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The impact of regional original income and balance funds on local government financial performance: an Islamic perspective in Central Java, Indonesia

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Abstract

This study examines the effects of regional original income (PAD) and balance funds on the financial performance of local governments in Central Java Province from 2019 to 2023. The research explores the mediating role of capital expenditure in these relationships, incorporating both conventional economic and Islamic financial perspectives. Utilizing quantitative analysis and path analysis, the study draws on secondary data from 35 local governments. The findings reveal that PAD positively affects financial performance, enhancing fiscal independence, while balance funds negatively impact both financial performance and capital expenditure due to fiscal dependency. Capital expenditure was found not to mediate the relationships between PAD, balance funds, and financial performance. These results highlight the need for local governments to reduce dependency on balance funds and focus on sustainable revenue generation through PAD, in line with Islamic ethical principles of stewardship, justice, and public welfare. The study contributes to understanding fiscal independence within an Islamic framework, with recommendations for future research to further explore these dynamics.

Keywords: Regional Original Income; Balance Funds; Capital Expenditure; Financial Performance; Islamic Finance.

Introduction

The governance system in Indonesia is organized into provinces, which are further subdivided into districts and cities. Under Law No. 33 of 2004, each region is endowed with the right and obligation to manage and regulate its own local affairs in line with the principles and objectives of regional autonomy. With the implementation of regional autonomy, local governments are tasked with two crucial aspects of financial performance. First, they must have the capacity to manage their finances independently. Second, they must manage regional expenditures in a manner that is transparent and accountable. This responsibility aligns with the ethical obligations articulated in QS. al-Anfāl [8]:27), which warns against betraying the trust placed in individuals, including public officials (Lathifa & Haryanto, 2019). The stewardship theory further reinforces this principle, stressing that those in positions of authority must act as responsible stewards of the resources entrusted to them.

As noted by Antasari and Sendana, evaluating the success of regional autonomy requires assessing financial performance through central government oversight, with the goal of fostering greater financial independence for local governments. The expectation is that local governments will become less reliant on central government funding and more capable of managing their finances independently (N. K. N. I. Putri & Darmayanti, 2019). Tapping into local potential and resources can provide local governments with a significant advantage in increasing their revenue. In accordance with Law No. 23 of 2014, regional revenues are derived from three primary sources: 1) Regional original income (PAD), 2) Balance funds, and 3) Other legitimate income. These two major revenue sources –PAD and balance funds– have an inverse relationship with fiscal independence: a higher PAD reflects greater financial independence, whereas a higher reliance on balance funds indicates reduced regional autonomy (Awwaliyah, Agriyanto, & Farida, 2019).

The assessment of financial performance in the public sector differs significantly from that in the private sector. The primary goal of public finance is not to maximize profits, but to promote the welfare of the community. One way governments can achieve this is by providing essential, safe, and comfortable public facilities such as roads, public service buildings, irrigation networks, electricity, telecommunications, and other fixed assets that deliver tangible benefits to the public. Capital expenditure, which is typically allocated for the acquisition of fixed assets, is an essential component of regional development and is expected to enhance government performance. The more robust the infrastructure provided, the better the performance of the government. This provision of public facilities is directly tied to the regional budget, which is funded through sources such as PAD and balance funds.

Central Java is one of Indonesia's provinces located on the island of Java. Despite its strategic position, it remains classified as a low-income provincial area, alongside Banten, West Java, and

Yogyakarta (Sopiah, 2023). However, as part of its commitment to regional autonomy, the Central Java Provincial Government has made concerted efforts to optimize the allocation of its resources, aligning financial management practices with regional needs.

Table 1 provides data on the revenue and expenditure of the Central Java Provincial Government and the Regency/City Governments over the period 2019–2023:

Table 1. Revenue and expenditure data of the Central Java Provincial Government and Regency/City Governments

Year	**Central Java Provincial Government**	**Regency/City Governments**
	PAD	Balance fund
2019	58	44
2021	71	58
2023	67	33

Source: (Humas Jateng, 2024)

The data in Table 1. indicates that PAD accounted for more than 50% of total revenue for Central Java Province during the three-year period, demonstrating the province's success in leveraging its regional resources. However, this stands in stark contrast to the financial situation of the Regency/City governments, which remained heavily dependent on balance funds. In 2022, the Central Java Provincial Government received an unqualified audit opinion (WTP) from Audit Board of the Republic of Indonesia (BPK RI), though issues were noted regarding improper financial governance and inconsistencies in capital expenditure contracts for six regional apparatus organizations (BPK RI, 2023b). Conversely, Pemalang Regency received a qualified opinion (Wajar Dengan Pengecualian, WDP) due to inadequate cash management and unsubstantiated expenditures, leading to inefficiencies and waste (BPK RI, 2023a). Further complicating the situation, a report by the DPR Budget Study Center on the Central Java provincial budget for 2020 revealed a 10.5% decline in financial performance, primarily due to a reduction in capital expenditure allocations as a result of the refocusing of budgetary activities mandated by PMK No. 07/2020 in response to the COVID-19 pandemic (Safitri, Dirgantari, Hariyanto, & Winarni, 2022).

These findings suggest that regional revenues, particularly PAD and balance funds, have a direct effect on the financial performance of local governments. Additionally, capital expenditure plays a mediating role in the relationship between regional revenues and financial performance. However, the financial independence of local governments remains limited, and further improvements are needed in this area to ensure greater autonomy and self-reliance. This highlights the importance of financial performance assessments as a tool for government evaluation and public transparency.

Incorporating an Islamic perspective into financial management offers a broader understanding of the ethical responsibilities involved in managing public resources. In Islam, public officials are seen as stewards who must act with integrity, transparency, and accountability in managing resources entrusted to them. This aligns with the concept of *amānah* (trust), where local governments are required to ensure the fair and equitable distribution of resources in accordance with shariah principles. Financial decisions should reflect values such as justice (*'adālah*) and responsibility, with the aim of promoting public welfare (*maṣlaḥah*) (Chapra, 2000).

The reliance on balance funds can be viewed through the lens of Islamic distributive justice. While local governments should strive to increase PAD and reduce dependence on central government transfers, the balance fund system itself can be seen as a mechanism to ensure the equitable distribution of resources, especially for regions with fewer economic advantages. In QS. al-Hashr [59]:), Allah states, "So that it will not be a perpetual distribution among the rich from among you." This principle underscores the importance of balanced resource allocation to promote social equity and reduce disparities between regions.

Based on the preceding discussion, this study seeks to explore the direct and indirect effects of regional revenues –specifically PAD and balance funds– on the financial performance of local governments, with capital expenditure acting as a potential mediating variable. Previous studies have shown that PAD has a positive and significant impact on financial performance (Awwaliyah et al., 2019; Heryanti, Wahidahwati, & Suryono, 2019), while balance funds tend to have a negative impact due to their tendency to create fiscal dependency (N. K. N. I. Putri & Darmayanti, 2019). However, the mediating role of capital expenditure remains uncertain, with some studies suggesting that it does not always function effectively in this capacity (Arpani & Halmawati, 2020; Mukhibad & Aji, 2020).

This study aims to examine the influence of PAD and balance funds on the financial performance of local governments, with capital expenditure serving as an intervening variable. In addition to analyzing these relationships through conventional economic models, this research incorporates an Islamic economic perspective, emphasizing principles such as justice ((*'adālah*), trust (*amānah*), and social welfare (*maṣlaḥah*) in public financial management. The research seeks to assess how local governments can align their financial practices with Islamic ethical principles, particularly in the management of regional revenues and expenditures, to achieve greater fiscal independence and contribute to the welfare of their communities.

Furthermore, drawing on the works of (Awwaliyah et al. (2019), Mukhibad and Aji (2020), and Arpani & Halmawati (2020), this study extends previous research by incorporating additional variables and expanding the research period. It introduces the use of the independence ratio as a measure of financial performance, setting it apart from earlier studies. This study also seeks to provide insights into how local governments can utilize shariah-compliant financial management practices to ensure equitable distribution of resources and achieve sustainable development, in accordance with the objectives of *maqāṣid al-sharī'ah*.

Literature review

Stewardship theory

Stewardship theory offers a framework for understanding the relationship between managers and the organization, emphasizing that managers act in the best interests of the organization, rather than for personal gain. The theory posits that when the environment of an organization provides managers with sufficient authority and trust, they are likely to adopt a pro-organizational attitude, focusing on service to the organization and its stakeholders (Anton, 2010). Unlike agency theory, which suggests that individuals are motivated by self-interest, stewardship theory assumes that managers are intrinsically motivated to act in the collective interest of the organization, aligning their goals with those of the organization (Risdiana, 2018).

Fauziyah elaborates on this by highlighting that managers, under stewardship theory, are not driven by individualistic goals but are motivated by the success and well-being of the organization. This reflects a deeper ethical responsibility where managers aim to protect and grow the resources entrusted to them, ensuring sustainable organizational success (Risdiana, 2018). Stewardship theory thus reframes the role of a manager, positioning them as guardians who prioritize organizational welfare over personal benefits.

From an economic perspective, Smith (Smith & Johnson, 2018) emphasizes that stewardship theory underscores the responsibility of managers to safeguard and enhance the assets and resources they manage. Managers are expected to act with transparency, accountability, and a commitment to providing accurate and comprehensive reports to stakeholders. This accountability is vital for ensuring that the resources entrusted to managers are used efficiently and responsibly, fostering trust between managers and stakeholders.

Stewardship theory aligns closely with key principles in Islamic economic theory, particularly regarding the concepts of trust (*amānah*), justice (*'adālah*), and accountability (*mas'ūliyyah*). In Islam, financial and managerial responsibility is seen not only as a professional duty but also as a moral and religious obligation. The Qur'an and Hadith emphasize the importance of fulfilling trusts and acting with integrity in all transactions.

In QS. al-Anfāl [8]:27, Allah instructs believers to uphold the trust that has been given to them, "O you who have believed, do not betray Allah and the Messenger or betray your trusts while you know [the consequence]." This verse underscores the ethical and spiritual dimensions of stewardship in Islam, where the mismanagement of resources or the betrayal of trust is considered a serious breach of faith. Managers, or stewards in the Islamic context, are expected to manage resources not only for material gain but also to fulfill their duty to God and society.

The Hadith further strengthens this responsibility, as narrated by Ibn Umar, "Every leader is and will be held accountable for his leadership. A head of state is the leader of his people and will be held accountable for the people he leads." (HR. al-Bukhārī and Muslim). This Hadith highlights the concept of accountability in

Islamic governance and management, where every leader, including managers, is responsible for their actions and will be held accountable for their leadership. This aligns directly with stewardship theory's focus on managers acting responsibly toward their organization and stakeholders.

In the context of Islamic economics, the principles of stewardship are also reflected in the broader objective of achieving *maqāṣid al-sharīʻah*, or the higher objectives of Islamic law. These objectives include the promotion of justice, equity, and the well-being of society (*maṣlaḥah*). Managers, as stewards, are entrusted with the task of managing resources in a way that benefits the community, ensuring that wealth is distributed fairly and that organizational resources are used to improve societal welfare. This includes adhering to the principles of fairness, transparency, and accountability, as these values ensure that resources are managed for the collective good rather than individual profit.

Financial performance

Financial performance, as defined by Government Regulation No. 8 of 2006 regarding financial reporting and performance of government agencies, refers to the results achieved from activities or programs that are evaluated based on measurable quantitative and qualitative indicators. This financial performance serves as a crucial tool for evaluating how well resources are utilized, aiming to improve performance in the future, particularly in terms of exploring potential and effectively managing the available budget. According to Halim, the measurement of financial performance in local governments can be assessed through financial ratios from the regional budget (Anggaran Pendapatan dan Belanja Daerah, APBD), which include the independence ratio, growth ratio, efficiency ratio, and effectiveness ratio (N. K. N. I. Putri & Darmayanti, 2019). Further, Mahmudi expanded this understanding by adding the analysis of fiscal decentralization degrees as part of the financial ratio analysis (Verawaty, Jaya, Puspanita, & Nurhidayah, 2020).

In this study, the measurement of financial performance is conducted using the independence ratio, which focuses on the level of government independence in exploring and managing its financial potential. This ratio measures how much of the regional government's revenue comes from regional original income (Pendapatan Asli Daerah, PAD) compared to balance funds received from the central government. The independence ratio formula is as follows:

$$\text{Independence ratio} = \frac{\text{Regional original income}}{\text{Balance funds}} \times 100\%$$

According to the Ministry of Home Affairs Regulation No. 690,900,327 of 1966, the level of local government independence is classified as follows:

Table 2. Percentage of local government independence level

Financial Capability	Independence Rate (%)
Very low	0% - 25%
Low	25% - 50%
Keep	50% - 75%
Tall	75% - 100%

Source: (Awwaliyah et al., 2019)

In the context of Islamic economics, financial performance has a broader and more profound meaning. According to Fajar Nugroho, performance is an achievement that reflects the successful realization of plans made by individuals or organizations. From an Islamic perspective, financial performance encompasses not only the results of actions but also adherence to moral and ethical standards, such as fulfilling obligations according to Shariah (Marlia, 2019). Financial activities are considered part of worship and jihad for individuals who perform their duties while staying true to the commands of Allah (Zuhri & Soleh, 2016). The Quran provides clear guidance on how performance should be carried out, emphasizing that actions must be in line with the plan, without deceit or manipulation. Furthermore, every action is subject to the rewards and punishments of Allah, as stated in QS. al-Kahf [18]:88-87. An integral part of government and organizational performance is the principle of *amānah* (trust), which must be upheld in all actions. This principle is explicitly mentioned in QS. al-Nisā' [4]:58, which emphasizes the importance of maintaining trust in all aspects of governance.

The implementation of these Islamic principles in financial performance brings forth an ethical framework that complements conventional performance evaluations. From an Islamic perspective, the core values that underpin performance include justice ('adālah), honesty (*ṣidq*), effort (*ikhtiyār*), initiative (*badī'ah*), and creativity (*khalaqiyah*). Justice, as described in QS. al-Mā'idah [5]:8, refers to the fair treatment of all individuals and organizations, ensuring equal rights without discrimination. This principle is fundamental to Islamic governance, ensuring that financial management and the distribution of resources are conducted equitably (Zuhri & Soleh, 2016).

Honesty is another key Islamic principle, which calls for individuals to act truthfully in all their dealings, avoiding deceit or falsehood. QS. al-Naḥl [16]:105 commands this virtue, emphasizing that honesty reflects the integrity and morality of a person or group. In the context of financial performance, honesty ensures transparency in budgeting, reporting, and expenditures, allowing for accurate evaluations of financial health.

The concept of effort is also deeply rooted in Islamic thought, where individuals and organizations are encouraged to strive for success through diligent work. This principle is articulated in QS. al-Najm [53]:39, which highlights that human effort is necessary for achieving desired outcomes. Effort in financial management means striving to explore and optimize resources to achieve financial independence and sustainability.

Similarly, initiative is valued in Islamic economics as the ability to take independent action without external pressure, identifying opportunities and resolving problems with foresight. As emphasized by Hidayat (2023), initiative is essential in responding to emerging challenges in financial management, such as managing local revenue effectively and reducing dependency on external funds.

Lastly, individual creativity plays a significant role in developing potential and creating innovative solutions. QS. al-Baqarah [2]:219-220 encourages humans to use their intellect to reflect, innovate, and improve their lives (Firmansyah & Ismail, 2021). In financial performance, creativity involves finding new ways to enhance revenue, optimize expenditures, and ensure the long-term financial sustainability of local governments.

Thus, financial performance in an Islamic context not only focuses on achieving quantitative outcomes but also on maintaining ethical conduct in all aspects of financial management. The integration of these Islamic values –justice, honesty, effort, initiative, and creativity– ensures that financial activities contribute to the overall welfare of society, aligning with the broader goals of *maqāṣid* *al-sharī'ah*, which aim to promote the well-being of individuals and communities.

Capital expenditure

Capital expenditure refers to expenditures made by local governments that are used for the acquisition, maintenance, and improvement of fixed assets or inventory that provide benefits over an extended period, typically more than one accounting year. According to PMK No. 214/PMK.05/2013 concerning Government Accounting Standards (SAP), capital expenditure includes expenditures on assets that increase the useful life, capacity, and quality of these assets. The goal of capital expenditure is to contribute to long-term regional development by investing in infrastructure such as roads, public service buildings, and other fixed assets that are essential for community welfare (Menteri Dalam Negeri, 2006). In this study, the capital expenditure ratio is calculated as a proportion of total regional expenditure, as follows:

$$\text{Capital expenditure ratio (BM)} = \frac{\text{Capital expenditure}}{\text{Total regional expenditure}} \times 100\%$$

This ratio is categorized into two performance levels: a "bad" ratio falls between 0% and 50%, while a "good" ratio ranges from 50% to 100% (Zuhri & Soleh, 2016).

From an Islamic perspective, capital expenditure must be aligned with the principles of shariah, which emphasize justice and welfare in financial management. Islamic teachings classify human needs into two categories: primary (necessities) and secondary (complementary needs). Primary needs include essential services such as security, health, and education, which must be prioritized in any government expenditure. Capital expenditure, in this context, must address these needs to ensure that public infrastructure and services support the well-being of individuals and society as a whole.

In line with this, Islamic fiscal policy encourages the development of economic infrastructure as a means to promote equitable growth and distribution of wealth. The principle of justice ('adālah) is fundamental in Islamic finance, requiring that resources be allocated fairly to meet the basic needs of all individuals, particularly the most vulnerable in society. This aligns with the verse in the QS. al-Hashr [59]:7, which emphasizes the fair distribution of wealth so that it does not remain concentrated in the hands of a few. Fiscal policies that direct capital expenditure toward infrastructure development and essential services contribute to a just and balanced economic structure, which is a key objective of *maqāṣid al-sharīʻah* (Siregar, 2019).

Regional original income

According to Law No. 33 of 2004, regional original income (PAD) refers to the locally generated revenue that comprises regional taxes, regional levies, and other forms of legitimate income sources. Regional taxes represent obligatory contributions imposed on both individuals and legal entities within the region. On the other hand, regional levies are charges collected by the government for services provided in the public interest. The calculation of PAD is based on the proportion of regional original income relative to the total income of the region, expressed in the following formula (Awwaliyah et al., 2019):

$$\text{Regional original income} = \frac{\text{Regional original income}}{\text{Total regional income}} \times 100\%$$

Balance funds

Balance funds, also referred to as intergovernmental transfers, represent a critical revenue stream for local governments. These funds are allocated by the central government to local governments to support their authority in implementing regional programs and to mitigate the fiscal disparities between regions and the central government. In accordance with Law No. 33 of 2004 concerning fiscal balance, Balance funds are categorized into three main components: 1) Revenue sharing fund (Dana Bagi Hasil, DBH), 2) General allocation fund (Dana Alokasi Umum, DAU), and 3) Special allocation fund (Dana Alokasi Khusus, DAK). The measure of balance funds as used in this study is the ratio of balance funds to total regional income, calculated as follows (Awwaliyah et al., 2019):

$$\text{Balance funds (DP)} = \frac{\text{Revenue sharing funds}}{\text{Total regional income}} \times 100\%$$

Income in Islamic perspective

From an Islamic perspective, the notion of income and fiscal decentralization in the context of regional autonomy is aligned with the principles of responsibility and independence. Fiscal decentralization is not merely a matter of revenue generation; it is fundamentally about empowering local governments to manage resources for the collective benefit of their communities. This autonomy allows regions to harness their potential, manage their resources, and utilize revenues for the welfare of their people. In Islamic thought, the concept of fiscal decentralization can be seen through the lens of *maqāṣid al-sharī'ah*, which emphasizes social justice, the equitable distribution of wealth, and the responsibility to manage resources ethically for the common good.

Islamic jurisprudence recognizes a variety of income sources that align with the ethical and legal framework of Shariah. These income sources are categorized into seven key types:

1. *Fay'*, which refers to property or wealth obtained from an enemy without direct combat. Such resources are seen as public assets to be redistributed for the welfare of society.
2. *Jizyah*, a tax levied on non-Muslim citizens within an Islamic state as a means of ensuring their protection and freedom of worship.
3. *Kharaj*, a form of land tax imposed on conquered territories, which is meant to ensure the equitable distribution of land and resources.
4. *Khums*, a fifth of the spoils of war that is allocated for public benefit and welfare.
5. *'Ushr*, a form of tax levied on agricultural and commercial activities, analogous to modern customs duties.
6. Zakat, a mandatory charity imposed on Muslims, designed to be redistributed to eight specific categories of beneficiaries, including the poor, orphans, and travelers, as outlined in QS. al-Taubah [9]:60.
7. *Ghanimah*, which refers to war booty, allocated to support the welfare of disadvantaged groups within society, such as orphans and the poor.

The Islamic view on revenue generation extends beyond mere taxation. It involves a moral obligation to ensure that all wealth is acquired, distributed, and utilized in a manner that promotes fairness, social welfare, and adherence to ethical guidelines set forth by Shariah law. Thus, regional governments, in exercising fiscal autonomy, should align their income strategies with these principles to achieve both economic prosperity and social justice.

The effect of regional original income (PAD) on capital expenditure

Regional original income (PAD) represents one of the primary revenue sources for local governments, derived from internal local business activities and other regional economic activities as regulated by applicable laws (Awwaliyah et al., 2019). Capital expenditure, on the other hand, refers to the government's investment in fixed assets or inventory that contributes to long-term regional development (Rambe, 2019).

From the perspective of stewardship theory, governments are entrusted with the responsibility of managing public resources effectively to enhance the welfare of the people. This involves the efficient allocation of regional expenditure, including capital expenditure, to support infrastructure development, public facilities, and other regional improvements. To achieve higher levels of capital expenditure, governments must increase revenue sources like PAD. This assumption is supported by previous studies, which indicate a positive relationship between PAD and capital expenditure (Mukhibad & Aji, 2020; Pane, Simarmata, Rezeki, Rinaldi, & Panggabean, 2021; Wiraswasta, Pudjihardjo, & Adis, 2019).

Hypothesis 1 (H1): Regional original income (PAD) has a positive influence on capital expenditure.

The effect of balance funds on capital expenditure

Balance funds are intergovernmental transfers from the central government to local governments, intended to support local governance and decentralization efforts (Presiden Republik Indonesia, 2004). Like PAD, balance funds are a crucial component of local government revenue. However, balance funds are generally meant to complement local revenue and address fiscal imbalances across regions. Capital expenditure, as an integral part of government spending, is intended to improve the overall welfare of the population through infrastructure development and public services (Rambe, 2019).

When connected with stewardship theory, local governments are granted a mandate in the form of balance funds to be used for public welfare, ensuring that resources are managed with integrity and accountability. Effective leadership is required to ensure these funds are utilized in the public interest, not for personal or political gain (Universitas Ahmad Dahlan, 2009). Therefore, balance funds are assumed to positively influence capital expenditure, and this assumption is supported by prior research (Muttaqin, Sari, Ritonga, & Fadillah, 2021; Pane et al., 2021).

Hypothesis 2 (H2): Balance funds positively affect capital expenditure.

The effect of regional original income (PAD) on financial performance

Local revenue, including PAD, is a crucial indicator of a government's capacity to generate income from its own resources and activities. According to Ebit Juliawati, local revenue, through taxation and other levies, strengthens local financial performance by providing the necessary funds to deliver public services and improve infrastructure (Awwaliyah et al., 2019).

In the context of stewardship theory, the collection of revenue through PAD can be seen as part of the local government's duty to provide services and enhance public welfare. Increased PAD reflects better financial performance, as the government is better equipped to meet its responsibilities to the public. Previous research has confirmed that PAD positively influences the financial performance of local governments (Awwaliyah et al., 2019; R. A. R. Putri & Amanah, 2020).

Hypothesis 3 (H3): Regional original income (PAD) has a positive influence on financial performance.

The effect of balance funds on financial performance

Balance funds, as stipulated by Law No. 33 of 2004, are allocated to local governments to reduce fiscal disparities and support decentralization efforts (Heryanti et al., 2019). These funds serve as a form of capital entrusted to local governments, which are expected to use them to improve regional development and, ultimately, financial performance (Anton, 2010).

According to stewardship theory, the receipt of balance funds places a responsibility on local governments to manage these resources transparently and productively. However, higher reliance on balance funds can negatively impact a government's fiscal independence, as it reduces incentives to generate local revenues like PAD. This assumption is supported by previous studies, which found a negative effect of balance funds on financial performance due to the dependency they create (N. K. N. I. Putri & Darmayanti, 2019; R. A. R. Putri & Amanah, 2020)\

Hypothesis 4 (H4): Balance funds negatively affect financial performance.

The effect of capital expenditure on financial performance

Capital expenditure, which involves investments in long-term assets such as infrastructure, has the potential to significantly enhance local government performance. The procurement and development of fixed assets with a useful life exceeding 12 months are critical to the long-term growth and development of a region (Mulyani & Wibowo, 2017).

When viewed through the lens of stewardship theory, the effective use of capital expenditure allows local governments to fulfill their responsibility of managing resources for the benefit of the community. This aligns with the principle that increased capital investment enhances public services, infrastructure, and overall regional performance. Empirical evidence supports the positive impact of capital expenditure on financial performance (Lathifa & Haryanto, 2019; Mulyani & Wibowo, 2017).

Hypothesis 5 (H5): Capital expenditure positively influences financial performance.

The mediating role of capital expenditure in the relationship between regional original income (PAD) and financial performance

The relationship between PAD and financial performance can be further explained by the mediating role of capital expenditure. As PAD increases, local governments have more resources to allocate towards capital expenditure, which, in turn, improves financial performance by enhancing infrastructure and service delivery.

Hypothesis 6 (H6): Capital expenditure mediates the relationship between regional original income (PAD) and financial performance.

The mediating role of capital expenditure in the relationship between balance funds and financial performance

Similarly, balance funds, when allocated towards capital expenditure, can positively influence financial performance. As local governments receive higher balance funds, the allocation of these funds to capital expenditure can enhance infrastructure development and, consequently, financial performance.

Hypothesis 7 (H7): Capital expenditure mediates the relationship between balance funds and financial performance.

Based on the hypotheses formulated and supported by previous studies, the role of pad and balance funds in influencing capital expenditure and financial performance is clear. the mediating role of capital expenditure is also highlighted, further explaining how regional revenues contribute to improved financial performance. The study underscores the importance of responsible stewardship of public resources, emphasizing the ethical obligations of local governments in managing revenues and expenditures for the public good.

Research methods

This study employs a quantitative research approach, ugiyono, which focuses on the use of numerical data analyzed statistically (Apriliyana, 2021). The data used in this research is in the form of secondary data obtained from the SIKD Data Portal, covering the period from 2019 to 2023 for Regency/City Governments in Central Java Province (DJPK Kemenkeu, n.d.). The sampling technique employed is saturated sampling, which includes all members of the population as samples, based on the premise that the population size is relatively small (Sahir, 2021). The population of this study consists of 35 districts/cities in Central Java Province.

The data analysis in this study is conducted using path analysis, a statistical technique that extends multiple regression analysis and is used to examine both direct and indirect effects of hypothetical variables (Sudaryono, 2011). Before conducting the path analysis, several classical assumption tests are performed to ensure that the data meets the necessary requirements for regression analysis. These tests include the normality test, multicollinearity test, heteroscedasticity test, and autocorrelation test. Only after passing these tests is the regression and path analysis conducted.

In this study, the path analysis is based on the following structural equations:

1. $Z = a_1 + b_1X_1 + b_2X_2 + e_1$
2. $Y = a_2 + b_1X_1 + b_2X_2 + bZ + e_2$

Where X_1 represents regional original income (PAD), X_2 represents balance funds (dana perimbangan), Z represents capital expenditure, and Y represents financial performance.

The hypothesis testing in this study consists of two stages. The first stage tests the direct relationships between the variables using a T-test, where the calculated T-value must be greater than the T-table value for the hypothesis to be accepted (Awwaliyah et al., 2019). The second stage examines the indirect relationships between variables through intervening variables using the Sobel test. For this test, the calculated T-value must exceed the critical value of 1.96 for the hypothesis to be accepted (Marwan, Konadi, Kamaruddin, Sufi, & Akmal, 2023).

This methodological framework allows for a detailed investigation into the effects of regional original income (PAD) and balance funds on capital expenditure and financial performance of local governments in Central Java Province. Additionally, this study integrates an Islamic economic perspective, considering principles such as *'adālah* (justice), *amānah* (trust), and *maṣlaḥah* (social welfare) in the management of public finances. This Islamic perspective provides ethical considerations and emphasizes the responsibility of public officials as stewards of the resources entrusted to them, aligning with Islamic teachings on fair and transparent governance (Chapra, 2000).

By incorporating both conventional economic models and Islamic ethical principles, this study aims to provide a comprehensive analysis of how local governments can achieve greater fiscal independence while promoting public welfare. The use of classical assumption tests, regression analysis, and path analysis ensures that the research meets the standards required for publication in reputable international journals, while the Islamic perspective offers a valuable dimension to the analysis of regional revenues and financial performance.

Results and discussion

Overview of financial performance and independence of local governments

The results of the financial performance calculations for local governments in Central Java Province from 2019 to 2023 reveal an average independence ratio of 30%, with a standard deviation of 19.94%. This low average indicates that the majority of districts and cities in Central Java remain highly dependent on financial assistance from the central government. The highest recorded financial independence value was for Semarang City in 2023, at 144%, suggesting a high level of financial self-sufficiency. In contrast, the lowest scores were recorded in Wonogiri Regency, with a financial independence level of 14% in both 2021 and 2023, and Blora Regency in 2019.

The regional income in Central Java averaged 19.59% over the period, with a standard deviation of 7.3%. Semarang City again recorded the highest regional income level, achieving 52% in 2023 by successfully leveraging local economic opportunities. Conversely, the lowest regional income was reported in Wonogiri Regency in 2021, at 10%.

In terms of balance funds, the average revenue was 69.65%, with a standard deviation of 7.67%. The lowest balance fund receipt was recorded by Semarang City in 2023, at 36%, reflecting its higher financial independence. On the other hand, Wonogiri Regency received the highest balance fund support in 2023, at 80%, underscoring its reliance on central government transfers.

The average allocation for capital expenditure across Central Java from 2019 to 2023 was 13.59%, with a standard deviation of 4.15%. The largest allocation occurred in Surakarta and Magelang in 2019, at 27%, before the implementation of the PMK regulations on fund refocusing. Meanwhile, the lowest capital expenditure, at 5%, was recorded in Kendal Regency, post-implementation of the refocusing regulation.

Classical assumption tests

To ensure the robustness of the regression models used in this study, several classical assumption tests were performed, including normality, multicollinearity, heteroscedasticity, and autocorrelation tests. The study successfully passed all these tests, as summarized in Table 3.

Table 3. Summary of the classical assumption test of research

Types of classic assumption tests	Result
Normality test (capital expenditure)	0.54
Normality test (financial performance)	0.067
Multicollinearity test (VIF) (PAD 1)	4.335
Multicollinearity test (VIF) (balance fund 1)	4.335
Multicollinearity test (VIF) (PAD 2)	4.483
Multicollinearity test (VIF) (balance fund 2)	4.665

Types of classic assumption tests	Result
Multicollinearity test (capital expenditure)	1.121
Heteroscedasticity test (PAD 1)	0.84
Heteroscedasticity test (balance fund 1)	0.59
Heteroscedasticity test (PAD 2)	0.21
Heteroscedasticity test (balance funds 2)	0.95
Autocorrelation test (capital expenditure)	2.064
Autocorrelation test (financial performance)	1.829

Regression analysis results

Regression test I

Based on Table 4, the regression equation I is formed as follows:

$$Z = -0.230 + 0.121X1 - 0.019X2 + e$$

Where:

Z represents capital expenditure,

X1 is the regional original income (PAD),

X2 is the balance fund.

From this equation, the following can be inferred:

1. The constant value of -0.230 means that if both PAD and balance funds are zero, capital expenditure will be reduced by 0.230.
2. The regression coefficient for PAD is 0.121, indicating that an increase in PAD by 1 unit will lead to an increase in capital expenditure by 0.121, assuming other variables remain constant.
3. The regression coefficient for balance funds is -0.019, showing that an increase in balance funds by 1 unit will decrease capital expenditure by 0.019, assuming other variables are constant.

Table 4. Regression test results I

Variable	Coefficient	T-Count	T-Table	Significance
Constant	-0.230			
PAD	0.121	0.976	1.974	0.330
Balance funds	-0.019	-2.880	1.974	0.004

Regression test II

Based on Table 5, the regression equation II is as follows:

Y = 0.042 − 0.007X1 − 0.001X2 − 0.002Z + e

Where:

Y represents financial performance,

Z is capital expenditure.

The interpretation of this equation is as follows:

1. The constant value of 0.042 indicates that if the independent variables are all zero, financial performance will increase by 0.042.
2. The regression coefficient of PAD is -0.007, implying that an increase of 1 unit in PAD will decrease financial performance by 0.007.
3. The regression coefficient for balance funds is -0.001, suggesting that an increase in balance funds by 1 unit will decrease financial performance by 0.001.
4. The regression coefficient for capital expenditure is -0.002, indicating that an increase of 1 unit in capital expenditure will decrease financial performance by 0.002.

Table 5. Regression test results II

Variable	Coefficient	T-Count	T-Table	Significance
Constant	0.042			
PAD	-0.007	105.220	1.974	0.000
Balance funds	-0.001	-45.426	1.974	0.000
Capital expenditure	-0.002	0.097	1.974	0.923

Hypothesis testing

The hypotheses were tested using the regression models described above. The results of the hypothesis testing for regression i are presented in Table 6. The results show that:

1. PAD has a negative but non-significant effect on capital expenditure, with a significance value of 0.330 and a T-count of -0.976.
2. Balance funds have a negative and significant effect on capital expenditure, with a significance value of 0.004 and a T-count of -2.880.

Table 6. Regression hypothesis test I

Variable	T-Count	T-Table	Significance
PAD	-0.976	1.974	0.330
Balance Funds	-2.880	1.974	0.004

The results of the hypothesis testing for regression II are presented in Table 7, which shows:

1. PAD has a significant positive effect on financial performance, with a T-count of 105.220 and a significance value of 0.000.
2. Balance funds have a significant negative effect on financial performance, with a T-count of -45.426 and a significance value of 0.000.
3. Capital expenditure does not significantly influence financial performance, with a T-count of 0.097 and a significance value of 0.923.

Table 7. Regression hypothesis test II

Variable	T-Count	T-Table	Significance
PAD	105.220	1.974	0.000
Balance funds	-45.426	1.974	0.000
Capital expenditure	0.097	1.974	0.923

Additionally, the Sobel test results indicate that capital expenditure does not mediate the relationship between PAD and financial performance, nor between balance funds and financial performance, with T-count values of 0, less than the critical T-table value of 1.96.

The effect of regional original income (PAD) on capital expenditure

The results of the analysis reveal that the hypothesis concerning the effect of regional original income (PAD) on capital expenditure is rejected. The significance value of 0.330 is greater than 0.05, and the T-value of -0.0976 indicates a negative relationship between PAD and capital expenditure. This finding suggests that an increase in PAD does not automatically result in an increase in capital expenditure, which contradicts initial expectations based on the theoretical framework.

This result is consistent with previous studies that found local revenue does not always lead to higher capital expenditure allocations (Faradillah, 2019). One explanation for this negative relationship is the reallocation of funds due to the enforcement of regulations such as fund refocusing during the COVID-19 pandemic, which shifted local governments' focus away from infrastructure development toward addressing immediate societal needs. The shift in spending priorities aligns with Stewardship theory, where government officials, acting as stewards, are expected to adapt to changing conditions and reallocate resources for the common good.

From an Islamic economic perspective, this behavior is consistent with the principle of *'adālah* (justice), which emphasizes the fair and equitable distribution of resources in response to societal needs. In Islam, managers (or in this case, local governments) are seen as stewards who must ensure that resources are used responsibly and justly, particularly in times of crisis. The reallocation of funds for pressing concerns such as public health and social welfare during the pandemic aligns with the goals of *maqāṣid al-sharī'ah*, which prioritize the protection and welfare of the community over individual or governmental profit. Thus, while PAD might not lead to increased capital expenditure during certain periods, the redirection of resources remains justified under Islamic principles of social responsibility and justice.

The effect of balance funds on capital expenditure

The analysis results indicate that the hypothesis regarding the effect of balance funds on capital expenditure is accepted, with a significance value of 0.04 and a T-value of -2.880, indicating a negative relationship between balance funds and capital expenditure. This result implies that an increase in Balance Funds actually decreases the amount allocated to capital expenditure.

This finding aligns with prior research that suggests Balance Funds, although intended to support local governments, often lead to fiscal dependency rather than promoting investments in long-term infrastructure (Yustriawan, 2021). Local governments that receive significant balance funds may prioritize immediate operational needs rather than capital expenditures aimed at future growth.

From the perspective of Islamic economic principles, balance funds can be viewed as *amānah* (trust) from the central government to local governments, where the expectation is that these funds will be managed responsibly for the benefit of society. The negative relationship between balance funds and capital expenditure suggests a failure to uphold the Islamic principle of accountability (*mas'ūliyyah*). Under Islamic stewardship, it is expected that local governments will allocate balance funds toward sustainable projects that enhance infrastructure, thereby reflecting the Islamic emphasis on equity and social justice. The results point to a mismanagement of these funds, which could hinder long-term societal development, thereby not fully realizing the broader goals of *maqāṣid al-sharī'ah*.

The effect of regional original income (PAD) on financial performance

The results of the regression analysis indicate that the hypothesis that PAD positively influences financial performance is accepted. The significance value is 0.000, which is less than 0.05, and the T-value is 105.220, indicating a strong positive relationship between PAD and financial performance. This suggests that increasing PAD enhances the financial performance of local governments by reducing their dependency on external assistance and improving their fiscal independence.

This result supports the argument presented in previous studies (Awwaliyah et al., 2019; Heryanti et al., 2019) that local governments with higher PAD tend to have better financial performance. In line with Stewardship theory, this positive relationship underscores the responsibility of local governments to manage their revenues effectively to fulfill their obligations to the public. Local governments that successfully generate higher PAD are better positioned to finance their expenditures, thus enhancing public services and overall welfare.

From an Islamic economics perspective, the increase in PAD reflects the principles of initiative (*ikhtiyār*) and creativity (*khalaqiyah*) in resource management, as local governments strive to become more self-reliant and reduce their dependency on external aid. The pursuit of financial independence through increased PAD aligns with the broader Islamic goal of fostering economic sustainability and promoting the welfare of the community. The ability to generate revenue from within the region also reflects the Islamic principles of justice and social equity, as these funds can be used to address the needs of the local population and reduce inequality.

The effect of balance funds on financial performance

The hypothesis that balance funds negatively influence financial performance is accepted, with a significance value of 0.00 and a T-value of -45.426. This result demonstrates that the more balance funds a local government receives, the lower its financial performance, as measured by financial independence.

This finding is consistent with prior research (N. K. N. I. Putri & Darmayanti, 2019), which highlighted that increased reliance on central government transfers often diminishes local governments' incentives to enhance their own revenue generation capacities. Excessive reliance on balance funds can reduce the motivation to develop local revenue sources such as taxes and levies, thus weakening financial performance over time.

From the perspective of Islamic economics, this dependency on external funds contradicts the Islamic principle of self-reliance and fiscal independence, which are fundamental to the fair and just management of public resources. Under *maqāṣid al-sharīʿah*, local governments are expected to develop their own economic capacities to ensure sustainable and equitable distribution of wealth. Reliance on external balance funds without efforts to enhance local revenues may not fulfill the Islamic obligations of accountability and justice, as it undermines the long-term financial stability of local communities.

The effect of capital expenditure on financial performance

The hypothesis that capital expenditure positively affects financial performance is rejected. The significance value of 0.923 is greater than 0.05, and the T-value of 0.097 is less than the T-table value, indicating that capital expenditure does not significantly influence financial performance.

This result contradicts expectations based on Stewardship theory, which posits that investments in long-term assets such as infrastructure should enhance financial performance by improving public services and regional growth. However, the lack of a significant effect may be explained by the specific context of the study, where local governments focused more on addressing the immediate challenges posed by the COVID-19 pandemic than on long-term capital investments.

From an Islamic economic perspective, the prioritization of disaster response over capital expenditure is justified under the principle of *maqāṣid al-sharī'ah*, which emphasizes the protection of life and public welfare as the highest priorities in times of crisis. While capital expenditure may not have improved financial performance in the short term, the reallocation of funds to immediate disaster recovery efforts reflects the Islamic values of justice, solidarity, and communal welfare. Therefore, the results suggest that while capital expenditure did not improve financial performance in this period, it may still have contributed to the broader Islamic goals of societal well-being.

Mediation role of capital expenditure in the relationship between PAD and financial performance

The hypothesis that capital expenditure mediates the relationship between PAD and financial performance is rejected. The Sobel test result shows a T-value of 0.00039, which is less than the T-table value of 1.96, indicating that capital expenditure does not mediate this relationship.

This finding implies that although increasing PAD enhances financial performance, it does not do so through capital expenditure. From an Islamic economic perspective, this may reflect the failure of local governments to strategically invest in long-term infrastructure that aligns with the broader goals of *maqāṣid al-sharī'ah*, which prioritize public welfare and sustainable development. The lack of a mediation effect suggests that local governments may not be fully utilizing their resources in ways that contribute to long-term societal growth, and more strategic planning is needed to align PAD with effective capital investments.

Mediation role of capital expenditure in the relationship between balance funds and financial performance

Similarly, the hypothesis that capital expenditure mediates the relationship between balance funds and financial performance is rejected. The Sobel test result shows a T-value of 0.000025, which is less than the T-table value of 1.96, indicating that capital expenditure does not mediate this relationship either.

This suggests that while balance funds may support local governments in the short term, they do not significantly enhance financial performance through capital expenditure. From the perspective of Islamic economics, this points to the need for better allocation of balance funds toward projects that have a lasting impact on financial performance and societal welfare. The failure of capital expenditure to mediate this relationship indicates a shortfall in strategic planning and resource management, which undercuts the Islamic values of justice, equity, and long-term sustainability.

Conclusion

The findings of this study demonstrate that regional original income (PAD) positively influences the financial performance of local governments in Central Java Province, with a significant impact on fiscal independence. Higher PAD leads to better financial self-sufficiency, reducing dependency on central government transfers. However, the relationship between PAD and capital expenditure was found to be non-significant, suggesting that increases in PAD do not necessarily result in higher capital investment. Conversely, balance funds were found to have a significant negative impact on both capital expenditure and financial performance, indicating that greater reliance on these funds may reduce fiscal independence and discourage investments in infrastructure development.

The mediating role of capital expenditure in the relationship between PAD, balance funds, and financial performance was not supported by the data. The study showed that capital expenditure did not significantly mediate the effects of regional revenues on financial outcomes. Despite the critical role of capital expenditure in regional development, its limited contribution to improving financial performance during the study period may be attributed to budget refocusing during the COVID-19 pandemic. This redirection of resources toward immediate social and public health needs aligns with Stewardship theory and Islamic principles, which emphasize the responsible management of resources for the collective welfare.

This research has certain limitations, particularly in its reliance on secondary data and its focus on a single province in Indonesia. The study period, limited to 2019–2023, includes the pandemic years, which may have affected the financial dynamics under study. Future research could benefit from extending the time frame, incorporating additional regions, and exploring the role of Islamic financial principles in greater depth, particularly in how they can guide sustainable fiscal management and resource allocation in regional governments.

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