World Journal of Advanced Research and Reviews

eISSN: 2581-9615 CODEN (USA): WJARAI

Cross Ref DOI: 10.30574/wjarr

Journal homepage: https://wjarr.com/

(Review Article)

Literature review on local government financial performance measurement

Ida Bagus Agung Haridharma Purba *

Faculty of Economics and Business, Udayana University, Bali, Indonesia.

World Journal of Advanced Research and Reviews, 2025, 25(01), 060-063

Publication history: Received on 21 November 2024; revised on 30 November 2024; accepted on 01 January 2025

Article DOI: https://doi.org/10.30574/wjarr.2025.25.1.4054

Abstract

Financial performance of local governments plays a critical role in ensuring the success of fiscal decentralization and sustainable regional development. As fiscal responsibilities shift from central to regional governments, the ability to measure and evaluate financial performance becomes increasingly important. This study synthesizes theoretical frameworks and empirical research to provide a comprehensive understanding of financial performance measurement in local governments. The metrics analysed include Locally Generated Revenue (LGR), Financial Ability Index (FAI), and fiscal independence. The study identifies key challenges in the measurement process, such as dependency on central transfers, variations in economic potential, and inconsistencies in financial reporting. It further explores the formulas and methodologies underlying these metrics, emphasizing their application in evaluating local fiscal health. Policy recommendations focus on standardizing metrics, enhancing technical capacity, and formulating innovative strategies to optimize revenue generation and ensure regional fiscal sustainability.

Keywords: Financial performance; Financial ratios; Local government; Locally Generated Revenue

1. Introduction

Fiscal decentralization has transformed governance by devolving fiscal responsibilities to local governments, thereby enhancing their role in managing resources, delivering public services, and addressing regional priorities. This paradigm shift aims to improve accountability, transparency, and citizen participation by aligning fiscal decisions with local needs. Oates posits that fiscal decentralization fosters efficiency by empowering local governments to allocate resources according to regional preferences. However, the success of decentralization depends significantly on the ability of local governments to generate and manage their revenues effectively, which requires robust financial performance measurement frameworks [1].

In Indonesia, fiscal decentralization was formally established through Law No. 22/1999 and Law No. 25/1999, which granted local governments greater autonomy over their budgets. Despite these reforms, many local governments struggle to achieve fiscal independence due to limited Locally Generated Revenue (LGR) and high reliance on central government transfers. These challenges underscore the importance of measuring financial performance to identify fiscal strengths and weaknesses, enabling targeted interventions to enhance autonomy. Financial performance metrics, such as LGR, Financial Ability Index (FAI), and fiscal independence ratios, have emerged as essential tools in this regard, providing quantitative insights into the fiscal health of local governments [2].

This review focuses on the theoretical and empirical foundations of financial performance measurement, exploring its role in evaluating fiscal autonomy and regional sustainability. The study examines key metrics and their respective methodologies, highlighting their application in policy formulation and development planning. It also discusses the challenges associated with measuring financial performance, emphasizing the need for standardized metrics and capacity-building initiatives. By integrating theoretical frameworks and empirical findings, this review aims to provide

* Corresponding author: Ida Bagus Agung Haridharma Purba

Copyright © 2025 Author(s) retain the copyright of this article. This article is published under the terms of the Creative Commons Attribution Liscense 4.0.

a comprehensive perspective on local government financial performance measurement and its implications for regional development.

2. Theoretical Framework

2.1. Theory

2.1.1. Fiscal Decentralization Theory

Fiscal decentralization theory serves as the foundation for understanding the transfer of fiscal authority from central to regional governments. The theory argues that decentralization enhances resource allocation efficiency by aligning fiscal decisions with local preferences and priorities. According to Oates, decentralization fosters economic growth by enabling local governments to tailor public services to the specific needs of their communities, thereby improving overall welfare. However, the theory also highlights the potential challenges of fiscal decentralization, such as disparities in revenue-generating capacity among regions and the risk of fiscal mismanagement due to limited local expertise [3].

2.1.2. Principal-Agent Theory

Principal-agent theory provides a framework for analysing the relationship between central and local governments in a decentralized system. In this context, the central government acts as the principal, delegating fiscal responsibilities to local governments (agents) with the expectation of efficient resource management and service delivery. However, agency problems, such as moral hazard and asymmetric information, can arise, leading to inefficiencies and accountability gaps. These issues underscore the importance of performance measurement as a mechanism to monitor and evaluate the fiscal activities of local governments [4].

2.1.3. Financial Performance Measurement Framework

Financial performance measurement frameworks provide tools for evaluating the fiscal health and management capabilities of local governments. These frameworks typically incorporate indicators such as LGR growth, FAI, and fiscal independence ratios to assess revenue generation, resource allocation, and expenditure efficiency. By enabling comparative analyses across regions, these metrics facilitate evidence-based policy decisions and targeted interventions to address fiscal disparities [6].

2.2. Methods

This study employs a systematic approach to measure local government financial performance through key indicators, namely Locally Generated Revenue (LGR), Financial Ability Index (FAI), and fiscal independence. The study integrates the formulas, interpretations, and criteria for evaluating these metrics, providing a robust framework for assessing fiscal health and autonomy.

The measurement of LGR performance involves two main parameters: growth rate and contribution. The growth rate evaluates the percentage increase in LGR over a given period, calculated by dividing the difference between the current year's LGR and the previous year's LGR by the previous year's LGR, then multiplying the result by 100. Contribution assesses the proportion of LGR in the total regional expenditure, calculated by dividing LGR by total expenditure and multiplying the result by 100. For LGR performance, regions with higher growth rates and significant contributions to expenditures are considered fiscally healthier. A high growth rate indicates expanding revenue streams, while a high contribution reflects substantial reliance on local revenue.

The FAI offers a comprehensive measure of fiscal capacity by integrating three indices: growth, share, and elasticity. The growth index compares a region's LGR growth to the maximum observed growth, highlighting relative performance. The share index assesses the region's LGR contribution to total expenditure against the highest contribution across regions. Elasticity measures the sensitivity of LGR to changes in economic output, calculated by dividing the percentage change in LGR by the percentage change in GRDP. The FAI is computed as the average of these three indices, with criteria categorized as follows: low financial ability (0.00–0.33), moderate financial ability (0.34–0.43), and high financial ability (0.44–1.00). Regions with higher FAI values demonstrate better fiscal resilience and adaptability to economic changes.

The fiscal independence ratio determines the reliance of local governments on their own revenue sources. This metric is calculated by dividing LGR by total regional income, then multiplying by 100 to express it as a percentage. The criteria

for fiscal independence are as follows: very low independence (≤25%), low independence (26–50%), moderate independence (51–75%), and high independence (76–100%). A high fiscal independence ratio indicates robust self-reliance, whereas a low ratio reflects dependency on external funding sources such as central or provincial government transfers.

These metrics are interpreted against established criteria to provide meaningful insights. For instance, LGR performance is deemed ideal when both growth and contribution values are high, reflecting a region's ability to generate significant revenue and allocate it effectively for regional development. Similarly, a high FAI score indicates balanced growth, substantial contribution, and strong elasticity, signifying fiscal health and adaptability. Meanwhile, fiscal independence levels reveal the extent of financial self-sufficiency and potential areas for improving revenue generation strategies.

By applying these methods and criteria, this study evaluates disparities in fiscal performance, identifies best practices, and provides actionable recommendations for enhancing financial autonomy. This approach ensures a comprehensive and standardized assessment of local government fiscal health, contributing to effective policy-making and sustainable regional development.

3. Results and discussion

LGR is a cornerstone of fiscal independence, reflecting the ability of local governments to generate their income through taxes, retributions, and other local sources. A high LGR growth rate signals a government's capacity to expand its revenue base, while a significant contribution to the regional budget highlights its reliance on local resources. The discussion identifies disparities in LGR performance, attributing them to variations in economic potential, tax administration efficiency, and local policies. Regions with diversified economies and robust fiscal policies tend to achieve higher LGR growth and contributions, emphasizing the importance of resource optimization.

FAI offers a multidimensional perspective on financial performance by integrating growth, share, and elasticity indices. This composite metric provides a nuanced understanding of fiscal health, highlighting areas requiring intervention. For instance, regions with low elasticity scores often struggle to adapt revenue generation to economic growth, necessitating targeted capacity-building initiatives. The FAI is also valuable for benchmarking performance, enabling policymakers to identify fiscal outliers and prioritize resources for underperforming regions.

Fiscal independence is critical for achieving true regional autonomy, as it reflects a government's ability to finance its operations without external support. High fiscal independence ratios indicate robust revenue-generation mechanisms and effective resource management. However, many regions remain reliant on central government transfers, highlighting the need for structural reforms and revenue diversification strategies. The discussion underscores the importance of reducing fiscal dependency to enhance policy discretion and foster sustainable development.

Several challenges impede the effective measurement of financial performance, including inconsistent reporting standards, limited technical capacity, and economic disparities among regions. Inconsistent data undermines the reliability of comparative analyses, while limited expertise restricts the adoption of advanced fiscal tools. Economic disparities exacerbate these challenges, as less developed regions often lack the resources to implement effective financial strategies. Addressing these challenges requires the adoption of standardized metrics, capacity-building programs, and targeted interventions to support lagging regions.

The integration of financial performance metrics into policymaking is essential for enhancing fiscal management and accountability. Policymakers should prioritize the standardization of metrics to ensure consistency and comparability across regions. Capacity-building initiatives, such as training programs for local government officials, can enhance technical expertise and promote the adoption of innovative fiscal practices. Best practices include leveraging local economic potentials, such as tourism and agriculture, to diversify revenue streams and reduce dependency on external transfers.

4. Conclusion

The measurement of financial performance is integral to the success of fiscal decentralization and regional autonomy. Metrics such as LGR, FAI, and fiscal independence provide valuable insights into the fiscal health of local governments, enabling evidence-based policy decisions and targeted interventions. This literature review highlights the strengths and

limitations of these metrics, emphasizing their role in fostering sustainable fiscal practices.

However, challenges such as inconsistent reporting, limited technical capacity, and economic disparities must be addressed to maximize the effectiveness of financial performance measurement. Standardizing metrics and enhancing technical expertise through capacity-building initiatives are essential steps in this direction. Policymakers should also focus on integrating these metrics into regional development planning frameworks, ensuring that fiscal decisions align with long-term sustainability goals.

Future research should explore the development of advanced metrics that account for regional disparities and dynamic economic conditions. By refining financial performance measurement frameworks, local governments can enhance their fiscal management capabilities, reduce dependency on external funds, and achieve greater autonomy in governance.

Compliance with ethical standards

Disclosure of Conflict of Interest

The author confirms that they have no identifiable conflicts of interest, financial interests, or personal affiliations that could have influenced the research reported in this article.

References

[1] Oates WE. Fiscal decentralization and economic development. National Tax Journal. 1993;46(2):237-43.

[2] Mardiasmo. Public Sector Accounting. Yogyakarta: Andi; 2005.

[3] Basri H, Syaparuddin, Junaidi. Mapping of the performance of local real income and the financial capacity of districts/cities in Jambi Province. J Financing Perspective of Regional Governments. 2013;1(2):81-90.

[4] Hidayat M, Hadi MF, Widiarsih D. Analysis of the financial capacity of districts/cities in West Sumatra Province in the era of regional autonomy. J Sungkai. 2016;4(2):36-55.

[5] Widodo J. Good governance: An Analysis of the Dimension of Accountability and Bureaucratic Control in the Era of Decentralization and Regional Autonomy. Surabaya: Insan Cendekia; 2001.

[6] Sularmi, Suwarno A. Analysis of the performance of local governments in dealing with regional autonomy. J Financial Accounting. 2006;5(1):28-50.