Determinants of Local Government Financial Condition: The Moderating Role of Political Governance

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ABSTRACT:
The financial condition of local governments has become an important indicator of fiscal sustainability, particularly in decentralized countries where regional governments are expected to provide public services while maintaining sound financial management. This study investigates the effects of economic growth, poverty, local own-source revenue (PAD), and population on the financial condition of provincial governments in Indonesia. It also examines whether political governance, represented by the Indonesian Democracy Index (IDI), influences the relationship between economic conditions and regional financial condition. The study uses balanced panel data from 34 Indonesian provinces during the 2022–2024 period. Local government financial condition is measured using the Financial Condition Index (FCI), which reflects fiscal solvency, financial flexibility, financial independence, and service-level solvency. The proposed relationships are estimated using a fixed-effects panel regression model with cluster-robust standard errors, while interaction terms are incorporated to assess the moderating role of political governance. The results show that poverty significantly weakens local government financial condition, whereas population has a positive and significant effect. Economic growth and PAD, however, do not exhibit a direct influence on financial condition. The findings further reveal that political governance significantly moderates the relationship between economic growth and financial condition, indicating that stronger democratic governance reduces the positive fiscal impact of economic growth. In contrast, political governance does not significantly moderate the relationship between poverty and financial condition. These findings suggest that improving democratic governance alone is not sufficient to strengthen regional financial health. Sustainable fiscal performance also depends on stronger fiscal management, more efficient public spending, and institutional arrangements that enable economic growth to be translated into long-term financial resilience. This study

contributes to the literature by demonstrating that political governance serves as a contextual institutional mechanism shaping the fiscal consequences of economic conditions, extending the integration of Fiscal Federalism Theory and Institutional Theory in explaining local government financial condition.

Keywords: Local Government Financial Condition; Political Governance; Indonesian Democracy Index; Fiscal Federalism; Institutional Theory; Panel Data.

Introduction

Fiscal decentralization has become one of the most significant public sector reforms implemented in many developing countries, including Indonesia. Since the implementation of regional autonomy, local governments have been granted greater authority to manage public finances, mobilize local own-source revenues, and provide public services according to regional needs. The primary objective of fiscal decentralization is to improve allocative efficiency, accountability, and responsiveness in public resource management (Smoke & Lewis, 1996; Martinez-Vazquez & McNab, 2003). Nevertheless, considerable disparities in fiscal capacity and financial performance across Indonesian provinces indicate that decentralization alone does not automatically produce stronger local government financial condition (Afonso et al., 2024).

Local government financial condition has become an increasingly important issue in public sector accounting because it reflects the government's ability to maintain fiscal sustainability, fulfil financial obligations, and continuously deliver public services over time (Ritonga et al., 2019). Financially sound local governments are expected to possess adequate fiscal capacity, financial flexibility, and financial independence while maintaining efficient service delivery (Ritonga et al., 2019). Consequently, understanding the determinants of local government financial condition has become an important research agenda in fiscal decentralization and public financial management literature (Iacuzzi, 2022; Iacuzzi et al., 2025).

Previous studies have primarily focused on economic and fiscal determinants of local government financial condition. Economic growth is generally expected to improve fiscal sustainability by expanding the tax base, increasing economic activity, and generating additional government revenues (Martinez-Vazquez & McNab, 2003). Likewise, Local Own-Source Revenue (PAD) has been widely recognised as an indicator of fiscal autonomy because it reduces dependence on intergovernmental transfers and provides greater flexibility in regional financial management (Ritonga et al., 2019). In contrast, poverty is commonly associated with fiscal pressure because governments are required to increase expenditure on social protection, health care, education, and poverty alleviation programmes while facing limited revenue-generating capacity (Warner et al., 2021).

Despite these theoretical expectations, empirical findings remain inconclusive. Several studies report that economic growth and fiscal capacity significantly improve local government financial condition, whereas other studies find weak or statistically insignificant relationships (Afonso et al., 2024; Iacuzzi et al., 2025). Similarly, the influence of poverty on financial condition varies across countries and institutional settings because fiscal outcomes are shaped not only by economic resources but also by the effectiveness of public financial management and institutional quality (Iacuzzi et al., 2025). These inconsistencies suggest that economic and fiscal resources alone are insufficient to explain variations in local government financial condition.

Recent literature increasingly highlights the importance of institutional quality in determining government performance (Iacuzzi, 2022). Institutional Theory argues that effective institutions improve policy implementation

through stronger accountability, transparency, political participation, and more efficient resource allocation (Kyriacou et al., 2015). Within the context of fiscal decentralization, political governance may determine whether economic resources can be effectively transformed into sustainable fiscal outcomes. Regions characterised by stronger democratic institutions are expected to have more effective monitoring mechanisms, higher transparency, and better public financial management (Ricciuti et al., 2016). Nevertheless, stronger democratic governance may also increase public demand for government expenditure and social services, thereby creating additional fiscal pressures that influence the relationship between economic growth and local government financial condition (Pal & Wahhaj, 2012).

Although previous studies have examined governance as an important determinant of government performance, relatively limited attention has been devoted to its role as a moderating mechanism. Most existing studies conceptualise governance as an independent variable that directly affects fiscal performance rather than as a contextual factor capable of strengthening or weakening the effects of economic conditions on financial sustainability (Ricciuti et al., 2016). Consequently, empirical evidence explaining how political governance alters the relationship between economic growth, poverty, and local government financial condition remains limited, particularly in developing countries implementing fiscal decentralization.

This research addresses this gap by investigating the determinants of local government financial condition across Indonesian provincial governments while simultaneously examining the moderating role of political governance. Political governance is measured using the Indonesian Democracy Index (IDI), which captures three important dimensions of democratic quality: civil liberties, political rights, and democratic institutions (Rusmin et al., 2014; Sijabat, 2024). Indonesia provides an appropriate research setting because provincial governments exhibit substantial disparities in fiscal capacity, economic development, and institutional quality despite operating under the same fiscal decentralization framework (Digdowiseiso, 2023).

This study contributes to the literature in three important ways. First, it extends the fiscal decentralization literature by integrating economic, fiscal, demographic, and institutional perspectives within a single analytical framework. Second, it advances Institutional Theory by demonstrating that political governance should be understood not merely as a direct determinant of government financial performance but as a contextual mechanism that influences how economic growth is translated into sustainable fiscal outcomes. Third, the study provides new empirical evidence from Indonesian provincial governments, thereby enriching the growing literature on regional financial condition in emerging economies.

The findings are expected to contribute both theoretically and practically. From a theoretical perspective, this study strengthens the integration between Second-Generation Fiscal Federalism Theory and Institutional Theory by explaining the contingent role of political governance in regional fiscal sustainability (Feld et al., 2016). From a policy perspective, the findings suggest that improving local government financial condition requires not only stronger economic growth and increased local revenue but also more effective fiscal management, poverty reduction strategies, and stronger democratic institutions capable of translating economic resources into sustainable public financial outcomes.

2. Literature Review and Hypothesis Development

2.1 Fiscal Federalism Theory

Fiscal Federalism Theory provides a primary theoretical foundation for understanding the relationship between decentralization and regional financial conditions. According to this theory, fiscal decentralization enhances economic efficiency by allocating public resources closer to citizens' preferences and local needs. Local governments are assumed to possess better information about regional priorities, which enables them to deliver public services more

efficiently than the central government. Therefore, fiscal decentralization is expected to strengthen fiscal autonomy, improve accountability, and support sustainable regional development (Oates, 2005).

The second generation of Fiscal Federalism Theory broadens this perspective by emphasizing that the success of decentralization depends not only on fiscal autonomy but also on institutional capacity, governance quality, and accountability mechanisms. Fiscal resources alone are insufficient to ensure sound financial management when local governments lack effective institutions and administrative capacity. Consequently, institutional arrangements and governance mechanisms become critical determinants of regional financial sustainability (Martinez-Vazquez & McNab, 2003).

In the Indonesian context, fiscal decentralization has significantly expanded the authority of provincial governments in managing public finances. However, substantial disparities in regional financial conditions persist across provinces, indicating that the outcomes of decentralization depend not only on economic resources but also on governments' ability to manage fiscal resources effectively. This perspective suggests that stronger economic capacity does not automatically guarantee better financial conditions without effective fiscal management and institutional support (Lubis & Ningsi, 2022).

2.2 Institutional Theory

Institutional Theory argues that institutions play a fundamental role in shaping economic and governmental performance. Institutions consist of formal rules, informal norms, and enforcement mechanisms that regulate political, economic, and social interactions. High-quality institutions reduce uncertainty, enhance accountability, improve transparency, and facilitate more efficient resource allocation.

In public financial management, political governance represents an important institutional mechanism that influences fiscal decision-making and government performance. Democratic institutions characterized by transparency, political accountability, public participation, and effective oversight are expected to improve fiscal discipline and strengthen public sector performance (Wardhani et al., 2017).

Unlike previous studies that mainly examined governance as a direct determinant of financial performance, this study positions political governance as a moderating mechanism that influences how economic and socioeconomic factors affect regional financial conditions. Therefore, Institutional Theory provides a conceptual foundation for explaining why political governance can strengthen or weaken the relationship between economic growth, poverty, and government financial sustainability (Lubis & Ningsi, 2022).

2.3 Regional Financial Conditions

Regional financial conditions refer to the ability of local governments to maintain fiscal sustainability while fulfilling public service obligations over time. Financially healthy governments possess sufficient fiscal capacity to finance development programs, respond to economic shocks, and maintain long-term budget stability without excessive dependence on intergovernmental transfers (Sebestova et al., 2018).

Previous studies have measured regional financial conditions using various indicators, including fiscal solvency, budget flexibility, revenue sustainability, expenditure efficiency, and financial independence. A comprehensive Financial Condition Index (FCI) provides a broader assessment by integrating multiple dimensions of local government financial performance.

In decentralized government systems, regional financial conditions have become an important indicator for evaluating the effectiveness of local fiscal management. Variations in financial conditions across regions indicate that fiscal sustainability is influenced not only by economic capacity but also by socioeconomic challenges, demographic characteristics, and the institutional environment (Iacuzzi et al., 2025).

2.4 Economic Growth and Local Government Financial Condition

Economic growth has long been recognised as one of the principal drivers of local government financial sustainability because it expands economic activity, broadens the tax base, increases employment, and stimulates private investment. According to Fiscal Federalism Theory, economic expansion enhances the fiscal capacity of subnational governments by increasing local revenue sources and reducing dependence on intergovernmental transfers (Oates, 2005). As regional economic output increases, governments are expected to collect higher tax revenues and user charges, thereby strengthening their ability to finance public services, maintain fiscal flexibility, and improve long-term financial sustainability (Martinez-Vazquez & McNab, 2003).

From the perspective of public financial management, economic growth contributes to stronger fiscal resilience because governments operating in growing economies generally possess greater budgetary capacity to respond to economic shocks and maintain service delivery (Feld et al., 2016). This argument is consistent with Second-Generation Fiscal Federalism, which suggests that economic performance enhances fiscal sustainability only when supported by effective institutions and sound fiscal governance.

Previous empirical studies generally support the positive relationship between economic growth and government financial condition. Afonso et al. (2025) found that stronger macroeconomic performance contributes positively to fiscal sustainability by improving governments' fiscal reaction capacity and strengthening long-term budget balance. Likewise, Iacuzzi, Padovani, and Canestrini (2025), using cross-country evidence from municipalities in nine countries, reported that stronger fiscal autonomy and favourable economic conditions are associated with healthier local government financial conditions, although the relationship is not always linear.

Evidence from Brazil also demonstrates that municipalities with stronger economic capacity and greater fiscal autonomy generally exhibit healthier fiscal conditions than municipalities characterised by weaker economic performance (Silva et al., 2024). Furthermore, Maher, Park, and McDonald (2025) argued that local government fiscal condition is shaped by socio-economic characteristics, institutional settings, and intergovernmental fiscal arrangements, indicating that economic growth constitutes one of the fundamental determinants of fiscal sustainability.

Nevertheless, empirical findings remain inconclusive. While economic growth increases fiscal capacity, several studies argue that its positive effects may not automatically improve local government financial condition because governments often respond to economic expansion by increasing public expenditure, infrastructure investment, and redistributive programmes. Consequently, rapid economic growth does not necessarily translate into healthier public finances when fiscal discipline and institutional quality remain weak (Kyriacou et al., 2015; Ricciuti et al., 2016; Pal & Wahhaj, 2012). Similarly, comparative evidence suggests that the benefits of fiscal autonomy and economic expansion differ across institutional contexts, implying that governance quality influences the conversion of economic resources into sustainable fiscal outcomes.

These inconsistent findings indicate that economic growth alone cannot fully explain variations in local government financial condition. In decentralized governments, the effectiveness of economic growth in strengthening fiscal sustainability depends on governments' ability to transform expanding economic resources into sustainable financial management through sound fiscal policies and effective institutions. Therefore, this study expects economic growth to positively influence local government financial condition.

H1: Economic growth positively affects local government financial condition.

2.5 Poverty and Local Government Financial Condition

Poverty represents one of the most influential socio-economic challenges affecting the financial

sustainability of local governments. High poverty levels increase governments' obligations to provide public services, including education, healthcare, housing assistance, employment programmes, and social protection. At the same time, poor communities generally contribute less to local tax revenues because of their relatively limited income and economic activity. Consequently, poverty simultaneously increases public expenditure while constraining governments' revenue-generating capacity, thereby weakening local government financial condition.

Institutional Theory suggests that governments facing persistent poverty require stronger institutional capacity to allocate limited public resources efficiently. Without effective governance, increasing social expenditure may generate structural fiscal pressure, reduce fiscal flexibility, and weaken governments' ability to maintain long-term financial sustainability (Kyriacou et al., 2015).

Previous empirical studies consistently demonstrate the adverse fiscal consequences of poverty. Warner et al. (2021) argued that higher poverty levels substantially increase fiscal pressure because governments allocate a larger proportion of public expenditure to mandatory social programmes. Likewise, Afonso et al. (2025) reported that unfavourable socio-economic conditions weaken fiscal sustainability by reducing governments' capacity to maintain long-term fiscal balance.

Evidence from comparative local government studies further indicates that socio-economic characteristics constitute important determinants of local government financial condition. Maher, Park, and McDonald (2025) concluded that local fiscal condition cannot be explained solely by financial variables because socio-economic environments, including poverty and demographic characteristics, substantially influence governments' fiscal resilience. Similarly, studies on municipal fiscal health suggest that financially vulnerable governments are more likely to experience persistent socio-economic disadvantages that constrain fiscal capacity and increase expenditure obligations (Iacuzzi et al., 2025).

However, the magnitude of poverty's influence differs across institutional environments. Governments characterised by stronger governance systems and better expenditure management may mitigate the fiscal burden associated with poverty through more efficient allocation of public resources and improved accountability (Ricciuti et al., 2016). Consequently, poverty does not necessarily produce identical fiscal consequences across all regions, indicating that institutional quality may shape the relationship between poverty and local government financial condition.

Based on Fiscal Federalism Theory and Institutional Theory, this study argues that higher poverty levels reduce governments' fiscal capacity, increase expenditure commitments, and ultimately weaken local government financial condition.

H2: Poverty negatively affects local government financial condition.

2.6 Local Own-Source Revenue and Local Government Financial Condition

Local Own-Source Revenue (Pendapatan Asli Daerah—PAD) represents one of the most important indicators of fiscal autonomy under a decentralized governance system. Fiscal Federalism Theory argues that decentralization improves public sector efficiency by granting subnational governments greater authority to mobilize local revenues and allocate public expenditures according to regional priorities (Oates, 2005). Consequently, governments with stronger own-source revenue are expected to possess greater fiscal independence, enhanced financial flexibility, and stronger capacity to provide sustainable public services.

Within the Indonesian decentralization framework, PAD serves as the principal indicator of a local government's ability to finance development independently from central government transfers. Higher PAD allows governments to diversify revenue sources, reduce fiscal dependence on balancing funds, and

improve long-term fiscal resilience (Ritonga et al., 2019). From the perspective of public financial management, governments with greater fiscal autonomy generally demonstrate higher financial sustainability because they possess greater discretion in responding to fiscal shocks and changing public demands.

Previous empirical studies generally support the positive relationship between local own-source revenue and local government financial condition. Ritonga et al. (2019) argued that stronger fiscal independence contributes significantly to healthier local government financial condition because governments become less dependent on external funding sources. Similarly, Afonso et al. (2025) found that stronger revenue-generating capacity improves fiscal sustainability by increasing governments' ability to maintain balanced budgets and financial resilience. Maher, Park, and McDonald (2025) further concluded that revenue capacity constitutes one of the strongest predictors of local government fiscal condition across municipalities operating under decentralized fiscal systems.

Evidence from Indonesian local governments also supports this relationship. Digdowiseiso (2023) demonstrated that local fiscal capacity contributes positively to regional financial performance because governments with higher revenue autonomy are better able to finance development programmes and maintain fiscal sustainability. Likewise, several Indonesian public finance studies report that higher PAD strengthens financial independence and improves local governments' ability to provide public services while reducing reliance on central government transfers.

Nevertheless, previous findings remain inconclusive. Several studies suggest that increasing PAD does not automatically improve financial condition because additional revenues are frequently accompanied by higher expenditure commitments and operational costs. Furthermore, local governments characterised by weak fiscal discipline may fail to transform additional revenue into sustainable financial performance (Kyriacou et al., 2015; Ricciuti et al., 2016). These inconsistent findings indicate that fiscal autonomy alone cannot guarantee healthier financial condition without effective governance and sound public financial management.

Based on Fiscal Federalism Theory and previous empirical evidence, this study argues that greater local own-source revenue enhances fiscal independence, improves financial flexibility, and strengthens local government financial condition.

H3: Local own-source revenue positively affects local government financial condition.

2.7 Population and Local Government Financial Condition

Population constitutes an important demographic characteristic influencing both the fiscal capacity and expenditure responsibilities of local governments. According to Fiscal Federalism Theory, population size affects the demand for public services, infrastructure provision, education, healthcare, and administrative expenditure. Consequently, demographic changes may either strengthen or weaken local government financial condition depending on governments' fiscal capacity and institutional effectiveness (Oates, 2005).

A larger population potentially generates greater economic activity, broader tax bases, and increased local government revenues. Regions with larger populations generally experience higher consumption, greater labour market participation, and stronger business activity, all of which contribute positively to fiscal capacity. Conversely, rapid population growth also increases government expenditure on infrastructure, transportation, public health, education, environmental management, and social services. Therefore, the overall influence of population on financial condition depends on whether revenue growth exceeds expenditure expansion.

Previous empirical studies report mixed findings regarding the relationship between population and local government financial condition. Maher, Park, and McDonald (2025) identified demographic characteristics as important

determinants of municipal fiscal condition, arguing that population influences both fiscal capacity and expenditure requirements. Likewise, Iacuzzi et al. (2025) found that demographic structure significantly affects local government financial resilience because municipalities with rapidly changing populations experience different fiscal pressures and service demands.

Studies conducted within decentralized government systems also suggest that population may generate economies of scale in public service delivery, thereby improving fiscal efficiency when supported by effective governance and sufficient fiscal resources (Afonso et al., 2025). However, other studies indicate that rapid population growth may weaken fiscal sustainability because governments face increasing expenditure obligations that are not always matched by corresponding revenue growth (Warner et al., 2021). Consequently, previous findings remain inconclusive.

These conflicting empirical findings indicate that population should not be viewed solely as a demographic variable but rather as a contextual factor affecting both government revenue capacity and expenditure needs. In decentralized governments such as Indonesia, where substantial disparities exist in fiscal capacity across provinces, the impact of population on financial condition is likely to vary according to regional economic development and institutional effectiveness.

Therefore, this study proposes the following hypothesis:

H4: Population significantly affects local government financial condition.

2.8 Political Governance as a Moderator of the Relationship between Economic Growth and Local Government Financial Condition

Political governance has increasingly been recognised as one of the most important institutional determinants of public sector performance. Unlike traditional perspectives that focus primarily on fiscal and economic resources, Institutional Theory argues that government performance is fundamentally shaped by the institutional environment within which public policies are formulated and implemented (North, 1990). Institutions establish the formal and informal rules governing public decision-making, accountability, transparency, and political participation, thereby influencing how governments transform economic resources into public value.

Within decentralized fiscal systems, political governance plays a crucial role in determining whether economic growth can be translated into sustainable fiscal outcomes. According to Second-Generation Fiscal Federalism, decentralization improves public sector efficiency only when supported by high-quality institutions capable of promoting accountability, limiting opportunistic behaviour, and encouraging efficient public expenditure (Feld et al., 2016). Consequently, economic growth alone does not necessarily strengthen local government financial condition because the effectiveness of fiscal management depends on institutional quality.

Political governance is commonly reflected in democratic accountability, transparency, public participation, political competition, and legislative oversight. Regions characterised by stronger democratic governance generally possess more transparent budgeting processes, greater citizen participation, and more effective monitoring of public expenditure, thereby reducing agency problems and improving fiscal accountability (Kyriacou et al., 2015). These institutional characteristics are expected to enhance governments' ability to convert expanding economic resources into sustainable financial performance.

However, democratic governance may also generate opposite fiscal consequences. Public Choice Theory suggests that stronger democratic institutions often increase electoral competition and political incentives to expand public expenditure. Politicians may respond to electoral pressure by increasing redistributive programmes, subsidies, social assistance, and public infrastructure spending beyond governments' fiscal capacity (Pal & Wahhaj, 2012). Similarly, Ricciuti et al. (2016) argued that

political institutions influence fiscal discipline because governments operating within competitive political environments frequently experience greater expenditure commitments. Consequently, stronger political governance does not always strengthen fiscal sustainability and may instead reduce the positive fiscal effects of economic growth.

Previous empirical evidence remains inconclusive. Kyriacou et al. (2015) found that higher institutional quality improves fiscal performance by increasing government accountability and expenditure efficiency. Likewise, Feld et al. (2016) argued that institutional quality determines whether fiscal decentralization produces efficient public financial management. Conversely, Ricciuti et al. (2016) reported that political competition may increase government expenditure and reduce fiscal discipline. Pal and Wahhaj (2012) also demonstrated that decentralization may generate inefficient public spending when political incentives dominate fiscal decision-making.

Evidence from Indonesia further suggests that regional differences in democratic quality influence public financial management. Rusmin et al. (2014) found that stronger governance improves financial accountability through better institutional control mechanisms. Sijabat (2024) also reported considerable variation in democratic governance across Indonesian provinces, indicating that institutional quality may shape fiscal outcomes despite similar decentralization policies.

Although previous studies have extensively examined the direct relationship between governance and fiscal performance, relatively limited attention has been devoted to governance as a **moderating mechanism**. Most studies conceptualise governance as an independent determinant of government performance, whereas very few investigate whether democratic governance changes the effectiveness of economic growth in improving local government financial condition. This represents an important research gap because economic growth may generate different fiscal consequences under different institutional environments.

Based on Institutional Theory and Second-Generation Fiscal Federalism, this study argues that political governance functions as a contextual mechanism influencing how economic growth affects local government financial condition. Therefore, the following hypothesis is proposed:

H5: Political governance moderates the relationship between economic growth and local government financial condition.

2.9 Political Governance as a Moderator of the Relationship between Poverty and Local Government Financial Condition

Poverty constitutes one of the most significant fiscal challenges faced by local governments because it simultaneously increases expenditure requirements and reduces governments' revenue-generating capacity. Nevertheless, the fiscal consequences of poverty are unlikely to be uniform across regions because governments differ substantially in institutional quality, administrative capacity, and governance effectiveness. Institutional Theory argues that effective institutions improve governments' ability to allocate scarce public resources efficiently, prioritise public expenditure, and maintain fiscal sustainability despite socioeconomic challenges (North, 1990).

Political governance may therefore influence how governments respond to poverty-related fiscal pressures. Governments characterised by stronger democratic institutions generally possess greater transparency, more effective legislative oversight, higher public participation, and stronger accountability mechanisms. These institutional characteristics improve programme targeting, reduce leakages in social expenditure, and enhance the efficiency of poverty alleviation policies (Kyriacou et al., 2015). Consequently, stronger political governance may reduce the adverse fiscal consequences of poverty by improving expenditure efficiency and public financial management.

Conversely, democratic governance may also intensify fiscal pressure. Competitive political environments frequently encourage governments to expand social assistance programmes and redistributive spending in response to electoral incentives. While these policies may improve social welfare, they simultaneously increase long-term expenditure commitments and reduce governments' fiscal flexibility (Pal & Wahhaj, 2012). Ricciuti et al. (2016) similarly argued that political institutions significantly influence fiscal discipline because political competition often encourages higher public spending.

Previous empirical studies provide mixed evidence regarding the interaction between governance and socioeconomic conditions. Kyriacou et al. (2015) demonstrated that institutional quality strengthens public sector efficiency by improving accountability and reducing inefficiencies in government expenditure. Feld et al. (2016) likewise argued that institutional quality determines the effectiveness of decentralized fiscal systems. However, comparative evidence also indicates that democratic governance may generate greater fiscal commitments through increased redistributive policies and public service provision, particularly in developing countries where fiscal resources remain limited (Pal & Wahhaj, 2012).

Despite these developments, previous studies have rarely examined whether political governance changes the influence of poverty on local government financial condition. Existing studies generally analyse governance and poverty as separate determinants of fiscal performance rather than investigating their interaction. Consequently, empirical evidence explaining whether stronger democratic governance mitigates or intensifies the fiscal consequences of poverty remains limited, particularly in Indonesian provincial governments.

This study therefore proposes that political governance functions as a contextual institutional factor that shapes the relationship between poverty and local government financial condition. The following hypothesis is proposed:

H6: Political governance moderates the relationship between poverty and local government financial condition.

2.10 Research Gap

Although previous studies have substantially advanced the understanding of local government financial condition, several important research gaps remain.

First, previous studies have primarily focused on the direct effects of economic and fiscal variables, such as economic growth, local own-source revenue, fiscal capacity, and poverty, on government financial performance (Ritonga et al., 2019; Afonso et al., 2025; Iacuzzi et al., 2025). While these studies provide valuable insights into the determinants of fiscal sustainability, they largely assume that economic resources automatically translate into better financial outcomes. Such an assumption overlooks the possibility that institutional quality may influence the effectiveness with which governments convert economic resources into sustainable financial condition.

Second, existing literature generally conceptualises political governance as an independent determinant of government performance rather than as a contextual institutional mechanism. Previous studies have demonstrated that democratic governance improves transparency, accountability, and fiscal discipline (Kyriacou et al., 2015; Rusmin et al., 2014; Ricciuti et al., 2016). However, limited empirical attention has been devoted to examining whether political governance modifies the influence of economic conditions on local government financial condition. Consequently, the moderating role of political governance remains insufficiently explored.

Third, previous empirical findings remain inconsistent regarding the influence of economic growth and poverty on local government financial condition. Several studies report that economic growth significantly strengthens fiscal sustainability through increased revenue capacity (Afonso et al., 2025), whereas others argue that economic growth may not necessarily improve government financial condition because

increasing public expenditure and weak institutional quality offset potential fiscal gains (Kyriacou et al., 2015; Pal & Wahhaj, 2012). Likewise, although poverty is generally associated with fiscal stress, the magnitude of its impact differs considerably across institutional settings, suggesting that contextual factors may shape this relationship. **Fourth**, empirical evidence from developing countries, particularly Indonesia, remains relatively limited. Most previous studies have been conducted in developed countries characterised by relatively homogeneous institutional quality and mature fiscal systems (Iacuzzi et al., 2025; Afonso et al., 2025). In contrast, Indonesian provincial governments operate under the same fiscal decentralisation framework while exhibiting substantial variation in democratic governance, fiscal capacity, economic development, and public financial management (Digdowiseiso, 2023; Sijabat, 2024). This institutional diversity provides an appropriate setting to investigate whether political governance influences the relationship between socioeconomic conditions and local government financial condition.

To address these gaps, this study develops an integrated framework that combines Fiscal Federalism Theory and Institutional Theory to examine the determinants of local government financial condition. More importantly, this study extends previous literature by positioning political governance, measured using the Indonesian Democracy Index (IDI), as a moderating variable rather than merely an independent determinant. By doing so, this study contributes to the growing literature on fiscal decentralisation and public financial management by explaining how institutional quality shapes the effectiveness of economic growth and poverty in influencing local government financial condition.

3. Methodology

This chapter explains the research design, population and sample, variable measurement, and research models used in the study.

3.1 Research Design

This study employs a **quantitative research approach** using panel data regression to investigate the determinants of regional financial health in Indonesian provincial governments. Panel data analysis was chosen because it combines cross-sectional and time-series observations, allowing the study to control for individual heterogeneity while improving estimation efficiency and reducing omitted variable bias. In addition, panel regression provides more reliable parameter estimates than purely cross-sectional or time-series approaches when analyzing regional fiscal performance. This study specifically examines whether **Political Governance** moderates the relationship between **Economic Growth** and **Regional Financial Health** (Hwang et al., 2026).

3.2 Population and Sample

The population of this study consists of all provinces in Indonesia. The sample is selected using **purposive sampling** based on the following criteria:

1. Provinces with Regional Government Financial Statements (*Laporan Keuangan Pemerintah Daerah* / LKPD) audited by the Audit Board of the Republic of Indonesia (*Badan Pemeriksa Keuangan* / BPK).
2. Provinces with statistical and economic data published by the Central Statistics Agency (*Badan Pusat Statistik* / BPS), including indicators of economic growth, population, and regional investment.
3. Provinces that have official regional government websites.
4. Provinces whose fiscal data are published by the Ministry of Finance of the Republic of Indonesia to ensure data validity, consistency, and completeness (Sijabat, 2024).

3.3 Variable Measurement

This study uses 12 variables grouped into three categories to examine the effects of fiscal and institutional factors on regional economic outcomes. The **dependent variable (Y)** is Regional Financial Health, measured using the **Financial Condition Index (FCI)**. The **independent variables (X)** include Economic Growth, Poverty, Local Own-Source Revenue,

and Political Governance. The **control variable (Z)** is Population. The model is intended to isolate the effects of resource capacity and governance quality on regional financial performance.

3.4 Operational Definition of Variables

Variable	Operational Definition	Measurement
Regional Financial Health (Y)	Measured using the Financial Condition Index (FCI) developed by Ritonga (2014; 2024). Regional financial health refers to the ability of local governments to meet their financial obligations, including short-term obligations, long-term obligations, operational obligations, and obligations to provide public services.	1) Budget solvency = Total revenue / Total expenditure 2) Short-term solvency = Current assets / Current liabilities 3) Long-term solvency = Total assets / Total liabilities 4) Financial independence = PAD / (PAD + Transfers) 5) Financial flexibility = (Total revenue − Special Allocation Fund revenue) / Total liabilities 6) Service-level solvency = Total expenditure / Population FCI = w1DI1 + w2DI2 + … + wnDIn, where FCI = Financial Condition Index; w = dimension weight; DI = dimension index; n = number of dimensions.
Economic Growth	The growth rate of real GRDP (*Gross Regional Domestic Product*) (Wooldridge, 2010; Aslan & Kayalidere, 2018).	Ln(GRDPt) − Ln(GRDPt−1). Natural logarithms are used to estimate growth elasticity.
Poverty	The percentage of the population living below the poverty line (Cizmar et al., 2020).	Percentage of poor population relative to the total provincial population.
Local Own-Source Revenue (PAD)	Total regional revenue derived from local taxes, user charges, and returns from the management of regional assets (Brueckner, 2003; Aslan & Kayalidere, 2018).	Total realized local own-source revenue, including local taxes, local levies, and returns from regionally owned assets. Measured in natural logarithm (Ln) form to reduce heteroskedasticity.
Political Stability / Political Governance	Measured using the Indonesian Democracy Index (*Indeks Demokrasi Indonesia* / IDI), which reflects the extent to which political processes, civil liberties, and democratic institutions operate according to constitutional principles.	Indonesian Democracy Index (IDI), calculated as Regional Index Score / 100 × 100%.
Population	Total regional population (Wooldridge, 2010).	Natural logarithm of total population.

Figure 1: Operational definitions and measurements of study variables

3.5 Research Model

The baseline regression model is specified as follows:

$$RFH_{it} = \beta_0 + \beta_1 EG_{it} + \beta_2 POV_{it} + \beta_3 PAD_{it} + \beta_4 PG_{it} + \beta_5 POP_{it} + \varepsilon_{it}$$

Where:

- **RFH** = Regional Financial Health
- **EG** = Economic Growth
- **POV** = Poverty
- **PAD** = Local Own-Source Revenue
- **PG** = Political Governance

- **POP** = Population

To examine the moderating role of Political Governance, interaction terms are included in the regression model:

$RFH_{it} = \beta_0 + \beta_1 EG_{it} + \beta_2 POV_{it} + \beta_3 PAD_{it} + \beta_4 PG_{it} + \beta_5 (EG \times PG)_{it} + \beta_6 (POV \times PG)_{it} + \beta_7 POP_{it} + \varepsilon_{it}$

Where:

- **EG × PG** represents the interaction between Economic Growth and Political Governance
- **POV × PG** represents the interaction between Poverty and Political Governanc

Result and Discussion

4. Results

4.1 Descriptive Statistics

Variable	Obs.	Mean	Std. Dev.	Min	Max
Financial Condition Index (FCI)	**102**	**-0.0005**	**1.0003**	**-0.92**	**4.5**
Economic Growth (ln_eg)	**102**	**3.4946**	**0.0379**	**3.4128**	**3.5791**
Poverty (pov)	**102**	**0.0977**	**0.0442**	**0.042**	**0.209**
Local Own-Source Revenue (ln_pad)	**102**	**28.6828**	**1.1584**	**26.7272**	**31.5778**
Political Governance (gov)	**102**	**77.8847**	**5.7271**	**56.55**	**89.25**
Population (ln_pop)	**102**	**8.4124**	**1.0258**	**6.3608**	**10.8267**

Table 2 presents the descriptive statistics for all variables included in the analysis. The study comprises 102 balanced panel observations representing 34 Indonesian provincial governments over the 2022–2024 period. The equal number of observations across variables indicates that no missing data were identified during the estimation process.

The Financial Condition Index (FCI) has a mean value of −0.0005 with a standard deviation of 1.0003, reflecting the standardized nature of the index. The minimum and maximum values range from −0.92 to 4.50, indicating considerable variation in local government financial condition across provinces and years. This wide dispersion suggests substantial differences in fiscal resilience, financial flexibility, and fiscal independence among provincial governments.

Economic growth, measured as the natural logarithm of Gross Regional Domestic Product (ln_eg), records a mean value of 3.4946 with a relatively small standard deviation (0.0379). The limited variation indicates that provincial economic growth remained relatively stable throughout the observation period.

The average provincial poverty rate is 9.77%, ranging from 4.20% to 20.90%. The standard deviation of 4.42 percentage points indicates substantial socioeconomic disparities among Indonesian provinces, reflecting heterogeneous regional development conditions.

Local own-source revenue (ln_pad) exhibits a mean value of 28.6828 with values ranging between 26.7272 and 31.5578. The relatively wide range indicates considerable differences in fiscal

capacity and revenue-generating ability across provincial governments. The logarithmic transformation reduces scale differences and improves the distributional properties of the variable for regression analysis.

Political governance, measured using the Indonesian Democracy Index (IDI), has an average score of 77.88, with values ranging from 56.55 to 89.25. These figures indicate that although the overall quality of political governance is relatively high, meaningful institutional differences remain across provinces.

Finally, the natural logarithm of population (ln_pop) records a mean value of 8.4124 and a standard deviation of 1.0258, reflecting substantial demographic variation among Indonesian provinces. Such variation is expected to influence both fiscal capacity and public expenditure requirements.

Overall, the descriptive statistics indicate sufficient variation across fiscal, economic, demographic, and governance variables, providing an appropriate empirical basis for estimating the determinants of local government financial condition.

4.2 Correlation Matrix and Multicollinearity

Variable	FCI	EG	POV	PAD	GOV	POP	VIF
Financial Condition (FCI)	1.000						-
Economic Growth (EG)	...	1.000					1.xx
Poverty (POV)	...	...	1.000				1.xx
Local Own-Source Revenue (PAD)	...	...	...	1.000			**9.39**
Political Governance (GOV)	...	...	...	...	1.000		1.xx
Population (POP)	...	...	...	**0.8667**	...	1.000	**6.28**
Mean VIF							**3.12**

Prior to estimating the regression model, Pearson correlation analysis and multicollinearity diagnostics were conducted. The highest correlation coefficient was observed between local own-source revenue (PAD) and population ($r = 0.8667$), indicating a relatively strong positive association. This relationship is expected because provinces with larger populations generally possess broader economic bases and greater revenue potential.

Despite this relatively high correlation, the Variance Inflation Factor (VIF) analysis indicates that multicollinearity is not a serious concern. The mean VIF is 3.12, while the highest VIF is recorded for PAD (9.39), followed by population (6.28). Since all VIF values remain below the commonly accepted threshold of 10 (Hair et al., 2022), the estimated regression coefficients are unlikely to suffer from severe multicollinearity. Therefore, all explanatory variables are retained in the subsequent regression analysis.

4.3 Model Selection

Test	Statistic	p-value	Decision
Chow Test	$F = 3.42$	0.0000	Fixed Effects
Breusch–Pagan LM Test	$chibar^2 = 9.75$	0.0009	Random Effects
Hausman Test	$\chi^2 = 16.60$	0.0201	Fixed Effects
Mundlak Test	$\chi^2 = 22.73$	0.0019	Fixed Effects

To determine the most appropriate panel-data estimation model, four specification tests were performed: the Chow test, Breusch–Pagan Lagrange Multiplier (LM) test, Hausman test, and Mundlak test.

The Chow test strongly rejects the pooled ordinary least squares (OLS) model ($F = 3.42$; $p < 0.001$), indicating that the fixed-effects model provides a significantly better fit. The LM test further rejects pooled OLS in favour of the random-effects model (chibar^2 = 9.75; $p = 0.0009$). Subsequently, both the Hausman test ($\chi^2 = 16.60$; $p = 0.0201$) and the Mundlak test ($\chi^2 = 22.73$; $p = 0.0019$) reject the random-effects specification and support the use of the fixed-effects estimator.

Based on these results, the fixed-effects model is selected as the primary estimation approach because it effectively controls for unobserved time-invariant provincial heterogeneity. To obtain statistically reliable inference in the presence of potential heteroskedasticity and serial correlation, all estimations employ province-clustered robust standard errors.

4.4 Regression Results

Variables	Model 1 Baseline	Model 2 Moderation
Economic Growth	-4.3648 (4.2840)	-0.2357 (3.7486)
Poverty	-53.7681*** (14.4440)	-79.2055*** (24.1821)
Political Governance	-0.0260 (0.0284)	-0.0291 (0.0283)
Local Own-Source Revenue	-0.2981 (0.3796)	-0.4447 (0.3509)
Population	0.9850** (0.3817)	1.2302** (0.5577)
Economic Growth × Governance	–	-1.2251*** (0.4371)
Poverty × Governance	–	-1.4655 (0.8858)
Year Effects	Yes	Yes
Provincial Fixed Effects	Yes	Yes
Clustered Standard Errors	Yes	Yes
Observations	102	102
Provinces	34	34
Within R^2	0.1592	0.2060
Prob > F	0.0000	0.0000

Table 5 reports the estimation results obtained from the fixed-effects model with province-clustered robust standard errors. Model 1 presents the baseline regression without interaction terms, whereas Model 2 incorporates the moderating role of political governance.

The regression model is jointly significant, with an F-statistic of 13.00 ($p < 0.001$), indicating that the explanatory variables collectively explain variations in local government financial condition. The within R^2 increases from 0.1592 in Model 1 to 0.2060 in Model 2, suggesting that the inclusion of the interaction terms improves the explanatory power of the model.

Among the main explanatory variables, poverty exhibits a negative and statistically significant association with local government financial condition ($\beta = -79.2055$; $p < 0.01$). In contrast, economic growth and local own-source revenue are not statistically significant. Population has a positive and significant coefficient ($\beta = 1.2302$; $p < 0.05$), indicating that provinces with larger populations tend to exhibit better financial condition after controlling for other explanatory variables.

Regarding the moderating effects, the interaction between economic growth and political governance is negative and statistically significant ($\beta = -1.2251$; $p < 0.01$). Conversely, the interaction between poverty and political governance is statistically insignificant ($\beta = -1.4655$; $p = 0.108$).

The joint significance test of the interaction terms yields an F-statistic of 3.94 ($p = 0.0292$), indicating that the moderating variables are jointly significant. However, this joint significance is primarily driven by the interaction between economic growth and political governance.

To further interpret the moderating effects, marginal effect analysis was conducted. The results indicate that the marginal effect of economic growth changes from positive but statistically insignificant under low political governance to negative and statistically significant under high political governance. In contrast, the marginal effect of poverty remains negative and statistically significant across all governance levels, although the interaction effect itself is not statistically significant.

4.5 Marginal Effects Analysis

Table 6. Marginal Effects of Economic Growth and Poverty across Political Governance Levels

Political Governance	Marginal Effect of Economic Growth	p-value	Marginal Effect of Poverty	p-value
Low	6.7807	0.207	-70.8125	0.000
Mean	-0.2357	0.950	-79.2055	0.001
High	-7.2520	0.034	-87.5985	0.002

Table 6 presents the conditional marginal effects of economic growth and poverty at low, average, and high levels of political governance. The results indicate that the effect of economic growth changes substantially across governance levels. Under low political governance, the effect of economic growth is positive but statistically insignificant. At the average level of governance, the effect becomes negligible, whereas under high political governance it turns negative and statistically significant.

In contrast, poverty consistently exhibits a negative and statistically significant effect across all governance levels. Although the adverse effect becomes larger as political governance increases, the interaction term itself is statistically insignificant, indicating that political governance does not significantly moderate the relationship between poverty and local government financial condition.

5.1 Economic Growth and Local Government Financial Condition

The empirical findings indicate that economic growth does not significantly influence local government financial condition, leading to the rejection of H1. This result suggests that higher provincial economic growth does not necessarily improve fiscal health or financial sustainability. Although economic expansion is generally expected to enlarge the regional tax base and stimulate fiscal capacity, these benefits are not automatically reflected in provincial financial condition.

One plausible explanation is that Indonesia's fiscal decentralisation system remains characterised by substantial dependence on intergovernmental transfers. Provincial governments have relatively limited authority to capture the full benefits of regional economic expansion because major tax revenues continue to be administered centrally. Consequently, increases in Gross Regional Domestic Product (GRDP) do not necessarily generate proportional improvements in local fiscal capacity. In addition, economic growth is often accompanied by increasing demands for infrastructure investment, public services, and development expenditure, which may offset additional fiscal resources generated by economic expansion.

This finding is consistent with Institutional Theory (North, 1990), which argues that economic resources alone are insufficient to improve organisational performance without effective institutional arrangements. Similarly, Second-Generation Fiscal Federalism suggests that decentralisation only improves government financial performance when supported by strong governance, fiscal discipline, and efficient public financial management (Feld et al., 2016). Therefore, economic growth should not be viewed as a sufficient condition for improving local government financial condition.

The result corroborates the findings of Kyriacou et al. (2015), who demonstrated that institutional quality determines whether economic development translates into stronger fiscal sustainability. Likewise, Ricciuti et al. (2016) argued that political and institutional environments substantially influence governments' fiscal performance. However, the present finding differs from Afonso et al. (2025), who reported a positive relationship between economic performance and fiscal sustainability. This discrepancy may reflect differences in institutional contexts, as European countries generally possess stronger fiscal autonomy and more mature public financial management systems than Indonesian provincial governments.

These findings imply that policies aimed solely at accelerating economic growth are unlikely to improve provincial financial condition unless accompanied by reforms that strengthen fiscal autonomy, revenue mobilisation, expenditure efficiency, and institutional quality.

5.2 Poverty and Local Government Financial Condition

The regression results demonstrate that poverty exerts a significant negative effect on local government financial condition, thereby supporting H2. Provinces with higher poverty rates tend to experience weaker financial conditions because poverty simultaneously increases government expenditure obligations while reducing local revenue-generating capacity.

From a fiscal perspective, higher poverty requires governments to allocate greater financial resources to social protection programmes, healthcare, education, employment assistance, food security, and other redistributive policies. These expenditure commitments reduce fiscal flexibility and limit governments' ability to allocate resources for productive investments capable of generating future revenue. Consequently, persistent poverty creates structural fiscal pressure that weakens long-term financial sustainability.

This finding strongly supports Fiscal Federalism Theory (Oates, 2005), which emphasises that governments' fiscal sustainability depends on balancing expenditure responsibilities with available fiscal resources. When expenditure obligations increase faster than revenue capacity, governments experience declining financial flexibility and weaker fiscal resilience. Institutional Theory further suggests that governments operating under stronger institutional arrangements are better able to prioritise expenditure and allocate scarce public resources more efficiently (North, 1990).

The present finding is consistent with Warner et al. (2021), who concluded that poverty substantially increases fiscal stress because governments devote larger portions of their budgets to mandatory social expenditure. Similarly, Afonso et al. (2025) found that unfavourable socioeconomic conditions weaken fiscal sustainability, while Iacuzzi et al. (2025) reported that financially vulnerable governments are frequently characterised by persistent socioeconomic disadvantages.

These findings highlight that poverty reduction should be regarded not only as a social objective but also as an important fiscal strategy. Policies promoting employment creation, inclusive economic development, human capital improvement, and targeted poverty alleviation are expected to improve both public welfare and local government financial sustainability.

5.3 Local Own-Source Revenue and Local Government Financial Condition

Contrary to expectations, local own-source revenue (PAD) does not significantly affect local government financial condition, leading to the

rejection of H3. Although fiscal decentralisation theory argues that stronger own-source revenue enhances fiscal independence and financial sustainability, the present findings suggest that increasing PAD alone is insufficient to improve provincial financial condition.

Several explanations may account for this result. First, considerable disparities remain in the revenue structure of Indonesian provinces. Many provincial governments continue to rely heavily on transfers from the central government, while PAD contributes only a relatively small proportion of total regional revenue. Consequently, variations in PAD may not substantially alter overall fiscal capacity.

Second, increases in PAD are frequently accompanied by rising operational expenditure and development commitments. Additional revenue is not always allocated to improve fiscal resilience but may instead finance routine administrative expenditure or politically driven programmes. As a result, higher PAD does not necessarily translate into healthier financial conditions.

This finding differs from Ritonga et al. (2019), who reported that fiscal independence strengthens local government financial condition. However, it supports arguments advanced by Kyriacou et al. (2015) and Ricciuti et al. (2016), who emphasised that institutional quality and fiscal management play a more important role than revenue growth alone in determining fiscal sustainability.

Accordingly, improving provincial financial condition requires not only increasing PAD but also strengthening expenditure quality, budget efficiency, and fiscal governance.

5.4 Population and Local Government Financial Condition

The empirical results indicate that population has a positive and statistically significant effect on local government financial condition, supporting H4. The estimated coefficient suggests that provinces with larger populations tend to exhibit stronger financial conditions after controlling for economic growth, poverty, local own-source revenue, and political governance.

This finding indicates that population should not merely be viewed as a demographic burden but also as an important source of fiscal capacity. Larger populations generally create broader economic activity, larger labour markets, greater household consumption, and more diversified business sectors. These conditions increase the potential tax base and expand regional economic activities that indirectly support provincial fiscal capacity. Consequently, provinces with larger populations may possess greater opportunities to strengthen financial sustainability despite facing higher expenditure responsibilities.

The result is consistent with Fiscal Federalism Theory, which argues that demographic characteristics influence both the revenue-generating capacity and expenditure obligations of subnational governments (Oates, 2005). Although population growth increases demand for education, healthcare, transportation, and public infrastructure, these additional expenditures may be offset by larger economic activity and stronger fiscal capacity when governments manage public resources efficiently.

This finding is also supported by Maher, Park, and McDonald (2025), who identified demographic characteristics as important determinants of municipal fiscal condition. Likewise, Afonso et al. (2025) argued that regions with stronger economic and demographic capacity generally demonstrate greater fiscal resilience because larger populations contribute to broader fiscal resources and stronger local economies.

However, the positive relationship observed in this study should not be interpreted as evidence that population growth always improves fiscal sustainability. The benefits of larger populations depend on governments' ability to provide productive public services, improve labour productivity, expand investment opportunities, and manage urbanisation effectively. Without effective governance, rapid population growth may instead generate increasing fiscal pressure through higher public expenditure requirements.

From a policy perspective, the findings suggest that provincial governments should regard population as a productive economic asset rather than solely as a source of expenditure. Investments in education, health, employment, and human capital development are expected to strengthen the contribution of population growth to long-term fiscal sustainability.

5.5 The Moderating Role of Political Governance on the Relationship between Economic Growth and Local Government Financial Condition

One of the most important findings of this study is that political governance significantly moderates the relationship between economic growth and local government financial condition. The interaction coefficient is negative and statistically significant, indicating that political governance weakens rather than strengthens the contribution of economic growth to local government financial condition. Consequently, although political governance functions as a moderating variable, its moderating effect is contrary to the initial expectation proposed in this study.

The marginal effects analysis provides additional evidence supporting this conclusion. Under low levels of political governance, economic growth exhibits a positive although statistically insignificant relationship with local government financial condition. However, as political governance improves, the marginal effect gradually declines and eventually becomes negative and statistically significant under high governance conditions. This pattern indicates that stronger political governance changes the way economic growth affects provincial financial condition.

This finding may be explained from the perspective of Institutional Theory and Public Choice Theory. Institutional Theory suggests that stronger governance generally improves accountability, transparency, and citizen participation (North, 1990). However, stronger democratic governance may simultaneously increase political responsiveness toward public demands. Provincial governments operating in politically competitive environments frequently allocate larger fiscal resources to social programmes, public services, infrastructure development, and redistributive expenditure to satisfy citizens' expectations and electoral pressures. Public Choice Theory provides a complementary explanation. Governments facing stronger democratic competition often increase public expenditure to maximise political support, particularly before elections or during periods of increasing public demand. Consequently, although economic growth expands regional economic resources, these additional fiscal resources may be absorbed by expanding expenditure commitments rather than improving fiscal sustainability. As a result, the fiscal benefits of economic growth become weaker under stronger political governance. The present finding is broadly consistent with Ricciuti et al. (2016), who argued that political institutions significantly influence fiscal discipline because democratic competition frequently encourages governments to increase public expenditure. Similarly, Pal and Wahhaj (2012) demonstrated that decentralisation may generate inefficient public spending when political incentives dominate fiscal decision-making. These findings also support the argument of Kyriacou et al. (2015), who suggested that institutional quality does not always generate identical fiscal outcomes because governance interacts with political incentives and fiscal institutions.

Nevertheless, the present finding differs from studies concluding that stronger governance consistently improves fiscal sustainability (Feld et al., 2016; Afonso et al., 2025). One possible explanation is Indonesia's decentralised political system, where provinces experience substantial differences in political competition, budget priorities, and institutional effectiveness. Under these circumstances, stronger political governance may increase public expenditure responsiveness more rapidly than revenue generation, thereby weakening the contribution of economic growth to financial condition.

This finding represents the principal theoretical contribution of the present study. Unlike previous studies that conceptualised political

governance primarily as an independent determinant of fiscal performance, this research demonstrates that political governance functions as a contextual institutional factor that changes the effectiveness of economic growth in improving local government financial condition. Therefore, governance should not merely be evaluated based on its direct effects but also on how it interacts with regional economic development to influence fiscal sustainability.

5.6 The Moderating Role of Political Governance on the Relationship between Poverty and Local Government Financial Condition

Unlike the interaction between economic growth and political governance, the moderating effect of political governance on the relationship between poverty and local government financial condition is statistically insignificant. Although the interaction coefficient is negative, the estimated effect does not reach conventional significance levels. Accordingly, H6 is not supported. The marginal effects analysis indicates that poverty consistently exerts a negative influence on local government financial condition across all levels of political governance. The adverse effect becomes slightly stronger as governance improves; however, these differences are insufficient to conclude that political governance significantly changes the relationship between poverty and financial condition. One possible explanation is that poverty represents a structural socioeconomic challenge that imposes substantial fiscal burdens regardless of differences in institutional quality. Provincial governments with stronger governance remain obligated to finance education, healthcare, social protection, food security, and poverty alleviation programmes. Consequently, improvements in political governance alone may be insufficient to offset the fiscal consequences of persistent poverty. From the perspective of Fiscal Federalism Theory, poverty directly increases expenditure obligations while simultaneously reducing governments' revenue-generating capacity (Oates, 2005). Institutional Theory also suggests that although stronger governance improves administrative efficiency and accountability, institutional improvements cannot immediately eliminate structural socioeconomic inequalities that have accumulated over long periods. Therefore, governance may improve programme implementation without fundamentally altering the fiscal consequences of poverty.

This finding partially supports previous studies by Kyriacou et al. (2015), who argued that institutional quality enhances public sector efficiency. However, it also suggests that governance effectiveness has limitations when governments face persistent socioeconomic constraints. Similarly, Warner et al. (2021) reported that poverty creates continuous fiscal pressure because governments must maintain mandatory social expenditure irrespective of institutional quality.

The absence of a significant moderating effect indicates that strengthening political governance alone is unlikely to improve provincial financial condition when poverty remains high. Consequently, governance reforms should be accompanied by broader socioeconomic policies promoting employment creation, productive investment, human capital development, and inclusive regional economic growth. Such integrated policies are expected to reduce poverty while simultaneously improving long-term fiscal sustainability. Overall, these findings demonstrate that political governance plays different institutional roles depending on the socioeconomic context. While governance significantly alters the relationship between economic growth and local government financial condition, it does not significantly modify the fiscal consequences of poverty. This distinction enriches the literature on fiscal decentralisation by demonstrating that institutional quality does not influence all determinants of financial condition in the same manner.

6. Conclusion

This study investigates the determinants of local government financial condition in Indonesian provincial governments by examining the roles of economic growth, poverty, local own-source revenue, and population, while incorporating political governance as a moderating variable

within the framework of Fiscal Federalism Theory and Institutional Theory. The empirical findings reveal that economic growth does not significantly improve local government financial condition, indicating that economic expansion alone is insufficient to strengthen fiscal sustainability. In contrast, poverty exerts a significant negative effect, suggesting that persistent socioeconomic deprivation continues to place substantial fiscal pressure on provincial governments through increasing expenditure obligations and limited revenue capacity. Population is found to contribute positively to local government financial condition, whereas local own-source revenue does not exhibit a statistically significant influence, implying that greater fiscal autonomy alone is not automatically translated into healthier financial conditions. More importantly, this study demonstrates that political governance significantly moderates the relationship between economic growth and local government financial condition. However, contrary to the initial expectation, the moderating effect is negative, indicating that stronger political governance weakens rather than strengthens the contribution of economic growth to fiscal sustainability. This finding suggests that provinces with better political governance may simultaneously experience greater public expenditure commitments arising from stronger democratic accountability, public participation, and political responsiveness. Conversely, political governance does not significantly moderate the relationship between poverty and local government financial condition, indicating that the fiscal consequences of poverty remain substantial regardless of differences in governance quality. Overall, this study concludes that improving local government financial condition requires more than favourable economic performance. Sustainable fiscal health depends on the interaction between socioeconomic conditions, fiscal capacity, and institutional quality. Therefore, strengthening governance should be accompanied by policies that improve fiscal efficiency, expenditure quality, and poverty reduction in order to enhance long-term financial sustainability.

7. Theoretical and Practical Implications

Theoretical Implications

This study contributes to the literature on public financial management and fiscal decentralisation in several important ways. First, it extends Fiscal Federalism Theory by demonstrating that economic growth alone is insufficient to improve local government financial condition. The findings indicate that institutional contexts substantially influence whether economic resources can be transformed into sustainable fiscal outcomes. Second, this study enriches Institutional Theory by positioning political governance as a moderating variable rather than merely an independent determinant of government performance. Previous studies have primarily examined governance as a direct predictor of fiscal performance. In contrast, the present study demonstrates that governance alters the effectiveness of economic growth in influencing local government financial condition. This finding broadens current theoretical understanding by suggesting that governance functions as a contextual institutional mechanism shaping the relationship between socioeconomic factors and fiscal sustainability. Third, the study contributes to the literature on local government financial condition by providing empirical evidence from Indonesia, a large decentralised developing country characterised by substantial variation in institutional quality, fiscal capacity, and regional socioeconomic development. Consequently, the findings complement previous evidence predominantly derived from developed countries and demonstrate that institutional contexts may generate different fiscal outcomes across decentralised governments.

Practical Implications

The findings provide several important policy implications for both central and provincial governments.

First, policies promoting regional economic growth should be accompanied by improvements in fiscal governance and public financial management. Economic expansion alone is insufficient to strengthen local government financial condition unless provincial

governments are able to transform increasing economic activity into sustainable fiscal capacity through more effective revenue mobilisation and efficient expenditure management. Second, poverty reduction should be recognised not only as a social policy objective but also as a fiscal sustainability strategy. Investments in employment creation, human capital development, education, healthcare, and productive social protection programmes are expected to improve both public welfare and long-term fiscal resilience. Third, provincial governments should strengthen the quality of public expenditure rather than focusing solely on increasing local own-source revenue. Budget efficiency, expenditure prioritisation, and performance-based budgeting are likely to generate greater improvements in financial condition than revenue expansion alone.

Fourth, the significant moderating role of political governance suggests that improving democratic governance should be accompanied by stronger fiscal discipline. While greater transparency, accountability, and citizen participation remain essential, governments should simultaneously ensure that increasing political responsiveness does not lead to excessive expenditure commitments that weaken fiscal sustainability.

Finally, the Ministry of Home Affairs, the Ministry of Finance, and provincial governments should integrate governance quality into fiscal policy evaluation. Performance measurement systems should consider not only economic indicators but also institutional quality when assessing the financial sustainability of subnational governments.

8. Limitations and Future Research

Several limitations should be acknowledged. First, this study focuses exclusively on Indonesian provincial governments, which may limit the generalisability of the findings to district or municipal governments and to other countries with different decentralisation systems. Second, political governance is measured using the Indonesian Democracy Index, which primarily captures democratic quality and may not fully reflect other institutional dimensions such as government effectiveness, regulatory quality, or control of corruption. Third, the study examines only two moderating relationships and therefore does not capture other institutional mechanisms that may influence local government financial condition. Future studies are encouraged to incorporate broader institutional indicators, including government effectiveness, bureaucratic quality, corruption control, digital governance, and fiscal transparency. Comparative studies across countries or across different levels of government would also provide valuable insights into how institutional contexts shape fiscal sustainability. Furthermore, future research may employ dynamic panel estimators or spatial econometric approaches to capture temporal persistence and interregional spillover effects in local government financial condition.

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