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THE EFFECT OF BALANCING FUNDS AND CAPITAL EXPENDITURE ON THE FINANCIAL PERFORMANCE OF CITY GOVERNMENTS IN EAST JAVA

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Abstract

This study aims to examine the effect of balancing funds and capital expenditure on financial performance. A quantitative approach with an associative research design was employed. The population consists of city governments in East Java Province, with a sample of seven cities selected using purposive sampling, resulting in 21 observations during the 2022–2024 period. Data were collected through documentation and analyzed using the SEM-PLS method. The results show that both balancing funds and capital expenditure do not have a significant effect on financial performance. In terms of direction, balancing funds have a negative relationship, while capital expenditure has a positive relationship, although both are statistically insignificant. The coefficient of determination (R^2 = 0.182) indicates that these variables explain only 18.2% of financial performance, while the remaining 81.8% is influenced by other factors outside the model.

Keywords: *Balanced Funds, Capital Expenditure, Financial Performance*

1. INTRODUCTION

The implementation of decentralization in Indonesia provides greater authority for regional governments in managing financial affairs (UU No. 23, 2014). However, in practice, financial management remains suboptimal due to limitations in fiscal capacity and managerial capability, leading to mismatches between budget targets and realization (Putri & Herawati, 2022). This condition is reflected in city governments in East Java during 2022–2024, where budget absorption remains uneven and indicates less optimal financial performance.

The budget absorption data presented in Table 1.1 indicates an average realization of around 89%, indicating that planning and implementation are not yet fully effective. This situation is also influenced by the revenue structure, which is still dominated by balancing funds from the central government.

Table 1. 1 Comparison of City Government Budgets and Realizations in East Java Province 2022-2024

YEAR	CITY	BUDGET	REALIZATION	% ABSORPTION
2022	Surabaya	Rp10.636.827.593.321,00	Rp9.448.236.778.683,50	89%
	Malang	Rp2.545.685.224.017,00	Rp2.188.318.745.870,33	86%
	Kediri	Rp1.873.584.434.592,00	Rp1.482.748.596.777,33	79%
	Mojokerto	Rp1.197.460.466.254,00	Rp1.064.223.652.876,43	89%
	Pasuruan	Rp1.061.506.656.840,00	Rp939.274.546.104,50	88%
	Probolinggo	Rp1.263.103.482.080,00	Rp1.080.134.068.338,53	86%
	Madiun	Rp1.310.574.608.272,00	Rp1.165.410.106.455,26	89%
2023	Surabaya	Rp10.821.334.252.595,00	Rp9.543.590.902.934,50	88%
	Malang	Rp2.829.655.226.955,00	Rp2.596.706.284.209,93	92%
	Kediri	Rp1.920.256.048.812,00	Rp1.566.450.723.233,00	82%
	Mojokerto	Rp1.211.286.652.880,00	Rp1.113.313.472.916,49	92%
	Pasuruan	Rp1.153.911.589.473,00	Rp1.010.778.967.728,92	88%
	Probolinggo	Rp1.116.603.394.169,00	Rp1.016.894.990.872,63	91%
	Madiun	Rp1.280.060.781.955,00	Rp1.194.903.395.527,39	93%
2024	Surabaya	Rp11.500.368.580.693,00	Rp9.998.040.835.382,49	87%
	Malang	Rp2.620.698.813.849,00	Rp2.455.641.071.583,72	94%
	Kediri	Rp1.891.393.326.713,00	Rp1.558.866.792.688,00	82%
	Mojokerto	Rp1.091.813.690.658,00	Rp1.029.380.997.073,17	94%
	Pasuruan	Rp1.140.715.996.510,00	Rp1.054.171.463.379,27	92%
	Probolinggo	Rp1.099.642.611.061,00	Rp1.039.189.025.613,39	95%
	Madiun	Rp1.246.786.210.085,00	Rp1.172.206.504.141,49	94%
AVERAGE				**89%**

Source: Report on City Government Budget Realization in East Java Province (processed data, 2026)

Table 1. 2 Proportion of City Government Balancing Funds in East Java 2022–2024

YEAR	CITY	BALANCING FUND	TOTAL INCOME	PERCENTAGE
2022	Surabaya	Rp2.475.155.880.738,00	Rp8.791.308.679.482,20	28%
	Malang	Rp1.164.294.384.628,00	Rp2.171.753.404.373,60	54%
	Kediri	Rp986.070.144.312,00	Rp1.453.556.698.954,24	68%
	Mojokerto	Rp564.749.435.829,79	Rp916.439.416.602,17	62%
	Pasuruan	Rp626.097.743.201,00	Rp911.656.871.775,11	69%
	Probolinggo	Rp652.144.647.692,00	Rp955.089.232.636,99	68%
	Madiun	Rp668.609.902.487,00	Rp1.060.716.311.084,55	63%
2023	Surabaya	Rp2.564.776.881.262,00	Rp9.604.779.764.405,37	27%
	Malang	Rp1.233.407.465.441,00	Rp2.344.815.945.277,81	53%
	Kediri	Rp974.723.803.335,00	Rp1.478.072.837.268,00	66%
	Mojokerto	Rp609.735.022.212,00	Rp1.007.952.645.674,44	60%
	Pasuruan	Rp635.710.664.212,00	Rp941.695.238.574,70	68%
	Probolinggo	Rp634.206.402.044,00	Rp968.433.112.167,29	65%
	Madiun	Rp666.070.630.012,80	Rp1.117.612.130.232,42	60%
2024	Surabaya	Rp2.814.643.777.326,00	Rp10.034.448.255.551,40	28%
	Malang	Rp1.288.635.522.105,00	Rp2.465.737.922.935,90	52%
	Kediri	Rp971.768.094.258,00	Rp1.507.326.107.383,27	64%
	Mojokerto	Rp599.335.996.564,00	Rp1.000.058.776.830,36	60%
	Pasuruan	Rp648.726.164.052,00	Rp970.175.327.046,91	67%
	Probolinggo	Rp656.882.353.121,00	Rp992.701.449.220,29	66%
	Madiun	Rp725.271.874.685,63	Rp1.171.513.055.718,60	62%
AVERAGE				**58%**

Source: Report on City Government Budget Realization in East Java Province (processed data, 2026)

Based on Table 1.2, balancing funds still dominate the revenue structure of city governments in East Java Province, contributing an average of 58% of total regional revenue.

Most cities, such as Kediri, Mojokerto, Pasuruan, Probolinggo, and Madiun, have a proportion above 50%, approaching 70%, indicating a high dependence on central government transfers. In contrast, Surabaya City recorded a lower proportion, around 27–28%, reflecting a relatively higher level of fiscal independence. This difference indicates an imbalance in financial capacity between regions and indicates that the dominance of balancing funds has the potential to impact local government financial performance.

Table 1. 3 Proportion of Capital Expenditure to Total Regional Expenditure by City Governments in East Java Province 2022–2024

YEAR	CITY	CAPITAL EXPENDITURE	TOTAL REGIONAL EXPENDITURE	PERCENTAGE
2022	Surabaya	Rp1.766.030.466.528,00	Rp9.448.236.778.683,50	19%
	Malang	Rp310.813.569.513,00	Rp2.188.318.745.870,33	14%
	Kediri	Rp169.126.180.227,31	Rp1.482.748.596.777,33	11%
	Mojokerto	Rp261.761.638.363,59	Rp1.064.223.652.876,43	25%
	Pasuruan	Rp129.718.487.434,85	Rp939.274.546.104,50	14%
	Probolinggo	Rp250.674.126.301,82	Rp1.080.134.068.338,53	23%
	Madiun	Rp232.434.449.701,97	Rp1.165.410.106.455,26	20%
2023	Surabaya	Rp1.671.895.816.185,00	Rp9.543.590.902.934,50	18%
	Malang	Rp405.779.018.058,00	Rp2.596.706.284.209,93	16%
	Kediri	Rp198.705.950.406,00	Rp1.566.450.723.233,00	13%
	Mojokerto	Rp229.515.774.166,00	Rp1.113.313.472.916,49	21%
	Pasuruan	Rp146.150.795.740,00	Rp1.010.778.967.728,92	14%
	Probolinggo	Rp112.290.783.286,00	Rp1.016.894.990.872,63	11%
	Madiun	Rp217.790.302.662,69	Rp1.194.903.395.527,39	18%
2024	Surabaya	Rp1.897.241.994.668,00	Rp9.998.040.835.382,49	19%
	Malang	Rp191.931.112.915,68	Rp2.455.641.071.583,72	8%
	Kediri	Rp152.123.432.240,00	Rp1.558.866.792.688,00	10%
	Mojokerto	Rp147.874.897.358,00	Rp1.029.380.997.073,17	14%
	Pasuruan	Rp127.858.320.269,00	Rp1.054.171.463.379,27	12%
	Probolinggo	Rp75.418.956.796,94	Rp1.039.189.025.613,39	7%
	Madiun	Rp159.166.507.474,73	Rp1.172.206.504.141,49	14%
AVERAGE				**15%**

Source: Report on City Government Budget Realization in East Java Province (processed data, 2026)

Based on Table 1.3, the proportion of capital expenditure in city governments in East Java remains relatively low and has not reached the expected allocation standard, indicating that regional spending is still dominated by operational expenditure. This condition suggests limited investment in infrastructure and public services, which may constrain regional development. Ideally, capital expenditure should receive a larger allocation as regulated in Law No. 1 of 2022 (UU No. 1, 2022). In addition, the high dependence on balancing funds reflects a gap between actual financial management practices and expected standards.

Empirical studies also show inconsistent findings regarding the effect of capital expenditure on financial performance. Some studies find no significant effect Atmoko & Khairudin (2022), while others report a positive influence Ratnasari & Meirini (Ratnasari & Meirini, 2022), indicating the need for further investigation. However, limited studies focus specifically on city-level governments in East Java using SEM-PLS analysis to examine the effect of balancing funds and capital expenditure on financial performance. Therefore, this

study aims to analyze the effect of balancing funds and capital expenditure on the financial performance of city governments in East Java Province during the 2022–2024 period.

LITERATURE REVIEW

Agency Theory

Agency theory explains the relationship between the principal, the party granting the mandate, and the agent, the party carrying out the mandate (Jensen & Meckling, 1976). In the public sector context, this theory is used to understand the relationship between the central government and regional governments, where each party can have different interests (Sutisman et al., 2024).

The Balancing Fund

The Balancing Fund is a fund sourced from the State Budget and allocated to regional governments to support financing for regional needs and the implementation of decentralization (Adinata, 2022). This fund is also a key component of the regional revenue structure, contributing significantly to the Regional Budget (Kulsum & Wijaya, 2023). Its primary objective is to reduce fiscal disparities between regions and increase the capacity of regional governments to carry out government functions effectively and efficiently (UU No. 1, 2022).

Capital Expenditures

Capital expenditures are government expenditures used for investment in the procurement or construction of fixed assets to support the provision of public facilities and infrastructure (Permatasari & Trisnaningsih, 2022). This expenditure aims to increase the value of regional assets and provide long-term benefits to the government and the public. Capital expenditures include the procurement or improvement of assets such as land, buildings, equipment, and infrastructure (roads, irrigation, and networks), thus playing a crucial role in improving the quality of public services.

Regional Government Financial Performance

Regional Government Financial Performance reflects a local government's ability to manage and implement finances in accordance with budget planning (Rohanda & Azhar, 2023).This performance is generally measured through financial ratio indicators that reflect fiscal capacity and the region's level of independence. In addition to serving as an evaluation tool, financial performance also demonstrates the local government's ability to optimize revenue sources and support development financing. In this study, financial performance measurement focused on the regional independence ratio and degree of decentralization (Wicaksono & Sigalingging, 2024).

Hypothesis Development

H1: Balancing funds have a significant effect on financial performance.
H2: Capital expenditure has a significant effect on financial performance.

2. RESEARCH METHOD

This study employs a quantitative approach to examine the effect of balancing funds and capital expenditure on financial performance. The population consists of city governments in East Java Province during the 2022–2024 period. Using purposive sampling based on data availability, the study obtained 21 observations from 7 cities: Surabaya, Malang, Kediri, Mojokerto, Pasuruan, Probolinggo, and Madiun.

Table 2. 1 Sample Selection Reconciliation

Number	Criteria	Not Eligible	Eligible
1.	Cities located in East Java Province	0	9
2.	The city government publishes the complete 2022–2024 Budget Realization Report (LRA) on its official website.	2	7
	Total Sample		**7**
	Total Data Processed (2022-2024)		**21**

Source: processed data 2026

The study uses secondary data from audited Regional Government Financial Statements (LKPD), particularly Budget Realization Reports (LRA), collected from official city government websites. The data cover balancing funds and capital expenditure for the 2022–2024 period and were gathered through documentation techniques.

Data analysis is conducted using Structural Equation Modeling–Partial Least Squares (SEM-PLS) with SmartPLS 4.0. The analysis includes descriptive statistics, evaluation of the measurement model (outer model), evaluation of the structural model (inner model), and hypothesis testing.

This study uses balancing funds and capital expenditures as independent variables, and financial performance as the dependent variable. Balancing funds are measured based on total intergovernmental transfers, while capital expenditures are measured based on the proportion of capital expenditures to total expenditures. Financial performance in this study is measured based on two indicators: the degree of decentralization ratio and the regional independence ratio. The structural model examines the effect of balancing funds and capital expenditures on financial performance using the SEM-PLS approach.

3. RESULTS AND DISCUSSION

Descriptive Statistical Analysis Results

Table 3. 1 Descriptive Statistical Analysis Results

Name	No.	Type	Missings	Mean	Median	Scale min	Scale max	Observed min	Observed max	Standard deviation	Excess kurtosis	Skewness	Cramér-von Mises p value
X1	1	MET	0	698.190.192.810	619.089.878.000	267.031.306.000	3.183.471.047.000	267.031.306.000	3.183.471.047.000	571.177.408.265	18.507	4.164	0.000
X2	2	MET	0	131.896.469.524	142.033.043.000	7.257.482.000	245.964.876.000	7.257.482.000	245.964.876.000	69.055.776.264	-0.356	-0.548	0.137
KK_1	3	MET	0	490.822.265.286	331.714.847.000	27.651.629.000	1.559.767.515.000	27.651.629.000	1.559.767.515.000	438.688.897.071	2.449	1.923	0.000
KK_2	4	MET	0	236.991.176.476	237.586.136.000	1.000	609.339.522.000	1.000	609.339.522.000	186.994.908.449	-0.048	0.711	0.070

Source: processed data 2026

Descriptive statistical analysis is used to provide an overview of the data characteristics, including measures such as mean, standard deviation, and data distribution. This study examines balancing funds (X1) and capital expenditure (X2) as independent variables, and financial performance (Y) as the dependent variable, measured by the regional independence ratio (KK_1) and the degree of decentralization ratio (KK_2).

The results indicate that balancing funds have the highest average value with greater variability, reflecting differences in transfers across regions. In contrast, capital expenditure shows a lower mean with a more stable distribution, indicating relatively consistent spending patterns.

For financial performance, KK_1 exhibits higher variability and a less normal distribution, suggesting differences in regional independence, while KK_2 shows a more stable and normally distributed pattern. Overall, the variables demonstrate different characteristics, which may affect their relationship with financial performance.

Outer Model Analysis Results

1) Convergent Validity

The outer model evaluation in this study includes convergent validity testing to assess the extent to which indicators represent their respective constructs. An indicator is considered valid if it has an outer loading value greater than 0.7.

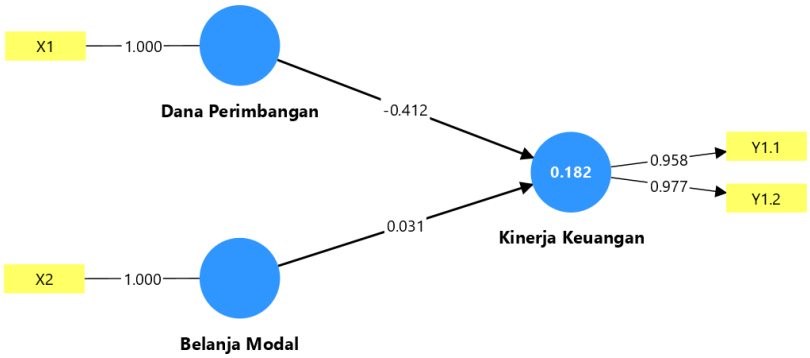

Figure 3. 1 SmartPLS Algorithm Results

Source: processed data 2026

Table 3. 2 Convergent Validity Test Results

	Capital Expenditures	Balancing Fund	Financial Performance
X1.		1,000	
X2.	1,000		
Y1.1			0,958
Y1.2			0,977

Source: processed data 2026

The results show that all indicators meet this criterion, indicating that they are valid and suitable for inclusion in the model. Variables with a single indicator exhibit a loading

value of 1.000, as they are directly measured by that indicator. In addition, convergent validity is also evaluated using the Average Variance Extracted (AVE), where a value above 0.5 indicates adequate validity.

Table 3. 3 AVE Value Test Results

	Average Variance Extracted (AVE)
Financial Performance	0,936

Source: processed data 2026

The results demonstrate that the financial performance variable meets this threshold, confirming that its indicators are valid. Meanwhile, AVE is not separately assessed for variables with a single indicator.

2) Discriminant Validity

Discriminant validity testing is conducted to ensure that each construct is distinct from others. This is assessed using cross-loading values, where an indicator is considered valid if it has a higher loading on its assigned construct than on other constructs.

Table 3. 4 Discriminant Validity Test Results

	Capital Expenditures	Balancing Fund	Financial Performance
X1	-0,445	1,000	-0,426
X2	1,000	-0,445	0,214
Y1.1	0,274	-0,336	0,958
Y1.2	0,158	-0,469	0,977

Source: processed data 2026

The results indicate that all indicators meet this criterion, as each shows the highest loading on its respective variable. Therefore, all constructs in this study are confirmed to have adequate discriminant validity.

3) Composite Reliability

Composite reliability is used to assess the internal consistency of constructs. A variable is considered reliable if it has a composite reliability value above 0.70.

Table 3. 5 Composite Reliability Test Results

	Composite reliability (rho_a)	Composite reliability (rho_c)
Financial Performance	0,995	0,967

Source: processed data 2026

The results show that all constructs meet this criterion, indicating good reliability. In this study, only the financial performance variable is evaluated, as it consists of multiple indicators, while other variables with single indicators are not separately assessed.

4) Cronbach's Alpha

Cronbach's Alpha is used to evaluate the internal consistency of indicators within a construct. A variable is considered reliable if the Cronbach's Alpha value is at least 0.70.

Table 3. 6 Cronbach's Alpha Test Results

	Cronbach's alpha
Financial Performance	0,933

Source: processed data 2026

The results indicate that the financial performance variable meets this threshold, confirming good reliability. Variables with a single indicator are not separately assessed in this test.

Inner Model Analysis Results

1) R-Square (R^2)

The R-square test is used to measure the extent to which independent variables explain the dependent variable. A higher R^2 value indicates greater explanatory power of the model.

Table 3. 7 R-Square (R^2) Test Results

	R-square	R-square adjusted
Financial Performance	0,182	0,092

Source: processed data 2026

The results show that the R^2 value for financial performance is 0.182, meaning that 18.2% of its variation is explained by the independent variables, while the remaining 81.8% is influenced by other factors outside the model.

2) Path Coefficients

Table 3. 8 Path Coefficients Test Results

	Path coefficients
Capital Expenditures -> Financial Performance	0,031
Balancing Fund -> Financial Performance	-0,412

Source: processed data 2026

Path coefficients indicate the direction of the relationship between variables. The results show that capital expenditure has a positive direction, while balancing funds have a negative direction toward financial performance. However, both variables are not statistically significant, indicating that they do not have a significant effect on financial performance.

3) F-Square

Table 3. 9 F-Square Test Results

	f-square
Capital Expenditures -> Financial Performance	0,001
Balancing Fund -> Financial Performance	0,167

Source: processed data 2026

The f-square test measures how strong the influence of each independent variable is on the dependent variable. The results show that capital expenditure has a very small effect on financial performance ($f^2 = 0.001$). In contrast, balancing funds have a moderate effect ($f^2 = 0.167$).

Hypothesis Test Results

Table 3. 10 Hypothesis Test Results

	Original sample (O)	Sample mean (M)	Standard deviation (STDEV)	T statistics (O/STDEV)	P values
Capital Expenditures -> Financial Performance	0,031	-0,020	0,171	0,180	0,857
Balancing Fund -> Financial Performance	-0,412	-0,624	0,277	1,489	0,137

Source: processed data 2026

Hypothesis testing uses a significance level of 0.05, where a p-value above 0.05 means there is no significant effect. The results show that capital expenditure does not significantly affect financial performance ($p = 0.857$). Likewise, balancing funds also do not have a significant effect ($p = 0.137$). In simple terms, both variables do not have a meaningful impact on financial performance.

3.1 The Impact of Balanced Funds on Financial Performance

Balancing funds are transfers from the central government to local governments, including DAU, DAK, and DBH, aimed at supporting regional financing. The results show that balancing funds do not have a significant effect on financial performance ($\beta = -0.412$; $t = 1.489$; $p = 0.137$), indicating that their contribution is not statistically meaningful. This finding is consistent with Dhicky & Kusuma (2023), who also found no significant effect.

This result differs from the initial hypothesis, which assumed a positive influence. The finding suggests that the effectiveness of balancing funds depends on how well they are managed, including planning, spending priorities, and financial management. In other words, large transfers alone do not guarantee improved financial performance without optimal

management. This is also supported by Rizqi & Hanifa (2025), who emphasize that financial performance is more influenced by management effectiveness and fiscal independence.

3.2 The Impact of Capital Expenditure on Financial Performance

Capital expenditure represents government spending on infrastructure and fixed assets aimed at improving public services and fiscal performance. However, the results show that capital expenditure does not have a significant effect on financial performance (β = 0.031; t = 0.180; p = 0.857). This indicates that its impact is not statistically meaningful, which is consistent with (Ardelia et al., 2022).

These findings contradict the initial hypothesis, which assumed a positive relationship between capital expenditure and financial performance. This condition implies that the magnitude of capital expenditure alone is insufficient to enhance regional financial performance. The effectiveness of capital expenditure is highly dependent on the quality of planning, the appropriateness of development priorities, and the efficiency of budget management. Without strategic allocation, the impact of capital expenditure on financial performance tends to be limited. This is supported by Afonso et al., (2024) who argue that public sector performance is more strongly influenced by expenditure efficiency rather than the size of government spending itself.

4. CONCLUSION

This study examines the effect of balancing funds and capital expenditure on the financial performance of city governments in East Java. The results indicate that both balancing funds and capital expenditure do not have a significant effect on financial performance during the 2022–2024 period. In terms of direction, balancing funds show a negative relationship, while capital expenditure shows a positive relationship; however, both are statistically insignificant.

The coefficient of determination (R^2 = 0.182) suggests that these variables explain only a small portion of financial performance, while the majority is influenced by other factors outside the model. These findings imply that the size of transfers and capital spending alone is insufficient to improve financial performance without effective planning, proper prioritization, and sound financial management.

Despite these findings, this study is limited by the use of only two independent variables, a relatively small sample size, and a short observation period. Therefore, future research is recommended to include additional variables, expand the research scope, and use a longer time frame. For policymakers, improving budget planning, allocation, and oversight is essential to enhance financial performance outcomes. In this context, this study contributes to the existing literature by emphasizing that the effectiveness of financial management plays a more critical role than the magnitude of fiscal transfers and capital expenditure in determining regional financial performance, particularly in the context of local governments in East Java.

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