The Determinants of Local Government Performance

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Abstract

This research aims to examine the determinants of local government performance in Indonesia. Data were collected from 114 local governments in Java Island from 2016 to 2019 through observation. The independent variables used are regional status, total assets, capital expenditure, independence level, and balancing funds. Meanwhile, the dependent variable is local government performance measured by the ratio of income to costs incurred. This research uses multiple regression to test the determinants factor of local government performance. The results showed that total assets, capital expenditure, and independence level positively affect local government performance. This indicates an increase in assets, increase in capital expenditure, and independent level has significant impact on improving local government performance. However, regional status and balancing funds do not have a significant impact on the performance.

Keywords: performance, local government, decentralization, capital expenditure, independence level

1. Introduction

This research examined the factors affecting local government financial performance in Java Island, Indonesia. Even though local government regarded as public organizations, they are obligated to efficiently manage funds (Balaguer-Coll, Prior, & Tortosa-Ausina, 2007; da Cruz & Marques, 2014; Jamo, 2021). Local governments are responsible for carrying out certain tasks as best as possible to provide maximum public services, undoubtedly related to financial and non-financial management. Besides, those with good performances tend to have a good impact on the community.

In Spain, the research carried out by Balaguer-Coll et al. (2007) stated that local government performance is strongly influenced by regional size. Therefore, resources were efficiently allocated to large regions than smaller ones. Hence it is important to use regional size to assess local government performance. Furthermore, Balaguer-Coll, Prior, and Tortosa-Ausina (2016) examined the factors affecting a region's debt using data from Spain. The results showed that fiscal, socio-economic, and political factors have a significant effect on debt management. Each region's characteristics also influence the impact of these 3 factors. According to Balaguer-Coll et al. (2016), it is important to understand the role of regional size for optimal local government performance.

Several research have also been carried out on local government performance determinants in the past 10 years, showing increased attention (Milán-García, Rueda-López, & De

Pablo-Valenciano, 2021). Narbón-Perpiñá, Arribas, Balaguer-Coll, and Tortosa-Ausina (2020) examined the financial, social, demographic, economic, and political aspects of Spain's governance. The results showed that capable leaders and external factors drove the efficiency gained during the 2009 to 2015 crisis. Regional heads play roles during the general elections by using their discretion in determining the required budget (Setiawan & Rizkiah, 2017). They intend to make a good impression on the people, thereby having a greater probability of re-election. Therefore, certain political factors affect regional heads' discretion in determining and using budgets (Widyaningrum, Setiawan, & Brahmana, 2019).

The research on local government performance determinants was also carried out by Afonso and Fernandes (2008), using data acquired in Portugal. The results showed that non-financial factors such as community education level, purchasing power, and geographical distance affect the efficient management of state finances. Afonso and Fernandes (2006) previously examined governments' performances in Lisbon and Portugal and discovered that the expenditure level does not correlate with community welfare. This indicates that resource management needs to be improved, and the government's efforts are in line with improving the living standards. Furthermore, the community's active participation has a positive impact on the region's resource management (Benito, Guillamón, Martínez-Córdoba, & Ríos, 2021).

Borge, Falch, and Tovmo (2008) examined the efficient determinants in the public sector using data acquired in Norway. Factors, such as aspects fiscal, political, budgetary, and the citizens' democratic participation, were investigated. The test

results showed that the fiscal capacity and the diverse parliament parties composition have a negative impact on the efficiency level. However, the extent of participation promotes efficiency in terms of rendering public sector services. This is because the citizens are actively involved in supervision to maintain the standard of services provided by the local government. Moreover, Borge et al.(2008) stated that the budgeting system that uses the top-down method also negatively impacts efficiency. This research depicts the importance of understanding the factors affecting government performance, as measured by the effectiveness of the public sector services.

Goeminne and George (2019) examined these determinants using local government samples in Flemish. This research adopted a framework (Donaldson, 1987), which stated that the performance of an entity is influenced by exogenous factors, such as organizational and environmental contingencies (Winarna, Widagdo, & Setiawan, 2017). The results showed the importance of organizational contingency attributes, such as government expenditure and previous financial performance, in predicting local government performance. This is in line with the research carried out by Jung (2012), which stated the importance of organizational size related to the federal government performance in the USA.

This research adopted a contingency approach as proposed by previous studies (Goeminne & George, 2019; Mnif & Gafsi, 2020). The theory developed by Donaldson (1987, 2006) stated several ways to improve organizational performance. A certain approach tends not to be effective in another, therefore, it is important to consider the internal and external characteristics. Goeminne and George (2019) reported the relevance of considering public sector organizations' internal and external context to improve their performances.

Indonesia has an important starting point related to governance, namely the issuance of Law No.22/1999 and Law No.25/1999. Meanwhile, Law No.22/1999 regulates the local government administration in the country because they are authorized to regulate and manage various affairs for the community's welfare. Meanwhile, Law No.25/1999 regulates the financial balance between the central and local governments, which have the right to manage finances sourced from the Regional Original Income and Balancing Funds. Therefore, they are authorized to regulate several matters regarding administrative governance and the management of financial resources. The implementation of these 2 laws is an important step in the decentralization process in the country. Furthermore, the Indonesian government issued Law No. 32/2004, which stipulates the Local Government as a substitute for Law No.22/1999. Law No.23/2014 was further issued in lieu of Law No.32/2004 related to the administration of the public organization. Balaguer-Coll, Prior, & Tortosa-Ausina (2010), and Benito, Bastida, & García (2010) stated that there is a strong link between decentralization and local government, with broad capabilities in terms of managing personal affairs for better performance. This proves that decentralization has a positive

impact on performance.

This research aims to examine the factors affecting the local government's performance achievement. The attributes include the characteristics, such as the regional status of municipalities with higher discretion in decision-making and financial management. Other factors tested are assets owned by the local government, total capital expenditure, independence level, and balancing funds. This is expected to provide input on good local government management to improve its performance.

2. Research Methodology

This research examines the financial performance determinants using data collected from Level II Local Governments in Java Island from 2017 to 2019.

The dependent variable is the financial performance, while the independent include regional status, local government size, capital expenditure, independence level, and balancing funds. Financial performance is measured to determine the efficiency of funds and its operationalization involves comparing the income with the government's burden.

The 5 independent variables adopted in this research are described as follows. First, regional status is a dummy variable, 1 for local government categorize as regions, municipalities, and regencies and 0 for local government if categorize as district. Second, the local government size is calculated by the natural log (ln) of assets. Third, capital expenditure shows the regional expenditure that has long-term benefits and is calculated using the ratio capital expenditure to total expenditure. Fourth, the independence level shows an area's ability to independently finance its needs by utilizing sources originating from local own revenue. It is calculated by transferring funds through loans. Fifth, balancing funds are described as finances transferred from the central (State Budget) to the local governments. This variable is calculated using the natural log (ln) of balancing funds transferred by the central government.

The equation used to test the independent variable impact on the dependent one is reported as follows.

$$\text{Perfi,t} = \alpha + \beta_1 \text{LGStit} + \beta_2 \text{LGSizeit} + \beta_3 \text{LGEqit} + \beta_4 \text{LGAutit} + \beta_5 \text{LGBalit} + \varepsilon$$

Perfi,t depicts the local government performance, which is calculated by dividing revenue by expenditure. LGStit is the regional status regarded as a dummy variable with 0 and 1, indicating municipalities and regencies and LGSizeit is calculated using ln total assets. Meanwhile, LGEqit is a local government expenditure used to determine the total capital funds. LGAutit is the independence level measured by dividing the Regional Original Income with the total transfer funds. LGBalit depicts balancing fund measured by its ln transferred from the central to the local governments.

3. Results And Discussion

Table 1 provides information about descriptive statistics

Variable	Mean	Median	Maximum	Minimum
Perf	1.1360	1.1249	1.8402	0.8272
LGSizeit	29.049	28.940	31.430	26.486
LGEqit	0.2151	0.2050	0.8687	0.1055
LGAutit	0.2994	0.2139	1.5017	0.0783
LGBalit	27.931	27.965	30.506	26.947

Table 1: Descriptive Statistics

GENERAL MANAGEMENT

Variable	Frequency 1	Frequency 0
LGStit	0.7469	0.2531

Table 2: Descriptive Statistics for Dummy Variable

According to Table 1, the local governments' mean performance is 1,136, which shows that the income earned is higher than the funds spent. This performance has a range of values between 0.8272 and 1.8402. Furthermore, the mean ratio of capital to total expenditures is 21.51%. This proves that Level II local governments allocated 21.51% of their capital expenditures, and its ratio has a median of 20.50% with a maximum and minimum of 10.55% and 86.87%, respectively.

Table 1 also shows that independence means the level is 29.94%, which also depicts that the average Regional Original Income compared to transfer funds is 29.94%. Meanwhile, the independence level shows a minimum and maximum of 7.83% and 150.17%, respectively. Furthermore, based on table 2, the regional status shows that 74.69% and 25.31% of the local governments have regency and municipality status.

	Perf	LGSizeit	LGEqit	LGAutit	LGBalit
Perf	1,0000				

LGSizeit	0,3302***	1,0000			
	0,0000	-----			
LGEqit	0,2178***	0,1377***	1,0000		
	0,0000	0,0060	-----		
LGAutit	0,3714***	0,7037***	0,1408***	1,0000	
	0,0000	0,0000	0,0051	-----	
LGBalit	0,0082	0,4440***	-0,0471	0,0037	1,0000
	0,4407	0,0000	0,1958	0,4730	-----

*** significant 1%

Table 3: Correlation

Variable	Coefficient	Std. Error	t-Statistic	Prob.
LGStit	0.0033	0,0211	-0,1561	0,8760
LGSizeit	0,0342	0,0157	2,1780	0,0301**
LGEqit	0,1726	0,0665	2,6253	0,0091***
LGAutit	0,0802	0,0399	2,0087	0,0454**
LGBalit	0,0137	0,0228	-0,6043	0,5460
C	0,4670	0,5256	0,8886	0,3749
F Value				0,0000***
Adjusted R2	0,1190			

, *significant 5%, 1%

Table 4: Regression Test Results

Table 3 describes the correlation between the independent and dependent variables. The results show that there is a strong relationship between local government size and performance. This is positive and significant at level 1%, which indicates a strong relationship between these 2 variables. Furthermore, the table also depicts a strong and significant correlation between capital expenditure and local government performance. This is also positive and significant at 0.2178 and 1%, respectively. A similar circumstance occurred between the independence level and local government performance. Additionally, a positive and significant correlation ($\beta = 0.3714$ with a significance of 1%) exists between the 2 variables. However, an insignificant correlation exists between balancing funds and local government performance. Generally, Table 3 shows the existence of a strong correlation between 3 independent variables including capital expenditure, local government size, and independence level, and the dependent one, namely local government performance.

Table 4 examines the impact of the independent variables on the dependent one using regression testing and unbalanced panel data. The results show that regional status has an insignificant effect on local government performance. This is evident from the values β , t-value, and probability of 0.0332, -0.1562, and 0.8760, respectively. Furthermore, local governments have no significant performance based on the regional status with insignificant differences amongst municipalities and regencies. Balancing funds also do not affect local government performances as shown from the values of β , t-value, and probability, which equals 0.0137, -0.6043, and 54.60%, respectively. Moreover, the probability is far greater than the 10% threshold, therefore it was concluded that the balancing funds have an insignificant effect on the achievement of local government performances.

According to table 4, the local government size has a significant effect on its performance. Statistical testing shows that this variable has β , t-value with probability values of 0.0342,

2.1780, and 3.01%, respectively. The local government size positively affects the achievement of its performance at a significance of 5%. This research also proves that capital expenditure has a significant effect on local government performance with β , t-value, and probability values of 0.1726, 2.6253, and 0.91%. Therefore, the capital expenditures of the local governments have a positive effect on their performance at a significance of 1%. Table 4 shows that the independence level significantly affects performance achievement. Statistical testing indicates that this variable has β , t-value, and probability of 0.082, 2.0087, and 4.54%. The independence level positively affects local government performance achievement at a 5% significance.

Furthermore, Table 4 shows that regional status and balancing funds transferred from the central government have an insignificant effect on performance. In the context of regional status, this research uses a dummy variable to distinguish between municipalities and regencies. The result showed no difference between municipalities and regencies. Furthermore, the amount of balancing funds also has an insignificant effect on performance.

The three independent variables, namely size, capital expenditure, and independence level, positively affect local government performance. Therefore, the larger the size, the greater the probability of carrying out their tasks effectively. A high independence level also has a greater effect in helping the governments to perform effectively. These results indicate the importance of considering size in assessing their performances and policies in allocating capital expenditures.

The results generally show the importance of assigning specific factors to public organizations. Therefore, it is important to consider local government size, capital expenditure allocation, and independence level. Thus, this research confirms the contingency theory (Donaldson, 1987; Goeminne & George, 2019; Mnif & Gafsi, 2020), and stated the importance of considering the specific context of an entity to assess its performance (Winarna et al., 2017). This is in line with previous studies (Balaguer-Coll et al., 2007, 2016), which stated that size significantly affects performance. A larger size gets more attention from the community, enabling them to actively obtain better achievements (Benito et al., 2021) through higher efficiency levels (Borge et al., 2008). Jung (2012) also confirmed the importance of local government size in achieving performance.

The importance of allocating regional capital expenditures was also reported. There is a significant and positive relationship between capital expenditure and local government performance. Capital expenditure describes the allocated funds for assets that have a long-term impact and increases a region's ability to achieve better performance. Therefore, this research is consistent with the studies carried out by Goeminne and George

(2019), which stated the importance of local government financial capacity to predict future performance. However, this is inconsistent with the study carried out by Afonso and Fernandes (2006), which stated that local government expenditure had an insignificant impact in terms of improving community welfare.

The importance of increasing local governments' independence levels to enhance their performances was indicated in this research. Besides, those with higher independence levels have a higher probability of achieving better performances. This is consistent with the implementation of decentralization, which expects local governments to deal with financial problems, thereby enabling them to utilize resources to improve their performance and community welfare freely. Therefore, this research is consistent with the studies carried out by Balaguer-Coll et al. (2010) (2010) and Benito et al. (2010), which stated that a strong relationship exists between decentralization and local government financial performance. This is also in line with the studies carried out by Barankay and Lockwood (2007), Boetti, Piacenza, and Turati (2012), using samples from Switzerland and Italy which stated the importance of a region's independence in performing effectively.

4. Conclusion

The factors affecting the achievement of financial performance, using local government samples from Indonesia, were examined. The results show that it was affected by 3 important factors: size, capital expenditure allocation, and independence level. Local governments with a larger size and allocate more of their capital expenditure are likely to achieve better performances, which is also greatly affected by the independence level. Meanwhile, with respect to regional status, there is no difference between municipality and regency. Balancing funds also has an insignificant effect on local government performance.

Second, this study focuses on the determinants of local government in Java Island. The limitation of the study are the current study focuses on financial and organizational factors only to test the determinants local government performance. However, as Setiawan and Rizkiah (2017) and Widyaningrum et al. (2019) stated, understanding the political context in the discretionary budget process is important. Therefore, further research needs to consider the political aspect when examining factors affecting local government performances. Moreover, Afonso and Fernandes (2006) stated the importance of considering non-financial aspects, which is also applicable to future research. Therefore, future studies should use the local government context using all local government in Indonesia sample.

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