

THE ROLE OF REGIONAL ORIGINAL INCOME, REGIONAL SIZE, AND TRANSFER FUNDS IN IMPROVING REGIONAL FINANCIAL PERFORMANCE



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Abstract

This study analyzes the implementation of the regional autonomy system after the transition from a centralized system, focusing on evaluating the financial performance of local governments through aspects of independence, effectiveness, and regional financial growth. The main factors influencing local financial performance are local government size, local own-source revenue (PAD), and transfer fund management. This study offers a new contribution by examining the simultaneous influence of PAD, regional size, and transfer funds on regional financial performance, especially in Tarakan City, which has unique geographical and socioeconomic characteristics. The results of this study provide important insights for local governments in designing more effective and efficient financial management strategies. In addition, these findings are expected to be a reference for policymakers in formulating transfer fund allocation formulas and PAD optimization to improve regional financial performance sustainably. This research method uses a descriptive quantitative approach with a purposive sampling technique. The data used is secondary quantitative data, and the analysis is conducted using multiple linear regression with classical assumption tests. The results show that PAD has a positive effect on regional financial performance, supporting financial independence. In contrast, regional size has a negative effect, reflecting resource management challenges in larger regions. Fund transfers have a positive effect, confirming their role in improving regional financial performance. This research also opens up opportunities for further studies on the relationship between regional financial management and regional economic development.

Keywords: Regional Original Income, Regional Size, Transfer Funds, Regional Financial Performance

INTRODUCTION

Indonesia has long run a centralized government system, which concentrates power and authority in full to the central government so that all decisions at the center and in the regions are in the hands of the central government alone (Z. D. Siahay & R. Siahay, 2023; Fatkhurrozi, 2024). The condition of Indonesia's archipelagic regions makes the centralization system less effective, considering that each region's needs differ. The centralized system that generalizes every policy in all regions creates authoritarian practices in the central government because the central government seems to force each region to implement every policy adequately. conditions do not support them by Mardiasmo's (2021).

Pratiwi & Susiyanto (2021) states that due to the many shortcomings and obstacles in implementing the centralization system, Indonesia began to implement a regional autonomy system through Law Number 22 of 1999 concerning Regional Government, and the government officially enacted it. On 1st January 2001, the central government gave authority to local governments to regulate and manage their government affairs according to the principles of autonomy and assistance based on the Law. Since the enactment of Law No. 22 of 1999 concerning Regional Government, which underwent several changes and was last amended to Law No. 9 of 2015, the government has substantially granted autonomy to provinces, regencies, and cities, a broader authority and autonomy compared to the previous era.

Regional autonomy brings positive changes in terms of regional authority to regulate and manage their regional households, aligning with Mardiasmo's (2021) theory, which states that this decentralization should produce two tangible benefits: First, it encourages increased participation, initiative, and creativity of the community in development, and it promotes equitable distribution of development results (justice) throughout the region by utilizing the resources and potential available in each region. Second, the allocation of productive resources improves by shifting the role of public decision-making to the lowest level of government, which has the most complete information.

Local governments are required to be able to manage their own finances using the Regional Revenue Budget (APBD) instrument, which is a financial budget for the local government work plan within an annual period, where the budget can be used as the main

instrument in formulating and determining regional policies. To formulate policies and improve the quality of regional services, which is one of the objectives of regional autonomy, local governments must have a source of funding to support the running of all regional needs. Regional Original Income (PAD) is one of the main sources of regional financing and expenditure.

Pratiwi & Susiyanto (2021) states that basically, if a region has a high enough PAD, the autonomous region will be freer and independent in determining service needs to the community. So the greater the contribution of PAD to the APBD structure, the smaller the region will depend on the central government. Apart from PAD, regional funding revenue also comes from the General Allocation Fund and the Special Allocation Fund. General allocation funds and special allocation funds are sources of funding from balancing funds. Kurniati & Devi (2022) explains that balancing funds, or what is often called transfer funds, have an important role, especially to achieve efficiency and fairness in the provision of public services. For a region that is lacking in income or regional revenue, which may also be lacking in natural resources, the balancing fund is the main source of income that is important in the operation and development of local government.

Khusaini (2018) state that with the Law on Regional Government, local governments must improve the efficiency and effectiveness of their administration by paying more attention to aspects of relations between government structures and between local governments, potential, and global factors, while granting the broadest possible authority to the regions, along with the rights and obligations to implement regional autonomy within the unified government administration system. Therefore, local governments must be able to organize themselves to create good governance.

A government with good governance will be realized with sound financial management, because in carrying out the course of government, it is essential to pay attention (Sasongko & Rachma, 2021). Mardiasmo (2021) states that government performance is a matter that is the focus of attention in state financial management. The government's performance is the local government's efforts to obtain and use funds to develop the region concerned. Therefore, government performance needs to be measured to provide a statement of the success of the local government and to identify improvements if needed.

This study makes a significant contribution to the literature on regional financial management by identifying the relationship between Regional Original Income (PAD), Regional Size, and Transfer Funds on regional financial performance, particularly in the context of Tarakan City. As a border area with limited resources, Tarakan faces significant challenges in meeting its development needs and public service provision. Previous research, such as that conducted by Prastiwi & Aji (2020), highlights the critical role of transfer funds in reducing fiscal disparities between regions. However, that study primarily focused on the general distribution of transfer funds and did not specifically address the interaction of PAD and regional size with financial performance in a specific region.

Additionally, Sari & Wati (2021) emphasize the importance of a holistic approach to understanding the financial performance of local governments, such as regional original revenue, general allocation fund, and regional expenditure. While relevant, this study remains general and does not consider the unique characteristics of border areas such as Tarakan. Similarly, the study by Mihálik et al. (2019) explores the importance of fiscal autonomy influenced by a region's ability to manage local resources. However, it does not discuss the constraints faced by regions with limited natural resources. These gaps in the literature underscore the need for a more contextualized and comprehensive analysis.

This research aims to address these gaps by providing a thorough examination of the interaction between PAD, regional size, and transfer funds on the financial performance of Tarakan City. The goal is to deliver deeper, evidence-based insights and offer strategic recommendations for local governments to enhance fiscal independence, financial management transparency, and budgetary efficiency. Thus, this study not only enriches academic literature but also provides practical guidance for improving financial governance and promoting sustainable regional development.

REVIEW OF LITERATURE

Regional Financial Performance

The grand theory underpinning regional financial performance is primarily rooted in **Agency Theory**, which elucidates the relationship between principals (citizens) and agents (government officials) in the context of public financial management (Jensen & Meckling,

2000). This theory posits that government officials, entrusted with managing public resources, may have personal interests that diverge from the welfare of the citizens they serve. Consequently, mechanisms such as transparency, accountability, and performance evaluation are essential to align the interests of agents with those of the principals (Mahmudi, 2010). In the realm of regional financial performance, Agency Theory provides a framework for understanding how local governments manage fiscal resources and the potential conflicts that may arise between elected officials and the public. Furthermore, fiscal transparency, as emphasized by **Mardiasmo (2021)**, is a critical component that mitigates agency problems, enhancing the efficiency and effectiveness of regional financial management. This theoretical perspective is crucial for analyzing the effectiveness of fiscal policies and governance structures at the regional level. Empirical studies, such as those by **Ishak (2021)** and **Sinurat (2020)**, have further demonstrated the relevance of Agency Theory in explaining variations in regional financial performance, particularly in decentralized governance systems.

Regional financial performance is shaped by various interrelated factors that include fiscal decentralization, revenue generation capacity, administrative efficiency, economic conditions, and governance quality. One of the primary factors is fiscal decentralization, which allows local governments greater autonomy in managing financial resources. According to Fischer and Baskaran (2020), fiscal decentralization improves financial performance by enabling local governments to design policies that address specific regional needs, thereby enhancing accountability and efficiency. However, they also caution that excessive decentralization without adequate oversight can lead to fiscal mismanagement, highlighting the importance of balanced autonomy. Another critical determinant is the capacity for revenue generation, particularly through own-source revenues such as local taxes and levies. Research by Zhang and Warner (2022) shows that regions with higher local revenue-generation capacities demonstrate superior financial performance due to reduced reliance on intergovernmental transfers, fostering fiscal independence. This finding underscores the importance of local economic development in strengthening financial sustainability.

Administrative capacity also plays a significant role. Effective financial management, skilled personnel, and robust institutional frameworks are essential for ensuring sound regional financial performance. According to Bell and Bowman (2021), administrative inefficiencies, such as weak financial reporting systems and lack of transparency, often undermine financial outcomes. They emphasize the need for capacity-building initiatives to improve fiscal governance. Economic factors, such as regional GDP and industrialization levels, also significantly influence financial performance. As noted by Huang and Wei (2021), regions with diversified economies and higher industrial productivity benefit from a broader tax base and greater financial stability. This economic resilience enables such regions to allocate resources more effectively and manage budgets efficiently.

Local Revenue

Local revenue, commonly referred to as *Pendapatan Asli Daerah (PAD)* in Indonesia, represents the financial resources generated autonomously by regional governments to fund their administrative and developmental activities. The theoretical foundation of PAD is deeply rooted in Fiscal Federalism Theory, which advocates for the decentralization of fiscal responsibilities to subnational governments. This decentralization is posited to enhance efficiency in public service delivery by aligning resources with local preferences and needs (Oates, 1999). Musgrave's Theory of Public Finance further delineates the roles of different government levels, assigning stabilization and redistribution functions to the central government, while allocating the allocation function to local governments. This framework underscores the importance of local revenue generation in enabling regional authorities to effectively provide public goods and services tailored to their constituencies (Musgrave, 1959).

In developing countries, the Theory of Fiscal Decentralization emphasizes that empowering local governments with revenue-generating authority can lead to improved governance and economic development. However, it also cautions against potential disparities arising from uneven resource distribution among regions (Bird & Vaillancourt, 1998). Empirical studies have explored the determinants and impacts of local revenue generation. For instance, Bahl and Linn (1992) identified that the capacity of local governments to generate revenue is influenced by factors such as economic base,

administrative capacity, and intergovernmental fiscal transfers. They argue that enhancing local revenue mobilization requires reforms in tax policy, administration, and intergovernmental fiscal relations.

Halim (2018) Regional Original Income is the revenue region's activities. Sources within its territory are levied based on local regulations by applicable laws and regulations. Niode (2013) also argues that Regional Original Income comes from within the region and is concerned with financing the region's activities. Sasana (2011) argues that the regional revenue sector is vital because it shows how much an area can finance government activities and regional development. The indicator that measures local revenue is the source of local revenue. According to Law Number 32 of 2004 Article 157, regional revenue sources consist of 1) local taxes, 2) local levies, 3) regionally owned companies and the results of the managing of separated assets, and 4) other legitimate local revenue.

Regional Size

The concept of regional size pertains to the scale and scope of a region's economic, demographic, and geographic dimensions, which significantly influence its economic development and governance structures. A foundational framework for understanding regional size is provided by New Economic Geography (NEG), which examines how economic activities are distributed across space and the resulting regional disparities. NEG posits that larger regions often benefit from agglomeration economies, where the concentration of industries and services leads to increased productivity and innovation (Krugman, 1991). This concentration can attract more businesses and labor, further enhancing the region's economic performance.

In contrast, Institutional Theory emphasizes the role of governance structures and institutional frameworks in shaping regional development. According to this perspective, the size of a region can impact its administrative efficiency and policy implementation. Larger regions may face challenges related to coordination and governance complexity, potentially hindering effective decision-making and resource allocation (Rodríguez-Pose, 2013). Conversely, smaller regions might benefit from more streamlined governance structures, allowing for more agile and responsive policy measures. Empirical studies have explored the relationship between regional size and economic performance. For instance, Crescenzi and

Rodríguez-Pose (2011) found that while larger regions often exhibit higher levels of innovation due to agglomeration effects, smaller regions can achieve comparable economic outcomes through effective governance and targeted policy interventions. Their research suggests that the advantages of regional size are not solely determined by scale but are also influenced by the quality of institutions and the strategic utilization of resources

Government Regulation Number 71 of 2010 also explains that assets are economic resources controlled and owned by the government due to past events and from which future economic and social benefits. Research by Saputro and Mahmud (2015) shows that the size of the organization or entity, in this case, the local government, can be measured by population. Manik (2013) also used the total population as a proxy for the size of the local government. According to Murhadi (2013), a company measures its size using total assets owned because the value is more stable than sales and market capitalization. Company size can be proxied by the natural logarithm of total assets to reduce excessive data fluctuations.

Fiscal Transfers

Fiscal transfers are a critical component of intergovernmental fiscal relations, designed to address vertical and horizontal imbalances in fiscal capacity among various government levels. These transfers play a pivotal role in ensuring equitable resource distribution and fostering regional development. The theoretical basis for fiscal transfers is primarily grounded in Wicksell's Principle of Equity, which advocates for resource allocation that ensures fairness among jurisdictions with varying fiscal capacities. This principle underpins the necessity of transfers to enable less affluent regions to provide comparable levels of public goods and services as wealthier ones (Wicksell, 1896). Building on this, Musgrave's Framework of Public Finance identifies fiscal transfers as essential for achieving the redistributive function of public finance. Musgrave highlights that while the allocation and stabilization functions are more effectively managed at the central level, redistribution requires a carefully designed system of fiscal transfers to address interregional inequalities (Musgrave, 1959).

Recent empirical studies emphasize the design and implementation of fiscal transfers as key determinants of their effectiveness. Ahmad and Brosio (2019) discuss the role of conditional and unconditional transfers, noting that well-targeted conditional transfers can

incentivize improved service delivery and fiscal discipline at the regional level. Meanwhile, Weingast (2020) argues that poorly designed transfers can lead to inefficiencies, such as fiscal dependency and reduced incentives for local revenue generation. Furthermore, fiscal transfers are often viewed through the lens of Resource Allocation Efficiency Theory, which posits that transfers should aim to correct market failures and allocate resources where they yield the highest social returns. This theory is particularly relevant in addressing fiscal gaps that hinder equitable development (Stiglitz & Rosengard, 2015).

According to Law No. 33 of 2004, balancing funds are funds sourced from APBN revenues allocated to regions to fund regional needs in implementing decentralization. Regional autonomy to date still presents various problems. Geographical conditions and natural resources are diverse, with different regional potential, which creates differences in the financial ability to meet their needs, or what is commonly called the fiscal gap. According to the Minister of Home Affairs No. 32/2008, the regions are given an Equalization Fund through the APBN, which is a transfer. One of the objectives of providing the Balance Fund is to reduce the fiscal gap between the government and the regions and between regions so that no one area is left behind and to increase regional capacity in exploring regional economic potential. The balancing funds in Law No. 25 of 1999 and Law No. 33 of 2004 consist of (a) Revenue Sharing Funds, (b) General Allocation Funds, and (c) Special Allocation Funds.

RESEARCH METHOD

The research adopts a descriptive quantitative approach, which focuses on analyzing numerical data to describe and interpret phenomena systematically. This methodology is suitable for studies aiming to quantify variables, analyse patterns, and provide objective insights into specific research problems (Creswell & Creswell, 2018). The process begins with collecting data in numerical form through structured instruments such as surveys, questionnaires, or secondary data. The collected data are then statistically analyzed to test hypotheses or verify theoretical frameworks. This approach follows a deductive reasoning model, starting from general theories or assumptions and using empirical observations to validate these theories. The study emphasizes providing an accurate representation of the

observed data and answering research questions through clear, data-driven results. By employing descriptive quantitative methods, the research ensures objectivity, replicability, and a comprehensive understanding of the investigated variables (Bryman, 2019).

The study utilizes a purposive sampling technique, which involves selecting samples based on predefined criteria to ensure their relevance to the research objectives. Purposive sampling is widely used in studies requiring a focused approach, allowing researchers to select data sources that best address the research questions (Etikan, 2021). In this research, the sample criteria were determined based on financial documentation critical to analyzing the financial performance of the Tarakan City Government over the 2018-2022 period. The specific criteria for the samples are as follows: (1) Regional Budget (APBD) Reports, which include the realization of Regional Original Income for the Tarakan City Government from 2018 to 2022, providing insight into the region's revenue management; (2) Notes to Financial Statements (CALK), which document the total assets of the Tarakan City Government during the same period, offering a comprehensive view of the region's asset management; and (3) APBD Reports on Transfer Funds, which detail the balance funds or financial transfers received from the central government from 2018 to 2022. These documents form the core dataset for analyzing the interplay between PAD, asset management, and transfer funds in determining regional financial performance.

Data collection in this study employs the library research or document study technique, a method focusing on extracting and analyzing secondary data to address research questions effectively. This approach involves systematically reviewing, analyzing, and summarizing information from various documented sources, such as books, transcripts, official reports, letters, and other relevant literature (Creswell & Creswell, 2018). The process includes reading, examining, and recording pertinent data to support the research objectives. The use of secondary data through document study offers significant advantages, particularly in terms of efficiency and accessibility. Unlike primary data collection, which requires creating research instruments and identifying participants, document analysis provides readily available resources that save time and streamline the research process. This method is particularly useful in studies that rely on historical or contextual data, as it allows researchers to examine existing records and synthesize findings systematically. The

relevance and reliability of the documents ensure the validity of the data collected, making this technique a robust choice for research (Yin, 2020).

Data analysis in this study was conducted using multiple linear regression analysis, a statistical method designed to examine the relationship between a dependent variable and two or more independent variables. This approach is particularly useful for understanding the collective influence of multiple predictors on a single outcome variable, as well as for estimating the average value of the dependent variable based on the known values of the independent variables (Creswell & Creswell, 2018). The analysis was preceded by classical assumption tests, including tests for normality, multicollinearity, heteroscedasticity, and autocorrelation, to ensure the reliability and validity of the regression model (Gujarati & Porter, 2018). The multiple regression formula is as follows:

$$Y = \alpha + b_1 X_1 + b_2 X_2 + b_3 X_3 + e$$

The Description is Y = Regional Financial Performance X1= Regional Original Income X2 = Regional Size X3 = Transfer Fund α = Constant b_t = Regression Coefficient e = Standard Error.

This model was used to evaluate the impact of Regional Original Income, Regional Size, and Transfer Funds on the financial performance of the Tarakan City Government. The regression coefficients represent the degree to which each independent variable contributes to changes in the dependent variable. This method allows for a nuanced analysis of the factors influencing regional financial performance, ensuring that the study provides accurate and actionable insights into fiscal management strategies.

RESULTS AND DISCUSSION

Classical Assumption Test Results

The classic assumption test is a series of statistical tests to check whether the regression analysis meets the underlying assumptions. These assumptions are essential to fulfill so that regression analysis results become valid and reliable. The following are the results of the classical assumption test used in this study: Assumption of Residual Normality, this assumption states that the residuals (the difference between the actual observed value and the value predicted by the model) must follow a normal distribution.

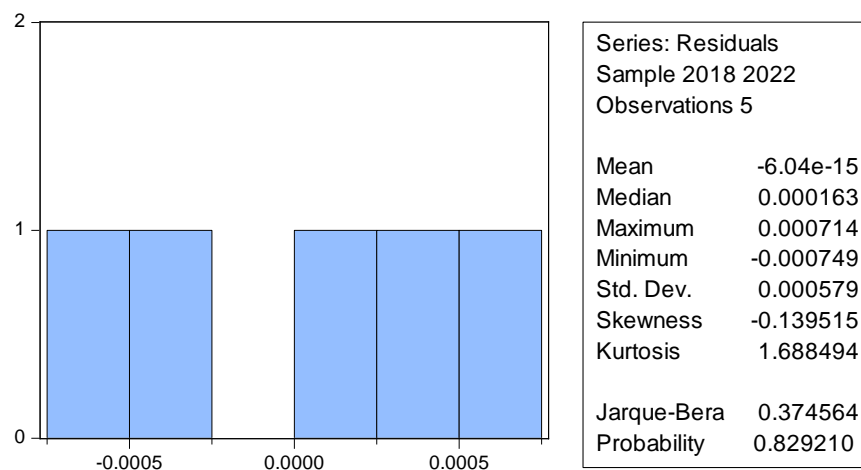


Figure 1.

Jarque-Bera Test Results

Source: Eviews, data processed (2023)

The figure above shows that the Jarque-Bera test was used to test the residuals' normality. The Jarque-Bera value (0.374) is low, and the probability value is high (0.829). Thus, this indicates that the assumption of the normality of the residuals is met.

Homoscedasticity Assumption, Homoscedasticity refers to the assumption that the variability of the residuals (the difference between the actual observed value and the value predicted by the model) is constant across levels of independent variable values.

Table 1.

Glejser Test Results

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.006274	0.002523	2.486858	0.2434
ROI (X1)	5.95E-05	2.74E-05	2.169931	0.2749
RS (X2)	-2.90E-05	1.53E-05	-1.895791	0.3090
TF (X3)	2.12E-05	1.26E-05	1.690534	0.3401

Source: Eviews, data processed (2023)

Table 1 shows the Glejser test used to test the assumption of homoscedasticity. The probability (Prob.) associated with the Glejser coefficient is high (above 0.05), so there is no sufficient statistical evidence to reject the assumption of homoscedasticity. That indicates that we can consider homoskedasticity fulfilled.

Regression Analysis Results

The following table shows the results of multiple linear regression analysis.

Table 2.
Regression Analysis Results

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	21.72240	0.030174	719.9113	0.0009
ROI (X1)	0.193892	0.000328	591.2408	0.0011
RS (X2)	-0.045329	0.000183	-247.8136	0.0026
TF (X3)	0.019068	0.000150	126.9555	0.0050
R-squared	1.000000	Mean dependent var		12.75000
Adjusted R-squared	1.000000	S.D. dependent var		3.609515
S.E. of regression	0.001159	Akaike info criterion		-10.69211
Sum squared resid	1.34E-06	Schwarz criterion		-11.00456
Log likelihood	30.73028	Hannan-Quinn criter.		-11.53070
F-statistic	12934148	Durbin-Watson stat		3.331590
Prob(F-statistic)	0.000204			

Source: Eviews, data processed (2023)

Based on Table 2 above, the regression coefficient of each variable is obtained with the help of the Eviews program; the regression equation is obtained as follows:

$$RFP = 21.722 + 0.193 \text{ ROI} - 0.045 \text{ RS} + 0.019 \text{ TF}$$

The results of the multiple linear regression equation above can be interpreted as follows: The constant value of 21.722 (positive) means that if the independent variable, namely Regional Original Income, Regional Size and Transfer Funds, is fixed or constant, the dependent variable, namely Regional Financial Performance, will increase by 21.722 units. The coefficient value of the Regional Original Income variable (X1) of 0.193 means that if the regional original income increases by 1 unit, the regional financial performance will increase by 0.193 units. The positive coefficient indicates a unidirectional relationship between local revenue and regional financial performance. Implies that the higher the regional own-source revenue, the higher the regional financial performance. The coefficient value of the Regional Size variable (X2) is -0.045, which means that if the regional size variable increases by 1 unit, the regional financial performance will decrease by 0.045 units. The negative coefficient means that there is an unidirectional relationship between regional size and regional financial performance. Implies that the higher the size of the region, the lower the regional financial performance. The coefficient value of the Transfer Fund variable (X3) is 0.019, meaning that if the transfer fund increases by 1 unit, the regional financial

performance will also increase by 0.019 units. The positive coefficient indicates a unidirectional relationship between transfer funds and regional financial performance. That implies that the higher the transfer of funds, the higher the regional financial performance.

The Effect of Regional Original Income on Regional Financial Performance

The results showed that Regional Original Income positively and significantly affects Regional Financial Performance. The positive findings indicate that an increase in Regional Original Income contributes positively to regional financial performance; this can be interpreted as a strengthening of regional financial autonomy, where the ability of regions to collect and manage financial resources independently positively impacts their finances. This finding may indicate that regions have the potential to develop their local economies by increasing their own-source revenues. Here is the sentence: Local governments can direct locally generated revenue to support critical sectors that trigger economic growth and improve community welfare.

Previous research supports the findings of this study, stating that local governments can design policies that encourage economic growth and increase local revenue to improve their financial performance (Andaresta & Aswar, 2021). To strengthen financial performance, regions can consider a strategy of diversifying their own-source revenues. This diversification can help reduce the risk of revenue instability and give regions more flexibility in dealing with changing economic conditions (Sudirman, 2017). Local own-source revenues reflect the extent to which regions have financial autonomy. This financial autonomy allows regions to manage financial resources independently, which can affect regional financial performance (Tambunan, 2017).

Regional Original Revenue (Pendapatan Asli Daerah, PAD) is a crucial component of local government financial structures, reflecting a region's capacity to generate independent income without relying on transfers from the central government. Empirical studies have shown that PAD has a positive and significant influence on local financial performance. For example, research by Dewata, Sari, and Nouvanti (2021) found that an increase in PAD directly contributes to improving the financial performance of local governments in South Sumatra Province. This is attributed to PAD's ability to provide a stable funding source for financing development programs and public services. Furthermore,

a study by Digdowiseiso, Subiyanto, and Cahyanto (2021) emphasized that higher PAD enables local governments to exercise greater flexibility in fiscal decision-making, thereby enhancing the efficiency and effectiveness of local financial management. Consequently, robust PAD not only strengthens regional fiscal capacity but also promotes accountability and transparency in budget management. Additionally, Pratiwi (2018) highlighted that increased PAD can reduce regional dependence on fiscal balance funds from the central government, fostering fiscal independence and improving local financial performance. This independence allows local governments to be more responsive to local needs and allocate resources more effectively.

However, it is important to note that while PAD has a positive influence, its effectiveness heavily depends on the local government's capacity to manage and optimize local resources. Research by Putri and Amanah (2020) pointed out that without effective management, an increase in PAD does not necessarily correlate with improved financial performance. Therefore, enhancing PAD must be accompanied by improvements in managerial capacity and good governance practices. Overall, the literature indicates that PAD plays a significant role in improving local financial performance. However, to maximize its benefits, local governments must prioritize strengthening financial management capacities and implementing sound governance practices. By doing so, PAD can serve as an effective instrument for achieving fiscal independence and enhancing the welfare of local communities.

The Effect of Regional Size on Regional Financial Performance

The results showed that regional size negatively and significantly affected Regional Financial Performance. The negative effect of size on regional financial performance can indicate that more significant regions face challenges in managing resources efficiently. The difficulty in managing an enormous bureaucracy or effective coordination within the local government can affect financial performance due to inefficient management of development resources. The negative effect of size on financial performance may also reflect higher financial instability in more significant regions. Extensive regions are more vulnerable to economic fluctuations and need more flexibility to address the financial challenges that arise.

This study's results align with previous research, which shows that local government size significantly negatively affects the financial performance of a large population that is not proportional to the efficiency ratio of regional financial management. A higher efficiency ratio identifies poor financial performance (Mulyani & Wibowo, 2017). If the role of total assets in improving the financial performance of local governments needs to function correctly, then most of the assets owned by local governments are less productive in improving the financial performance of local governments. The large number of regional assets will make it difficult for the government to monitor each of these assets directly (Nugroho & Prasetyo, 2018).

The relationship between regional size and financial performance has been a subject of extensive research, with several studies indicating that larger regional sizes can negatively and significantly impact regional financial performance. This phenomenon is often attributed to the complexities and challenges inherent in managing expansive regions. A study by Wijayanti and Suryandari (2020) found that regional size negatively affects the financial performance of local governments. The research suggests that larger regions may face difficulties in efficiently allocating resources and managing expenditures, leading to decreased financial performance. This is particularly evident in regions with diverse and widespread populations, where the costs of providing public services escalate, and administrative challenges become more pronounced.

Similarly, research by Digdowiseiso, Subiyanto, and Cahyanto (2021) indicates that regional size has a negative impact on financial performance. The study highlights that larger regions often encounter increased operational costs and complexities in governance, which can strain financial resources and hinder effective financial management. The authors argue that the administrative burden associated with managing larger areas can lead to inefficiencies and reduced financial performance. Furthermore, a study by Putri and Amanah (2020) supports these findings, demonstrating that regional size negatively influences financial performance. The research points out that larger regions may struggle with coordination and communication across various administrative units, leading to inefficiencies and increased costs. These challenges can impede the region's ability to maintain sound financial health and deliver public services effectively.

In contrast, smaller regions often benefit from more streamlined administrative processes and closer proximity between government officials and constituents, facilitating more efficient resource allocation and financial management. The reduced complexity in governance structures allows for quicker decision-making and more effective implementation of policies, contributing to better financial performance. However, it is essential to note that while regional size can pose challenges to financial performance, other factors such as governance quality, economic development, and resource availability also play crucial roles. Effective leadership and robust financial management practices can mitigate some of the negative impacts associated with larger regional sizes. For instance, regions that invest in capacity building and adopt innovative governance models may overcome the challenges posed by their size and achieve sound financial performance.

The Effect of Transfer Funds on Regional Financial Performance

The results showed that funds transfer positively and significantly affect Regional Financial Performance. The positive findings indicate that transfer funds positively impact regional financial performance. Transfer funds can provide additional resources that local governments can use to support development programs, public services, and strategic projects. This finding may indicate that the transfer policy from the central government can play a positive role in improving local financial performance. Therefore, the effective implementation of fund transfer policies can be essential in strengthening local financial capacity. This finding also reflects the central government's efforts to create fairness and equality among regions, where fund transfers that serve as redistribution instruments can help reduce economic inequality among regions, ensuring that less developed regions also receive support.

Previous research also supports the results of this study, stating that transfer funds or balanced funds finance government administration to enable effective community services. The greater the balancing funds received, the greater the budget local governments can manage to meet their needs. The government will monitor the implementation of the balancing funds to motivate local governments to perform better (Nugroho & Prasetyo, 2018). Transfer funds can play a role in providing regional financial stability. With a reliable

source of revenue from the central government, regions can better cope with financial uncertainty and implement long-term programs.

Regional transfer funds, commonly referred to as intergovernmental fiscal transfers, play a pivotal role in shaping the financial performance of local governments. These transfers are designed to address fiscal disparities, ensure equitable service delivery, and bolster the financial capacity of subnational entities. Empirical studies have consistently demonstrated a positive and significant impact of these transfers on regional financial performance. A study by Boadway and Shah (2019) highlights that intergovernmental transfers are instrumental in mitigating fiscal imbalances across regions. By providing additional financial resources, these transfers enable local governments to meet their expenditure needs without imposing excessive local taxes, thereby enhancing their fiscal health and service delivery capabilities.

Similarly, research by Martinez-Vazquez and Searle (2020) underscores the importance of well-designed transfer systems in promoting fiscal equity and efficiency. Their findings suggest that when transfers are allocated based on transparent and objective criteria, they can significantly improve the financial performance of recipient regions by ensuring adequate funding for essential public services. A study by Smoke (2017) examines the role of intergovernmental transfers in strengthening local government finances. The research indicates that such transfers are crucial for enabling local governments to fulfill their expenditure responsibilities, particularly in regions with limited own-source revenues. This support is vital for maintaining fiscal stability and enhancing the overall financial performance of local administrations.

Furthermore, a study by Bird and Smart (2018) explores the impact of conditional and unconditional transfers on local government performance. The authors find that while both types of transfers positively influence financial performance, unconditional transfers provide greater flexibility, allowing local governments to allocate resources according to their specific needs and priorities, thereby optimizing financial outcomes. However, the effectiveness of transfer funds in improving regional financial performance is contingent upon several factors, including the design of the transfer system, the capacity of local governments to manage funds effectively, and the presence of accountability mechanisms. Research by Shah (2020) emphasizes that for transfers to yield positive outcomes, they must

be accompanied by strong institutional frameworks that promote transparency and accountability in fund utilization.

CONCLUSION

This study shows that regional original income has a positive and significant influence on regional financial performance, indicating that an increase in PAD can strengthen fiscal independence and improve the efficiency of local government financial management. On the other hand, area size has a negative and significant effect on Local Financial Performance, reflecting the administrative and operational challenges faced by regions with more extensive areas. Fund transfers from the central government positively and significantly impact Local Financial Performance, which is essential in providing financial stability and supporting public services and local development. The results of this study imply that local governments need to focus on more optimal PAD management, improve governance in managing large areas, and utilize transfers strategically to promote sustainable development. Policy recommendations include improving financial management capacity, diversifying local revenue sources, and implementing transparent governance to maximize the benefits of transfers and reduce dependence on the central government.

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