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CAN BUDGET RATCHETING MODERATE THE RELATIONSHIP BETWEEN FINANCIAL PERFORMANCE AND CAPITAL EXPENDITURES?

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Abstract
Budget ratcheting can serve as a moderator the relationship between financial performance and capital expenditure since it can help the government to control spending related to capital expenditure. This study aimed to examine the effect of financial performance and budget ratcheting on capital expenditure, and the ability of budget ratcheting to moderate the relationship between financial performance and capital expenditure. The population in this study were all districts/cities in Aceh Province for the 2019-2021 period. From 23 samples within three-years observation, 69 observations were conducted using balanced panel data. The data analysis employed multiple linear regression and path analysis. The results showed that financial performance, as well as budget ratcheting, had an effect on capital expenditure, and budget ratcheting was able to moderate the relationship between financial performance and capital expenditure.
Keywords: financial performance; capital expenditure; budget ratcheting

1. Introduction
After the 1998 reform, during which bureaucratic and regional economic reforms were implemented, the Indonesian government underwent a dramatic change from a centralized to decentralized paradigm. This shift in paradigm was manifested in the form of the delegation of power. The decentralized system was more responsive to global changes. In addition, it gives wider authority to provincial or district governments to run effective and efficient governance (Bolen, 2019). Thanks to regional autonomy and decentralization of taxation, local governments now have the power to collect revenues and play an independent role in setting development priorities (Amin, 2015).
Regional autonomy grants freedom and authority to regional governments to regulate governance and development affairs in their territory. Regional autonomy is closely related to capital expenditure in that by granting authority to regional governments, regional governments have the responsibility to carry out development in their regions. Capital expenditure itself is a type of budget the government spends to finance any physical development, such as the construction of infrastructure, buildings, roads, bridges, and so on. Therefore, regional autonomy can have a positive impact on increasing capital spending in the region and accelerating the development of its infrastructure and other public facilities. In an effort to increase regional independence, local governments are required to optimize their revenue

potential by, among others, providing a greater proportion of capital expenditure for regional development in productive sectors that can generate revenue for the region (Harianto 2007).

Capital expenditures are used to purchase or increase a company's fixed assets, such as machinery, equipment, buildings, land and vehicles. This capital expenditure can help companies increase their production capacity, efficiency, and long-term profits. Capital expenditure can also be financed through sources such as internal company funds or loans from third parties. The increase in capital expenditure will have an impact in the coming period as it will result in increased community productivity and investors (Arsallya et al., 2021). Capital spending for development will ultimately result in increased standard of the community's living/welfare and public services, as well as raising the dignity of the autonomous regions (Bolen, 2019).

The budget allocated for the next period is usually based on the actual budget spent to evaluate performance. The next period's budget depends on the budget spending that reflects incremental budgeting. Incrementalism brings a negative consequence when there is a bias in the previous period's budget due to opportunistic behaviors in budgeting in the form of budgetary slack and budget ratcheting. This will lead to a decrease in performance, which will result in difficulties in measuring the actual level of performance (Mariani, 2022).

Several factors that affect capital expenditure include financial performance (Arsallya et al., 2021; Bolen, 2019; Herawati et al., 2021; Kuroki & Motokawa, 2021; Marlina, 2019; Safitri & Sari, 2020; Yulientinah & Nur, 2021); and budget ratcheting (Hercowitz & Strawczynski, 2004; Hidayah & Sari, 2022; Hla et al., 2016; Kuroki & Shuto, 2022; Manbait et al., 2022; Marlina, 2019; Misra, 2020; Nurhayati, 2018; Ruswandi et al., 2021; Safitri & Sari, 2020; Yulientinah & Nur, 2021). Financial performance can affect capital expenditures (Fitri et al., 2014) because they require adequate financial resources. If the company's financial performance is poor, it is likely that there will be capital expenditure restrictions because the available financial resources are limited. Budget ratcheting can also negatively affect capital expenditures (Safitri & Sari, 2020) because it can limit a company's ability to make long-term investments. If the company continues to cut budgets, its ability to invest in fixed assets may suffer. In this context, there is a complex relationship between budget ratcheting, financial performance and capital expenditure. While budget ratcheting can help save your budget, keep in mind that investing in fixed assets is also important for a company's long-term growth. Therefore, companies must carefully consider the impact of budget ratcheting and financial performance on capital expenditures, and find the right balance to optimize their spending.

In addition, budget ratcheting can moderate the relationship between financial performance and capital expenditure (Andrean & Sari, 2022; Nurhayati, 2018). Budgeting is an expenditure planning process used to effectively and efficiently allocate financial resources to achieve organizational goals (Hla et al., 2016). In this case, budget ratcheting enables more mature consideration in determining the right capital expenditure. In the relationship between financial performance and capital expenditure, budget ratcheting can act as a moderator because it can help the government to control spending related to capital expenditure. With budgeting, the government can ensure that capital expenditures are made in accordance with its needs and financial capacity.

2. Literature Review

2.1 Budget Racheting

Budget ratcheting is defined as the use of current performance as a basis for determining future budgets (Kuroki & Shuto, 2022). It is the practice of cutting unused budgets in the previous period, so that the budget is not allocated again in the next period. Meanwhile, capital expenditure is one used to acquire fixed assets that can be used in the long term, such as buildings, machinery and equipment. The budgeting is based on the pattern or the amount of the previous year's budget, commonly referred to as budget ratcheting (V. F. Sari et al., 2021). One school of traditional budget theory takes into account incrementalism in budgeting. The previous budget is the predictor of the future one, implying that the previous budget serves as a viable benchmark in the budget process. Thus, once a budget is created, it is not only meaningful in the current year but also creates expectations that it will be approved in subsequent years (Choi et al., 2021).

2.2 Capital Expenditure

According to the Regulation of the Minister of Home Affairs Number 13 of 2006 Article 53 concerning guidelines for regional financial management, capital expenditure is defined as an expenditure of the local government budget (commonly referred to as *Anggaran Pendapatan dan Belanja Daerah* or APBD) on the procurement and construction of tangible fixed assets that have a benefit value of more than 12 months used in government activities (Manbait et al., 2022). It is made by an organization or company to purchase assets or capital goods such as production equipment, vehicles, buildings and machinery needed to produce the goods or services. It is a long-term investment expected to provide benefits for the company in the long term. It is spending for long-term results that will be obtained in the next few years. This expenditure includes spending money, among others, to purchase fixed assets, waste management costs, promotion costs, and research and development costs (Muhamad et al., 2018).

2.3 Financial Performance

Regional government financial performance refers to the ability of the local government to manage available financial resources to meet community's needs and improve its welfare. Good local government financial performance can help strengthen the economic base, strengthen social systems, improve public services, and improve people's welfare. Financial performance serves as a measurement of the results of a company's strategy, policies and operations. These results are reflected in its return on assets and on investment (Kimunduu et al., 2017). Financial performance is one measure used to evaluate a region's financial performance. Its indicators can be used to measure how well a region manages its finances, in terms of its capability of generating income, efficient spending, debt management, and good asset management (I. P. Sari et al., 2016).

3. Hypothesis Development

3.1 Effect of Financial Performance on Capital Expenditures

A government's financial performance can affect its capital spending decisions in a number of ways. The following are some of the possible effects of financial performance:

1. Government revenue: If the government has a large amount of revenue, it is more likely to have more funds for capital expenditures. Conversely, if its revenue is low, its capital spending may be limited.
2. Government debt: If the government is heavily indebted, it is more likely to limit its capital spending so as not to further increase the debt. Conversely, if the government's debt is low, it may be easier for the it to obtain additional funds for capital expenditures.
3. Efficient financial management: If the government can manage its finances efficiently by, for example, reducing waste or increasing tax revenue, it may have more funds to use for capital expenditures.
4. Policy priorities: The government's capital expenditure decisions can be influenced by its policy priorities. For instance, if the government wants to improve infrastructure, the capital spending on infrastructure might be its top priority.

Capital expenditure is influenced by local own-source revenue, which is a projection of local government financial performance (Alpi & Ammy, 2021; Andrean & Sari, 2022; Mubarok et al., 2022; Nurhayati, 2018). Allocating funds for more capital expenditures can later help the regions to obtain financial resources to generate regional income, which in turn will improve the local governments' financial performance (Alpi & Ammy, 2021). However, several studies have reported a contrasting finding that financial performance has no effect on capital expenditure (Herawati et al., 2021; Salimah & Herliansyah, 2019).

H1: Financial Performance does not affect Capital Expenditures

3.2 The Effect of Budget Ratcheting on Capital Expenditures

Budget ratcheting is a budget management policy used by the government to ensure that budget spending does not exceed the budget provided in the previous year. This concept specifically relates to capital expenditures, i.e. expenditures used to increase or repair assets owned by the government such as roads, bridges, buildings or other infrastructure. However, the use of budget ratcheting in capital expenditure management can negative affect infrastructure development and public services. Restrictions on capital spending can hinder the ability of local governments to repair and enhance existing public assets, or even hinder the development of new assets needed to meet societal needs.

Therefore, it is important for local governments to use budget ratcheting policies wisely and in the right context. Local governments must consider factors such as community needs, infrastructure needs, and financial conditions when making decisions about spending capital expenditures. In addition, local governments must also ensure that budget expenditures are carried out efficiently and transparently, so that they can provide maximum benefits for society and the regional economy as a whole. The results of previous research show that budget ratcheting has an effect on capital expenditure (Andrean & Sari, 2022; Hidayah & Sari, 2022; Hla et al., 2016; Manbait et al., 2022; Nurhayati, 2018).

H2: Budget ratcheting affect Capital Expenditures

3.3 Effect of Financial Performance on Capital Expenditures as Moderated by Budget Ratcheting

General allocation fund budgeting is a process carried out by the government in predicting revenue targets to achieve within a certain period by taking into account and considering various rules and regulations related to revenue objects, such as laws, government regulations, and regional regulations. General allocation fund budgeting must be carried out in a transparent and accountable manner so that it can be publicly accountable. In addition, general allocation fund budgeting must be carried out by taking into account the principles of efficiency, effectiveness and fairness so that it can provide optimal benefits for society as a whole (Manbait et al., 2022). Budget ratcheting can affect the relationship between financial performance and capital expenditure. In a situation where the budget is always increasing from time to time, managers tend to allocate more budget for capital expenditures to maintain or improve their financial performance. This is especially the case when managers are measured and evaluated on their financial performance.

However, constant allocation of budget for capital expenditures without considering business needs or operational efficiency can lead to waste and reduced effectiveness. In this case, budget ratcheting can hinder the government's ability to manage resources effectively and can exacerbate the relationship between financial performance and capital spending. Thus, while budget ratcheting can moderate the relationship between financial performance and capital expenditure (Abdullah & Junita, 2016; Andrean & Sari, 2022; Hidayah & Sari, 2022; Manbait et al., 2022; Nurhayati, 2018; Safitri & Sari, 2020), it is important to consider the efficiency and effectiveness of resource management in a broader context. Decision making must be based on actual business needs and not merely on attempts to maintain or improve financial performance in an unsustainable way.

H3: Budget Ratcheting can Moderate the Relationship between Financial Performance and Capital Expenditures

4. Materials and Methods

4.1 Sample Selection and Data Source

The population is a collection of all relevant observation units and is the object of study or analysis. The population in this study comprised all observation units in the balanced panel data it used. In using balanced panel data, the population consisted of the same unit of observation in each observation period. The population in this study was all districts/cities in Aceh Province. The research sample totaled 23 City Regencies, with the year of observation being 2019-2021, during which 69 observations were conducted. The sample was selected by using purposive sampling method, using only the financial reports that presented the data and information in the audited district government financial reports as needed in the study.

4.2 Variables and Model

The variables used in this study were financial performance (X), capital expenditure (Y) as the independent variable and budget ratcheting (Z) as the moderator variable. For more details, see

Table 1. Using the multiple linear regression, the relationship between financial performance, budget ratcheting and capital expenditure was tested using the formulated model: **Y= *a* +bX+ bZ+ ε1… for hypotheses 1 and 2,**

Where:

Y = Capital Expenditures;
X = Financial Performance;
Z = Budget Ratcheting;
b = Regression coefficient;
a = Constant; And
ε_1 = Error term.

Furthermore, the ability of budget ratcheting in moderating the relationship between financial performance and capital expenditures using the path analysis method was tested using the formulated model: **Z = a + bX*Y +ε2… for hypothesis 3,**

where:
Y = Capital Expenditures;
X = Financial Performance;
Z = Budget Ratcheting;
b_1, b_2 = Regression coefficient;
X^*Y = Interaction;
a = Constant; And
ε_2 = Error term.

Hypothesis testing included simultaneous hypothesis testing (F test) and partial hypothesis testing (t test). Before testing the hypothesis, a basic assumption test that consisted of the normality test, multicollinearity test, heteroscedasticity test and autocorrelation test was carried out (Mariana et al., 2018).

5. Results

5.1 Basic Assumption Test

5.1.1 Normality test

The results of the normality test show that the residual values were normally distributed and the regression analysis was feasible since the residual values (Asymp. *Sig.* (2- *tailed)*) more than 0.050, i.e. 0.196 (see **Table 5)**.

5.1.2 Multicollinearity Test

The regression results showed that there were no symptoms of multicollinearity in the equation; in other words, the data meets the classic multicollinearity assumption test. This was based on the fact that the Tolerance value was above 0.10, which indicated that each variable in the model had sufficient variation and was not overly correlated with other variables, so there was no multicollinearity problem. In addition, VIF values for all variables were below 10, which indicated that there is no significant correlation between the variables in the model, as can be seen in **Table 4**.

5.1.3 Uji Heteroskedastisitas

The regression results showed that the scatterplots indicated that the data points spread randomly and were scattered both above and below 0 on the Y axis, as can be seen in Figure 1. This indicated that there was no clear pattern in the residual variance in the regression model. Therefore, it could be concluded that there was no heteroscedasticity in the regression model and the model was suitable for predicting the independent variables.

Autocorrelation Test

The regression results in **Table 2** showed that the value of Durbin-Watson was 1.635. When compared with the Durbin-Watson Table, the number of observational data was 69 with 2 independent variables. The DL value was 1.550, the DU value was 1.669, and the D value was 1.635, with the decision- making being DU < D < 4-DU, i.e. 1,669 < 1,635 < 2, 331. Thus, the regression model is free from autocorrelation problems.

5.2 Analysis

5.2.1 Multiple Regression Analysis

Hypothesis testing was conducted by using multiple linear regression analysis. The results were presented in **Table 4**. From these results, a regression equation could be constructed as follows:

$$Y= 24.133+0.143X-0.063Z+ \varepsilon_1$$

Table 3 showed the F *value* of 7,085 with a significance value of 0.002, which indicated that the independent variables jointly affected the dependent variable since the significance value was less than 5% or 0.05. This indicated that the variable financial performance and budget ratcheting could be used to predict regional capital expenditure in districts throughout Aceh. The coefficient of determination as shown in Table 2 was 0.177 or 17.7%, meaning that the financial performance and budget ratcheting variables were only able to explain 17.7% of the regional capital expenditure. The ability to explain this independent variable was relatively small because the remainder was 22.5%, which was explained by other variables not included in this study.

5.2.2 Effect of Financial Performance on Capital Expenditures

Based on the regression results in **Table 4** it was found that the significance value of financial performance was 0.001 with a t value of 3,356. The value of 0.001 was smaller than α=5% or 0.000<0.05. Thus, H01 was accepted and Ha2 was not, which indicated that financial performance had a positive and significant effect on capital expenditure in districts throughout Aceh. The 0.143 coefficient value of the regional original income variable indicated that if financial performance increased by 1 (one) percent, regional capital expenditure would increase by 14.3 percent, assuming other variables were constant.

5.2.3 Effect of Budget Ratcheting on Capital Expenditures

Based on the regression results in **Table 4,** it was found that the significance value of regional original income was 0.035 with a t value of -2.152. The value of 0.035 was smaller than α=5% or 0.035<0.05. Thus, H02 was not accepted and Ha2 was accepted, which indicated that budget ratcheting had a negative and significant effect on capital expenditure in districts throughout Aceh. The coefficient value of the regional original income variable was 0.063, which indicated that if the ratcheting budget increased by 1 (one) percent, capital expenditure would decrease by 6.3 percent, assuming other variables were constant.

5.3 Path Analysis

Hypothesis testing was conducted by using path analysis, with the results shown in **Table 7**. From these results, a regression equation can be constructed as follows:

$$Z = 22.915 + 0.131X^*Y + \varepsilon_2$$

Coefficient value of Adjusted R Square shown in Table 6 in the first model (1) before mediation was 0.106 or 1.06% and in the second model after mediation (2) was 0.152 or 1.52 %. This indicated a change in value from 0.106 before mediation to 0.152 after mediation. Therefore, H03 was not accepted and H03 was accepted, which indicated that the effect of financial performance (X) on capital expenditure (Y) could be moderated by *budget ratcheting* (Z).

6. Discussion

6.1 Effect of Financial Performance on Capital Expenditures

Financial performance affected capital spending. This indicates that the regional budget through regional original income has an influence on this relationship. However, in general, regional own-source revenue is indeed an important source of revenue for local governments in conducting capital expenditures. Regional original revenues are obtained from sources such as regional taxes, regional levies, regional wealth management results, and other legal sources. Regional financial performance can affect regional own-source revenues in various ways, such as increasing or decreasing tax and levy revenues, increasing or decreasing efficiency in regional financial management, and so on. If the regional financial performance is decent, the regional original income is likely to increase, so that the regional capital expenditure budget will also increase. Conversely, if the region's financial performance is poor, its own-source revenues will likely decrease, thus affecting its regional capital expenditure budget.

The results of the study show that financial performance has an effect on capital expenditure (Alpi & Ammy, 2021; Andrean & Sari, 2022; Mubarok et al., 2022; Nurhayati, 2018). Therefore, it is important for local governments to take into account the projected financial performance through regional original revenues in planning its capital expenditure budget. However, several studies have reported a contrasting finding that financial performance has no effect on capital expenditure (Herawati et al., 2021; Salimah & Herliansyah, 2019).

6.2 The Effect of Budget Ratcheting on Capital Expenditures

Budget ratcheting affects capital spending. This indicates that capital expenditure often requires a significant budget over a long period of time. Budget ratcheting is a practice in which local governments narrow or reduce budget allocations to certain sectors in an effort to save expenses. Budget ratcheting can result in difficulties for local governments in allocating sufficient budgets for capital expenditures. This can hamper their ability to improve infrastructure and public facilities, such as roads, bridges, schools and hospitals.

Budget ratcheting in capital spending can also exacerbate local government's economic growth and create social inequality. If a local government continues to narrow its budget allocations for capital expenditures, sectors that require long-term investment, such as infrastructure, health and education, may not develop as expected, thus impacting economic growth and people's prosperity.

As such, the continued practice of budget ratcheting could have a negative impact on local government's capital spending and long-term economic growth. Therefore, local governments need to consider the long-term impact of budget ratcheting practices when making budget decisions. The results of this study are in line with those of the previous studies which found that budget ratcheting had an effect on capital expenditure (Andrean & Sari, 2022; Hidayah & Sari, 2022; Hla et al., 2016; Manbait et al., 2022; Nurhayati, 2018).

6.3 Effect of Financial Performance on Capital Expenditures with Budget Ratcheting as Moderation

Financial performance affects capital expenditure as moderated by budget ratcheting. This shows that a local government's financial performance can affect its capital expenditures, and this influence can be moderated or strengthened by the concept of budget ratcheting. Budget ratcheting refers to a phenomenon when the government's budget tends to increase from year to year, even if its income or performance decreases or stagnates. In this context, if the regional financial performance is decent, the regional capital expenditure is likely to increase proportionately. However, if the regional financial performance is poor, the regional capital expenditure may not increase and even decrease.

The effect of financial performance on regional capital expenditures can then be moderated by budget ratcheting, which proves the existence of a complex relationship between financial performance, capital expenditures and budget ratcheting. If a region implements budget ratcheting, the regional capital expenditure is likely to continue to increase despite its poor financial performance. Conversely, if budget ratcheting is not implemented, the effect of financial performance on regional capital expenditure will be greater.

The results of this study were in accordance with those of previous studies which reported that budget ratcheting was able to moderate the relationship between financial performance and capital expenditure (Abdullah & Junita, 2016; Andrean & Sari, 2022; Hidayah & Sari, 2022; Manbait et al., 2022; Nurhayati, 2018; Safitri & Sari, 2020). It is important to look at the effectiveness and efficiency of local government's resource management in a broader context. Decision-making must be based on the real needs of each region and not just efforts to maintain or improve financial performance in an unsustainable way.

7. Conclusion

Financial performance affects capital expenditure. This shows that the regional budget through regional own-source revenue has an influence on this relationship. However, in general, regional own-source revenue is indeed an important source of revenue for local governments in conducting capital expenditures.

Budget ratcheting affects capital capital expenditure. This shows that capital expenditure often requires a significant budget over a long period of time. Budget ratcheting is a practice in which local governments narrow or reduce budget allocations to certain sectors in an effort to save expenses.

Financial performance affects capital expenditure as moderated by budget ratcheting. This shows that the financial performance of a region can affect capital expenditures made its local government, and this influence can be moderated or strengthened by the concept of budget ratcheting. Budget ratcheting refers to the phenomenon where a government's budget tends to increase from year to year, even if its income or performance decreases or stagnates.

List of Tables

Table 1 Operational Variables

Variable	Definition	Measurement	Scale
Capital Expenditures (Y)	Capital expenditures are expenditures from local government budget that are used for the procurement and construction of tangible fixed assets that have a benefit value of more than 12 months of use in government activities (Manbait et al., 2022)	Expenditure/IDR capital expenditure budget in the budget realization report	Ratio
Financial Performance (X)	Financial performance is a measure used to evaluate the financial performance of a region (I. P. Sari et al., 2016).	Figures/ IDR surplus /deficit values in operational reports	Ratio
Budget Ratcheting (Z)	Budget ratcheting is defined as using current performance as a basis for determining future budgets (Kuroki & Shuto, 2022).	$PAD_t - PAD_{t-1} - \alpha + y(PADR_{t-1} - PAD_{t-1}) + \varepsilon$	Ratio

Source: Processed data (2023)

Table 2 Model Summary[b]

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	.420[a]	.177	.152	.36028	1.635

a. Predictors: (Constant), Budget Ratcheting, Financial Performance

b. Dependent Variable: Capital Expenditures

Table 3 ANOVA[a]

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	1.839	2	.920	7.085	.002[b]
	Residual	8.567	66	.130		
	Total	10.406	68			

a. Dependent Variable: Capital Expenditures
b. Predictors: (Constant), Budget Ratcheting , Financial Performance

Table 4 Coefficients[a] (Multiple Linear Regression)

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.	Collinearity Statistics	
		B	Std. Error	Beta			Tolerance	VIF
1	(Constant)	24.133	1.212		19.919	.000		
	Financial Performance	.143	.043	.378	3.356	.001	.981	1.019
	Budget Ratcheting	-.063	.029	-.243	-2.152	.035	.981	1.019

a. Dependent Variable: Capital Expenditures

Table 5 One-Sample Kolmogorov-Smirnov Test

		Unstandardized Residual
N		69
Normal Parameters[a,b]	Mean	.0000000
	Std. Deviation	.35494261
Most Extreme Differences	Absolute	.095
	Positive	.064
	Negative	-.095
Test Statistic		.095
Asymp. Sig. (2-tailed)		.196[c]

a. Test distribution is Normal.
b. Calculated from data.
c. Lilliefors Significance Correction.

Table 6 Model Summary[c]

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	.345[a]	.119	.106	.36991	
2	.420[b]	.177	.152	.36028	1.635

a. Predictors: (Constant), Financial Performance
b. Predictors: (Constant), Financial Performance, Budget Ratcheting
c. Dependent Variable: Capital Expenditures

Table 7 Coefficients[a] (Path Analysis)

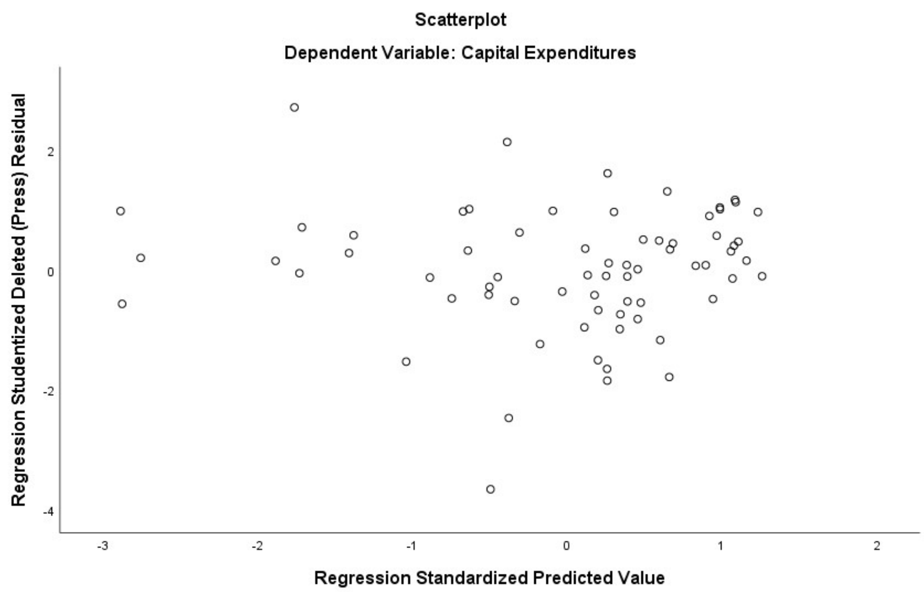
Model	Unstandardized Coefficients	
	B	Std. Error

1	(Constant)	22.915	1.100
	Financial Performance	.131	.043
2	(Constant)	24.133	1.212
	Financial Performance	.143	.043
	Budget Ratcheting	-.063	.029

a. Dependent Variable: Capital Expenditures

Figure Appendix

Figure 1 Scatterplot



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