that reflects the capacity of local governments to utilize local economic potential (Simamora & Budiwitjaksono, 2022). A high PAD is expected to improve financial efficiency through a more productive and targeted budget allocation. However, most regions still rely on transfer funds from the central government, such as the General Allocation Fund (DAU), the Special Allocation (DAK), and Revenue Sharing Fund (DBH), which can actually reduce regional incentives to explore local fiscal potential (Andaresta et al., 2021).

A number of studies show that PAD tends to have a positive effect on regional financial efficiency, because it encourages fiscal independence and improves budget

governance (joni fernandes, 2019; Ramlah, Sylvia Sjarlis, 2023). Conversely, reliance on transfer funds often negatively impacts efficiency, as it creates fiscal moral hazards and weakens regional innovation incentives (Kuhua et al., 2019; Budianto & Alexander, 2016). However, the results of research on the influence of DAU still vary, for example, Pradana & Handayani (2023) find a positive effect on financial performance, while Maharani & Armaini (2022) stated that it has no significant effect on fiscal efficiency. This emphasizes the importance of considering local contexts, governance quality, and institutional capacity in analyzing the relationship between transfer funds and regional financial efficiency. The concept of regional financial efficiency can be seen as the ability of local governments to convert fiscal inputs into optimal, transparent, and sustainable public service outputs (Machmud & Radjak, 2018). Capital expenditure as an instrument of long-term development has also been proven to have a positive effect on financial performance and fiscal efficiency (Series & Mustanda, 2019; Nasution et al., 2018). Normatively, the principles of efficiency, effectiveness, transparency, and accountability have been affirmed in Government Regulation No. 105 of 2000 Article 4, which is the foundation for local governments in managing public finances professionally and with integrity (Bastian, 2017). Although many studies have touched on PAD, transfer funds, and regional financial performance, studies that simultaneously and systematically analyze their impact on fiscal efficiency across Indonesia are still limited (Ramlah&Sylvia Sjarlis, 2023; Andaresta et al., 2021). DGT data shows that PAD's contribution to total national regional revenue is still around 25.4% (Syaukani et al., 2024), which indicates that there are still major challenges in improving fiscal efficiency. Therefore, more in-depth research is needed to analyze how the combination of PAD and transfer funds affects the financial efficiency of local governments, especially in the dynamic period of 2019–2023. The gap in this study is that there has not been a study that examines the influence of PAD and transfer funds on the efficiency of local governments in Indonesia. Although some studies have examined the relationship between PAD, transfer funds, and regional financial performance, studies that specifically assess the direct impact of PAD and transfer funds on fiscal efficiency in Indonesia, taking into account the dynamics between the two factors in the context of fiscal decentralization policies, are still limited. In addition, most previous studies have focused on the partial relationship between these variables without simultaneously considering the influence of the two on the efficiency of regional financial management. This study aims to analyze the impact of PAD and transfer funds on the fiscal efficiency of local governments in Indonesia using district/city panel data during the period 2019 to 2023. This study will also consider control variables such as regional size, age of local government, and geographical location to provide a more comprehensive understanding of the factors that affect fiscal efficiency at the regional level. The results of this study are expected to make a significant contribution to the Ministry of Home Affairs, the Ministry of Finance, and local governments in developing more effective and sustainable fiscal policies.

The findings of this study are expected to be important recommendations for the central and regional governments in formulating fiscal policies that support the increase of Regional Original Revenue (PAD) as a more independent and optimal

source of financing. In addition, there is a need for adjustments to the transfer fund mechanism to avoid excessive dependence, so that local governments are encouraged to manage local resources more innovatively and efficiently to increase financial effectiveness. That way, the right fiscal policy will be able to strengthen regional fiscal independence while improving the quality of public services and supporting sustainable development.

LITERATURE REVIEW

Theory of fiscal decentralization

Fiscal decentralization is the concept of delegating financial management authority from the central government to local governments which aims to increase the efficiency and effectiveness of public services and strengthen regional fiscal independence. The theory of fiscal decentralization emphasizes that granting greater fiscal autonomy to the regions encourages local governments to optimize the management of financial resources, especially Regional Original Revenue (PAD), so as to reduce dependence on transfer funds from the central government Oates (2005). In Indonesia, the implementation of fiscal decentralization is regulated through Law Number 23 of 2014 concerning local governments which strengthens the role of local governments in managing finances through the management of PAD and the use of transfer funds.

Theories Good governance

Good governance is a governance concept that emphasizes the principles of transparency, accountability, effectiveness, efficiency, public participation, and law enforcement in public sector management (UNDP, 1997). The application of the principle of good governance aims to ensure that public resources are managed responsibly and directed to achieve the interests of the community optimally.

In the context of regional financial management, good governance plays an important role in controlling the fiscal behavior of local governments, especially in the use of Regional Original Revenue (PAD) and transfer funds. Without good governance, increasing fiscal capacity has the potential to encourage the expansion of unproductive operational spending, thereby reducing regional financial efficiency. Therefore, the implementation of good governance is the main prerequisite for the implementation of fiscal decentralization to produce efficient and accountable regional financial management (Bank, 1992; Mardiasmo, 2018).

Research by Ramlah & Sylvia Sjarlis (2023) which shows that PAD has a positive and significant effect on regional financial performance, while transfer funds have a negative influence that is significant. This study shows that fiscal independence through PAD optimization can improve the financial efficiency of local governments, while dependence on taranssphere funds tends to reduce this efficiency.

Regional original revenue (PAD)

Regional Original Revenue (PAD) is one of the main members of local government financing that comes from local economic potential, such as regional taxes, repetition, results of regional wealth management, and others. The PAD reflects the fiscal independence of the regions and the ability of the regions to finance development needs without relying too much on transfer funds from the central government.

This research supports the positive relationship between PAD and the financial efficiency of local governments. Ramlah & Sylvia Sjarlis (2023) found that PAD had a significant positive effect on regional financial performance. Fachri et al., (2024) also shows that the increase in PAD is collated with an increase in independence which leads to efficiency in regional budget management. Therefore, the Regional Original Revenue (PAD) plays a strategic role in encouraging the efficiency of local government financial management. With the management of PAD that is transparent, accountable, and in accordance with the needs of regional development, the efficiency of budget use can be improved, thereby strengthening the regional financial performance as a whole. So the first hypothesis (H1) in this study is:

H1 : Regional Original Revenue Has a Positive Effect on Efficiency

Dana Transfer

Transfer funds from the central government to local governments, such as the General Allocation Fund (DAU), Special Allocation Fund (DAK), and Revenue Sharing Fund (DBH), aim to help balance fiscal capacity between regions and support the implementation of development programs. However, excessive transfer funds can cause fiscal dependency which has the potential to reduce local government incentives to increase Regional Original Revenue (PAD) and manage resources efficiently.

This study shows a negative relationship between transfer funds and the financial efficiency of local governments. Ramlah & Sylvia Sjarlis (2023) Found that fund transfers have a significant negative effect on regional financial performance, which indicates that dependence on transfer funds reduces the motivation of local governments to manage finances efficiently Fachri et al., (2024) It also emphasized that fiscal efficiency will decrease if regions are too dependent on transfer funds rather than optimizing PAD. Therefore, transfer funds from the central government are considered as a factor that can hinder the improvement of the financial efficiency of local governments, because dependence on and taransphere reflects low regional fiscal independence. The high dependence on transfer funds has the potential to reduce incentives for regions to manage resources optimally. By reducing such dependency and encouraging fiscal independence, efficiency in budget management can be further improved in a sustainable manner. So the first hypothesis (H2) in this study is:

H2 : Transfer Funds Negatively Affect Efficiency

RESEARCH METHODS

Data

Data collection in determining samples in this study uses *purposive sampling*. The data used in this study is data on local governments in Indonesia as many as 548 provinces/cities/regencies per year. The data of this study is from 2019-2023. However, because there are 6 districts/cities in the Jakarta Special Capital Region (DKI) Province area, they are not included in this sample because they have been incorporated as part of the DKI Jakarta Province reporting entity. In addition, because there are 4 districts (Raja Ampat Regency, South Sorong Regency, Maybrat Regency, and Tambrauw Regency) that were only formed in 2023 and none in previous years (2019-2022), these districts were excluded from this research sample. Therefore, the data used is 542 per year of observations or 99.85%, so that the final total of data used in this study is 2,710 observations. All data used in this study are sourced from local government agencies in Indonesia, efficiency data (total operating value and total regional expenditure), local original revenue, and transfer funds come from the Ministry of Finance, and data on the age, status, and geographical location of local governments come from the Ministry of Home Affairs.

Empirical Model of Research

To answer the research problem as well as test the hypothesis, the empirical model in this study is as follows:

$$Efesiensi_{it} = \beta_0 + \beta_1 \ln PAD_{it} + \beta_2 \ln DFit + \beta_3 Agesit + \beta_4 Islandit + \beta_5 Munit + \epsilon_t \dots \dots \dots (1)$$

Efesiensi_{it} is a variable of local government financial efficiency which is measured by the percentage of the amount of Operating Expenditure divided by the total Regional Expenditure. **lnPAD_{it}** is a variable of Regional Original Revenue (PAD) which is measured by the amount of PAD. **lnDFit** is a variable of Transfer Funds which is measured using the total General Allocation Fund (DAU), Special Allocation Fund (DAK), and Profit Sharing Fund (DBH).

The control variables in this study were *Agesit*, *Island_t*, *Munit*. *Agesit*, is a variable of the age of the Regional Government in 2019-2023 which is measured using the number of years of formation of the local government until 2022. *Island_t*, is a variable of the geographical location of the Regional Government which is measured using dummy, namely "1" if the Regional Government is on the island of Java, and another "0". , *Munit*. is the variable of the status of the Regional Government which is measured using dummy, namely "1" if the Regional Government has the status of a City, and "0" if the other.

Table 1**Variable Operations and Data Sources**

Variabel	Variable Operationalization	Data Source
Efesiensiit	The government's financial efficiency is measured by the number of operations divided by total regional expenditure (Mahmudi, 2016).	Ministry of Finance
lnPADit	Lagortma Natural (LN) total Regional Original Revenue	Ministry of Finance
lnDFit	Natural Rhythm (LN) Total Transfer Funds	Ministry of Finance
Agesit	The age of the Regional Government in 2019-2023 is measured based on the number of years since the establishment of the local government until 2023	Ministry of Home Affairs
Munit,	Local government status: 1=City, 2=Regency, 3=Province	Ministry of Home Affairs
Islandit	Geographical location: 1=Java Island, 0=outside Java	Ministry of Home Affairs

Source: output STATA-17 (women, 2025).

RESEARCH RESULTS**Statistics Descriptive Variable****Table 2****Statistical description of variables**

Variabel	Mean	Standard Deviation	Min	Max
Efesiensiit	67.61	8.51	34.31	93.82
lnPADit*	568.81	2,48	2.59	49.14
lnDFit*	1.45	1,47	392.24	22.67

<i>Agesit</i>	44,17	24,01	5	73
<i>Munit,</i>	0,89	0,75	0	3
<i>Islandit</i>	0,21	0,41	0	1

Number of Observations = 2,710

Explanation of the operation of the variable in table 1

*) In billions of rupiah

Source: output STATA-17 (women, 2025).

Table 2 above shows the results of descriptive statistical testing for all variables in this study. The mean of the **Efficiency** variable shows a figure of 67.61, this figure shows that, in general, regional budget management in Indonesia is still at a fairly good level. The mean of **lnPADit** shows a value of 568.81, which indicates the amount of PAD managed by the government. The mean **lnDFit** shows a value of 1.45, which indicates a fairly even distribution between regions.

Variable Correlation Analysis

Table 3
Variable Correlation Analysis

	Efesiensi it	lnPADit	lnDFit	<i>agesit</i>	<i>munit,</i>	<i>islandit</i>
Efesiensiit	1.000 0					
lnPADit	0.3039*** 0.0000	1.0000				
lnDFit	-0.0379*** 0.0000	0.7486*** 0.0000	1.0000			
<i>Agesit</i>	0.2679*** 0.0000	0.5519*** 0.0000	0.4391** * 0.0000	1.0000		
<i>Munit,</i>	0.3252*** 0.0000	0.4125*** 0.0000	0.3703** * 0.0000	0.0997*** 0.0000	1.0000	
<i>Islandit</i>	0.3252*** 0.0000	0.4125*** 0.0000	0.3648** * 0.0000	0.4563*** 0.0000	0.0332 0.0836	1.0000

0.0000

Number of Observations = 2,710

Explanation of the operation of the variable in table 1

= P-Value Significant 1%

Source: output STATA-17 (women, 2025).

Table 3 above shows that the correlation analysis between the main variables used in this study has a correlation between **lnPADit** and **Efficiency** of 0.3039 with a P-value of 0.0000 showing a significant relationship at the level of 1%. This describes that the higher the Regional Original Revenue obtained by the local government, the higher the efficiency of financial management achieved.

Meanwhile, from the correlation results between **lnDFit** and **Efficiency**, it has a value of -0.0379 with a P-value of 0.0000, indicating that the increase in transfers funds tends to be related to a decrease in the financial efficiency of local governments. In other words, greater reliance on transfer funds can potentially reduce efficiency in regional financial management. Regarding control variables, such as *ageit*, *munit*, and *islandite* with efficiency, there is a significant correlation with government financial efficiency.

Pengujian Hypothesis

Hypothesis testing is essential in quantitative research because it can determine whether there is an influence, relationship, or difference between the variables being tested based on empirical evidence. The decision is based on a probability value or a p value, with the p value used as the significance limit being $p < 0.05$.

Table 4
Penguji Hypothesis

$$Efesiensiit = \beta_0 + \beta_1 lnPADit + \beta_2 lnDFit + \beta_3 agesit + \beta_4 islandit + \beta_5 munit + \epsilon$$

..... (1)

Variabel	Expected Sign	Efesiensiit
Consit		264.619 0.000
lnPADit	H1: (+)	2.885*** 0.000
lnDFit	H2: (-)	-10.021*** 0.000
Agesit	(+/-)	0.067*** 0.000

<i>Munit</i>	(+/-)	3.961*** 0.000
<i>Islandit</i>	(+/-)	3.378*** 0.000
Prov > F		0.0000
Adj R-Square		0.373
obs		2.710

= *P-value significant 1%*

Number of Observations = 2,710

Table 1 describes the operational variables.

Source: output STATA-17 (women, 2025).

The test results on this research model show that there is an Adjusted R-Square of 0.373 which means that this model is able to explain 37.3% of the variation in the financial efficiency of local governments. The **lnPADit** variable had a significant positive effect on the government's financial efficiency with a coefficient of 2.885 at a significant level of 1% ($p < 0.01$). This indicates that increasing Regional Original Revenue will encourage an increase in the financial efficiency of local governments. In other words, the larger the PAD obtained, the less efficient the local government will be in managing finances. With transparent, accountable, and in accordance with the needs of regional development, the efficiency of budget use can be improved, thereby strengthening the overall financial performance of the region. However, with PAD management that is not balanced with good budget planning and control, this condition can lead to increased efficiency, which in this study reflects the increasing level of regional financial inefficiency. These findings support (H1) which states that **lnPADit** has a positive effect on **efficiency**. The **lnDFit** variable has a significant negative influence on the government's financial efficiency with a coefficient of -10.021 at a significant level of 1% ($p < 0.01$). This shows that the increase in transfer funds tends to reduce the efficiency of local government financial management, which may be due to excessive dependence on transfer funds from the central government thus affecting the effectiveness of regional budget management. Meanwhile, transfer funds are a source of funding which is generally accompanied by provisions for use and stricter reporting and supervision mechanisms. This condition encourages local governments to manage the budget in a more controlled and careful manner. So that controlled budget management is estimated to reduce the value of financial efficiency, which means increasing the level of regional financial efficiency. This supports (H2) which states that **lnDFit** is negative to **Efficiency**. Regarding the existence of control variables, ages showed a co-efficiency value of 0.067 with a significant p-value of 0.000 at 1% which means that the age of the local government has a positive effect on financial efficiency. The mun variable shows a coefficient of 3,961 with a p-value of 0.000, adjusted to 1% which means that the number of government units has a positive impact on efficiency. Meanwhile, the island variable has a coefficient of 3,378 with a p-value of 0.000, significant at 1% which shows that geographical location can also improve the financial efficiency of local governments.

The results of this study show that Regional Original Revenue (PAD) has a significant effect on the financial efficiency of local governments, while transfer funds from the central government tend to have a negative influence. These findings support the theory of fiscal decentralization which emphasizes that regions with their own financial resources tend to be more efficient in fiscal decision-making because they are closer to their communities and local needs (Oates 2005). The theory of good governance emphasizes the importance of the principles of transparency, accountability, effectiveness, and public participation in public sector financial management (UNDP, 1997). In this context, the implementation of good governance acts as a control mechanism so that increasing regional fiscal capacity does not encourage inefficient spending behavior. Without good governance, an increase in PAD and transfer funds has the potential to trigger the expansion of less productive operational expenditures, so that the efficiency of regional financial management is not achieved optimally (Bank, 1992; Mardiasmo, 2018). Therefore, a combination of the theory of fiscal decentralization and good governance is used in this study to explain the variation in the financial efficiency of local governments in Indonesia.

These results are corroborated by research Ramlah & Sylvia Sjarlis (2023), Fachri et al., (2024), and Hariani & Febriyastuti (2020), which found that the PAD not only reflects fiscal capacity, but also demonstrates the quality of regional financial management. When PAD becomes the main source of funding, local governments have an incentive to manage the budget efficiently so that the results are felt directly by the community. Proper management of PAD will strengthen fiscal discipline, encourage spending efficiency, and increase government accountability in providing public services.

Research by Chindy & Angrainy (2025) further shows that well-managed PAD is able to strengthen fiscal discipline, expand fiscal space for development spending, and improve the ability of regions to respond to the needs of the community. This is also guaranteed by Budianto & Alexander (2016), which found that high PAD indicates strong fiscal autonomy, as well as institutional ability to explore local potential.

Thus, increasing PAD that is managed transparently and responsibly is able to strengthen fiscal efficiency and expand regional fiscal space for sustainable development. These findings also reinforce that increasing PAD is not only a matter of increasing income, but reflects the institutional and managerial ability of local governments to maximize their local potential. Therefore, the strategy to increase PAD is very strategic to encourage efficiency and strengthen regional fiscal independence.

The second finding in this study shows that transfer funds from the central government have a negative influence on the financial efficiency of local governments, which indicates a tendency towards fiscal dependence. These findings support the results of the study Fachri et al., (2024) which states that fiscal efficiency tends to be lower in regions that rely heavily on transfer funds from the

center, especially if it is not accompanied by increased institutional capacity and a strong fiscal oversight system. In practice, high allocation of transfer funds without proper planning and management can create a fiscal illusion and a moral hazard effect, where local governments feel no need to seek an increase in PAD because funds are already available automatically from the center.

This is in line with the results of the research Machmud & Radjak (2018), which states that transfer funds such as DAU, DAK, and DBH are only effective if used simultaneously and integrated with regional fiscal strategies. Priyono et al., (2020) It also underlines the importance of efficient management of transfer funds to achieve community welfare, because only with the right use of the funds can they contribute to optimal financial performance.

The strategy is in line with the views of Luh Nopia Yudiastuti & Edy Sujana (2023) which shows that regional financial performance will improve significantly if transfer funds are used in conjunction with strategic planning and targeted capital expenditure. In this context, a transformation in transfer fund policies is needed to encourage performance, for example through achievement-based fiscal incentive schemes. This approach can increase the motivation of local governments to use funds more wisely and efficiently. In addition, public participation in budget planning and evaluation, as conveyed by Oh et al., (2019), also plays an important role in maintaining fiscal effectiveness and efficiency because it encourages social control over fiscal policies taken by local governments. Thus, these results confirm that strengthening fiscal efficiency requires a combination of increasing PAD and reforming System more measurable, transparent, and based on real needs in the region.

CONCLUSION

This study empirically confirms that Regional Original Revenue (PAD) has a positive and significant influence on the efficiency of local government financial management in Indonesia. This reflects that the higher the income that is successfully collected from local sources, the greater the ability of the region to manage finances effectively and independently. In this context, PAD acts as a reflection of fiscal independence that shows the extent to which a region is able to explore the potential of the local economy and optimally manage available resources to support sustainable development. On the other hand, the transfer of funds from the central government—including the General Allocation Fund (DAU), the Special Allocation Fund (DAK), and the Revenue Sharing Fund (DBH)—actually shows a significant negative influence on regional fiscal efficiency. Excessive dependence on transfer funds has the potential to cause fiscal illusion and moral hazard, where local governments are less encouraged to increase PAD optimally. These findings reinforce the thinking in fiscal decentralization theory that fiscal independence is an important foundation in strengthening public financial efficiency, accountability, and governance.

The practical implication of these findings is the need to optimize PAD as a key strategy in strengthening fiscal efficiency and regional independence. Local

governments are expected to be more aggressive in carrying out institutional reforms, strengthening the digitization of tax and levy administration, and increasing the transparency of financial statements. On the other hand, the central government needs to redesign the fiscal transfer system to be more performance-based, so as not to cause excessive fiscal dependence but instead encourages regions to strengthen their own financial capacity. In addition, fiscal policy formulation should consider the characteristics of each region, including the age of government, the number of organizational units, and geographical conditions, so that policies can be more adaptive and contextual.

However, this research has limitations. First, the scope of data is limited to districts/cities in Indonesia during the 2019–2023 period, so the results of the study may not fully describe the dynamics at the provincial level or over a longer period of time. Second, the measurement of fiscal efficiency is still limited to indicators of the ratio of expenditure to income and the level of fiscal independence, which do not yet reflect the overall quality of public services. Third, this study has not considered other external factors, such as socio-economic conditions, human resource capacity, and local political dynamics that also affect fiscal efficiency. Therefore, follow-up research is recommended to expand the unit of analysis to the provincial level, extend the observation period, and include more relevant control variables. In addition, a more comprehensive methodological approach, such as dynamic models or multi-level modeling, can provide a deeper and more comprehensive understanding of the factors that affect the efficiency of local government financial management in Indonesia.

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