

# **Analysis Of The Effect Of Regional Financial Performance To Economic Growth and Poverty Through Capital Expenditure**

## **(Case study of 38 Regencies/Cities in East Java Province)**

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### **Abstract**

This research was conducted to empirically prove the effect of financial performance measured from the ratio of expense to income, fiscal efforts, financing capability, and the level of fiscal decentralization degree towards a number of variables, which are: (1) capital expenditure, (2) economic growth and poverty, (3) economic growth and poverty through capital expenditure, and (4) poverty through capital expenditure and economic growth.

This research was performed using path analysis method. The samples of this research are 38 districts/cities in East Java Province during the last 7 years (2005-2011).

The result of this research shows that the financial performance measured from financing capability shows insignificant direct effect towards capital expenditure and economic growth while the effect to poverty shows positive significant effect. Furthermore, from the effects of indirect financial performance through capital expenditure, there are variables of expenditure to income ratio, fiscal efforts, and degree of fiscal decentralization variables which have significant indirect effects towards the economic growth (in a positive way) and poverty (in a negative way) while for the financial performance effects through capital expenditure and economic growth to poverty have significant indirect and negative influence, particularly those are measured using expense to income ratio, fiscal efforts, and the level of fiscal decentralization. Finally, in order to better financial performance in particular it is necessary to optimize the financing capabilities in terms of both revenue and expenditure, in terms of revenue optimization of PAD, Silpa, and loan, while expenditure optimizers need to conduct a review of expenditure that has been done.

**Keywords:** financial performance, expense to income ratio, fiscal effort, financing capability, the level of fiscal decentralization, capital expenditure, economic growth, poverty

### **1. Introduction**

Before the implementation of decentralization system. Regional development policy is still dominantly controlled by regional government and central government so that this causes huge dependency between regional government and central government. I causes central government expense is increasing while on the revenue side does not have much change because of the regional government effort to boost central government revenue by managing resources which has not optimal yet. Eventually, to reduce this dependency in 1999, central government granted an authority to regional government which is reinforced by UU no 22 and 25 in 1999 which had been changed to UU no 33 and 34 in 2004. Thus, by these two regulations, regional government owned their authority in making development and managing regional finance.

Although the decentralization system has been implemented for almost 10 years, regional government has not managed its regional finance well, and it could be observed from two cases. Firstly, the revenue aspect has not been able to optimize its potential because the regional government is still unable to be autonomous. Besides, its financial income is still depending on the central government (Saragih, 2003). The second case is from expenditure aspect which is still unable to manage its expense well because most of its funds are spent for personnel expenditure instead of capital expenditure.

Financial management of certain region could be reflected from Regional Government Budget (APBD) which is owned by every region, so that it could be used as an instrument to create regional development regulation for regional government. Since the budget is very important, it should contain performances, in which related to budget as an internal or external financial performance. Internal financial performance could be a comparison between components which are contained in the budget, while external financial performance could be a

correlation between budget allowance and economic development and reduction of economic problem such as poverty.

Measurement of regional financial performance has not been performed yet by any economist or financialist. However, some economists whose names are Musgrave, Richard A and B, has formulated financial performance measurement. Musgrave, Peggy in their book of "Public Finance In Theory and Practice" said that measurement of financial performance is an analysis between regional financial ratio and report of income; and expenditure budget calculation. So that regional financial performance could be seen from income and expenditure perspective. Financial performance form income aspect consist of degree of fiscal decentralization ratio, degree of fiscal decentralization, fiscal effort ratio, and financing viability ratio, whereas expenditure aspect of financial performance consists of expenditure to income ratio (Reksohadiprojo, 1999).

However, as explained on the previous discussion that many regional governments in Indonesia have not been able to manage their finance well. This means that the financial performance is still poor and one of the is a regional government is East Java. The Government of East Java was picked as the subject of this study since East Java is registered as one of the province which has the most regencies/cities. Many samples of the development for financial performance of regency/city's government in East Java were classified as inadequate. First of all, measurement using expenditure to income ratio, if it is compared between 2006 and 2011, it would show a degradation of development and classified as inadequate. This is also proved by the increase of the number of regencies/cities which ratio is between 90-100% in 17 regencies/cities in 2006 to 30 regencies/cities in 2011.

Secondly, although it is shown a better development result, financial performance is measured using fiscal effort. However, fiscal effort ratio is still inadequate category in which regencies/cities which are classified as the good (satisfying) ones, increase to 15 regencies/cities in 2011, which are only 9 regencies/cities in 2006. The third is that, if financial performance is measured using decentralization degree, their result shows that there are still many regencies/cities classified as unsatisfying although the number of regencies/cities has declined from 30 regencies/cities in 2006 to 29 regencies/cities in 2011. Finally, financial performance is measured using financing viability in which if it is measured by using this measurement would show that there are regencies/cities classified as satisfactory. This would be shown from 30 regencies/cities classified as satisfying in 2006 and even in 2011.

Furthermore, as explained before that financial performance also has external impact such as the creation of economic development and reduction of poverty. Based on the calculation of financial performance which has been performed, it shows a result of satisfying capital viability, while expenditure to income ratio, fiscal effort, and decentralization degree is still classified as unsatisfying. This could lead to low economic growth rate of regencies/cities which compared to economic growth rate from 2008 to 2010. The number of regencies/cities which has PDRB (Gross Domestic Regional Product) rate below PDRB of East Java Province in 2008 is 12 regencies/cities, 28 regencies/cities in 2009, and 26 regencies/cities in 2010. However, in addition to affect economic growth rate, financial performance also have impact to the number of poverty in regencies/cities in East Java is higher than the percentage of poor population in Indonesia such as 18.19% in 2008, 16.22% in 2009, 15.26% in 2010, to 13.85 in 2011.

Based on facts above, this research tries to discuss about the effect of financial performance of region to the economic and poverty growth through capital expenditure in regencies/cities of East Java Province. Furthermore, there are more things to discuss in this paper. Session 2 will discuss about theories which are the fundamental of this research, session 3 will discuss about framework of this research, while session 4 will discuss about research methodology. Results and discussions of this research will be elaborated in session 5. Finally, session 6 is conclusion and recommendation.

## 2. Literature Review

Economic growth could be defines as the increasing of goods and services produce in one country. In classical economics theory by Adam Smith, David Ricardo, Thomas Robert Malthus, and John Stuart Mill, it is said that economic growth of a region is influenced by four factors that are population, capital accumulation, technology, and natural resources. In other words, to create economic growth, a region must have those factors. Based on classical economics theory, the economic growth would be influenced by those four factors. The government will have high potential in order to implement decentralization of government autonomy system. Implementing

decentralized government system, the government indirectly could own one of those factors to create economic growth through capital accumulation.

Decentralization system could increase capital accumulation of regional government because of regional government in decentralization system has extended authority in extracting and managing its potential. It also has to be followed by financing resources which was regulated by the central government. The transfer of authority to regional government, according to traditional theory of fiscal federalism, stated that allocative benefits which are received by regional government in decentralization system. Allocative benefit stated in traditional theory means that regional government will get information easier related to region's potentials or regional growth, when it is compared with information owned by central government.

If allocative benefits are available in decentralization system, capital accumulation factor to create economic growth in the region could be earned. Capital accumulation could be earned by regional government if they could create a good financial performance. Government financial performance could be observed from two ways that come from income and expenditure aspect. In income aspect, financial performance could be observed from how significant regional government to extract income potentials in their region, or in other words, optimize regional own source of revenue (PAD), so that financial performance from income aspect could be measured using degree of fiscal decentralization ratio, fiscal effort, and regional autonomy (Reksohadiprojo, 1999). Those ratios could be used to see financial performance of regional government because those ratios could prove how regional government optimizes their regional own source of revenue (PAD).

PAD, as a basis to value regional government financial performance from income aspect, in this research is similar to a research conducted by Gorodnichenko (2001). In this research about flypaper effect phenomenon, the alteration of central government transfer allocation and economic in Ukraine have a result that regional government owns income response more elastically to government expenditure compared to response of central government transfer to government expenditure.

While on expenditure aspect, government financial performance could be seen from how regional government could spend effectively and efficiently. By effective and efficient expenditure, regional government only needs minimum fund to gain maximum output. In other words, while expenditure is minimum, there will be residual income to spend on more useful matter. This is similar to a research conducted by Antonis Adam, Manthos D. Delis, and Pantelis Kammas (2008) which explains that fiscal decentralization could improve expenditure to the income ratio in public sector that affects economic performance. For measuring government financial performance from expenditure aspect, it could be calculated through expenditure to income ratio (Reksohadiprojo, 1999)

Based on the explanations above, good governance financial performance will reflect modal accumulation so it could be used to create economic growth as in one financial performance measurement, which is autonomy ratio, is a representation from people participation level in regional development. Thus, the more people spend for regional tax in retribution describes the higher level of society's welfare (Halim, 2007). A research by Phan Minh Ngoc (2008) also stated that technology advance, statistically has no effect to economic growth while capital has significant effect to economic growth in Vietnam. Financial performance which reflects the increase of capital income, which influences growth is reinforced by government expenditure theory. This theory, which was explained by Keynes, stated that an economic growth could be created if it depended on government spending allocation performance. Regional government spending allocation performance is influenced by the amount of regional government income source. Furthermore, this regional income source in decentralization system is strongly influenced by the level of PAD income and transfer fund.

Thus, it can be concluded that good financial performance will reflect to the change in income and government spending allocation or it is often referred as budget management change. The change of budget management will influence fiscal performance change in a region and it will affect economic growth. The effect of financial performance which is measure using regional potential optimization to growth has also been researched by Miron Wilnicki (2009) about "The post conservative orphan: why the USA needs an effective government economic policy". This research concluded that to restore economic condition, The USA has to utilize its potential such as tax reform, improvement in financial system control, and removal of education discrepancy, since those problems could harm economic growth of The USA. On the other hand, the effect of financial performance growth is also supported by a research conducted by Geert Bakaert, Campbell R. Harvey, Christian T. Lundblad (2007). This research reviews about correlation of financial transparency to economic growth in china. The result explains that foreign trade and investment has not had important role in economic growth. This

is because China's financial sector has not been efficient due to government's institution which is not powerful enough.

### 3. Research Framework

Essentially, the implementation of decentralization system expects regional government to be able to be more autonomous by increasing income and spending expenditure according to the target and need. Increasing income in decentralization system could be earned by regional government by optimizing PAD potentials, while expenditure, which is right on target, could be performed by spending necessarily which is according to needs so that it could be more efficient. It could be observed from expenditure to income ratio. Increasing potential of PAD and increasing of expenditure to income ratio can be used as a reflection of regional government financial performance in decentralization system.

Since financial performance is an achievement measurement in financial aspect including income and regional expenditure, the financial performance could be reflected from the increasing of PAD income and efficiency of regional expenditure. Financial performance measurements are measured using financial ratios to APBD which the implementation has been set (Halim, 2007). Financial performance from income aspect could be measured using fiscal effort ratio, degree of decentralization, and financing viability, in which those ratios could be used as instruments of financial performance from income aspect since those ratios measure the optimization and spending of PAD, for example fiscal effort ratios to measure government effort in achieving PAD target to regional income and financing viability ratio to measure PAD viability in fulfilling regional needs. While financial performance from expenditure aspect is measured by expenditure to income ratio in which this ratio could measure the level of usage of income for development.

Furthermore, the increasing of PAD and expenditure to income ratio which reflect financial performance affects the escalation of income of a region. Meanwhile, when the income of a region is increasing, it will influence its expenditure as explained in the theory of government expenditure by Peacock and Wieszman. This theory explains that the increase of income causes the expenditure to increase. In decentralization, the increase of expenditure is expected to enhance spending in capital expenditure sector instead of routine expenditure. A research conducted by Vegassari (2011) explained that regional independence ratio and expenditure to income ratio has significant effect to capital expenditure in the following year.

The increase of capital expenditure is expected that it could enhance economic growth and decrease poverty in a certain region. The increase of capital could affect economic growth. This corresponds with growth classical theory in which explained that economic growth in a certain region could be influenced by four factors; they are population, technology, natural resource, and capital. By having one of those four factors, economic growth could be reached. A research conducted by Phan Minh Ngoc (2008) in Vietnam stated that technological advance statistically does not affect growth while capital has significant influence to economic growth.

Furthermore, based on the theory of backwardness and economic growth, it is explained that poverty in a certain region is caused by the difference of economic growth in two regions, in which one region has higher economic growth than in another region. As a result, this economic growth discrepancy causes capitals in the less growing region to transfer to the higher growing region which will impoverish the less growing region.

Finally, the increase of income stating regional financial performance could influence government expenditure in which will affect economic growth and lowering poverty. Thus, one of implementation goal of decentralization system, which called development of regions, could be achieved.

### 4. Research Methodology

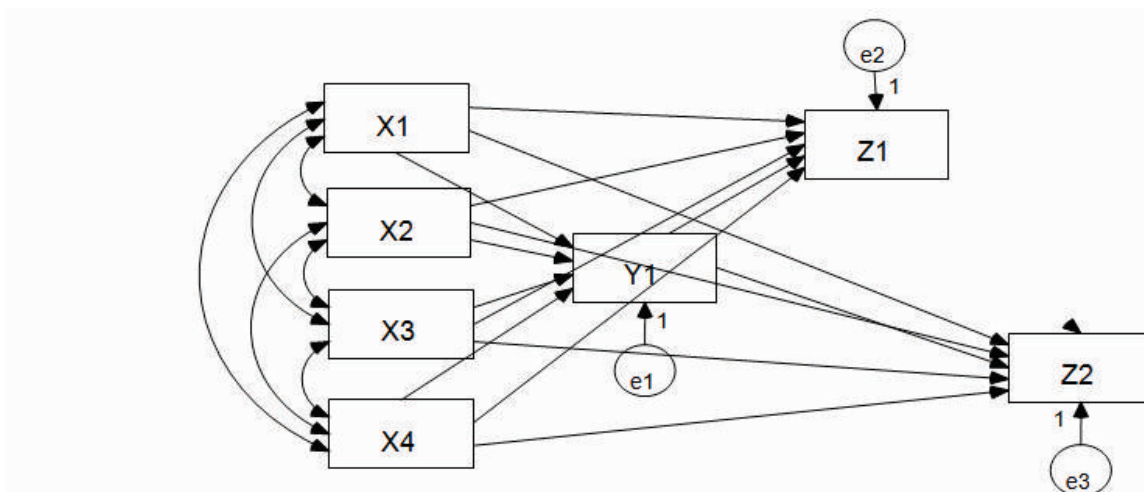
This research will analyze the effect of regional finance performance measured using degree of fiscal decentralization, fiscal effort, financial viability, and expenditure to income ratio to economic growth and poverty with capital through capital expenditure. This research will use descriptive qualitative approach. It will be conducted in regencies/cities in East Java with the details of 29 regencies and 9 cities.

The type of data used in this research is secondary data and panel data sources within 7 years from 2005 to 2011. The data prior to 2005 is not used because of different composition of expenditure. The sources of secondary data are from Directorate General of Fiscal Balance Ministry of Finance of the Republic of Indonesia and Publication Report of Central Bureau of Statistic of East Java Province. To fulfill the aim of this research, which is purposed to know the level of influence of regional financial performance variable to economic growth and

poverty, Path Analysis method is used.

Path Analysis Model in this research is as follows:

**Figure of Hypothesis Model**



Keterangan:

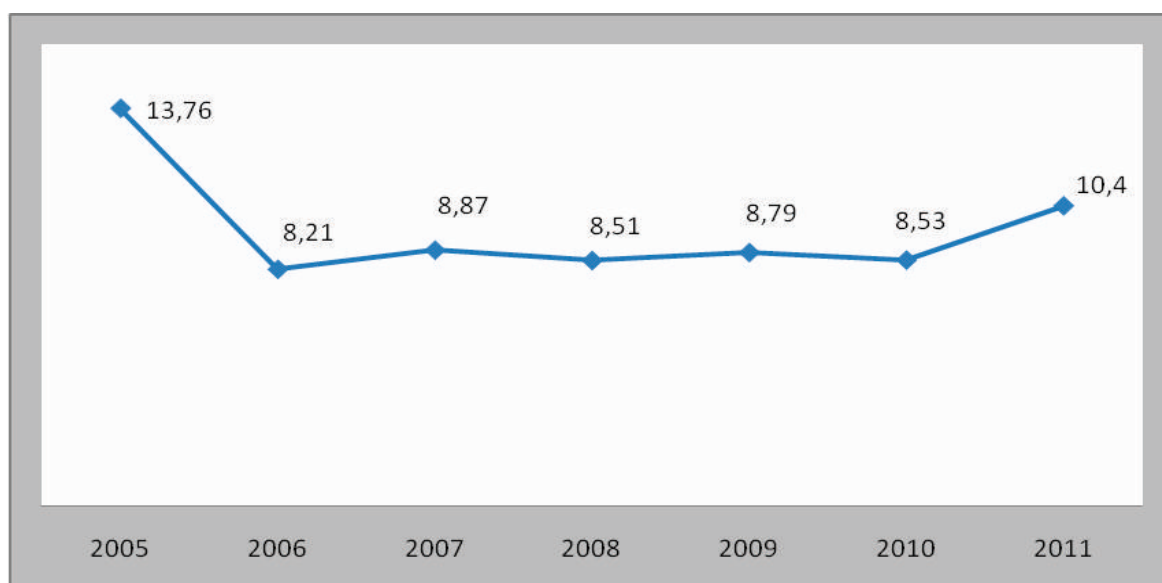
- $X_1$  = Expenditure to income ratio (RPP)
- $X_2$  = Fiscal effort (UP)
- $X_3$  = Financing viability (RKP)
- $X_4$  = Degree of fiscal decentralization (DDF)
- $Y_1$  = Capital Expenditure (BM)
- $Z_1$  = Economic Growth (PE)
- $Z_2$  = Poverty (TK)
- P = Path coefficient
- e = residual

## 5. Results and Discussion

In this research, the analysis result shows that there is indirect effect between financial performance measured through expenditure to income ratio, degree of fiscal decentralization, fiscal effort, and financing viability to economic growth and poverty level through capital expenditure. However, from the 4 variables which are used as measurement of financial performance, financing viability variable has insignificant effect to capital expenditure. The reason of insignificance of financing viability could be seen from the equation to calculate financing viability which is earned from PAD income divided by non-employee routine expenditure.

There are two reasons why financing viability has insignificant effect based on financing viability equation. First of all, from quantifier side which is PAD, in which in the development of PAD in regencies/cities in East Java Province is still classified as somewhat little, so that to use fund from PAD for spending activities is less likely to perform. The average of PAD proportion to total amount of income of regencies/cities in East Java from 2006 to 2011 could be seen from the graphs below.

**Figure of Average Proportion Trend of PAD to Income of Regencies/Cities in East Java Province from 2006-2011 (%)**

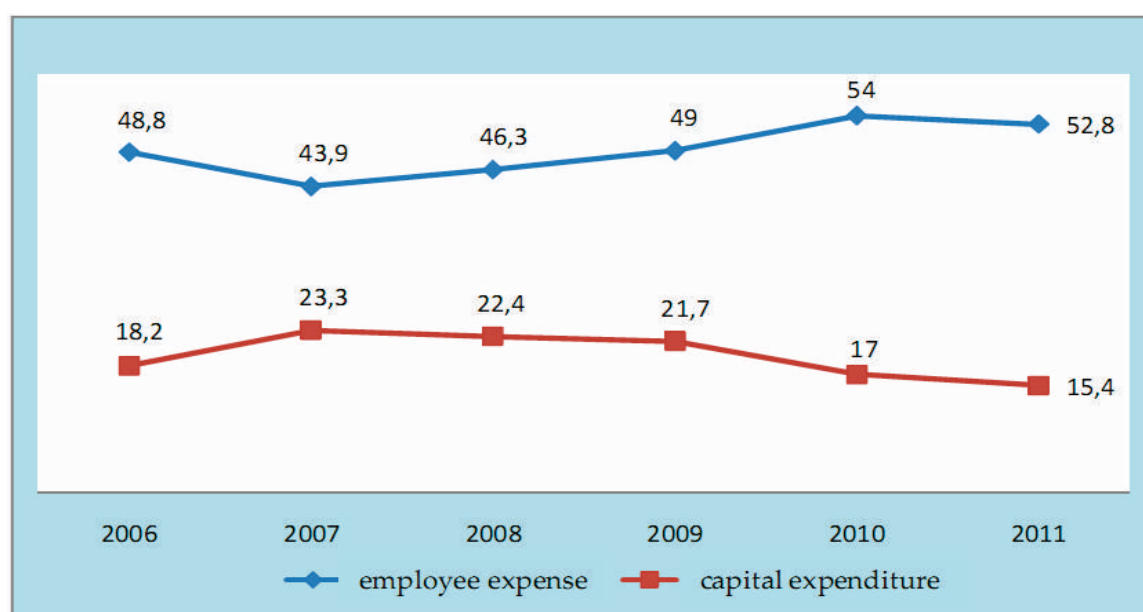


Source : DJPK (treated data)

Based on the graph above, it could be inferred that average proportion of PAD of regencies/cities in East Java Province from 2005 to 2011 is listed below 15%, in which within those years the highest proportion is in 2005 by 13,76% and the lowest is in 2006 by 8,21%.

Secondly, the reason of the insignificance of financing viability to capital expenditure is because of the spending of regencies/cities government in East java is spent more on employee expensethan capital expenditure. This could be seen from comparison between average proportions of employee expense and capital expense of the government from the graph below.

**Figure of Average Trend Comparison of Employee Expense and Capital Expenditure of Regencies/Cities in East Java Province within 2006-2011 (%)**



Source: DJPK (treated data)

The comparison between average proportion of employee expense and capital expenditure of regencies/cities in East Java is very significant. This is shown by the average proportion of employee expense from 2006 to 2011

which is always above 43%. On the contrary, the average proportion of capital expenditure is still below 25% from 2006 to 2011. The high average proportion of employee expenses is due to regional government who holds recruitment of civil servant every year. Furthermore, some civil servant who should have stopped working received a work extension so that it caused more expense for the employee expense.

In public theory, each government's expenditure could create economic growth. Government expenditure could be classified into, consumption and investment matter. When the government expenditure is for consumption, they will spend APBD (Regional Government Budget) for employee expense. In the other hand if government expense is for investment, they will spend APBD for capital expenditure. However, although both capital expenditure and employee expense could create economic growth, the pattern of economic growth is different.

Firstly, growth which is created from investment will only be able to be performed by regions which have massive income. The reason is that for spending the budget on investment, government should halt its consumption to increase future ability (revenue/wealth) so it can be inferred that for creating economic growth through investment is a creation of long term growth. Secondly, an economic growth created from employee expense is by paying employee's salary. By doing so, employees could perform consumption and while employee expense increase their consumption will increase. The economic growth created from employee expense may not create value added in the future because the goods consumed are not only produced domestically but also imported. Thus, the increase of consumption will not improve nation's productivity.

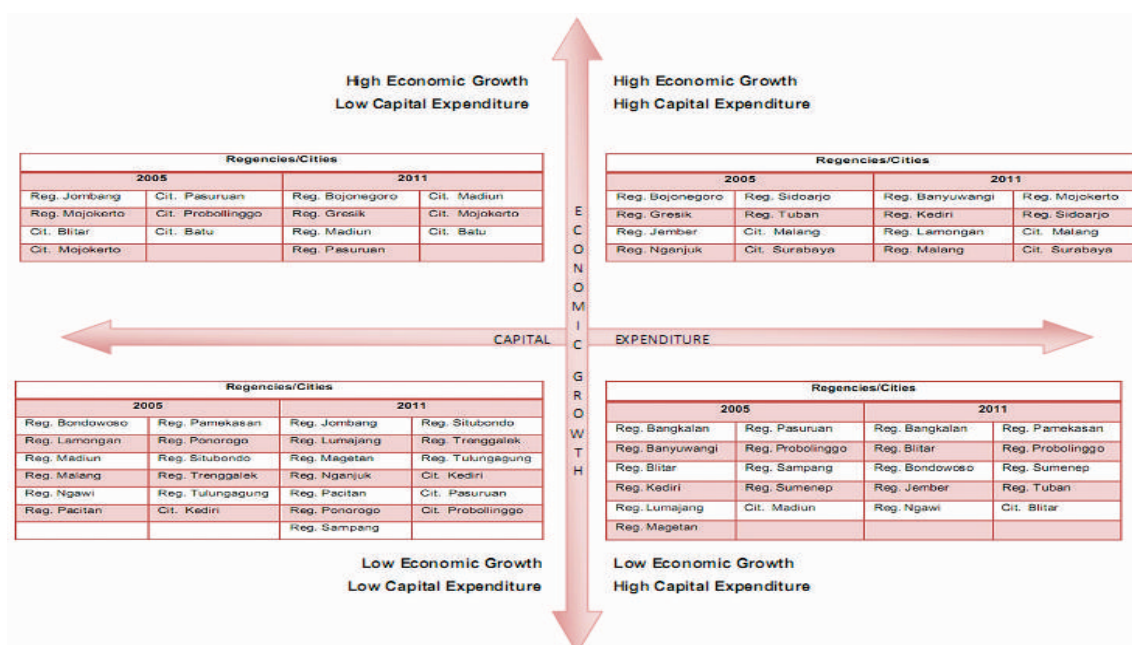
To explain the effect of each variable which is used as measurement of financial performance to economic growth and the level of poverty, especially through government expense from capital expenditure will be explained as follows:

Firstly, regional financial performance which is measured from degree of decentralization fiscal and fiscal effort (calculation mostly using PAD) has significant effect to economic growth and the level of poverty because PAD earned is used by regencies/cities government to fund capital expenditure. For example, the government of Surabaya has decreased its employee expense and spent more spending on physical infrastructure sector. This was purposely conducted to improve public facilities. For example, the installation of frontage road to reduce traffic jam (Ahmad Yani Street in specific) and repair road facilities access to Bung Tomo Stadium in which, there are many economic activities, which is done by the citizen, are occurred. One of the example in this case is many small scale vendors sells around Bung Tomo stadium so if the road access is improved, the vendors will be easier to sell their goods, because there will be more consumers coming due to easy access to this stadium.

Regional financial performance is measured using expenditure to income ratio has significant effect to capital expense. This is because of expenditure to income ratio means government could know the capability of excess income. Remembering that expenditure to income ratio will be used in order to know the amount of fund needed to expense, so that excess income could be used for new expenses which are purposed for social welfare. One of the cities in East Java which has high amount of excess income is Surabaya. The high amount income excess automatically increases income in the following year. That income increase will affect the amount of spending regulated in regulation, such as health expense through JAMKESMAS program and educational expense through improvement of school building, school facilities, and allocation of school operational aid. By health programs, poor people could get free health services, while by education expenses, Surabaya could get high quality of young generation who could help build their region in the future.

The correlation between financial performance variable to economic growth and poverty is similar to a research conducted by Dharmendra Dhakal, Gyan Pradhan, Kapal P Upadhyaya (2009) stated that in NRPP1, domestic capital has significant effect to economy while foreign investment does not have much significance. To know the correlation between capital expenditure owned by a region to economic growth and poverty could be seen in the graph below.

**Figure of Quadrant of Correlation of Capital Expenditure to Economic Growth of Regencies/Cities in East Java within 2005 and 2011**



Source: DJPK and BPS (treated data)

Based on quadrant comparison between economic growth and capital expenditure in regencies/cities in East Java in 2005 and 2011, it could be seen that the total of regencies/cities in East Java was changed. In 2005 and 2011, the highest number of regencies/cities in East Java was inside quadrant III which meant that the growth of economic and capital expenditure was low. In 2005, the number of regencies/cities was 12 while in 2011 increased to 13 regencies/cities. By this increase in quadrant III, it shows that there is a close correlation between capital expenditure and economic growth. Since there were many regencies/cities in East Java in 2011 which had below average capital expenditure, it also indicated that the effect of decentralization to capital expense has not been significant yet.

Furthermore, based on the figure above, according to quadrant I which has high economic growth and high capital expenditure, the number of regencies/cities in East Java within quadrant I in 2005 and 2011 are 8 regencies/cities and they are still the same. Although the number of regencies/cities was at the same in 2005 and 2011, the number of regencies/cities classified in quadrant I had much difference. The number of regencies/cities classified in quadrant I in 2005 and 2011 were only 2 cities and those were Malang and Surabaya.

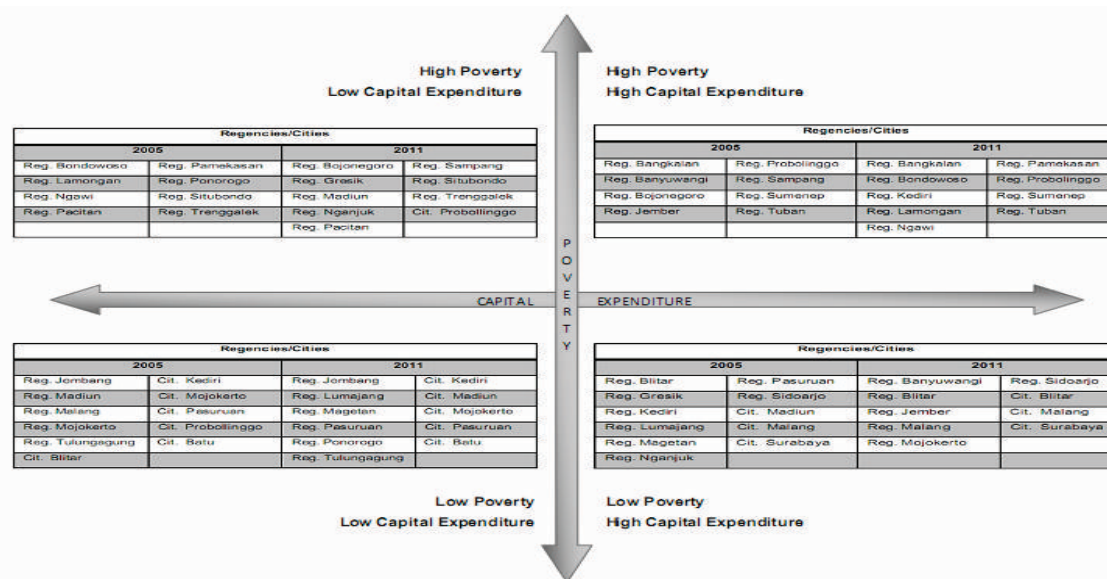
In quadrant II, which is the quadrant of regencies/cities has high economic growth and low capital expenditure. The number of regencies/cities classified in this quadrant in 2005 and 2007 are 7 regencies/cities. However, as in quadrant I, regencies/cities which are still in the same quadrant in 2005 and 2011 are only Mojokerto and Batu while in the other region there are regions that have an increase of capital expenditure, even though the economic growth stays high such as in Mojokerto. There are also regencies/cities which has constant capital expenditure and lower economic growth such as in Pasuruan and Probolinggo.

Then for the last quadrant is in quadrant IV It has a meaning of low growth but high capital expenditure, there is a decrease from 2005 to 2011, in which in 2005 the regencies/cities belong to this quadrant is 11 while in 2011 decrease to 10. There are only 4 regencies/cities which stay in quadrant IV; they are Bangkalan, Blitar, Probolinggo, and Tuban. Since there are regencies/cities in quadrant IV in 2011 it means that there are mismanagement conducted by the government, in which management means for spending and designation.

The correlation between capital expenditure and poverty in regencies/cities in East Java in 2006 and 2011, could be seen in the quadrant below.



### Quadrant of Correlation of Capital Expenditure and Poverty of Regencies/Cities in East Java Province in 2005 and 2011



Source: DJPK and BPS (treated data)

Based on quadrant above, it could be known that in 2005 the number of regencies/cities classified in quadrant III and IV are at the same of 11 regencies/cities, while in 2011 more regencies is classified in quadrant III and less in quadrant IV. It shows that there was a change in capital expenditure but those changes do not necessarily able to reduce poverty as expected. The progress of each quadrant in 2005 and 2011 will be explained as follows:

First of all, to compare quadrant I which shows high poverty level and high capital expenditure in 2005 and 2011, there was an increasing in regencies/cities from 8 regencies/cities in 2005 in 9 regencies/cities in 2011. The increase in quadrant I explain that capital expenditure which had been spent in 2005 to 2011 could not reduce poverty but increase their poverty instead. Regencies/cities classified in quadrant I within those years are Bangkalan Regency, Probolinggo Regency, Sumenep Regency, and Tuban Regency while regencies/cities which the development declines from quadrant IV to quadrant I is Kediri.

Secondly, the development of quadrant II which mean regencies/cities which have high poverty but low capital expenditure between 2005 and 2011 has also increased from 8 regencies/cities in 2005 to 9 regencies/cities in 2011. From 9 regencies/cities in quadrant II there is only one regency which hve stayed since 2005; they are Pacitan Regency, Situbondo Regency, and Trenggalek Regency. Meanwhile, regencies/cities which show signiffcant influence of capital expenditure to poverty level is Gresik Regency and Nganjuk regency. These regencies had high capital expenditure causing low poverty in 2005 and in 2011 capital expenditure were reduced so it is affecting the increase of poverty level.

The third, the progress of quadrant III which means low capital expenditure and low poverty level in 2005 and 2011 has the same number of 11 regencies/cities. Regencies/cities which stay in quadrant III in 2005 and 2011 are Jombang Regency, Tulungangng Regency, Kediri city, Mojokerto City, Pasuruan City, and Batu City. Since there are many regencies/cities in quadrant III, it means that all this time, regional government of those regencies/cities use certain regulations unrelated to capital expenditure to reduce poverty instead capital expenditure.

Fourthly, the progress of quadrant IV means that regencies/cities have high capital expenditure and low poverty level between 2005 and 2011. The number of regencies/cities in this quadrant reduced from 11 regencies/cities in 2005 to 9 regencies/cities in 2011. It could be concluded that the development which is conducted by the government in decentralization system has unsatisfying result. In decentralization system, capital expenditure should have been spent more to reduce poverty in the region.

Based on quadrant of correlation between capital expenditure to capital economic and poverty level, there is a change of capital expenditure between 2005 and 2011 in some regencies/cities of East Java. This change is influenced by 2 problems. The first problem is because of the difference of pattern of government spending, in which the previous year government spending is spent mostly for consumption while in the following year the

government spending is mostly spent for investment of capital expenditure. The second problem is because of the increase of government income rate so that this income is expected to give more benefit in the future.

## 6. Conclusion

This research is aimed to find out the effect of regional financial performance by measuring expenditure to income ratio, degree of fiscal decentralization, fiscal effort, and financing viability to economic growth and poverty level through capital expenditures in 38 regencies/cities of East Java. Based on the analysis results and discussions in the previous chapter, it could be concluded that not all measurement of financial performance which is measured by expenditure to income ratio, degree of fiscal decentralization, fiscal effort, and financing viability has indirect effect to economic growth and poverty level in 38 regencies/cities of East Java by going through capital expenditure variable. From those 4 financial performance measurements, only 3 that have positive effect to economic growth and negative effect to poverty level and those are expenditure to income ratio, degree of fiscal decentralization, and fiscal effort. This result is called as inconsistent with hypothesis stated in this research because the financing viability has insignificant effect to economic growth and poverty level.

Based on the previous conclusion, this following few suggestions could be specially delivered to regional government:

- 1) Although 3 variables of financial performance which consist of degree of fiscal decentralization, fiscal effort, and expenditure to income ratio has significant direct or indirect effect to capital expenditure, economic growth, and poverty level, in fact those three financial performance variable are still unsatisfying. In order to have more significant effects, it is suggested to improve PAD management because PAD is one of influential aspect to regional financial performance. The improvement of PAD management could be performed by some ways, for example by complying to regulation, stricter sanction, improvement in apparatus capability and if it is necessary, reassessment of UU no 28 of 2009 about tax and regional retribution should be done.
- 2) Financial viability variable is insignificant to capital expenditure and economic growth and has positive impact to poverty. In order to strengthen financing viability in the future, optimization in items of APBD, such as from income aspect, could optimize available SILPAs (financial surplus). This is because most of regencies/cities in East Java have a high amount of SILPA so that it could be used well. Moreover, to strengthen regional government income, when the resource owned is very low, the government should be able to perform regional rent which has to fulfill the requirement to do so. Optimization from expenditure aspect, regional government should reassess the previous expenses. So that in the future, those expenses could be used for long term and could add more values instead of only for short term.

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