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Effect of Financial Performance Antecedents towards Local Government Performance (Local Government Study in Indonesia)

Suwiknyo,
Doctoral Programme of Economics and Business Faculty, Universitas Muslim Indonesia, Indonesia

Mahfud Nurnajamuddin,
Economics and Business Faculty, Universitas Muslim Indonesia, Indonesia

Baharuddin Semmaila,
Economics and Business Faculty, Universitas Muslim Indonesia, Indonesia

Bahar Sinring,
Economics and Business Faculty, Universitas Muslim Indonesia, Indonesia

Abstract:- This study aims to analyze the effect of fiscal illusions, budgetary slack, flypaper effects, and local financial distress on local financial performance and local government performance. Data collection used documentation studies with a total sample of 85 cities in indonesia. SEM (structural equation modeling) analysis was applied as a analytical tool with assistant of Smartpls 3.0 software. The result show a significant and positive impact of fiscal illusions, and flypaper effect on local financial performance, while non-significant direct effect was found between budgetary slack and financial performance. The results provide theoretical and practical implications for stakeholders in order to improve the performance of local governments in indonesia.

Keywords:- *Fiscal Illusion; Budgetary Slack; Flypaper Effect, Local Financial Distress, Local Financial Performance, Local Government Performance.*

I. INTRODUCTION

The success of the country is dependently rely on local governments perfomance amidst the current global changes (Global Megatrend). This change is radical, massive, well-structured and almost unstoppable, where the future of nations in the world will be affected by this, as explained by Vielmetter and Sell (2014), has identified global megatrends in the next two decades rapid urbanization, climate change, resource scarcity, geopolitics, geoeconomics, middle class growth, demography and social knowledge (global knowledge society), technological breakthroughs and innovation, global finance and global sustainability and responsibility.

The implementation of decentralization and local autonomy policies indicates their successes and failures in various other countries, especially Indonesia. Evidence of this issue is shown based on findings of several prior studies such as Bird and Vaillancourt (1998); Shah (2003); Banerjee (2002). The success of local financial management is largely determined by the ability of local financial performance. This was also stated by Mardiasmo (2002), Halim (2007), and Kuncoro (2011) argue that local financial performance shows the ability of the region to carry out local functions related to the ability of the region to explore the resources or potentials owned by the region in the context of improving the welfare of the community which is the goal of decentralization and local autonomy.

The evaluation of local financial performance based on the theory and empirical findings above, there is a research opportunity (novelty) for now; *first*ly, this research opportunity combines the NPM theory approach with other theories in local financial management namely; agency theory, fiscal theory, public financial theory and expectations theory. *Secondly*, research opportunities for developing research models, based on previous research results, financial performance is more approached by direct testing with local financial performance antecedent variables such as fiscal illusions (Dude, et al., 2014), budgetary slack (Rahim et al., 2013; Fozzard, 2001), flypaper effect (Widodo, 2007; Courant et al., 1979), and financial distress (adopted from the private sector Platt and Platt, 2002). *Thirdly*, the development of research constructs by examining financial distress factors as adoption of the private sector approach. *Finally*, the opportunity for this research to develop research nationally, based on the suggestions raised by the previous research, this research is focused on local governments throughout Indonesia with a sample of all City Governments in Indonesia. The currect study is expected to provides both academic and practical benefits.

II. THEORITICAL REVIEW

A. Local Financial Perfomance

Performance is a picture of achieving the implementation of an activity in achieving the goals, vision and mission of an organization (Bastian, 2006). Measurement of local government financial performance can be measured by various methods, such as local financial capacity or fiscal independence (Mahsun, 2006). Local financial capability is assessed from the share of local own-source revenue (PAD) to total local income in accordance with the principle of local autonomy with a measure of the ability to carry out decentralization matters with the ability to use local resources independently. The results of research by Palmer (1995) and Liu and Liu

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(2003), showed a positive relationship between the implementation of decentralization and economic growth.

B. Antecedents of Local Financial Performance

Fiscal illuision was first explained by an Italian economist named Amilcare Puviani, as decision makers who have authority in institutions create illusions in financial arrangements that are able to change financial behavior. Mueller as quoted by Dollery and Worthington (1999) provides a definition of contemporary fiscal illusion as follows: "*To bring about an increase in government size, for which citizens are not willing to pay voluntary, the legislative - executive entites must increase taxes burdens in such a way that licenses are unaware that they are paying more taxes ..... if tax burdens can be disguished in this way, citizens have the illusion that the government is smaller than it actually is and the government can grow beyond the levels of citizens prefer*."

Budgetary slack reflects the difference between the amount of budget deliberately prepared by managers and the best estimate of the company (Anthony and Govindarajan, 2001). Schiff and Lewin (1970) stated that subordinates create budgetary slack because it is influenced by personal desires and interests so that it will facilitate the achievement of budget targets, especially if manager's performance appraisal is determined based on budget achievement. This effort is carried out by determining income that is too low (understated) and costs that are too high (overstated).

Flypaper effect term arises from Okun (1930) thought which states "money sticks where it hits". So far, there is no equivalent of the word "Flypaper Effect" in Indonesian so this word is written as it is without being translated. Oates (1999) states that when the response of the Local Government is greater for transfers compared to the Local Own Revenue (PAD) of its own region, it is called the Flypaper Effect. According to Sagbas and Saruc (2008) there are two main theories from several studies on the source of the emergence of the Flypaper Effect that is often used, namely the Fiscal illusion and The bureaucratic model. The Fiscal illusion theory as a source of Flypaper Effect suggests that the Flypaper Effect occurs due to the ignorance or indifference of voters or local residents regarding financing and spending and decisions taken as a result of these misperceptions.

Financial distress is a situation where a company's operating cash flow is inadequate to pay off current obligations (such as trade payables or interest expense) and the company is forced to take corrective actions. Financial distress is a very severe liquidity problem that cannot be solved without changing the size of the company's operations or structure. Financial distress is a condition where the company's finances are in an unhealthy state or crisis.

C. Local Government Performance

Improved budget performance and local financial management occupy an important position in the strategy of empowering the Local Government to implement local autonomy and realize broad, real and responsible decentralization. Performance-oriented expenditure planning will improve the performance of local budgets. Estimated amount of fund allocation for each local government work unit and work program needed to produce a level of public service, adjusted to the demands and needs of the community.

III. CONCEPTUAL MODEL AND HYPOTHESIS

The Grand Theory used in this research, related to local financial performance refers to the concept of NPM to see the efficiency, effectiveness, and economics of managing local finances (Groot and Budding, 2014). Other theories such as the references are agency theory (Lane, 2003), fiscal illusion theory (Dollery and Worthington, 1999; Hewitt) for explain the local financial performance. Empirically also various research findings related to fiscal illusions (Dude, et al., 2014), budgetary slack (Lane, 2003), flypaper effect (Shinta, 2009; Widodo, 2007) and financial difficulties (Platt and Platt, 2002) in local financial performance. The proposed model is shown by Figure 1.

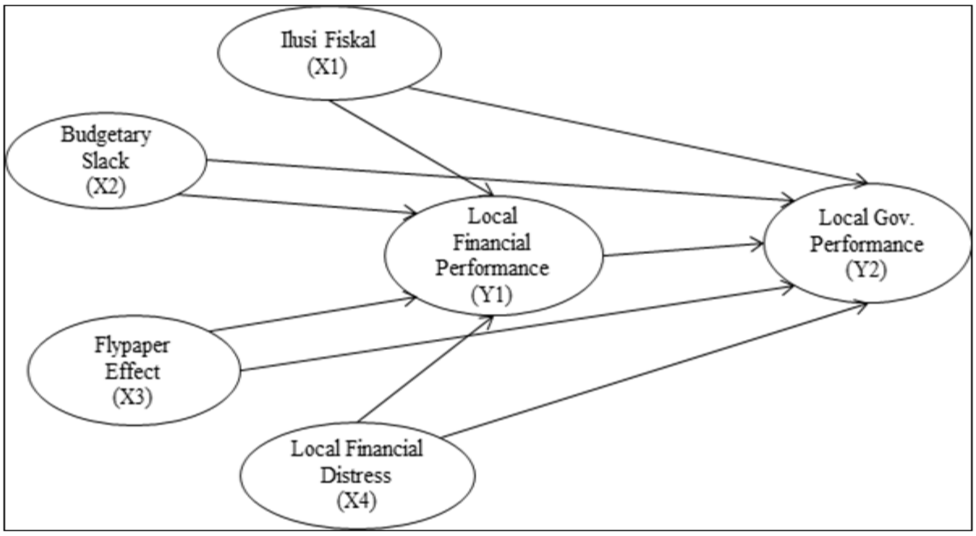

Fig 1:- Conceptual Model

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Based on a theoretical study of the problem to be examined, the researcher formulates the research hypothesis as follows:

1. Fiscal illusions have a significant effect on local financial performance.
2. Fiscal illusions have a significant effect on local government performance
3. Fiscal illusions affect local government performance through local financial performance
4. Budgetary slack has a significant effect on local financial performance
5. Budgetary slack has a significant effect on the performance of local government.
6. Budgetary slack has a significant effect on the performance of local governments through financial performance.
7. Flypaper effect has a significant effect on local financial performance.
8. Flypaper effect has a significant effect on the performance of local government.
9. Flypaper effect has a significant effect on the performance of local governments through the performance of local finances
10. Local financial distress have a significant effect on local financial performance.
11. Local financial distress have a significant effect on the performance of local governments.
12. Local financial distress have a significant effect on local government performance through local financial performance
13. Local financial performance has a significant effect on the performance of local governments.

IV. METHODS

An explanatory approach is used to explain the relationship and influence of several antecedents of financial performance including fiscal illusions, budgetary slack, flypaper effect, and local financial distress on local financial performance and local government performance (Ashoer, 2019). Field research is carried out for 5 (five) months starting from the receipt of this research proposal. The study was conducted at the City Government throughout Indonesia. The research method used is library research using secondary data from local government financial records in Indonesia.

This study uses sample determination criteria by first considering several aspects of determining the criteria that are targeted by the sample of the population that is the object of research (Ashoer et al., 2019). Determination of the sample with the following considerations; first, the potential availability and completeness of the data needed in research to determine the target sample; second, consideration of the sufficiency of the number of samples and data to meet the statistical assumptions (central limit theorema), and third, the selection of target samples from the entire population because the region publishes financial reports, budget realization reports, and financial reports issued by BPK for 3 (three) the last consecutive year. Based on the considerations of determining the sample, the method used is purposive sampling or called the sample with criteria. Determination of the sample with these criteria, the target sample in accordance with the criteria stated in this study is the City Government throughout Indonesia. City Government Samples meet all the established criteria relating to the availability and completeness of the data, the adequacy of the number of samples and data, and the criteria for samples published during the last three years. From the results of the determination of the sample, the target sample of research is the City Governments throughout Indonesia, totaling 85 City Governments in Indonesia.

Data analysis was performed quantitatively. Quantitative data analysis was performed using Structural Equation Modeling (SEM) analysis based on Partial Least Square (PLS). Analysis of the data used to solve the hypothesis model built in this study is Partial Least Square (PLS). Data analysis using the PLS (Partial Least Square) analysis model using the help of the Smart PLS computer package program (Solimun, 2017; Ashur, 2016), with the reasons: (1). The tiered analysis model and the structural equation model meet the recursive model. (2) Measurement of latent variables, which are any variables that cannot be measured directly. The analysis model is Structural Equation Modeling (SEM). Data processing tools are Microsoft Excel, SPSS and SmartPLS.

V. RESULTS AND DISCUSSION

A. Descriptive

Descriptive statistical analysis is intended to provide an overview of secondary data relating to the research variables. All data used for the analysis of the research model is sourced from secondary data obtained from reports published by the Ministry of Finance of the Republic of Indonesia and other relevant sources. Data from the ministry of finance in the form of, City Government APBD data, City Government GRDP data, City Government population data, City Poor Population Data, Fiscal Ability Index data, and Human Development Index data. The secondary data is raw data for the measurement of research variables.

B. Outer Model Analysis

Outer model analysis is carried out to ensure that the measurements used are feasible to be made measurements (valid and reliable). The coefficient of measurement model or called loading factor states the amount/ contribution of the indicator as a measure of the variable. The indicator with the highest loading factor indicates that the indicator is the strongest measure of the measured variable. The indicator is significant as a measure of the variable if the P-value <0.05, or the indicator is declared fixed. The measurement results show that all indicator variables obtain a loading factor greater than 0.7 and p-value of 0.001 <0.05 (significant). Therefore, all indicators are stated as significant as measuring their respective variables.

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Discriminant validity is related to the principle that different constructors (manifest variables) should not be highly correlated with other manifest variables. Discriminant validity test with PLS software can be known from the cross loading value by comparing the correlation of indicators with their latent variables must be greater than the correlation between indicators with other latent variables or by comparing the square root AVE for each construct with the correlation value between constructs in the model. Good discriminant validity is shown from the square root AVE for each construct must be greater than the correlation between constructs in the model. In the table above, it appears that the cross loading value for each indicator (colored column) is higher when compared to the correlation correlation with other latent variables, so that the latent variable has adequate discriminant validity.

	X1	X2	X3	X4	Y1	Y2
X1_1	0,975	0,093	-0,712	0,799	0,929	0,586
X1_2	0,975	0,075	-0,525	0,892	0,982	0,453
X2_1	0,086	1,000	-0,119	-0,062	0,092	-0,049
X3_1	-0,635	-0,119	1,000	-0,439	-0,533	-0,601
X4_1	0,866	-0,062	-0,439	1,000	0,882	0,428
Y1_1	0,979	0,092	-0,533	0,882	1,000	0,459
Y2_2	0,370	0,004	-0,403	0,277	0,306	0,740
Y2_3	0,471	-0,074	-0,542	0,394	0,415	0,847

Table 1:- Discriminant Validity

Reliability depicted by the root value of AVE for each each variable is greater than the correlation value between latent variables, so that latent variables are declared to have good discriminant validity. Based on the description above, the size of the cross loadings and the comparison of the AVE roots with the correlation of latent variables have fulfilled the requirements, so it can be concluded that the discriminant validity requirements have been fulfilled.

Latent Variable	AVE Roots
X1	**0,975**
X2	**1,000**
X3	**1,000**
X4	**1,000**
Y1	**1,000**
Y2	**0,795**

Correlation of Laten Variables						
	IF X1	SA X2	FP X3	KKD X4	KIKD Y1	KPD Y2
X1	**1,000**					
X2	0,086	**1,000**				
X3	-0,635	-0,119	**1,000**			
X4	0,866	-0,062	-0,439	**1,000**		
Y1	0,979	0,092	-0,533	0,882	**1,000**	
Y2	0,533	-0,049	-0,601	0,428	0,459	**1,000**

Table 2:- Comparison Results of AVE Root with Correlation of Latent Variables

To measure the reliability of a construct with reflexive indicators can be done with composite reliability test with the provisions that if the construct has a composite reliability value greater than 0.7, it can be concluded that the manifest variable has the accuracy and consistency of a good instrument. In the table above, it appears that the value of composite reliability produced by all constructs is very good, namely above 0.7 so that it can be concluded that all construct indicators are reliable or in other words all manifest variables of the three latent variables are proven to have accuracy, consistency and accuracy of instruments in measure the construct well.

Variabel Laten	Composite Reliability
Fiscal Illusion (X1)	0,971
Budgetary Slack (X2)	1,000
Flypaper Effect (X3)	1,000
Local Financial Distress (X4)	1,000
Local Financial Performance (Y1)	1,000
Local Government Performance (Y2)	0,774

Table 3:- Composite Reliability

In PLS to measure the reliability of a construct with reflexive indicators can be done with composite reliability test with the provisions that if the construct has a composite reliability value greater than 0.7, it can be concluded that the manifest variable has the accuracy, consistency and accuracy of a good instrument in measuring the construct. In the table above, it appears that the value of composite reliability produced by all constructs is very good, namely above 0.7 so that it can be concluded that all construct indicators are reliable or in other words all manifest variables of the three latent variables are proven to have accuracy, consistency and accuracy of instruments in measure the construct well.

➢ *Goodness of Fit PLS*

The feasibility of the research model can be proven by looking at the multivariate determination coefficient analysis expressed by Q-Square (Q). Q-Square is a measure of how well the observations made give results to the research model. Q> 0 indicates the model has predictive relevance.

The criteria for strength or weakness of the model are measured based on Q-square predictive relevance values ranging from 0 (zero) to one

Based on the R^2 value it can be calculated Q^2 or Stone Geiser Q-Square test, namely:

Q^2 = 1- (1-R12) (1-R22)(1-R32)...(1- Rp2)
Q^2 = 1- (1-0.975) (1-0.435)
Q^2 = 1-0.025 x 0.565 = 0.9858

The calculation results show the predictive-relevance value of 0.9858 or 98.58%. The predictive relevance value of 98.58% also indicates that the diversity of data that can be explained by the model is 98.58% or in other words the information contained in the 98.58% data can be explained by the model. While the remaining 1.42% is explained by other variables (not yet contained in the model) and error. Thus the structural model that has been formed is appropriate.

C. Inner Model Analysis

Testing the inner model (structural model) basically tests the hypothesis in the study. Hypothesis testing is done by t-test (T-Statistic) on each path of direct influence partially. The results of testing the hypotheses that present the direct and indirect relationships are summarized in the following Table 4.

No.	Direct Effect	Coefficient	p-value	Hypothesis
H1	X1 → Y1	0,987	0.000	Accepted
H2	X1→ Y2	1.113	0.110	Rejected
H3	X2 → Y1	0.028	0.104	Rejected
H4	X2→ Y2	-0.103	0.258	Rejected
H5	X3 → Y1	0.136	0.000	Accepted
H6	X3→ Y2	-0.335	0.016	Accepted
H7	X4 → Y1	0.088	0.242	Rejected
H8	X4 → Y2	0.070	0.705	Rejected
H9	Y1→ Y2	-0.862	0.162	Rejected
	Indirect Effect	**Coefficient**	**p-value**	**Hypothesis**
H10	X1 → Y1 → Y2	-0.851	0.143	Rejected
H11	X2 → Y1 → Y2	-0.024	0.359	Rejected
H12	X3 → Y1 → Y2	-0.117	0.119	Rejected
H13	X4 → Y1 → Y2	-0.076	0.539	Rejected

Table 4:- Hypothesis Testing; Direct and Indirect Effect
Significant level p-value < 0.05

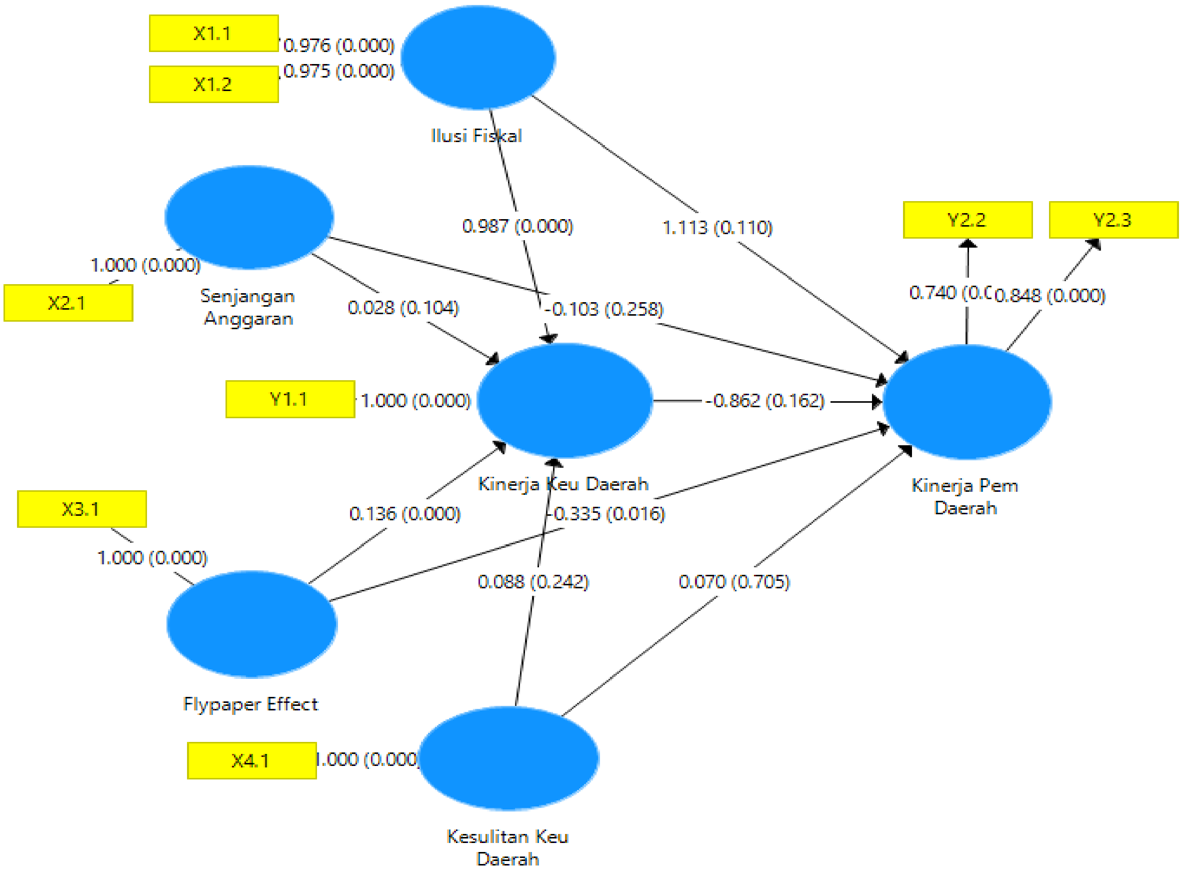

Fig 2:- Full Model PLS

D. Discussion

This study explores more deeply the antecedent variables of regional financial performance and the performance of local governments in Indonesia. The main theory that is referred to in this study is the New Public Management theory which was first introduced by the British Government by Prime Minister Margareth Teacher in the late 1070s through 1980 through The Financial Management and Next Steps initiatives and several city governments in the United States such as Sunnyvale in California (Gruening, 2001). Likewise in New Zealand, Australia and Sweden (Olson, et al., 1998). To reduce economic depression, improve taxation, competitive governance, value for money, more flexible and transparent. Theoretically, NPM inspires many ideas from various disciplines, such as that proposed by Gruening (2001), namely: Public Choice Theory, Management Theory, Classic Public Administration, Neo-classic Public Administration, Policy Analysis, Principal-Agent Theory, Property-right Theory, Neo-Austrian Theory School) and Transaction-cost Economics.

Public sector financial management as suggested by Gruening (2001), that the new public management (NPM) theory of public sector financial management can be used to assess the financial performance of local governments. The NPM theory developed so far in measuring financial and non-financial performance in government, this research is directed at the NPM theory approach (Gruening, 2001; Olson, et al., 1998; Hughes, 1998; Osborne and Gaebler, 1992). The evaluation of regional financial performance is also approached by the Public Financial Theory (Public Financial Theory) as stated by Musgrave (1959); Musgrave and Peggy B. Musgrave, 1984, 1994 and Thresch, 2002; Mardiasmo, 2002; Adi, 2009). In measuring public sector performance also requires agency theory approaches from Lane (2003), Holmstrom and Milgrom (1987), Wolfstetter (1999), Bolton and Dewatripont (2005), expectancy theory (Vroom, 1964), George and Jones (2005), Lawler (1971), George and Jones (2005), Rollinson (2005).

Fiscal illusions for the context of Indonesia are a necessity, not because of information asymmetry alone but because of the fact that local governments have not been able to optimize the reception of their own local revenues. This is what gives the consequence that the central government must distribute a number of funds to the regions in the form of balance funds. This study provides empirical evidence that the fiscal illusion that occurred precisely had a significant direct effect on improving regional financial performance. Regional independence marked by an increase in the ratio of Original Local Revenues to General Allocation Funds can be aggregated by the growth of the sectors of production of goods and services that can be observed through increasing GRDP. In other words, the development of production activities had a significant effect on increasing PAD revenues. Likewise, regional spending also has a significant direct effect on regional financial performance. Regional expenditure thus succeeded in providing a stimulus to the potential for greater acceptance of regional own-source revenues. Therefore, the results of this study provide strong evidence that fiscal illusions through actions to increase expenditure budgets so that transfer funds obtained from the central government are greater are carried out properly for the purpose of increasing the role of local governments in encouraging the growth of productive economic sectors and improving service infrastructure.

The direct effect of fiscal illusions on local government performance is proven to be better than the influence moderated by regional financial performance. This provides empirical evidence that the measurement of regional financial performance in this study in the form of an independence ratio does not have a direct effect on local government performance indicators in the form of the ratio of the poor population and the human development index. It can also be interpreted that the increase in regional independence marked by the higher original regional income compared to the general allocation fund has not been optimally utilized to aggregate the decline in the number of poor people and improve the human development index. This also indicates that general allocation funds have proven to be used more by regional governments to finance routine expenditures.

The phenomenon of the flypaper effect is shown by the large ratio of fund transfers from the central government compared to regional own-source revenue which triggers an increase in regional expenditure empirically proving that there is a positive and significant effect on improving regional financial performance. This result also confirms that the flypaper effect phenomenon does not only occur in areas with low original income but this also occurs in areas with high local original income, especially in this study, which sampled urban areas in Indonesia. The increase in transfer funds exceeding the region's own income capability will trigger increased spending. To ensure that regional government spending contributes to increasing regional independence, expenditure policies that originate from transfer funds must be regulated in such a way as to be able to aggregate the increased potential of regional revenues sourced from regional taxes and levies. Regional government expenditure revenue derived from and government transfers is optimized to achieve the objectives of financial management of routine expenditure and capital expenditure financing and revenue.

The flypaper effect has a significant effect on the performance of local governments as measured using the poor population ratio indicator and the human development index. Based on the direction of the variable relationship, the coefficient value is negative, which means the relationship between the flypaper effect on government performance is not unidirectional, meaning that the higher the value of the flypaper the effect will further decrease the value of local government performance. This finding indicates that the expenditure orientation of the regional government is still exclusive, namely to aggregate economic growth and increase regional independence but not to reduce the number of poor people and improve the human development index.

VI. CONCLUSION

The result show a significant and positive impact of fiscal illusions, and flypaper effect on local financial performance, while non-significant direct effect was found between budgetary slack and financial performance. The result also showed that there was a non-significant direct influence between fiscal illusions, budgetary slack on government performance, while oppositely there was a significant direct effect between flypaper effect on government performance. There is a non-significant direct influence between financial problem on local financial performance, there is no significant direct effect between financial problem on local governments performance. These results provide theoretical and practical implications for stakeholders in order to improve the performance of local governments in indonesia.

This study has limitations that can be used as a basis for further research to further refine the results of the analysis. The limitations of the research that researchers are aware of are as follows: (1) The object of this study only uses secondary data from the city government in Indonesia, amounting to 98 cities, but due to the limitations of the completeness of the data so that only 85 cities are fixed as a sample, whereas to provide a more comprehensive reflection it should also be able to blend with the data from the Regency government so that it can better reflect the diversity of conditions of the Regency / City Governments throughout Indonesia; (2) The amount of data used is also smaller, that is, it only uses data for 2016. This is due to the limitations of obtaining complete data for other years. Therefore, there are limitations in revealing variations in the change in value of each indicator used which allows for incomplete information so that the generalization power of the analysis model is lower; (3) The indicators used are still possible to be extended to other quantitative measures so that the indicators used to measure variables are truly reliable. This limitation is again due to the minimal availability of complete data for all areas studied.

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