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Financial accountability on local government and regional economic growth

Fitra Dharma*)
Universitas Lampung, Indonesia

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ABSTRACT

Audit opinions should be linked to regional economic growth as evidence of financial accountability. Previous research in Indonesia on government spending and regional economic growth has been inconsistent. Audit opinion of local government financial statements could result in discrepancies in the research findings. The purpose of this study is to determine whether there is higher economic growth in local governments that obtain an unqualified audit opinion (UAO) compared to local governments that obtain a modified audit opinion (MAO). This study uses district and city governments in Indonesia from 2016 to 2020 as a sample. The Mann-Whitney test shows that local governments that receive an unqualified audit opinion (UAO) have higher economic growth than those that receive a modified audit opinion. The results of this study show empirically that local government financial accountability is associated with regional economic growth.



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Corresponding Author:

Fitra Dharma,
Universitas Lampung
Email: fitra.dharma@feb.unila.ac.id

Introduction

Budgeting for the government symbolizes an explicit agreement between the people and their government to use public services resources and keep promises made by the government (Tanaka, 2007). In Indonesia, each newly inaugurated district head is responsible for developing a Medium-Term Development Plan (Rencana Pembangunan Jangka Menengah Daerah: RPJMD) for their five-year tenure. Then, each year, RPJMD is implemented through the Local Government Budgeting process (Anggaran Pendapatan dan Belanja Daerah: APBD).

Based on government regulation of the Republic of Indonesia Number 71 of 2010 concerning Government Accounting Standards, budgeting is a public policy statement that serves as the foundation for control with legal consequences. It serves as the foundation for evaluating the government's performance, and the result of budgeting implementation is stated in the government financial statement as the statement of government responsible. Local government financial statements (Laporan Keuangan Pemerintah Daerah: LKPD) are one method for regional governments to be held accountable for financial management.

The Audit Board of the Republic of Indonesia (Indonesia: Badan Pemeriksa Keuangan: BPK), an independent auditing institution, investigates the qualification of local government financial statements. BPK will audit the LKPD. The BPK audit result is a proxy for the financial management performance of regional governments. Regional financial management that is sound and following the regulations will receive an

unqualified opinion. At the same time, BPK will decline to state opinion in the case of poor financial management (disclaimer opinion).

Effective financial management indicates that the output target in APBD is met, implying that the expected outcome is also met. When the output and outcome of each budgeting period are met, the district head's mission of promoting public welfare is also met. Regional economic growth is one of the welfare indicators. Local government spending impacts economic growth (Deviani, 2016; Haryanto, 2013; Putri et al., 2018; Räsänen & Mäkelä, 2021).

The implementation of accounting standards helps the process of economic development (Enthoven, 1986). A standardized accounting system makes it easy to analyze, evaluate, and compare financial statements, calculate the cost, and help fiscal administration, budgeting, control, and audit so that it is easier to make economic planning and policy (Enthoven, 1986).

The implementation of accounting and audit is related to economic growth (Abdolmohammadi & Tucker, 2002). Accounting implementation can trigger economic growth. It provides an audited financial statement that is credible so that it reduces information asymmetry and lowers agency cost and information risk. The practice of accounting and auditing helps entrepreneurs plan and control their company (Abdolmohammadi & Tucker, 2002). Control and evaluation of performance and incentives made by the accounting system trigger the increase of marginal productivity of the worker and the increase of corporate performance: the more companies that perform well, the better economic growth of a country. In China, companies that obtained modified audit opinions would have difficulty obtaining loans from banks and tend to get loans from related party loans (Lin et al., 2011). Banks' funding difficulty shows a poor economic consequence when an entity does not obtain an unqualified opinion since a creditor feels that the risk of funding the company is higher.

Implementing public accountability in the regional government by conducting relevant and reliable accounting principles leads the regional development to achieve the output and outcome target of APBD and RPJMD. When the regional government conducts budgeting and reports it following the regulation, the local government financial statement will obtain an unqualified opinion (UAO).

UAO's opinion indicates that the implementation of local government spending reaches the output and outcome targets and is less likely to be distorted. Regional spending is one of the gross domestic product resources in the region. Therefore, the economic growth of the district/city that obtained unqualified opinion should be better than the region that did not obtain UAO because the regional government with UAO has less possibility of conducting budgeting distortion compared to the one with disclaimer opinion.

A study that investigates the correlation between audit opinion results and regional economic growth is rarely done. The studies on government expenditure and regional economic growth in Indonesia are varied and different. Some studies show that regional government spending increases economic growth (Deviani, 2016; Haryanto, 2013; Putri et al., 2018), but other studies found that government spending did not affect or even was not associated with the decrease of economic growth (Basuki et al., 2019; Djohan 2016 et al.). Di China, belanja pendidikan dan kesehatan berpengaruh pada perekonomian tetapi belanja modal tidak berpengaruh ((Luintel et al., 2020)

The difference in results might be caused by the quality of local government financial accountability. With more accountants and auditors, the country has better economic growth because its financial management is qualified (Abdolmohammadi & Tucker, 2002). In China, local audit institutions discovered that audits could detect misbehaviour and misconduct in public financial revenues and expenditures (Liu & Lin, 2012). A study on audit opinions in Riau Province, Indonesia, discovered no effect on public opinion on social welfare (Saragih & Hasibuan, 2020)

Regional economic growth will increase when financial accountability is qualified, achieve the output's budget, and decrease corruption. Saragih and Hasibuan (2020) discovered that audit opinions did not affect public prosperity. It could be because their sample size is limited to a single province in Indonesia, Riau. As a result, it is vital to expand the sample size throughout Indonesia over time. Therefore, this research empirically demonstrates that regional economic growth is enhanced when local governments get UAO audit opinions.

The main contribution of this study shows that the performance of local government financial accountability is related to regional economic growth. This result will emphasize the implementation of agency theory in a public organization. Practically, it will prove that the quality of local government financial management is related to people welfare.

Agency Theory

Agency theory explains that the agency relationship emerges when the principal delegates some authority to the agent to act on behalf of the principal (Jensen & Meckling, 1976). The principal in the public sector consists of various parties. Legislative can be the principal in the budgeting process if they have budget authority. The executives, which are district heads, are also the principal because they can determine the budget (Forrester, 2002;125). In the public sector, especially in the budgeting process, almost all government bureaucracies are agents because they are responsible for implementing programs and policies (Forrester, 2002;125).

Authority delegating leads to an information asymmetry between the agent and principal, as the agent has more knowledge about the organization or company than the principal. If the agent is rational and seeks maximum satisfaction, he or she cannot act in the principal's primary interest. An agent may act opportunistically in his or her interest and disregard the principal's interest (Jensen & Meckling, 1976).

Conflict of interest between owner and agent might be because the agent does not always act following the principal, so it triggers agency cost. Agency cost defines as the total cost spent by the principal to conduct supervision on an agent. Agency cost consists of monitoring cost, bonding cost, and residual loss. Monitoring cost is the cost incurred and borne by the principal for monitoring the agent's behaviour, which is measuring, observing, and controlling the agent's behaviour. Bonding cost is the cost borne by an agent to determine and follow the mechanism, ensuring that the agent acts for the principal's interest. Next, the residual cost is the sacrifice in decreasing the principal's welfare due to the difference between the agent's decision and the principal's decision.

Governor, major and regent in Indonesia are the elected agents of the electorate. Elected agents induce an agency problem (Zimmerman, 1977). A financial statement audit is the way of principal to conduct monitoring toward agent's activities. Credible audit results will reduce agency costs and information risk. When agency cost decreases, the principal's welfare will increase.

Local Government Financial Statement

Based on Minister of Home Affairs Regulation Number 64 the Year 2013 on the implementation of accrual-based governmental accounting standard on local Government, Local Government Budget (APBD) is a yearly financial plan of regional Government. APBD is discussed and agreed upon together with the regional Government and DPRD (Regional House of Representatives). It is appointed with regional government regulations.

According to the conceptual framework of Indonesian Governmental Accounting, budgeting in a governmental environment is a public policy statement. Budgeting is a fiscal target that describes the balance among expenditure, revenue and desires to finance. Budgeting becomes the foundation of controlling that has a legal consequence. Budgeting gives the foundation of government performance evaluation. The result of budgeting implementation is stated in the government financial statement as government responsibility to the public. Regional Government is governors, regents, or mayors, and regional apparatuses as the elements of regional government administration. Regional Financial Management includes planning, implementation, administration, reporting, accountability, and regional financial supervision. Local governments are required to report financial statements as accountability of APBD's Implementation. The Law of the Republic of Indonesia, Number 17 of 2003 concerning State Finance in Article 32, mandates that the accountability report for the APBD is prepared and presented under Government Accounting Standards. Government financial statement based on Indonesian governmental accounting standards consists of budgetary reports, financial statement, and Notes to Financial Statement (NFS). The budgeting implementation report consists of Budgeting Realization Report (BRR) and the Changes in Excess Budget Balance Report.

The financial statement consists of the balance sheet, Operational Report (OR), Cash Flow Statement (CFS), Statement of Changes in Equity (SCE). NTFS is a report that details and explains further the posts of budgeting implementation report or financial statement and is a report that cannot be separated from budgeting implementation report or financial statement.

The local Government also must report LKPD that BPK audits as external auditor of Government. The audit on LKPD is the way for the central Government to conduct control so that the local Government can serve local people, which is its responsibility. The audit result of BPK becomes the indicator of regional government financial management performance. The performance and accountability of regional Government are also measured every year to measure the output and outcome toward activity program of regional Government in achieving determined targets on budgeting document. The implementation of budgeting and accounting is meant to convince stakeholders that the regional Government's resources are used for people interests.

Economic Growth

Economic growth is the increase of long-term capacity in supplying various economic goods to its people in a country. This capacity increase is based on the technological advances and the necessary institutional and ideological adjustments (Kuznet, 1976). *Economic growth* is defined as the increase of economic activities that result in a rise in the quantity and quality of products and services produced in society (Sukirno, 2011;331). Economic growth will cause the prosperity of society.

Economic growth shows the extent to which economic activity will generate additional public income in a certain period (Mankiw, 2009;91). The indicator to measure economic growth is the growth rate of Gross Domestic Product (GDP). In a regional economic context, the size often used is Gross Regional Domestic Product (GRDP), which is the total gross value added produced by all economic sectors in the region. Meanwhile, income per capita is the total income of the region divided by the number of residents for the same year (Tarigan, 2005).

Financial Accountability

Law of Republic Indonesia, Number 15 of 2004 concerning the State Financial Management and Accountability Audit, states that audit is problem identification, analysis, and evaluation process. It is done independently, objectively, and professionally based on audit standards to evaluate the correctness, accuracy, credibility, and reliability of management and state financial responsibility information. BPK has responsible for auditing the government. BPK's audit consists of financial audit, performance audit, and audit for specific purposes.

The fundamental purpose of a government audit is to monitor, convince, and evaluate government accountability (Liu & Lin, 2012). Monitoring toward public power, especially the use of public resources through government audits, will reduce corruption because it strengthens public accountability and reduces the diversion of authority and public resources. The study on government audit and corruption in China found that more findings of deviation on audit had a positive correlation with the corruption rate (Liu & Lin, 2012).

Audit opinion consists of 5 types of opinions: unqualified opinion, unqualified opinion with explanatory paragraph, qualified opinion, adverse and disclaimer opinion (Arens et.al, 2014;71). Besides unqualified opinion, the four other types of opinion are categorized as the modified opinion (Cahyaningrum & Fitriany, 2013). Government financial management that is good and following the regulation will be given unqualified opinion, and BPK will state to give disclaimer opinion to the regional government with poor financial management

Hypothesis

The implementation of accounting helps economic development because standardized financial management facilitates the planning and policy-making of economics (Enthoven, 1986). The more qualified financial reporting and auditing in a country, the better the country's economic growth (Abdolmohammadi & Tucker, 2002; Bediako, 2017).

BPK's audit opinion is the reflection of financial accountability quality on the implementation of APBD. A regional government that manages finances under the regulation and presents as the regional government financial standards will obtain unqualified opinions. The regional government that manages regional finances that do not follow the regulation will obtain audit findings and disclaimer opinions from BPK. Unqualified audit opinions indicate that regional spending achieves output and outcome that is the target of APBD. When government spending reaches the desired outputs and outcomes, it will impact economic growth (Deviani, 2016; Haryanto, 2013; Putri et al., 2018; Räsänen & Mäkelä, 2021). Therefore, the regional government that obtained unqualified opinion has better economic growth than the region that did not.

H: Regional economic growth in Local Government that obtained Unqualified opinion is higher than the regional government that obtained modified audit opinion on its Financial Statements.

Method

Sample and Data

The population of this study is all local governments in Indonesia. Data of audit opinion are from summary audit report (Ikhtisar Hasil Pemeriksaan Semester: IHPS) of BPK. IHPS audit opinions used are the opinions in 2016-2020. Data on economic growth are Gross Domestic Product (GDP) publication data of district/city from the Central Bureau of Statistics (Badan Pusat Statistik: BPS).

Indonesia has 548 local governments from 2016 to 2020, according to BPS statistics. There are 34 provincial governments, 416 district administrations, and 98 municipal governments in the local government system. Provincial governments are superior to those of districts and cities. For the consistent level of research analysis,

this study draws samples from the district and local governments. There are four regions with insufficient data in the sample of 514 district and municipal governments. These regions must be excluded from the sample. Additionally, 18 regions with a high reliance on oil and mining were removed from the study. Thus, 5 years of monitoring can be used to examine 492 district and municipal governments.

Variable definition

Audit opinion (AO) is the result of BPK's examination of local government financial statements. Each year, throughout the reigns of regional leaders. The Supreme Audit Board's audit opinion indicates the level of financial accountability. The audit opinion consists of Unqualified Opinion (UO), Unqualified Opinion with Explanatory Language (UOEL), Qualified Opinion (QL), Adverse Opinion (AO) and Disclaimer of Opinion (DO). Apart from unqualified opinion, the modified opinion category encompasses four additional types of opinion (Cahyaningrum & Fitriany, 2013). We distinguish between an unqualified audit opinion (UAO) and a modified audit opinion (MAO) in this study.

Economic growth is defined as the increase of economic activities that result in a rise in the quantity and quality of products and services produced in society (Sukirno, 2011;331). The Gross Domestic Product (GDP) growth rate is used to gauge economic growth. In a regional economic context, the term "Gross Regional Domestic Product" is frequently used to refer to the region's Gross Regional Domestic Product (GRDP), which is the region's entire gross value-added created by all economic sectors.

Analysis Method

This study used an independent t-test to examine economic growth differences between local governments that got UAO and MAO opinions. The independent sample t-test is used to test the average difference between the two unrelated sample groups (Wiyono, 2011;240).

The independent t-test begins with a normality test. If the data is normally distributed, parametric analysis is being used. If the data are not normally distributed, the option officially adopted non-parametric testing. The Mann-Whitney test is a non-parametric test that is used to verify the research hypothesis.

Data Normality Test

The purpose of data normality testing is to determine if the data are normally distributed. The normality test is critical because it helps choose the statistical test instrument to employ for hypothesis testing. The Kolmogorov-Smirnov statistic is chosen because it is more sensitive than graph-based testing for detecting data normality (Ghozali Imam, 2018;111). The normality of the data is determined in such a way that if the significant result is greater than the specified significance threshold (0,05), then H_0 is considered normal. In contrast, if the test significance is less than ($\geq 0,05$), H_0 is rejected, indicating that the data are not normally distributed.

Result and Discussion

Statistics Descriptive

The first table discusses descriptive statistics. Between 2016 and 2020, the average economic growth (EG) of district/city governments in Indonesia was 5.519 per cent for those who received an Unqualified audit Opinion (UAO). Economic growth averaged 5.414 per cent for districts/cities that received modified opinions.

According to the UAO, the highest economic growth occurred in Banggai district, Central Sulawesi province, in 2017. At the same time, the district of North Morowali in Central Sulawesi province experienced the highest economic growth for local governments that received a modified opinion, at 16.91 per cent in 2019, which was the subject of a qualified opinion in that year.

Table 1. Statistics Descriptive

Description		N	Min	max	Mean	Std. dev
Modified opinion	EG	661	-4,597	16,917	5,414	1,598
Unqualified opinion	EG	1.799	-2,139	38,218	5,519	1,812

Note: EG: economic growth rate (in percent)

In 2016, the Kuantan Senggigi district government in Riau province experienced the lowest economic growth of any local government that received an Unqualified audit opinion, at -2.139 per cent. Meanwhile, the minimum value for local governments that received a modified opinion was -4.597 per cent, which occurred in Papua province's Biak district government in 2018 who received a disclaimer opinion from the Supreme Audit Agency (BPK) on their local government's financial statements.

Normality Test

The Kolmogorov-Smirnov test is employed in this normality test. If the Kolmogorov-Smirnov statistical test result is greater than 0.05, the data is considered normal; if the value is less than 0.05, the data is considered not normal. If the data are deemed not normal, a separate test is used that employs a non-parametric analysis of the Mann-Whitney test.

Table 2. Kolmogorov-Smirnov Normality Test for All Samples In 2011-2016

		EG
N		2460
Normal Parameters ^{a,b}	Mean	5.49108
	Std. Deviation	1.757802
Most Extreme Differences	Absolute	.139
	Positive	.134
	Negative	-.139
Test Statistic		.139
Asymp. Sig. (2-tailed)		.000 ^c
Monte Carlo Sig. (2-tailed)	Sig.	.000 ^d
a. Test distribution is Normal.		
b. EG : economic growth		

The normality test findings in Table 2 indicate a significance level less than 0.05. These findings imply that EG is not distributed normally. Due to the significance of the Kolmogorov Smirnov value, the difference test employs a non-parametric analysis of the Mann Whitney test.

Table 4. Mann-Whitney Hypothesis Testing

		EG
Mann-Whitney U		560763
Wilcoxon W		779554
Z		-2.165
Asymp. Sig. (2-tailed)		0,030
Monte Carlo Sig. (2-tailed)		Sig. 0,029
Monte Carlo Sig. (1-tailed)		Sig. 0,014
Mean rank	N	
	1.799	Unqualified Audit Opinion (UAO) 1.249,29
Mean	661	Modified Audit Opinion (MAO) 1.179,36
	1.799	Unqualified Audit Opinion (UAO) 5,519
	661	Modified Audit Opinion (MAO) 5,414
a. Grouping Variable: UAO		
EG: economic growth		

The Mann-Whitney difference analysis confirmed that the study's hypothesis is supported. When local governments manage their finances properly, in line with the rules, outputs and outcomes are reached, they will receive an Unqualified audit opinion from BPK. Local government expenditure has a good effect on the regional economy. thus, Local governments that receive an unqualified audit opinion have higher economic growth than local governments that receive a MAO opinion.

The study's findings demonstrate that regions that received the UAO opinion saw higher economic growth than regions that received the MAO view. This finding is consistent with the findings of Abdolmohammadi & Tucker (2002) and Enthoven, (1986), who discovered a relationship between audit opinion and economic growth. Nor does it contradict the work of Deviani (2016), Haryanto (2013), Putri et al. (2018); Räsänen & Mäkelä (2021), all of whom demonstrate that government spending affects economic growth.

This research on district and city administrations in Indonesia distinguishes from Saragih & Hasibuan (2020) which was limited to the province of Riau. Local governments in areas where oil and gas dominate the GRDP contribution, such as the province of Riau, the potential of regional financial accountability is unrelated to economic growth. However, regional governments in Indonesia that manage their finances effectively will generate better economic growth than regions that do not manage their APBD effectively.

Additionally, this research also supports the agency theory assertion that auditing financial statements is a tool used by the public and central government to exert control over local government behavior. Audits mitigate the danger of budget balance, as they can detect budget fraud (Liu & Lin, 2012). When government spending is in line with the targets, the general welfare of the populace improves.

These findings are helpful for central government regulators as well as regional heads and bureaucrats in the regions. Until now, regional leaders have believed that managing finances is simply a matter of adhering to the regulations. Financial accountability research that establishes a link between financial accountability and economic growth will drive regional leaders to continue managing funds prudently. Economic growth and increased welfare are campaign pledges made by nearly all regional leaders throughout each general election campaign. This finding is also excellent news for regulators who write financial reporting requirements. This research persuades regulators that accounting for local governments has a positive correlation with enhancing people's welfare.

Conclusion

This is a preliminary study attempting to establish a link between financial accountability and economic growth. The study's drawback is that it attempts to demonstrate the difference in economic growth between regions that obtain UAO and MAO views but does not examine the effect of audit opinions on economic growth. In economics, research on the effect of government spending on economic growth has been well established. However, the link between financial accountability and economic growth is novel and has received little empirical attention. Further study should be conducted to determine the influence of public accountability on economic indicators such as economic growth and and social welfare.

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