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The Effect of Capital Expenditure on Financial Performance with Local Revenue as a Mediating Variable

Nuru Nisa Pramesti[1], Raden Budi Hendaris[2*]
[1] Universitas Jenderal Achmad Yani, Cimahi, Indonesia, nurunisa_2360107036@ak.unjani.ac.id
[2] Universitas Jenderal Achmad Yani, Cimahi, Indonesia, budi.hendaris@lecture.unjani.ac.id

Corresponding Author: budi.hendaris@lecture.unjani.ac.id

Abstract: Regional autonomy is an attempt to give local governments more autonomy and less reliance on the federal government. The fact that just a few local governments enjoy this independence, however, is a phenomenon. As a result, this study looks at the variables that may influence regional financial success. Using Local own-source revenue as a mediating variable, this study examines how capital expenditures affect the regional financial performance of East Java Province's cities and districts. The quantitative method is the approach taken. Purposive sampling was utilized to gather data from East Javan district and city administrations' budget reports for 2018–2022. A review of the literature and applicable rules and regulations is the first phase of this investigation. Next comes data collecting, tabulation, analysis, reporting, and publication of the findings. The findings demonstrated that capital expenditure hurt financial performance. Nonetheless, they exerted a beneficial influence on local original revenue, which in turn positively affected financial performance. Economic performance was enhanced by capital investment funded through local original revenue. The study's findings indicate that East Javan districts and cities must increase capital spending and local own-source revenue to enhance their regional financial performance.

Keywords: Capital Expenditure, Local own-source revenue , Local Financial Performance

INTRODUCTION

Indonesia implements a local autonomy policy. Local governments can handle their issues and the interests of their populations when they have local autonomy. The concept of comprehensive local autonomy is governed by Law Number 23 of 2014, which grants local governments the power to oversee all matters of governance apart from those of the federal government (Fauzi, 2019). Local governments are expected to provide better public and social facilities to the population due to regional autonomy (Trisakti & Djajasinga, 2021). Relying less on the federal government to fund regional development is one way to achieve regional autonomy through regional independence. Even though the central government continues providing help and sharing, local governments still need to find other development funding sources (Maharjan & Vidyattama, 2024).

The regional independence ratio—the amount of PAD divided by the amount of transfer revenue (Runjung, 2022)- was used to assess the financial independence of the districts and cities in East Java Province. The results are shown below, along with an interpretation for 2022.

Table 1. Criteria for Regional Independence Districts and Cities in East Java in 2022

Independence Ratio	Criteria for Independence	Many local governments	%
0-25%	Very low	23	61%
>25-50%	Low	12	32%
>50-75%	Medium	2	5%
>75-100%	High	1	3%
Number of local governments		38	

Source: Local Government Financial Statements (2022) processed

The gap phenomena in this study can be explained by the data in Table 1, which shows that, on average, East Java Province's districts and cities (local administrations) have low levels of independence. Only 3% of the districts and cities in East Java Province have high regional independence; the remaining 61%, low 32%, and moderate 5% have very low financial capacities. As a result, most of East Java Province's districts and cities still fall into the low or very low independence category for their regional financial capacities, meaning that their low financial performance results from their continued heavy reliance on transfers from the federal government.

Capital spending positively and considerably impacts economic growth (Waryanto, 2017). Decentralization after regional autonomy should be able to motivate local governments to achieve financial independence (Badan Pemeriksa Keuangan, 2020). Instead of depending on balancing finances, local governments should be able to implement development projects using funds from Regional Original Revenue (PAD). The extent of local financial independence illustrates the capacity of regional finances to finance governance operations, improvement, and community activities autonomously (Wahab et al., 2017). Local administrations in East Java Province still have relatively little autonomy, according to the data in Table 1. Fund transfers from the federal government are still necessary for local governments to function. Investigating the causes of this and the variables influencing regional financial success is therefore essential. According to the findings of earlier research, Capital spending is a determinant of financial performance (Zamzami & Rakhman, 2023; Putri & Aswar, 2022; Setiawan & Winarna, 2022; Wijaya & Solikhi, 2022); Adikonang et al., 2021; Oktaviani et al., 2020; Yuliansyah et al., 2019; Leki et al., 2018). However, according to research by Sutopo Siddi (2018), Nauw Riharjo (2021), Thalib & Ekaningtias (2019), and Bilqis & Priyono (2023), capital expenditure has little bearing on regional financial success. Additionally, capital spending is a component that influences PAD (Putra & Algifari, 2023; Tampubolon & Ariadi, 2023; Albab et al., 2020; Wadjaudje et al., 2018). However, Hastuti's (2018) research findings demonstrate that PAD has little bearing on capital spending. PAD Hendaris & Sastradipraja (2024), Albab et al. (2020), Aswar (2019), and Yuliansyah et al. (2019) are more factors that impact financial success. However, according to research findings by Thalib & Ekaningtias (2019) and A'yun et al. (2024), PAD has little impact on regional financial performance. The findings of studies by Dwiyanto (2018), Aprianis (2021), Adikonang et al. (2021), and Darwanis & Saputra (2014) demonstrate that capital expenditure through PAD has an impact on regional financial status.

The theory of fiscal decentralization serves as the grand theory employed in this investigation. Delegating public financial authority and public service facilities from the national to the subnational level is known as fiscal decentralization (Tanzi, 1995). Decentralization, as defined by Law No. 33/2004, is the process by which the central government cedes control of its governance to independent regional administrations. Funding is included with the handover, according to the idea that money follows function. In other words, financing is determined by the duties at each level of government and follows those activities. Fiscal decentralization is a response to growing public demands to relate resource allocation to public preferences better to increase public activities' economic efficiency (Vo, 2010). Putting fiscal decentralization into practice gives local governments autonomy to improve the community's welfare. However, there are significant obstacles to intergovernmental coordination in planning, regulation, expenditure, and financing when implementing fiscal decentralization (Avci & Karasoy, 2021; Vazquez et al., 2017; Luiz, 2000). As a sign of decentralization, local governments can thus exercise their governing authority independently of state government support by using local own-source income (Aswar, 2019).

This study empirically examines the effect of capital expenditure through PAD on local financial performance. The results of this investigation contribute to accounting science, especially within the public sector, by improving regional economic performance, by improving regional economic performance. In order to improve the financial performance of district and city governments in the province of East Java, this research will determine what local governments must do about capital expenditures and local original revenue.

METHOD

The problem formulation and study objectives were addressed by applying quantitative research methods. Thirty-eight local administrations, encompassing all regions and towns within the East Java Province, were sampled for this study. A sample of 190 people was gathered using data from local government financial reports, East Javan district and municipal government budget realization reports, and BPK audit data from 2018 to 2022 (5 years of observation). Purposive sampling was used for the sample process. The following operational variables were employed in this investigation. Government Regulation Number 12 of 2019 defines capital expenditures as budgetary allocations for acquiring permanent property and additional assets that will provide utility beyond a single accounting period. The East Java Province's districts and cities' actual capital expenditures for each year between 2018 and 2022 are used to compute capital expenditures.The Budget Implementation Report is the source of the data. The independence ratio, which measures local governments' capacity to fund their own governmental operations and community activities, is used to assess financial performance in this study (Ambya, 2023). The amount of local original revenue is divided by the transfer revenue to determine the economic performance. The 2018–2022 Budget Realization Report serves as the data source. According to Law Number 1 of 2022, local original revenue local money derived from local taxes, levies, the outcomes of managing distinct local assets, and other lawful local revenues. The outcomes of managing distinct regional assets, local taxes, local levies, and other lawful PADs are added to determine PAD (Siswati & Kaloeti, 2024; Irianto et al., 2021). Source information taken from the 2018–2022 Budget Realization Report. The SmartPLS tool used the Partial Least Square-Structural Equation Modeling (PLS-SEM) technique to analyze the data.

RESULTS AND DISCUSSION

Descriptive Statistics

Table 2. Descriptive Statistical Value of Research Variables

Descriptive Statistics					
Variables	**N**	**Minimum**	**Maximum**	**Mean**	**Standard Deviation**
Capital Expenditure (X)	38	500 Billion	2.5 Trillion	1.2 Trillion	500 Billion

PAD (Z)	38	300 Billion	1.5 Trillion	800 Billion	400 Billion
Financial Performance (Y)	38	40%	90%	65%	15%

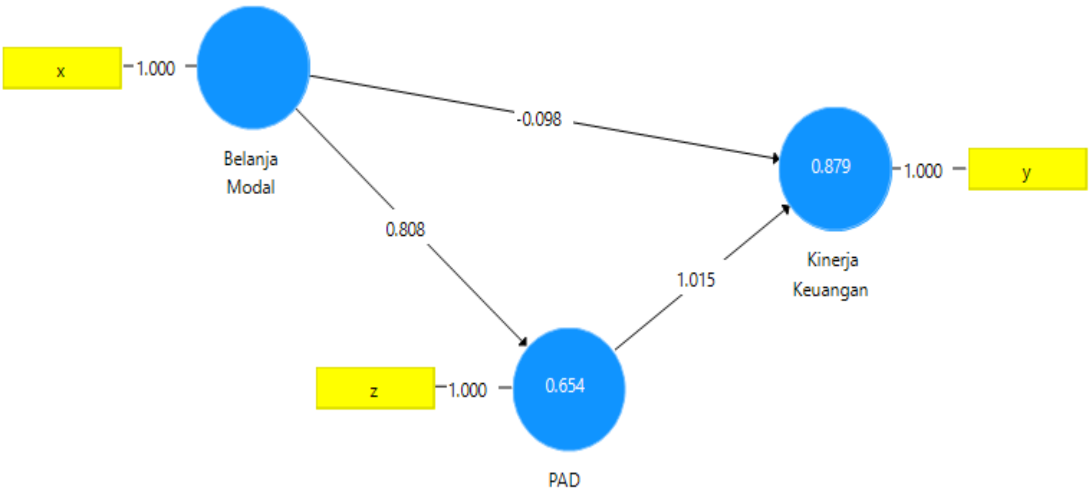
Source: Data processed, 2024

According to Table 2's data, the capital expenditure variable has a range of Rp 2.5 trillion - Rp 500 billion = Rp 2 trillion, with an average value of Rp 1.2 trillion, a minimum value of Rp 500 billion, and a maximum value of Rp 2.5 trillion. The standard deviation is Rp 500 billion. The PAD variable's values range from IDR 800 billion on average to IDR 300 billion at the lowest, IDR 1.5 trillion at the highest, and IDR 400 billion at the standard deviation. A standard deviation of 15%, a minimum value of 40%, a maximum value of 90%, and an average of 65% characterize the regional financial performance variable.

Outer Model Testing Results

Convergent Validity

The Average Variance Extracted (AVE) values and outer loading demonstrate convergent validity. If the AVE value exceeds 0.50 and the outer loading value exceeds 0.60, then each variable satisfies convergent validity (Hair et al., 2019). If these two requirements are satisfied, each variable is legitimate and suitable for additional study.



Source: Data processed, 2024

Image1 . Outer Loading Value of Each Variable

Each variable's outer loading value is 1.00, as shown in Figure 1. Every variable has an outside loading value greater than 0.60. As a result, convergent validity has been satisfied in one way.

Table 3. Average Variance Extracted (AVE) Value

Variables	Average Variance Extracted (AVE)
Capital Expenditure	1,000
Financial Performance	1,000
PAD	1,000

Source: data processed, 2024

Table 3 indicates that the Average Variance Extracted (AVE) value for each variable is 1.00. Each variable possesses an AVE value over 0.50 (Hair et al., 2019). Therefore, both criteria for convergent validity have been satisfied. Every variable in this study is legitimate and suitable for additional analysis.

Discriminant Validity

Table 4. Fornell-Larcker value

	Capital Expenditure	**Financial Performance**	**PAD**
Capital Expenditure	**1,000**	-	-
Financial Performance	0,723	**1,000**	-
PAD	0,808	0,936	**1,000**

Source: data processed, 2024

A measure of discriminant validity is the Fornell-Larcker value. If discriminant validity is satisfied, The root value of the Average Variance Extracted (AVE) for each latent variable exceeds its correlation with other latent variables (Hair et al., 2019). Each latent variable's AVE root value is more significant than its connection with other latent variables, as Table 4 demonstrates. Therefore, every variable satisfies The standards for discriminant validity.
Reliability

Table 5. Cronbach's Alpha and Composite Reliability values

	Cronbach's Alpha	**Composite Reliability**
Capital Expenditure	1,000	1,000
Financial Performance	1,000	1,000
PAD	1,000	1,000

Source: data processed, 2024

Cronbach's alpha and composite reliability metrics suggest reliability. Reliability is achieved when the composite reliability exceeds 0.70 and the Cronbach's alpha value surpasses 0.60. (Hair et al., 2019). Every variable has a Cronbach's alpha value of 1.00.The Cronbach's alpha coefficient for each variable exceeds 0.60. In the meantime, each variable has a composite reliability value of 1.00. The composite dependability value for each variable is higher than 0.70. Therefore, every variable in this study satisfies the dependability standards.

Inner Model Testing Results

R Square Value (R^2)

Table 6. R Square value

	R Square	**R Square Adjusted**
Financial Performance	0,879	0,878
PAD	0,654	0,652

Source: data processed, 2024

The financial performance variable's coefficient of determination (R2) is 0.879, as indicated in Table 6. This suggests that the capital expenditure and PAD variables can explain 87.9% of the variation in the economic performance variable. On the other hand, other factors not covered in this study account for the remainder. In the meantime, the coefficient of determination (R2) for the PAD variable is 0.654. This indicates that the capital expenditure variable can explain 65.4% of the variance in the PAD variable. On the other hand, other factors not covered in this study account for the remainder.

Size Square Effect Value (F^2)

Table 7. Size Square Effect Value (F^2)

	Financial Performance	**PAD**
Capital Expenditure	0,027	1,886
Financial Performance	-	-
PAD	2,944	-

Source: data processed, 2024

The effect size F2 illustrates the relative impact of the independent variable on the dependent variable. Cohen (1988) posits that an F2 value of 0.35 signifies a strong influence, 0.15 denotes a medium impact, and 0.02 reflects a negligible effect.

The F2 value of capital expenditure is 0.027. The impact of capital spending on financial performance is minimal., as indicated by an F2 value of 0.02-0.15. PAD's F2 value is 2.944. The effect size of PAD on economic performance is considered considerable when the F2 value is more significant than 0.35. The capital expenditure's F2 value is 1.886. The effect size of capital spending on PAD is substantial, as indicated by the F2 value of capital expenditure being more critical than 0.35.

Hypothesis Test

Table 8. Hypothesis Test Table

Variables	Coefficient	t	P (sig)	Conclusion	Description
Capital Expenditure -> Financial Performance	-0.098	0.883	0.378	H_1 is rejected	Not significant
Capital Expenditure -> PAD	0.808	10.846	0.000	H_1 is accepted	Significant
PAD -> Financial Performance	1.015	12.347	0.000	H_1 is accepted	Significant
Capital Expenditure->Revenue -> Financial Performance	0.820	8.434	0.000	H_1 is accepted	Significant

Source: data processed, 2024

The following are the findings of Hypothesis 1: Capital expenditure significantly and favorably affects regional financial performance.

The path coefficient of -0.098, count value of 0.883, and P value of 0.378 represent the results of assessing the hypothesis concerning the influence of capital expenditure on regional financial performance.The hypothesis is refuted as this indicates that capital expenditure has a negative and minimal impact on regional economic performance. The results of this investigation validate those of Sutopo Siddi's research, (2018), Nauw Riharjo (2021) & Thalib & Ekaningtias (2019), and Bilqis & Priyono (2023). The study's findings demonstrate that significant capital expenditures do not always translate into improved regional financial performance. For the investment to yield the anticipated advantages, the government must assess capital expenditure planning and management to make it more effective and efficient (Hendaris & Sastradipraja, 2024)

The findings support Hypothesis 2: Capital expenditure significantly and favorably affects PAD.

With a t-count value of 10.846 and a P value of 0.000, testing the hypothesis on the impact of capital expenditure on PAD reveals a path coefficient value of 0.808. The concept is accepted since this demonstrates how capital spending influences PAD. (0.808x0.808x100%) = 65.29% is the magnitude of the direct effect of capital expenditure on PAD, indicating that capital expenditure has a 65.29% impact on PAD. The effect size for the impact of capital spending on financial performance is small, as indicated by the calculated value of F2, which is 0.027. Growing PAD is only marginally impacted by an increase in capital expenditure. The findings of this investigation corroborate those of studies by Albab et al. (2020), Wadjaudje et al. (2018), Tampubolon & Ariadi (2023), and Putra & Algifari (2023). The study's findings suggest that local governments must continue to invest in development through suitable capital expenditures to promote community well-being. More capital investment in infrastructure construction and pertinent public services would enhance the community's welfare.

The findings support Hypothesis 3: PAD significantly and favorably affects regional financial performance.

The path coefficient, with a t-value of 12.347 and a P value of 0.000, is 1.015, based on the results of the hypothesis test about the effect of PAD on financial performance. The theory is valid as it illustrates the impact of PAD on financial performance. PAD exerts a direct influence of 103.02% on regional financial performance, as quantified by its effect on financial outcomes. (1.015x1.015x100%) = 103.02%. According to the computation results, the effect size of PAD on financial performance is vast, with an F2 value of 2.944. Regional financial performance is significantly impacted by rising PAD. The findings of this study corroborate those of studies by Yuliansyah et al. (2019), Albab et al. (2020), Aswar (2019), and Hendaris & Sastradipraja (2024). The study's findings suggest that raising PAD is one strategy local governments should use to boost regional financial performance. As a measure of local government financial performance, PAD displays the degree of independence of local governments.

Hypothesis 4: Through PAD, capital expenditure significantly and favorably affects financial performance; the findings support this theory.

A path coefficient of 0.820, a count value of 8.434, and a P value of 0.000 illustrate the influence of capital expenditure on regional financial performance via PAD. The P value is below 0.05, and the calculated value exceeds 1.96. The idea is acceptable since this demonstrates how capital spending through PAD influences financial performance. The findings of this study corroborate those of studies by Darwanis & Saputra (2014), Dwiyanto (2018), Aprianis (2021), and Adikonang et al. (2021).

CONCLUSION

The following are the conclusions drawn from the research findings and the discussion that has been presented.

1. Regional financial performance is negatively and negligibly impacted by capital expenditure. Although capital expenditure initiatives have not affected regional economic performance, they should eventually grow fixed assets and provide revenue streams. For capital expenditures to be beneficial, local governments must assess and effectively manage their allocations.
2. Capital expenditures significantly and favorably impact local revenue. Increasing PAD can have a favorable effect on capital expenditure allocation, which will enhance regional financial performance.
3. Regional financial performance is positively and significantly impacted by local own-source revenue. PAD allows local governments to manage their resources and potential independently. This demonstrates that to raise PAD, local governments must maximize and simplify tax and levy collection.
4. The fiscal performance of municipal administrations is positively impacted by capital expenditures made through PAD. PAD can mediate regional economic performance and capital expenditure.

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