

Fiscal Distress: The Role of Budget Policy in Local Government

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Government*

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1105

Submitted:
AUGUST 2025

Accepted:
OCTOBER 2025

ABSTRACT

Fiscal distress in local governments, particularly in South Sumatra, poses a significant challenge to delivering public services due to limited financial capacity. This study aims to examine the impact of budget policies, specifically surplus or deficit and solvency, on fiscal distress, using the stakeholder theory to understand how local governments adapt to central government funding pressures. The research employs a quantitative approach, analyzing data from 65 local governments in South Sumatra from 2020 to 2023, totaling 260 observations. Logistic regression is used to test the effect of budget deficit policy and three solvency ratios (operational, employee expenditure, and total budget solvency) on fiscal distress, measured by the regional fiscal capacity ratio. The findings show that 58% of local governments experienced fiscal distress, with budget deficits significantly increasing the likelihood of distress, while operational budget solvency significantly reduces it. Employee expenditure and total budget solvency show no significant effect, likely due to mandatory spending regulations. The study concludes that effective budget management, through realistic revenue projections and optimized operational expenditures, is crucial for mitigating fiscal distress, offering practical guidance for local governments to enhance financial stability.

Keywords: Budget Deficit, Budget Policy, Fiscal Distress, Local Government, Operational Solvency.

ABSTRAK

Kesulitan fiskal di pemerintah daerah, khususnya di Sumatera Selatan, menimbulkan tantangan yang signifikan terhadap penyediaan layanan publik karena terbatasnya kapasitas keuangan. Penelitian ini bertujuan untuk mengkaji dampak kebijakan anggaran, khususnya surplus atau defisit dan solvabilitas, terhadap kesulitan fiskal, dengan menggunakan teori pemangku kepentingan untuk memahami bagaimana pemerintah daerah beradaptasi dengan tekanan pendanaan pemerintah pusat. Penelitian ini menggunakan pendekatan kuantitatif, menganalisis data dari 65 pemerintah daerah di Sumatera Selatan dari tahun 2020 hingga 2023,

JIAKES

Jurnal Ilmiah Akuntansi
Kesatuan
Vol. 13 No. 4, 2025
pp. 1105-1114
IBI Kesatuan
ISSN 2337 – 7852
E-ISSN 2721 – 3048
DOI: 10.37641/jiakes.v13i5.3972

dengan total 260 observasi. Regresi logistik digunakan untuk menguji pengaruh kebijakan defisit anggaran dan tiga rasio solvabilitas (operasional, belanja pegawai, dan solvabilitas anggaran total) terhadap kesulitan fiskal, yang diukur dengan rasio kapasitas fiskal daerah. Temuan menunjukkan bahwa 58% pemerintah daerah mengalami kesulitan fiskal, dengan defisit anggaran secara signifikan meningkatkan kemungkinan kesulitan, sementara solvabilitas anggaran operasional secara signifikan menguranginya. Belanja pegawai dan solvabilitas anggaran total tidak menunjukkan pengaruh yang signifikan, kemungkinan karena peraturan pengeluaran wajib. Studi ini menyimpulkan bahwa pengelolaan anggaran yang efektif, melalui proyeksi pendapatan yang realistis dan pengeluaran operasional yang dioptimalkan, sangat penting untuk mengurangi kesulitan fiskal, menawarkan panduan praktis bagi pemerintah daerah untuk meningkatkan stabilitas keuangan.

Kata kunci: Defisit Anggaran, Kebijakan Anggaran, Kesulitan Fiskal, Pemerintah Daerah, Solvabilitas Operasional

INTRODUCTION

Fiscal distress is a critical condition that undermines the ability of local governments to deliver essential public services and maintain core functions, as it reflects a state of financial instability that hampers effective governance (Kloha et al., 2005). This issue has significant implications for public service quality, as local governments experiencing fiscal distress often struggle to meet community needs, leading to diminished trust and reduced administrative efficiency (Perlman, 2009). In Indonesia, fiscal distress has become a pressing concern, with the Ministry of Finance reporting in 2024 that 47% of provincial governments and 41% of district/city governments are classified as having low or very low fiscal capacity, signaling a high risk of fiscal distress (Regulation of the Minister of Finance of the Republic of Indonesia Number 65 of 2024). This condition is particularly alarming because it restricts the availability of funds, impairs service quality, disrupts cash management, and weakens overall financial performance (Aldag et al., 2017; Carmeli, 2008). The regional fiscal capacity ratio, as outlined in the Regulation of the Minister of Finance Number 65 of 2024, serves as a key indicator to assess whether a local government is experiencing fiscal distress, providing a standardized measure to evaluate financial health across regions.

Fiscal challenges faced by local governments are closely tied to their budget policies, which serve as a primary tool for managing economic resources and mitigating financial pressures (Mardiasmo & MBA, 2009). Policies, encompassing decisions on revenue targets, expenditure allocations, and surplus or deficit strategies, are instrumental in determining a government's financial stability (Jones & Walker, 2007; Nollenberger et al., 2003). The stakeholder theory provides a framework for understanding these dynamics, as it posits that local governments, heavily reliant on transfer funds from the central government, must adapt their budget policies to align with the expectations of influential stakeholders, such as the central government, to ensure fiscal sustainability (Honadle, 2003; Freeman & McVea, 2005). Effective budget policies, including achieving budget solvency and managing surplus or deficit levels, are crucial for preventing fiscal distress by ensuring that revenues adequately support operational and public service needs (Ritonga et al., 2012). This study focuses on the South Sumatra region, selected due to its high prevalence of fiscal distress, with 58% of local governments categorized as having low or very low fiscal capacity between 2020 and 2023, making it a critical case for examining budget policy impacts (Cahyani et al., 2024).

Previous studies have explored fiscal distress in local governments, but they often employ varied indicators that lack alignment with national standards, creating inconsistencies in assessing financial health (Halim et al., 2016; Darus, 2018). According to Ichi and Fadillah (2021), fiscal distress has been analyzed through factors such as local revenue and capital expenditure; however, these studies often overlook standardized metrics, including the regional fiscal capacity ratio. Suryani and Windijarto (2023) used

budget pressure as an indicator, while Septira and Prawira (2019) focused on fund balance, highlighting the diversity in approaches that may not fully capture the fiscal conditions defined by the central government. This research gap underscores the need for a study that utilizes the regional fiscal capacity ratio, as mandated by the Regulation of the Minister of Finance Number 65 of 2024, to provide a more consistent and policy-relevant measure of fiscal distress (Gorina et al., 2018; Trussel & Patrick, 2009). Unlike prior research, this study integrates budget policy dimensions, such as surplus/deficit and solvency, to offer a comprehensive analysis of fiscal distress drivers (Ansori et al., 2021; Puspitorini & Lenggogeni, 2022).

The objective of this study is to analyze the impact of budget policies, specifically surplus/deficit and operational budget solvency, on fiscal distress in local governments in the South Sumatra region, using the regional fiscal capacity ratio as the indicator. By addressing this gap, the study aims to provide actionable insights for local governments to mitigate fiscal distress through informed budget policies, aligning with the central government's fiscal capacity framework. This research contributes to the literature by offering a stakeholder theory perspective on how local governments adapt to central government policies and by providing empirical evidence from a region with significant fiscal challenges.

LITERATURE REVIEW & HYPOTHESIS DEVELOPMENT

Budget Deficit Policy and Fiscal Distress

Stakeholder theory posits that entities, including local governments, operate not only for their own interests but also to fulfill the expectations of stakeholders, whose support significantly influences their sustainability (Freeman & McVea, 2005). In the context of Indonesian local governments, the central government is a dominant stakeholder due to high dependency on transfer funds, which shape fiscal capacity and budget policies (Honadle, 2003). According to Freeman and McVea (2005), powerful stakeholders drive entities to adapt their strategies, and for local governments, this means aligning budget policies to mitigate fiscal distress. This adaptation is critical in Indonesia, where fiscal distress, characterized by inadequate funds for public services, threatens governance stability (Halim et al., 2016).

The stakeholder framework is directly relevant to this study, as budget policies, including surplus/deficit and solvency, reflect responses to central government funding policies (Carmeli, 2008; Ansori et al., 2021). These policies determine resource allocation for public services, a function jeopardized by fiscal distress, as measured by the regional fiscal capacity ratio (Kloha et al., 2005). By aligning with stakeholder expectations, local governments can enhance financial health, reducing fiscal distress risks and ensuring sustainable service delivery (Gorina et al., 2018; Maher et al., 2020; Chung & Williams, 2021).

Budget policy, as a tool for setting revenue and expenditure targets, determines whether a local government experiences a surplus or deficit, directly impacting fiscal distress (Mardiasmo & MBA, 2009). A budget deficit arises when expenditures exceed revenues, often requiring reliance on prior-year surpluses or loans, which can exacerbate financial strain (Reschovsky, 2004). According to Suryani and Windijarto (2023), mismanaged deficit policies increase fiscal distress by limiting funds for public services, a pattern observed in Indonesian local governments (Darus, 2018; Adnan et al., 2023). This financial imbalance disrupts cash management and service quality, as local governments struggle to meet operational needs, particularly in regions with low fiscal autonomy (Perlman, 2009; Lhutfi et al., 2020).

In Indonesia, most local governments plan deficits by leveraging previous years' surplus (SiLPA), but poor management can lead to fiscal distress (Trussel & Patrick, 2013; Shafira, 2022). The stakeholder theory suggests that deficit policies are adaptations to central government funding constraints, but excessive deficits may indicate ineffective alignment, increasing fiscal distress risks (Icih & Fadillah, 2021; Davidson & Ward, 2022).

H1: Budget deficit policy has a positive and significant effect on fiscal distress.

Budget Solvency Policy and Fiscal Distress

Budget solvency measures a local government’s capacity to generate revenue to cover expenditures, serving as a critical indicator of financial health (Nollenberger et al., 2003). According to Ritonga et al. (2012), solvency ratios, including those for operational (Ratio A), employee (Ratio B), and total expenditures (Ratio C), assess the ability to sustain operations without financial distress. Operational solvency (Ratio A), which evaluates revenue excluding specific allocation funds against non-capital expenditures, ensures funds for essential activities like salaries and goods/services (Natrini & Ritonga, 2017; Cahyani et al., 2024). High solvency reduces fiscal distress by enhancing financial stability, particularly in regions dependent on central transfers (Maria et al., 2021; Septira & Prawira, 2019).

Employee expenditure solvency (Ratio B) is vital, as high personnel costs can strain budgets, especially in regions with limited revenue (Kustati & Rahayu, 2025). Total solvency (Ratio C) reflects overall financial capacity, with higher ratios linked to lower fiscal distress risks (Park et al., 2018; Gregori & Marattin, 2019). The stakeholder theory underscores that solvency policies are adaptations to central government funding, balancing expenditures with resources (Bocchino & Padovani, 2021; Guo & Neshkova, 2018).

H2: Operational budget solvency (Ratio A) has a negative and significant effect on fiscal distress.

H3: Employee expenditure solvency (Ratio B) has a negative and significant effect on fiscal distress.

H4: Total budget solvency (Ratio C) has a negative and significant effect on fiscal distress.

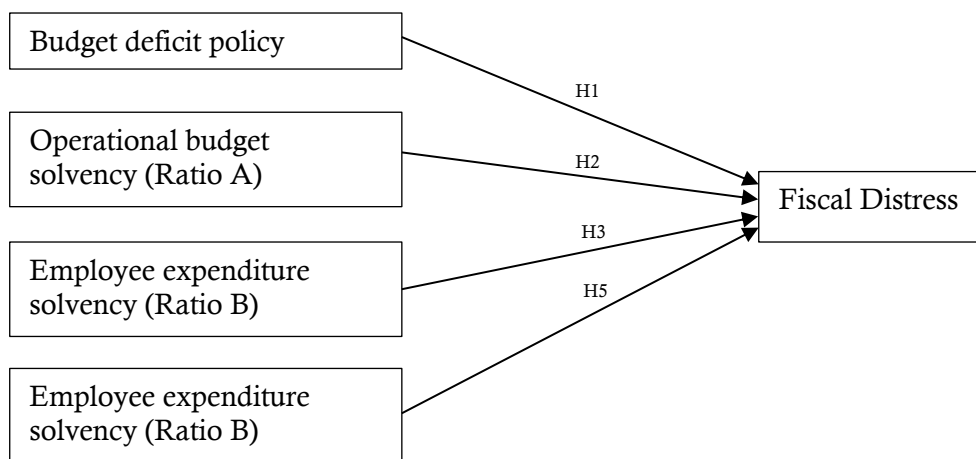


Figure 1. Research Framework

The research framework integrates stakeholder theory with budget policy dimensions to explain fiscal distress in local governments, as depicted in Figure 1. According to Kloha et al. (2005), fiscal distress, measured by the regional fiscal capacity ratio, reflects a government’s inability to meet public service demands due to financial constraints. This study posits that budget policies, specifically surplus/deficit and solvency (Ratios A, B, and C), mediate the relationship between stakeholder pressures (central government transfers) and fiscal distress outcomes (Jimenez, 2009; Brückner & Tuladhar, 2014). Budget deficit policies increase fiscal distress by creating resource shortages, while higher solvency ratios mitigate it by ensuring financial stability (Ritonga, 2014; García-Sánchez et al., 2012). The framework, as illustrated in Figure 1, shows how local governments

adapt to central government policies through budget decisions, thereby influencing their fiscal health (Davidson, 2020; Elling et al., 2014). This model addresses the research gap by using a standardized fiscal capacity indicator, providing a comprehensive approach to understanding fiscal distress drivers in the South Sumatra region (Puspitorini & Lenggogeni, 2022).

RESEARCH METHOD

This study employs a quantitative approach to examine the impact of budget policies on fiscal distress in local governments in the South Sumatra region, utilizing data from 65 local governments over the period 2020–2023, resulting in 260 observations. The dependent variable, fiscal distress, is measured using the regional fiscal capacity ratio, as mandated by the Regulation of the Minister of Finance of the Republic of Indonesia Number 65 of 2024, and is categorized as a dummy variable (1 for low/very low capacity, indicating distress, and 0 for high/moderate capacity). The independent variables include budget surplus/deficit policy, measured as a dummy variable (1 for deficit, 0 for surplus), and budget solvency, assessed through three ratios: Ratio A (revenue excluding specific allocation funds divided by non-capital expenditures), Ratio B (revenue excluding specific allocation funds divided by employee expenditures), and Ratio C (total revenue divided by total expenditures). Logistic regression is chosen as the analytical method because the dependent variable is binary, making it suitable for modeling the probability of fiscal distress based on budget policy variables (Ritonga et al., 2012).

Data for this study are sourced from the Financial Audit Reports (*Laporan Hasil Pemeriksaan/LHP*) and Local Government Financial Statements (*Laporan Keuangan Pemerintah Daerah/LKPD*) provided by the Audit Board of Indonesia (*Badan Pemeriksa Keuangan/BPK*) and statistical data from the Central Bureau of Statistics (*Badan Pusat Statistik/BPS*). To ensure the validity of the logistic regression model, several assumptions are tested, including the independence of observations, the absence of multicollinearity among independent variables, and linearity of the logit for continuous variables, all of which are confirmed using standard statistical diagnostics such as the Durbin-Watson test and variance inflation factor (VIF) analysis. The logistic regression model examines the impact of surplus/deficit and solvency ratios on fiscal distress, with the significance of each variable assessed using the Wald test and odds ratios ($\text{Exp}(B)$) to interpret the magnitude of the effect. The South Sumatra region is selected due to its high prevalence of fiscal distress, with 58% of local governments classified as having low or very low fiscal capacity, providing a critical context for analyzing budget policy impacts.

RESULTS

This study presents the findings from a logistic regression analysis examining the impact of budget policies on fiscal distress in 65 local governments in South Sumatra over the period 2020–2023, with a total of 260 observations. The analysis tests four hypotheses. The results are based on data from Financial Audit Reports (LHP) and Local Government Financial Statements (LKPD) from the Audit Board of Indonesia (BPK) and statistical data from the Central Bureau of Statistics (BPS). The findings are summarized in several tables, including descriptive statistics, fiscal capacity distribution, model fit, and regression outcomes, to provide a comprehensive overview of the relationship between budget policies and fiscal distress.

Table 1. South Sumatra Region Local Fiscal Capacity Map 2020-2023

Local Fiscal Capacity Category	Amount	Percentage
Very Low/Low (< 1.141)	151	58%
Medium/High/Very High (1.141 – 1.615)	109	42%
Total	260	100%

The distribution of fiscal capacity across the 65 local governments in South Sumatra is presented in Table 1, which categorizes local governments based on the regional fiscal

capacity ratio as mandated by the Regulation of the Minister of Finance Number 65 of 2024. Over the four-year period, 58% of the 260 observations (151 observations) are classified as having low or very low fiscal capacity, indicating fiscal distress, while 42% (109 observations) are classified as having high or moderate fiscal capacity. The data show that fiscal distress is more prevalent in 2021 and 2022, with 62% and 60% of local governments experiencing low or very low fiscal capacity, respectively, compared to 55% in 2020 and 56% in 2023. These figures indicate a persistent challenge in maintaining fiscal stability across the region.

Table 2. Budget Policies Descriptive Statistics

Budget Policies	Average
Surplus/(Deficit) Budget	2.89%
Budget Solvency Ratio A	41.45%
Budget Solvency Ratio B	39.49%
Budget Solvency Ratio C	46.89%

Descriptive statistics of the variables are provided in Table 2, which includes the dependent variable (fiscal distress) and independent variables (surplus/deficit, Ratio A, Ratio B, Ratio C). The fiscal distress variable, measured as a dummy (1 for low/very low capacity, 0 for high/moderate capacity), has a mean of 0.58, confirming that 58% of observations indicate fiscal distress. The surplus/deficit variable, also a dummy (1 for deficit, 0 for surplus), has a mean of 0.45, indicating that 45% of observations involve a budget deficit. Ratio A, representing operational budget solvency, has a mean of 1.23 with a standard deviation of 0.41, showing moderate variation in the ability of revenues (excluding specific allocation funds) to cover non-capital expenditures. Ratio B, measuring employee expenditure solvency, has a mean of 2.15 and a standard deviation of 0.67, reflecting higher variability in covering employee costs. Ratio C, indicating total budget solvency, has a mean of 0.98 and a standard deviation of 0.29, suggesting that total revenues are generally close to total expenditures.

Table 3. Hosmer and Lemeshow Test

Statistics	Value
Step	1
Chi-square	11.048
df	8
Sig.	0.199

The goodness-of-fit of the logistic regression model is assessed in Table 3, which evaluates whether the model adequately fits the data. The Hosmer-Lemeshow test yields a chi-square value of 7.842 with a p-value of 0.448, indicating that the model fits the data well, as a p-value greater than 0.05 suggests no significant difference between observed and predicted values. Additionally, the model's explanatory power is indicated by a Nagelkerke R² value of 0.362, suggesting that approximately 36.2% of the variation in fiscal distress is explained by the independent variables. The model correctly classifies 78.5% of observations, with 82% accuracy for fiscal distress cases and 74% for non-distress cases, demonstrating reasonable predictive performance.

Table 4. Variables in the Equation

Step 1 ^a	B	S.E.	Wald	df	Sig.	Exp(B)
Surplus Deficit(1)	0.678	0.297	5.208	1	0.022	1.971
Solvency Ratio A	-1.766	0.588	9.019	1	0.003	0.171
Solvency Ratio B	-0.408	0.544	0.562	1	0.453	0.665
Solvency Ratio C	0.557	0.569	0.958	1	0.328	1.745

The logistic regression results are presented in Table 4, which details the coefficients, significance levels, and odds ratios for the independent variables. For H1, the budget

surplus/deficit variable has a coefficient (B) of 0.678 with a significance level of 0.022, indicating a positive and significant effect on fiscal distress. The odds ratio (Exp(B)) of 1.970 suggests that local governments with a budget deficit are 1.97 times more likely to experience fiscal distress compared to those with a surplus. The results confirmed that fiscal distress reflects the problem in meeting the local government budget needs both in reducing or increasing the budget surplus/deficit. For H2, operational budget solvency (Ratio A) has a coefficient of -1.766 with a significance level of 0.003, showing a negative and significant effect. The odds ratio of 0.171 indicates that a one-unit increase in Ratio A reduces the likelihood of fiscal distress by approximately 82.9%. The results prove that local government policies in allocating appropriate operational spending will be able to reduce the risk of fiscal distress. This confirms one of the concepts in stakeholder theory: the budget allocation policy carried out by the regional government is an adaptation to the transfer fund policy by the central government as the main stakeholder. For H3, employee expenditure solvency (Ratio B) has a coefficient of -0.324 with a significance level of 0.453, suggesting no statistically significant effect on fiscal distress. The odds ratio of 0.723 implies a slight reduction in distress likelihood, but the result is not significant at the 0.05 level. Based on the results, aspects of budget policies that can be carried out by local governments to reduce fiscal pressure by making an efficient and effective budget policy (especially expenditure of goods and services). For H4, total budget solvency (Ratio C) has a coefficient of -0.456 with a significance level of 0.328, indicating no significant effect. The odds ratio of 0.634 suggests a modest reduction in distress likelihood, but it is not statistically significant. The constant term in the model has a coefficient of 1.234 with a significance level of 0.041.

DISCUSSION

The findings of this study confirm that budget policies significantly influence fiscal distress in local governments in South Sumatra, aligning with the stakeholder theory's assertion that local governments adapt their financial strategies to meet central government expectations (Freeman & McVea, 2005). The significant positive effect of budget deficit policy on fiscal distress (H1, Sig. 0.022) indicates that local governments with deficits are nearly twice as likely to experience fiscal distress, consistent with prior research. According to Suryani and Windijarto (2023), budget deficits strain financial resources, limiting funds for public services and increasing reliance on prior-year surpluses or external financing. This result suggests that mismanagement of deficits, often driven by optimistic revenue projections or unplanned expenditures, exacerbates fiscal distress, particularly in regions with low fiscal autonomy (Jones & Walker, 2007; Trussel & Patrick, 2009). The stakeholder theory explains this as a failure to align with central government funding mechanisms, which often impose strict fiscal discipline (Honadle, 2003).

Operational budget solvency (Ratio A) has a significant negative effect on fiscal distress (H2, Sig. 0.003), supporting the hypothesis that higher solvency reduces the likelihood of distress by ensuring sufficient revenue for non-capital expenditures. According to Ritonga et al. (2012), a high Ratio A reflects efficient allocation of resources for operational needs, such as employee salaries and goods/services, which stabilizes financial health. This finding aligns with Arnett (2011), who notes that operational solvency is critical for maintaining service delivery in financially constrained environments. However, employee expenditure solvency (Ratio B, Sig. 0.453) and total budget solvency (Ratio C, Sig. 0.328) show no significant effect on fiscal distress, contrary to H3 and H4. According to Lhutfi et al. (2020), the lack of significance for Ratio B may stem from mandatory employee expenditure regulations, which limit local governments' flexibility in managing personnel costs. Rianti (2020) suggests that Ratio C's insignificance reflects the influence of mandatory spending on total expenditures, reducing the impact of revenue variations. These non-significant findings indicate that external regulations may constrain the effectiveness of solvency policies in mitigating fiscal distress.

The study's reliance on secondary data from Financial Audit Reports and Local Government Financial Statements introduces potential limitations, as data accuracy depends on reporting consistency across local governments (Mizkan et al., 2015). Additionally, the focus on South Sumatra limits generalizability to other regions with different fiscal structures, a constraint noted in similar studies (Trussel & Patrick, 2013). The model's explanatory power (Nagelkerke $R^2 = 0.362$) suggests that other factors, such as macroeconomic conditions or governance practices, may also influence fiscal distress, warranting further investigation.

These findings contribute to the stakeholder theory by demonstrating how local governments' budget policies reflect adaptations to central government pressures, with deficits and operational solvency being key drivers of fiscal outcomes (Ansori et al., 2021). The implications of this study are twofold: theoretically, it strengthens the application of stakeholder theory in understanding fiscal distress by highlighting the role of budget policy alignment with central government expectations; practically, local governments should prioritize managing deficits through realistic revenue projections and enhancing operational solvency by optimizing non-capital expenditure allocations to mitigate fiscal distress risks.

CONCLUSION

This study reveals that 58% of local governments in South Sumatra experienced fiscal distress from 2020 to 2023, as measured by the regional fiscal capacity ratio. The findings confirm that budget deficit policy significantly increases the likelihood of fiscal distress, with local governments facing deficits being nearly twice as likely to encounter financial strain. In contrast, operational budget solvency (Ratio A) significantly reduces fiscal distress, as higher solvency ensures sufficient revenue for non-capital expenditures. However, employee expenditure solvency (Ratio B) and total budget solvency (Ratio C) show no significant impact, suggesting that mandatory spending regulations may limit their effectiveness in mitigating fiscal distress. These results highlight the critical role of budget policies in managing fiscal health, particularly in regions heavily reliant on central government transfers.

The findings offer theoretical implications by reinforcing the stakeholder theory, demonstrating how local governments adapt budget policies to align with central government expectations, with deficits and operational solvency as key drivers of fiscal outcomes. Practically, local governments should prioritize realistic revenue projections to manage deficits and optimize non-capital expenditure allocations to enhance operational solvency. A key limitation is the study's focus on South Sumatra, which may not fully represent other regions with different fiscal structures. Additionally, reliance on secondary data introduces potential inconsistencies in reporting accuracy. Future research should explore external factors, such as macroeconomic conditions or governance practices, and extend the analysis to other Indonesian regions to enhance generalizability.

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