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Fiscal Transfers and Local Revenue: Examining the Mediating Role of Capital Expenditure in Indonesia

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Abstract

Purpose

This study examines the mediating role of capital expenditure in the relationship between fiscal transfers (DAU and DAK) and Regional Original Revenue (PAD).

Design/methodology/approach

Using a quantitative approach, this study analyzes panel data from regencies/cities in Riau Province (2020–2024) through path analysis and Sobel test mediation using SPSS 23.

Findings

The results show that DAK positively affects capital expenditure, while DAU negatively affects it. Both DAU and DAK do not have a significant direct effect on PAD. However, capital expenditure significantly mediates the effect of DAK on PAD, but not DAU, indicating differences in allocation effectiveness.

Originality/value

This study highlights capital expenditure as a key mechanism linking fiscal transfers to revenue performance and demonstrates the differing impacts of discretionary and earmarked transfers.

Practical implications

The findings emphasize the need to strengthen capital expenditure allocation and improve the effectiveness of fiscal transfer policies.

Research limitations/implications

The study is limited to one regional context and a set of fiscal variables, suggesting future research should include broader institutional and economic factors.

Keywords

General Allocation Fund; Special Allocation Fund; Capital Expenditure; Regional Original Revenue; Fiscal Decentralization

Introduction

The implementation of regional autonomy in Indonesia gives local governments broad authority in managing their regional finances, including increasing Regional Original Revenue (PAD) through the optimization of local resource management. As stipulated in Law Number 23 of 2014 concerning Regional Government, local governments are responsible for financing development and administering government independently through PAD revenue and transfer funds from the central government.

Since the enactment of the regional autonomy policy through Law Number 22 of 1999, which was later refined into Law Number 23 of 2014 on Regional Government, the central government has given local governments the freedom to regulate and manage their own communities' interests. One of the main objectives of this fiscal decentralization policy is to

improve the effectiveness of regional financial management, improve public services, and reduce development disparities between regions. This framework gives regions the authority to explore the potential of Regional Original Revenue (PAD) and utilize transfer funds from the central government, which consist of General Allocation Funds (DAU), Special Allocation Funds (DAK), and Revenue Sharing Funds (DBH) (Elsivera & Abdillah, 2017).

However, despite the normative expectation that fiscal decentralization strengthens regional fiscal independence, empirical evidence in Indonesia shows persistent dependence on central government transfers, particularly DAU and DAK, which raises questions regarding the effectiveness of these funds in stimulating PAD growth. This inconsistency indicates a critical gap between policy objectives and actual fiscal outcomes at the regional level

The details of the General Allocation Fund and Special Allocation Fund for regencies/cities in Riau Province are as follows:

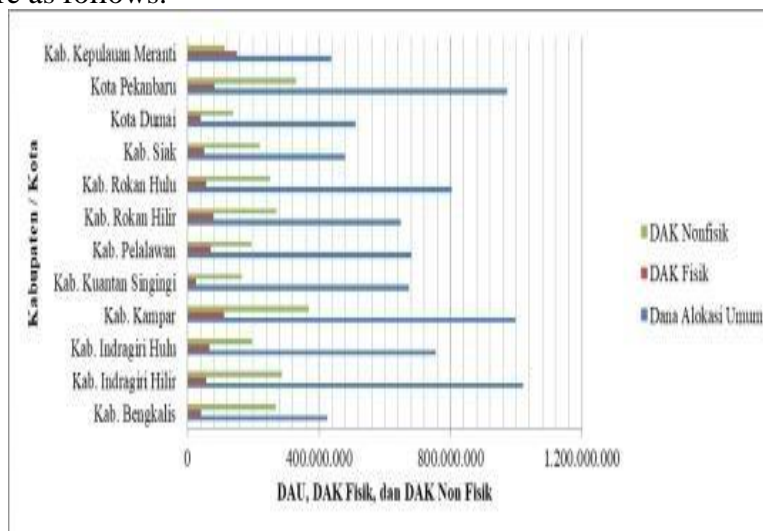


Figure 1. General Allocation Fund and Special Allocation Fund for Regencies/Cities in 2024.
 Source: Ministry of Finance of the Republic of Indonesia, 2025

Overall, the amount of General Allocation Fund (DAU) allocated to Riau Province and its regencies/cities reached IDR 9.98 trillion. DAU is a fund that can be used freely and is intended to finance regional needs that are not covered by regional original income (PAD). In this case, Indragiri Hilir Regency and Kampar Regency received high DAU allocations, amounting to more than IDR 1 trillion and IDR 997 billion, respectively. The city of Pekanbaru, as the provincial capital, also received a substantial DAU allocation, amounting to IDR 972 billion. This shows that many regions in Riau Province still depend on the central government to fund government activities and public services, due to the suboptimal potential of PAD.

More importantly, the dominance of transfer funds in regional budgets potentially creates fiscal illusion, where local governments rely excessively on external funding and reduce efforts to optimize endogenous revenue sources. This phenomenon suggests that the relationship between transfer funds and PAD is not straightforward and may depend on how these funds are allocated within the regional budget structure.

Overall, the imbalance in the distribution of DAU and DAK in Riau Province shows that not all regions have equal fiscal and institutional capacities. This has an impact on development inequality, the quality of public services, and uneven economic growth opportunities. In the future, affirmative policies are needed to strengthen regions with low fiscal capacity, while encouraging more equitable and fair planning and budget management capabilities.

Prior studies provide mixed findings regarding the impact of DAU and DAK on PAD. Some studies argue that transfer funds can stimulate regional revenue through increased investment and economic activity (Nurani & Saleh, 2023), while others highlight a negative or insignificant relationship due to inefficiencies and fiscal dependence (Algifari et al., 2021). However, these studies are largely fragmented and tend to examine direct effects, with limited attention to the underlying transmission mechanism through which transfer funds influence PAD.

In their research, Nurani & Saleh (2023) emphasize that capital expenditure plays a significant mediating role in influencing regional economic growth. Economic growth driven by increased government investment through capital expenditure will simultaneously expand the regional tax base and increase PAD revenue. In other words, the higher the capital expenditure directed to productive sectors, the greater the potential for increasing regional PAD.

Despite this insight, existing literature has not sufficiently integrated capital expenditure as a mediating mechanism within a unified empirical model that simultaneously examines DAU, DAK, and PAD. This indicates a clear research gap, particularly in understanding how fiscal transfers are transformed into revenue-generating capacity through budget allocation decisions.

In order for capital expenditure to contribute maximally to increasing local revenue, its allocation and management must be targeted, transparent, and accountable. Research by Marliana et al. (2022) shows that the effectiveness of capital expenditure is influenced by the

quality of development planning and regional fiscal capacity. Inaccurate capital expenditure planning can result in suboptimal infrastructure projects, stalled projects, or projects that have no significant impact on regional economic activity, which in turn has the potential to burden the regional budget in the future without providing a commensurate increase in PAD.

Local governments must utilize capital expenditure as a means of expanding the regional revenue base. The development of traditional markets, terminals, tourism facilities, and special economic zones, for example, not only improves public services but also has the potential to become a new source of PAD through the collection of levies, parking taxes, hotel taxes, restaurant taxes, and others. It is hoped that this strategy can reduce dependence on central transfer funds and strengthen regional fiscal independence.

From a theoretical perspective, this study positions stewardship theory as a lens to explain how local governments, as stewards, are expected to manage fiscal transfers responsibly to maximize public welfare through productive expenditure. However, the presence of fiscal illusion suggests potential deviations from stewardship behavior, thereby creating a theoretical tension that has not been adequately explored in prior research.

Therefore, this study offers a novel contribution by developing an integrated mediation model that examines the indirect role of capital expenditure in linking DAU and DAK to PAD, particularly within the context of regional governments in Riau Province. This approach not only addresses inconsistencies in prior findings but also provides a more nuanced explanation of how fiscal decentralization operates in practice.

Based on the above explanation and background, this study will be developed to further analyze: The Mediating Role of Capital Expenditure on the Effect of General Allocation Funds and Special Allocation Funds on Local Revenue in Regencies/Cities in Riau Province from 2020 to 2024.

Literature Review and Hypotheses Development

Stewardship Theory

Stewardship theory is an important corporate governance theory that assumes that managers must work as servants. Stewardship theory was developed by Donaldson and Davis (1991) and Donaldson and Davis (1993). Stewardship theory is an important corporate governance theory that assumes that managers act as stewards who prioritize organizational interests over personal interests. Stewardship theory was developed by Donaldson and Davis (1991; 1993), emphasizing that managers are intrinsically motivated to act in the best interest of stakeholders.

In the context of public sector governance, stewardship theory provides a relevant lens to explain how local governments are expected to manage fiscal resources responsibly to maximize public welfare. Unlike agency theory, which assumes opportunistic behavior, stewardship theory assumes alignment between government objectives and societal interests, particularly in managing public funds such as DAU and DAK.

However, this assumption is not always supported empirically. The phenomenon of fiscal illusion suggests that local governments may behave inconsistently with stewardship principles by relying excessively on transfer funds rather than optimizing PAD. This theoretical tension highlights the need to re-examine stewardship behavior in the context of fiscal decentralization, particularly through budget allocation decisions such as capital expenditure.

Regional Original Revenue (PAD)

Based on Law Number 1 of 2022, Regional Original Revenue (PAD) is revenue obtained by the region from local taxes, local levies, proceeds from the management of separated regional assets, and other legitimate Regional Original revenues in accordance with laws and regulations. Regional Original revenue is revenue generated by local governments from the implementation of government activities, services to the community, and the use of available resources (Anggoro, 2017).

Capital Expenditure

Based on Government Regulation No. 71 of 2010, capital expenditure is budget expenditure for the acquisition of fixed assets and other assets that provide benefits over more than one accounting period.

General Allocation Fund (DAU)

Based on Law No. 33 of 2004 concerning Financial Balance, the General Allocation Fund, hereinafter referred to as DAU, is a fund sourced from the State Budget (APBN) allocated to provinces and districts/cities with the aim of equalizing financial capabilities between regions to fund regional needs in the context of decentralization.

Special Allocation Fund (DAK)

Based on Law No. 33 of 2004, Special Allocation Funds are: Funds sourced from the State Budget allocated to certain regions with the aim of helping to fund special activities that are regional affairs and in accordance with national priorities as stipulated in the State Budget.

Hypothesis Development

The Effect of General Allocation Funds on Capital Expenditure

Within the fiscal decentralization framework, General Allocation Funds (DAU) function as unconditional transfers that provide local governments with discretion in budget allocation. From a stewardship perspective, such discretion should enable governments to prioritize productive spending, particularly capital expenditure, as a means of enhancing long-term public welfare. However, this theoretical expectation is not consistently supported in practice.

Empirical evidence reveals contrasting findings. Surakhman et al. (2019) document that DAU contributes positively to capital expenditure by increasing fiscal capacity. In contrast, Algifari et al. (2021) highlight the dominance of routine expenditure absorption, indicating that DAU is often diverted toward personnel and operational costs. This reflects fiscal illusion, where reliance on transfer funds reduces incentives for productive investment.

These conflicting findings suggest that DAU does not inherently determine capital expenditure, but its effect depends on allocation behavior within local governments. Nevertheless, given its magnitude in regional budgets, DAU remains a critical determinant of capital expenditure decisions.

H₁: General Allocation Funds affect Capital Expenditure.

The Effect of Special Allocation Funds on Capital Expenditure

Special Allocation Funds (DAK) are earmarked transfers designed to finance specific priority sectors, particularly infrastructure and public services. This structural characteristic reduces discretionary misuse and aligns local government spending with national development objectives. Within the stewardship framework, this reflects a stronger alignment between policy intent and implementation.

Empirical studies consistently support this relationship. Marlina et al. (2022) and Surakhman et al. (2019) demonstrate that DAK has a significant positive effect on capital expenditure, as these funds are directly allocated to asset-building activities. Unlike DAU, which is prone to reallocation, DAK inherently channels resources into productive investment.

Thus, both theoretically and empirically, DAK exhibits a strong and direct relationship with capital expenditure.

H₂: Special Allocation Funds affect Capital Expenditure.

The Effect of General Allocation Funds on Regional Original Revenue

The relationship between DAU and Regional Original Revenue (PAD) is theoretically ambiguous. On one hand, DAU increases fiscal capacity, enabling local governments to finance development programs that may stimulate economic activity and expand the tax base. From a stewardship perspective, this implies a potential positive contribution to PAD.

On the other hand, the discretionary nature of DAU introduces behavioral distortions. Empirical findings suggest that high dependence on DAU reduces fiscal effort, as local governments become less motivated to explore endogenous revenue sources (Algifari et al., 2021). This phenomenon of fiscal illusion indicates a potential negative or insignificant relationship between DAU and PAD.

The coexistence of these opposing mechanisms indicates that the direct effect of DAU on PAD remains inconclusive and context-dependent, warranting further empirical examination.

H₃: General Allocation Funds affect Regional Original Revenue.

The Effect of Special Allocation Funds on Regional Original Revenue

Special Allocation Funds (DAK) are intended to finance sector-specific development projects, particularly infrastructure, which theoretically enhances economic productivity and expands the regional revenue base. However, the effect of DAK on PAD is not immediate, as infrastructure development generates long-term economic benefits rather than short-term revenue increases.

Empirical evidence supports this argument. While some studies indicate that DAK contributes to regional economic development, others find that its direct effect on PAD is insignificant, suggesting that its impact operates through intermediate mechanisms (Algifari et al., 2021).

This indicates that DAK should not be conceptualized as a direct driver of PAD, but rather as an enabling factor whose effect depends on how it is transformed into productive assets.

H₄: Special Allocation Funds affect Regional Original Revenue.

The Effect of Capital Expenditure on Regional Original Revenue

Capital expenditure serves as a key instrument through which local governments convert fiscal resources into economic value. Investments in infrastructure and public facilities create multiplier effects that stimulate economic activity, increase productivity, and expand the tax base.

From a stewardship perspective, capital expenditure reflects the effectiveness of local governments in fulfilling their responsibility to generate long-term public value. Empirical studies consistently confirm this relationship. Nurani and Saleh (2023) and Widia Muharrami et al. (2024); Dasmar et.al (2020) find that capital expenditure significantly increases PAD through improved infrastructure and economic activity.

Thus, capital expenditure functions as a direct driver of regional fiscal capacity.

H₅: Capital Expenditure affects Regional Original Revenue.

The Mediating Role of Capital Expenditure in the Relationship between DAU and PAD

Given the inconsistent findings regarding the direct effect of DAU on PAD, it is necessary to

consider indirect mechanisms. Capital expenditure provides a logical transmission channel through which DAU can influence PAD by transforming fiscal resources into productive investments.

However, this mediation effect is conditional. When DAU is predominantly allocated to routine expenditure, its contribution to capital expenditure—and consequently to PAD—becomes limited. Conversely, when DAU is directed toward productive investment, it can generate a multiplier effect that enhances regional revenue.

Empirical evidence supports this conditional mediation. Surna Lastri et al. (2021) demonstrate that DAU can increase PAD through capital expenditure, highlighting the importance of allocation efficiency in determining fiscal outcomes.

H₆: General Allocation Funds affect Regional Original Revenue mediated by Capital Expenditure.

The Mediating Role of Capital Expenditure in the Relationship between DAK and PAD

Unlike DAU, DAK is inherently linked to capital expenditure due to its earmarked nature. This creates a stronger and more direct mediation pathway, as DAK is primarily used to finance infrastructure and other productive assets.

From a theoretical perspective, this reflects a more consistent application of stewardship principles, as the use of funds is aligned with long-term public value creation. Infrastructure development financed by DAK enhances economic activity, expands the tax base, and ultimately increases PAD.

Empirical findings reinforce this argument. While DAK may not directly affect PAD, its indirect effect through capital expenditure is significant (Marliana et al., 2022; Algifari et al., 2021).

Therefore, capital expenditure acts as a critical mechanism that transforms DAK into increased regional fiscal capacity.

H₇: Special Allocation Funds affect Regional Original Revenue mediated by Capital Expenditure.

Research Method

Type of Research

This type of research is causal research. Causal research is research that seeks to find comparisons in the form of cause and effect between several concepts or several variables or several strategies developed in management (Ferdinand, 2016). Meanwhile, the approach in this research is a quantitative approach. The quantitative approach aims to assist researchers in evaluating the extent to which data generated through certain methods is valid and truly reflects reality.

Research Location and Time

This research was conducted in Riau Province using secondary data in the form of General Allocation Funds, Special Allocation Funds, capital expenditure, and local revenue from 2020 to 2024 per district/city in Riau Province, published by the Riau Central Statistics Agency.

Population and Sample

In this study, the population used was reports on the General Allocation Fund, Special Allocation Fund, capital expenditure, and local revenue of regencies/cities in Riau Province from 2020 to 2024. A sample is a representative of the population being studied. A sample is a part of the population that is taken using certain methods. A sample is a part of the number and characteristics possessed by the population. The sample in this study consists of 5 years (the research period) multiplied by 12 regencies/cities in Riau Province. Thus, the sample consists of 60 reports.

Data Sources

The data source used in this study is secondary data. According to Sugiyono (2019), secondary data is data obtained or collected by researchers from existing sources. This data supports the discussion and research, so several sources of books or data obtained will help and critically review the research.

Data Collection Techniques

The data collection method was carried out using non-behavioral observation and documentation methods. Non-behavioral observation is a data collection method that involves observing, recording, and studying scientific works such as journals, dissertations, and books. It also involves documents such as General Allocation Funds, Special Allocation Funds, capital expenditures, and local revenues from the regencies/cities of Riau Province from 2020 to 2024.

Result

Descriptive Analysis

Descriptive analysis in the study entitled "The Mediating Role Of Capital Expenditure In The Effect Of General Allocation Funds And Special Allocation Funds On Local Revenue In Districts/Cities In Riau Province From 2020 To 2024" was conducted to provide an overview of the characteristics of the research data before further testing. This analysis includes the presentation of the mean, minimum, maximum, and standard deviation of the variables studied, namely Special Allocation Funds (DAK), General Allocation Funds (DAU), Capital Expenditure, and Local Own Source Revenue (PAD) in all districts/cities in Riau Province.

Table 1. Description of Research Variable

Description	PAD	BM	DAU	DAK
Mean	272.4832	295.2972	602.2752	268.9368
Median	192.5500	273.0150	602.7550	254.2250
Std. Deviation	210.19020	141.66530	185.50064	82.32162
Minimum	68.89	104.08	336.79	142.49
Maximum	890.29	891.49	980.52	483.79

Source: Processed data from SPSS 23, 2025

Based on the results of descriptive analysis, the Local Own-Source Revenue (PAD) variable in districts/cities in Riau Province for the 2020–2024 period shows an average of 272.48 with a median of 192.55. Capital Expenditure (BM) is an important instrument in regional fiscal policy because it serves to fund infrastructure development and public facilities and infrastructure. Based on the results of descriptive analysis, the average capital expenditure of districts/cities in

Riau Province during the 2020–2024 period was 295.30 with a median of 273.02. General Allocation Funds (DAU) are one of the main instruments of fiscal transfers from the central government to the regions with the aim of equalizing financial capabilities between regions. Based on the results of descriptive analysis, the average DAU value in regencies/cities in Riau Province during the 2020–2024 period is 602.28, with a median of 602.76. The Special Allocation Fund (DAK) is a transfer fund from the central government intended to fund certain activities in accordance with national priorities and specific regional needs. Based on the results of descriptive analysis, the average DAK received by districts/cities in Riau Province during the 2020–2024 period was 268.94, with a median of 254.23.

Classical Assumption Test

The results of the classical assumption tests indicate that the regression models used in this study satisfy the required statistical criteria, ensuring the reliability of subsequent hypothesis testing. The normality assumption is fulfilled based on both graphical and statistical approaches. The normal probability plot (P–P plot) shows that the residuals are distributed closely along the diagonal line, indicating an approximately normal distribution. This is further supported by the Kolmogorov–Smirnov (K-S) test, where all variables, including capital expenditure (BM), General Allocation Funds (DAU), Special Allocation Funds (DAK), and Regional Original Revenue (PAD), exhibit significance values greater than 0.05. These results confirm that the residuals are normally distributed and suitable for regression analysis (Ghozali, 2018; Hair et al., 2019).

Furthermore, the autocorrelation test using the Durbin–Watson statistic indicates that the regression models do not suffer from serious autocorrelation problems. In the first model, the Durbin–Watson value of 2.067 suggests no autocorrelation, while in the second model, the value of 1.453, although slightly below 2, still falls within an acceptable range, indicating only a weak indication of positive autocorrelation. Overall, the residuals can be considered independent across observations, and the assumption of no autocorrelation is generally satisfied (Gujarati & Porter, 2009).

The multicollinearity test results also confirm that there is no high correlation among the independent variables. All variables exhibit tolerance values above 0.10 and Variance Inflation Factor (VIF) values well below the threshold of 10, indicating that each independent variable contributes uniquely to the model without redundancy. This ensures the stability and interpretability of the regression coefficients (Hair et al., 2019).

In addition, the heteroscedasticity test, based on scatterplot analysis, shows that the residuals are randomly distributed around the zero line without forming any systematic pattern. This indicates homoscedasticity, meaning that the variance of the error terms remains constant across observations. This condition fulfills a key requirement for obtaining efficient and unbiased estimates in regression analysis (Wooldridge, 2013).

Overall, these findings demonstrate that both regression models meet the classical linear regression assumptions, ensuring that the estimated coefficients are unbiased, consistent, and efficient. Therefore, the models provide a valid and reliable basis for further path analysis and hypothesis testing.

Hypothesis Testing (Path Analysis)

Hypothesis testing in Substructure I is conducted to examine the direct effects of General Allocation Funds (DAU) and Special Allocation Funds (DAK) on capital expenditure as an intermediate variable. This analysis is essential to understand how fiscal transfers influence the allocation of productive public spending within the framework of fiscal decentralization. The estimation results are presented in Table 5, which reports the unstandardized and standardized coefficients, t-values, and significance levels for each relationship. These indicators provide the basis for evaluating the strength, direction, and statistical significance of the proposed hypotheses.

Table 5. Table of Coefficients for Substructure I Coefficients^a

Model	Ustandardized Coefficients		Standardized Coefficients		Sig.
	B	Std. Error	Beta	t	
1 (Constant)	260.645	63.143		4.128	.000
DAU	-.352	.099	-.461	-3.552	.001
DAK	.917	.223	.533	4.107	.000

Source: Processed Data SPSS 23, 2025

Based on the results presented in Table 5, Hypothesis 1 (H1), which states that General Allocation Funds (DAU) affect capital expenditure, is accepted. This is indicated by the t-value of -3.552 ($|t| = 3.552$), which is greater than the critical t-value of 2.002, and a significance level of 0.001 (< 0.05). However, the negative regression coefficient ($\beta = -0.352$) indicates that the effect is negative, suggesting that an increase in DAU is associated with a decrease in capital expenditure.

Furthermore, Hypothesis 2 (H2), which proposes that Special Allocation Funds (DAK) affect capital expenditure, is also accepted. This is supported by a t-value of 4.107, which exceeds the critical value of 2.002, and a significance level of 0.000 (< 0.05). The positive regression coefficient ($\beta = 0.917$) indicates that DAK has a significant positive effect on capital expenditure.

Hypothesis Test Model II

Hypothesis testing in Model II (Substructure II) is conducted to examine the direct effects of General Allocation Funds (DAU), Special Allocation Funds (DAK), and Capital Expenditure on Regional Original Revenue (PAD) as the dependent variable. This stage of analysis is essential to evaluate both the direct relationships and the role of capital expenditure as a mediating variable within the fiscal decentralization framework. The estimation results are presented in Table 9, which provides the unstandardized and standardized coefficients, t-values, and significance levels for each variable. These statistical indicators are used to assess the direction, magnitude, and significance of the relationships, thereby determining whether the proposed hypotheses are supported.

Table 9. Table of Coefficients for Substructure II
Coefficients^a

Model		Unstandardized Coefficients		Standardized Coefficients		
		B	Std. Error	Beta	t	Sig.
1	(Constant)	-138.778	104.401		-1.329	.189
	DAU	.263	.159	.232	1.655	.103
	DAK	.066	.369	.026	.179	.859
	BM	.796	.192	.537	4.143	.000

a. Dependent Variable: PAD

Source: Processed Data SPSS 23, 2025

Based on the results presented in Table 9, it can be concluded that Hypothesis 3 (H3), which proposes that General Allocation Funds (DAU) affect Regional Original Revenue (PAD), is rejected. This is indicated by the t-value of 1.655, which is lower than the critical t-value of 2.003, and a significance level of 0.103 (> 0.05), showing that the effect is not statistically significant despite having a positive coefficient ($\beta = 0.263$). Similarly, Hypothesis 4 (H4), which states that Special Allocation Funds (DAK) affect PAD, is also rejected. This is supported by the t-value of 0.179, which is far below the critical value of 2.003, and a significance level of 0.859 (> 0.05), indicating no significant relationship between DAK and PAD.

In contrast, Hypothesis 5 (H5), which proposes that capital expenditure (BM) affects PAD, is accepted. This is evidenced by a t-value of 4.143, which exceeds the critical value of 2.003, and a significance level of 0.000 (< 0.05). The positive regression coefficient ($\beta = 0.796$) further indicates that capital expenditure has a significant positive effect on PAD. These findings suggest that capital expenditure plays a more decisive role in enhancing regional revenue compared to direct fiscal transfers.

Based on the calculation results in sub-structure I and sub-structure II, a new structure can be formed, as follows:

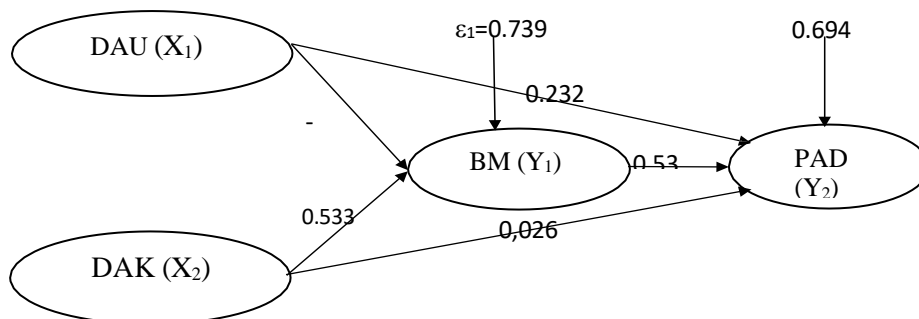


Figure 1. Combination of Structure I and Structure II

Mediation Test

The mediation analysis using the Sobel test reveals contrasting roles of capital expenditure in transmitting the effects of fiscal transfers on Regional Original Revenue (PAD). The results show that capital expenditure significantly mediates the relationship between General Allocation Funds (DAU) and PAD, but with a negative direction, as indicated by the calculated t-value of -2.64 , which exceeds the critical value of 2.003 in absolute terms. This finding implies that although DAU has an indirect effect on PAD through capital expenditure ($ab = -0.280$; $Sab = 0.106$), the resulting impact is counterproductive. The negative mediation effect reflects allocation inefficiencies, where a substantial portion of DAU is absorbed by routine expenditures rather than being directed toward productive investment, thereby weakening the potential multiplier effect on regional revenue. This condition is consistent with the concept of fiscal illusion, where dependence on transfer funds reduces incentives for productive fiscal management (Algifari et al., 2021; Oates, 1999).

In contrast, capital expenditure is found to positively and significantly mediate the relationship between Special Allocation Funds (DAK) and PAD. This is evidenced by a Sobel test t-value of 2.89 , which is greater than the critical value of 2.003 , indicating a significant indirect effect ($ab = 0.730$; $Sab = 0.253$). This result suggests that DAK, due to its earmarked nature, is more effectively allocated toward capital expenditure, which in turn stimulates economic activity and expands the regional tax base. These findings are in line with prior studies emphasizing the role of public investment in enhancing regional fiscal capacity through infrastructure-driven economic growth (Marliana et al., 2022; Nurani & Saleh, 2023). Overall, the results highlight that the effectiveness of fiscal transfers in improving PAD depends on allocation mechanisms, where earmarked transfers provide a more efficient transmission channel than discretionary funds.

Discussion

The empirical findings reveal that General Allocation Funds (DAU) have a significant negative effect on capital expenditure, indicating that higher DAU allocations are associated with a reduction in productive spending. This result suggests the presence of a substitution effect, where discretionary transfer funds are predominantly absorbed by routine expenditures rather than investment-oriented spending.

From a stewardship perspective, this finding reflects a deviation from the expected behavior of local governments as stewards of public resources. Instead of prioritizing long-term value creation through capital expenditure, local governments appear to favor short-term operational needs. This condition aligns with the concept of fiscal illusion, where dependence on central government transfers reduces incentives to allocate resources efficiently.

The negative relationship also indicates a crowding-out effect, in which the availability of flexible funds diminishes the urgency to invest in infrastructure and public assets. This finding extends prior studies (Algifari et al., 2021; Yusuf Faisal et al., 2024) by showing that the issue is not merely inefficiency, but a structural distortion in budget allocation behavior under fiscal decentralization.

In contrast to DAU, Special Allocation Funds (DAK) exhibit a positive and significant effect on capital expenditure, confirming their role as an effective instrument for promoting public investment. This finding highlights the importance of fund design, as the earmarked nature of DAK constrains discretionary misuse and ensures allocation toward productive sectors.

From a theoretical standpoint, this result supports stewardship principles, as local governments demonstrate alignment with national priorities when managing restricted funds. Unlike DAU, which allows flexibility, DAK enforces accountability through its targeted allocation.

This distinction suggests that the effectiveness of fiscal transfers is not solely determined by the amount of funding, but by the governance structure embedded in the transfer mechanism. Therefore, DAK represents a more reliable channel for increasing capital expenditure compared to DAU.

The results indicate that DAU does not have a significant effect on PAD, suggesting that increased fiscal transfers do not necessarily translate into higher regional revenue. This finding reinforces the argument that fiscal capacity alone is insufficient to enhance fiscal independence.

From a behavioral perspective, this outcome reflects fiscal illusion, where local governments become reliant on transfer funds and reduce efforts to explore endogenous revenue sources. The absence of a significant relationship indicates that DAU may weaken fiscal discipline rather than strengthen revenue-generating capacity.

Moreover, this finding implies that PAD growth is driven more by underlying economic structures—such as regional industrial composition—than by transfer allocations. In the context of Riau Province, economic activities in natural resource sectors appear to play a more dominant role than fiscal policy instruments. Thus, this study extends prior research (Algifari et al., 2021) by demonstrating that DAU may not only be ineffective in increasing PAD but may also indirectly discourage fiscal innovation.

The findings show that DAK does not have a significant direct effect on PAD, indicating that its contribution to regional revenue is not immediate. This result highlights the temporal dimension of fiscal policy, where infrastructure investments require time to generate economic returns.

From a theoretical perspective, this finding suggests that the impact of DAK is inherently indirect and mediated through structural changes in the regional economy. Infrastructure development enhances connectivity, productivity, and market access, but these effects materialize gradually and are not immediately reflected in revenue indicators.

This explains why prior studies report inconsistent direct effects of DAK on PAD. The absence of significance in this study does not imply ineffectiveness, but rather indicates that the relationship operates through intermediate mechanisms, particularly capital expenditure. Therefore, evaluating DAK solely based on direct effects may lead to underestimation of its true contribution to regional fiscal capacity.

Capital expenditure is found to have a positive and significant effect on PAD, confirming its role as a key driver of regional fiscal capacity. This finding supports the argument that

productive public investment generates multiplier effects that expand the tax base and increase revenue potential.

From a stewardship perspective, capital expenditure represents the extent to which local governments translate fiscal resources into long-term economic value. The positive relationship indicates that when resources are allocated toward infrastructure and public assets, they contribute directly to revenue generation.

This finding is consistent with prior studies (Nurani & Saleh, 2023; Widia Muharrami et al., 2024), but also strengthens the argument that capital expenditure is not merely an outcome of fiscal policy, but a critical mechanism that determines the effectiveness of fiscal decentralization.

The mediation analysis reveals that capital expenditure transmits the effect of DAU to PAD, but in a negative direction. This indicates that although DAU influences capital expenditure, the allocation is not sufficiently productive to generate positive revenue outcomes.

This finding suggests that the mediating mechanism is distorted by allocation inefficiency. In other words, DAU fails to create a positive multiplier effect because it is not optimally directed toward productive investment.

From a theoretical standpoint, this result challenges the assumption of stewardship behavior, indicating that discretionary fiscal authority may lead to suboptimal allocation decisions. The negative mediation effect highlights the importance of governance quality in determining whether fiscal transfers enhance or hinder regional revenue.

Thus, the effectiveness of DAU is not determined by its size, but by how it is allocated within the budget structure.

In contrast, capital expenditure significantly mediates the relationship between DAK and PAD in a positive direction, indicating that DAK contributes to regional revenue through productive investment. This finding confirms that earmarked transfers are more effective in generating economic outcomes because they are structurally linked to capital expenditure. Infrastructure development financed by DAK creates a multiplier effect that enhances economic activity and expands the regional tax base.

From a stewardship perspective, this result reflects a more consistent alignment between policy objectives and implementation, as the restricted nature of DAK reduces the risk of misallocation. Therefore, capital expenditure serves as a critical transmission mechanism that transforms DAK into increased fiscal capacity, highlighting the importance of expenditure structure in fiscal decentralization outcomes.

A key insight emerging from this study is the contrasting behavior of DAU and DAK. While DAU, as a block grant, introduces flexibility that may lead to allocation inefficiency, DAK, as an earmarked fund, demonstrates a more consistent pathway toward productive expenditure and revenue generation.

This distinction suggests that the design of fiscal transfer mechanisms plays a crucial role in shaping regional financial outcomes. The findings extend stewardship theory by showing that

government behavior is not solely determined by intrinsic motivation, but also by institutional constraints embedded in fiscal policy design.

Furthermore, this study highlights that the relationship between fiscal transfers and PAD is not linear, but mediated by capital expenditure. This provides a more nuanced understanding of fiscal decentralization by emphasizing the importance of expenditure structure rather than merely the volume of transfers.

Conclusion

This study provides a comprehensive examination of how fiscal transfer mechanisms influence regional revenue performance through the allocation of capital expenditure within the framework of fiscal decentralization. The findings reveal a fundamental distinction between the roles of General Allocation Funds (DAU) and Special Allocation Funds (DAK), highlighting that the effectiveness of fiscal transfers is not determined solely by their magnitude, but by their allocation structure and governance design.

Empirically, DAK demonstrates a consistent and positive contribution to capital expenditure, reflecting its effectiveness as an earmarked transfer that directly supports productive investment. In contrast, DAU exhibits a negative relationship with capital expenditure, indicating that discretionary transfers tend to be absorbed by routine spending, thereby limiting their capacity to stimulate long-term economic development. This divergence underscores the importance of institutional constraints in shaping fiscal behavior at the regional level.

Furthermore, the absence of significant direct effects of both DAU and DAK on Regional Original Revenue (PAD) suggests that fiscal transfers do not automatically enhance regional fiscal independence. Instead, this study confirms that capital expenditure serves as a critical transmission mechanism. The positive mediating role of capital expenditure in the relationship between DAK and PAD demonstrates that infrastructure investment generates indirect and long-term fiscal benefits through the expansion of the regional economic base. Conversely, the ineffective mediation of capital expenditure in the relationship between DAU and PAD indicates allocation inefficiencies that weaken the potential multiplier effect of discretionary funds.

These findings contribute to the theoretical development of fiscal decentralization by demonstrating that the relationship between intergovernmental transfers and regional revenue is inherently indirect and structurally mediated. The study extends stewardship theory by showing that local government behavior is not solely driven by normative alignment with public interest, but is also shaped by institutional design and fiscal incentives. In particular, the contrast between DAU and DAK highlights how different transfer schemes can produce distinct behavioral and economic outcomes.

From a practical perspective, the results emphasize the need for stronger allocation discipline and performance-oriented fiscal management. Local governments should prioritize capital expenditure that generates high economic multipliers in order to expand the tax base and reduce dependency on central transfers. At the same time, policymakers should consider redesigning

fiscal transfer mechanisms by incorporating performance-based elements that link funding to measurable economic and fiscal outcomes, thereby strengthening accountability and efficiency in public resource management.

This study is not without limitations. The analysis relies on secondary data from regional financial reports, which may be subject to reporting inconsistencies. In addition, the model focuses on a limited set of fiscal variables and does not incorporate broader institutional and economic factors, such as governance quality, political dynamics, or regional economic structure, which may influence fiscal outcomes. The use of a quantitative approach also limits the ability to capture behavioral and contextual dimensions of budgeting practices. Furthermore, the findings are context-specific to Riau Province, and caution should be exercised when generalizing to other regions with different fiscal and economic characteristics.

Future research is therefore encouraged to adopt a more integrative approach by incorporating additional variables and mixed-method designs in order to better capture the complexity of fiscal decision-making at the regional level. Such efforts will contribute to a more comprehensive understanding of how fiscal decentralization can be optimized to achieve sustainable regional development.

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