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REFORMULATING REGIONAL HEADS' REMUNERATION THROUGH FISCAL CAPACITY AND WELFARE INDICATORS

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ABSTRACT

Research Originality – Although recent policy discussions have called for reformulation of Indonesian regional heads, existing proposals remain largely normative and have not provided an operational remuneration model. To the best of the author's knowledge, this study is the first to develop a multidimensional remuneration framework that integrates regional fiscal capacity, demographic complexity, fiscal discipline, and welfare indicators into a unified formula and evaluates its implications through simulation across Indonesian regional governments.

Research Objectives – This study develops and evaluates a remuneration framework that reflects contemporary fiscal conditions, demographic complexity, and governance priorities while encouraging prudent fiscal management and improved public welfare.

Research Methods – The proposed remuneration model incorporates four principal dimensions: regional fiscal capacity represented by Regional Original Revenue (PAD), demographic complexity measured through a nonlinear population function, fiscal discipline represented by a maximum personnel expenditure ratio of 30% of the regional budget, and poverty as a welfare safeguard indicator. The framework was evaluated through simulation using 23 regional governments representing diverse fiscal and socioeconomic characteristics.

Empirical Results – The simulation results indicate that remuneration outcomes differ substantially across regions and are no longer determined solely by fiscal capacity. Instead, remuneration reflects the combined effects of fiscal performance, demographic conditions, budget discipline, and welfare outcomes. The proposed framework reduces PAD's dominance as the sole determinant of remuneration while strengthening incentives for prudent fiscal management, improved welfare performance, and accountable regional governance.

Implications – The findings contribute to the literature on public sector incentive design by demonstrating that remuneration systems should be structured around multiple governance dimensions rather than single fiscal indicators. From a policy perspective, remuneration reform should complement, rather than substitute, Indonesia's Transfer to Regions (TKD) system, with remuneration functioning as a behavioral incentive for regional leaders while intergovernmental fiscal transfers remain the principal instrument for regional fiscal equalization.

Keywords: Fiscal Capacity; Fiscal Decentralization; Local Government; Public Welfare; Remuneration Reform.

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INTRODUCTION

Fiscal decentralization in Indonesia has significantly transformed regional financial management. Fiscal capacities across regions have developed unevenly since the implementation of regional autonomy. Several regions with strong economic activity have been able to generate substantially larger fiscal

capacities than others, and in some cases, regencies or municipalities possess fiscal capabilities exceeding those of certain provinces. This phenomenon is particularly evident in several major cities on Java Island, where regional original revenue (Pendapatan Asli Daerah/PAD) is considerably higher than that of provinces with more limited economic bases.

Differences in fiscal capacity are accompanied by varying levels of administrative complexity. Regions with large populations and intensive economic activities face more complex governance and administrative challenges than regions with smaller administrative scales. Consequently, policy approaches based solely on administrative classifications, such as the distinction between provinces and regencies/municipals, do not necessarily reflect the actual complexity of RG. Fiscal decentralization frequently generates asymmetric governance capacities across regions due to differences in economic structures, demographic conditions, institutional quality, and administrative burdens. Regions with similar administrative status may experience substantially different governance pressures and fiscal responsibilities.

Nevertheless, the financial entitlements of regional heads in Indonesia are still regulated under relatively outdated regulations, namely, Government Regulation No. 59 of 2000 concerning the Financial Rights of Regional Heads and Deputy Regional Heads and Government Regulation No. 109 of 2000 concerning the Financial Position of Regional Heads and Deputy Regional Heads. These regulations were introduced during the early period of regional autonomy and have not undergone substantial revisions over the past 2 decades, despite significant changes in regional fiscal conditions over the past two decades.

Under these regulations, regional heads' financial entitlements consist of two primary components. The first category consists of salaries and salary-related allowances. Their structure is similar to the civil servants' compensation system.

APPLICATIONS FOR PRACTICE

- Remuneration should not depend solely on local revenue growth.
- Population size, budget management, and poverty levels should also be considered.
- The government needs gradual regulatory reform supported by greater transparency and oversight.

Table 1 Salary Structure of Regional Heads (in IDR)

No	Position	Amount
1.	Governor	3.000.000
2.	Deputy Governor	2.400.000
3.	Regent/Mayor	2.100.000
4.	Deputy Regent/Mayor	1.800.000

Source: Government Regulation No. 59 of 2000 (2001)

However, since the regulation was enacted in 2000, the nominal salary levels stipulated in Government Regulation No. 59 of 2000 have not been adjusted since the regulation was enacted in 2000. Substantial economic changes have occurred over the past 2 decades, while the real value of these salaries has declined significantly. In the literature on political economy, stagnant remuneration for public officials is often linked to political considerations and public perceptions. Politicians may be reluctant to support public officials' salary increases because such policies can be perceived as self-serving (Pedersen et al., 2018). Remuneration reforms can also be politically sensitive. Higher compensation for public officials may face public resistance, particularly where institutional trust is low and concerns about corruption remain. Public sector compensation policies should consider not only short-term fiscal pressures but also institutional capacity and the long-term quality of public service delivery (Murphy et al., 2020).

Table 2 Calculation of Operational Support Expenditures for Regional Heads (in IDR)

No.	Category	Minimum Amount	Maximum Percentage
1.	Governors and Deputy Governors		
a.	PADs up to 15 billion	150 million	1.75 %
b.	PADs above 15 billion up to 50 billion	262.5 million	1.00 %
c.	PAD above 50 billion up to 100 billion	500 million	0.75 %
d.	PADs above 100 billion up to 250 billion	750 million	0.40 %
e.	PAD above 250 billion up to 500 billion	1 billion	0.25 %
f.	PAD above 500 billion	1.25 billion	0.15 %
2.	Regents/Mayors and Deputy Regents/Mayors		
a.	PADs up to 5 billion	125 million	3.00 %
b.	PAD above 5 billion up to 10 billion	150 million	2.00 %
c.	PADs above 10 billion up to 20 billion	200 million	1.50 %
d.	PAD above 20 billion up to 50 billion	300 million	0.80 %
e.	PAD >50 billion up to 150 billion	400 million	0.40 %
f.	PAD above 150 billion	600 million	0.15 %

Source: Government Regulation No. 109 of 2000

In addition to salaries, regional heads are entitled to operational support expenditures as regulated under Article 9 of Government Regulation No. 109 of 2000. The operational support amount is determined based on regional PAD. The regulation uses a relatively simple approach, with a percentage of PAD serving as the main basis for calculating regional heads' operational expenditures.

Although the PAD-based approach provides flexibility for regions with different fiscal capacities, its implementation for more than 2 decades has revealed several limitations. First, using PAD as the main variable does not account for other indicators, such as population size and public service burdens, that may reflect the complexity of regional governance. Second, the formula does not fully reflect more recent developments in fiscal regulation, particularly changes in regional expenditure composition.

Relying heavily on PAD as an indicator in remuneration systems may also encourage local governments to prioritize short-term revenue increases through aggressive levies, licensing practices, and other revenue-oriented policies. Such policies may not adequately consider broader economic and social impacts. Over time, they may affect the investment climate, weaken public service orientation, and create imbalances between fiscal performance and societal welfare outcomes. Public sector incentive systems that excessively rely on narrow and measurable indicators may also distort governance priorities. Public officials may focus on activities that are directly associated with measurable rewards while paying less attention to other important but less measurable responsibilities (Campbell, 2018; Holmstrom & Milgrom, 1991). Furthermore, fiscal decentralization alone may not sufficiently reduce regional inequality. Improvements in governance quality, including greater bureaucratic efficiency and stronger anticorruption measures, may also be needed (Kyriacou et al., 2017).

Law No. 1 of 2022 concerning Fiscal Relations between the Central Government and Regional Governments (HKPD Law) introduced several regional fiscal disciplines. One important provision limit personnel expenditure to a maximum of 30% of total regional expenditure (APBD) and requires capital expenditures, excluding transfer expenditures, to account for at least 40 percent of APBD, excluding transfer expenditures. Regional governments have until 2027 to comply with these provisions. Therefore, the regulation reflects a broader policy direction towards greater control over regional expenditure structures. High personnel expenditure ratios may reduce fiscal flexibility and limit the available resources for infrastructure development and public service delivery. In this context, regional heads' financial entitlements should be considered alongside the development of the fiscal regulatory framework.

Fiscal discipline indicators, such as the ratio of personnel expenditure to total regional expenditure, could be incorporated into the remuneration framework to better align regional leadership incentives with sound fiscal governance, accountability, and long-term development objectives. Public officials' remuneration discussions extend beyond compensation and are closely related to governance and integrity in public financial management. Cressey's (1953) Fraud Triangle Theory explains fraudulent behavior through the interaction of pressure, opportunity, and rationalization. Rationalization is particularly relevant to remuneration because individuals may justify unethical behavior when they perceive that their compensation is not proportionate to their responsibilities (Abdullahi & Mansor, 2015; Awang et al., 2020). However, contemporary governance literature increasingly views corruption not only as a result of individual moral failure but also as an institutional incentive problem associated with information asymmetry, weak accountability mechanisms, and poorly designed governance arrangements. From this perspective, remuneration is not simply a compensation policy. It is also part of the broader institutional incentive structure that may shape public officials' behavior and support accountable and effective governance.

These issues are illustrated by several recent sting operations conducted by the Indonesian Corruption Eradication Commission (KPK) involving regional heads in recent years. These cases do not establish a causal relationship between remuneration and corruption. However, they illustrate the continuing importance of institutional governance and accountability in RFM. Accordingly, this study considers remuneration reform as a component of a broader incentive structure within regional fiscal governance.

A more rational and balanced remuneration framework is therefore expected to strengthen the alignment between fiscal incentives, governance objectives, and public accountability rather than serving as a standalone anticorruption policy. Considering the evolution of regional revenue capacity, developments in regional fiscal regulations, and the increasing complexity of regional governance, reformulation of regional heads' remuneration has become a relevant policy issue for scholarly examination. This study seeks to develop a multidimensional remuneration framework that better aligns fiscal incentives with governance complexity, fiscal discipline, and public welfare objectives.

This study contributes to the literature on public policy and regional finance in several ways. First, a multidimensional remuneration model for regional heads by integrating regional revenue capacity (proxied by PAD), demographic complexity, fiscal discipline, and welfare indicators within a unified incentive framework. Second, the study extends the literature on public sector incentives by demonstrating that

remuneration systems relying on a single indicator may generate imbalanced policy incentives and governance distortions. Third, it offers an operational policy design that can be directly adapted within the framework of regional fiscal governance framework.

Table 3 Recent KPK Sting Operations Involving Regional Heads

No	Name	Regional Position	Date of sting operation	Alleged Case
1	Abdul Azis	East Kolaka, Southeast Sulawesi	8 August 2025	Allegedly received bribes in the form of an 8% project fee (IDR 9 billion) from the East Kolaka Regional Hospital.
2	Abdul Wahid	Governor of Riau	3 November 2025	Allegedly demanded an informal share ("preman fee") amounting to 8% (IDR 4 billion) of the increased budget of the Public Works and Spatial Planning Agency budget.
3	Sugiri Sancoko	Regent of Ponorogo, East Java, Indonesia	7 November 2025	Allegedly provided bribes to maintain his position and influence hospital-related projects.
4	Maidi	Mayor of Madiun, East Java, Indonesia	19 January 2026	Allegedly engaged in extortion during the licencing process under the pretext of CSR contributions.
5	Sudewo	Regent of Pati, Central Java, Indonesia	19 January 2026	Allegedly imposed illicit charges in appointments to village administrative positions (extortion).
6	Fadia Arafiq	Regent of Pekalongan, Central Java, Indonesia	3 March 2026	Alleged corruption in public procurement through a company established by the suspect.
7	S. Auliya Rachman	Regent of Cilacap, Central Java, Indonesia	13 March 2026	Allegedly committed extortion under the pretense of collecting holiday allowances (THR).

Source: www.kpk.go.id

LITERATURE REVIEW

Agency theory, developed by Jensen & Meckling (1976), provides the primary analytical framework for understanding public officials' behavior. The theory explains that separating resource ownership from organizational management can create conflicts of interest between principals and agents, resulting in agency costs. Citizens can be viewed as principals who delegate authority to governments as agents responsible for managing public resources and delivering public services.

This relationship involves information asymmetry and imperfect monitoring because governments generally possess more information than citizens about fiscal policies, budget allocation, and administrative decisions than citizens. These conditions can make it difficult for citizens to fully observe or evaluate the actions of public officials. Therefore, institutional arrangements and incentive structures are therefore important for limiting opportunistic behavior and aligning public officials' interests with broader public objectives.

Institutional incentive structures play a central role in influencing public officials' behavior, particularly in public organizations characterized by information asymmetry and imperfect monitoring. Laffont & Martimort (2009) argued that contract design should not only provide compensation but also establish incentives for agents to act in accordance with the interests of principals. This perspective is consistent with Holmstrom's (1982) concept of moral hazard, which suggests that agents whose actions cannot be fully observed may pursue strategies that maximize their personal utility, even when those strategies generate negative externalities for society.

Therefore, in public governance, remuneration can be understood as part of a broader institutional incentive structure that may help address moral hazard and strengthen governance quality (Pierret, 2019). Weak incentives and accountability mechanisms may also contribute to moral hazard inefficiencies in the provision of public goods and services through moral hazard (Alam, 2023). However, incentive design in public organizations is more complex than that in private organizations because public institutions operate under multitasking responsibilities, multiple principals, and substantial difficulties in measuring organizational performance (van Triest, 2024).

While incentive theory emphasizes the importance of aligning individual behavior with organizational objectives, public-sector organizations present additional challenges. Unlike private organizations, public institutions pursue multiple and sometimes competing objectives, such as fiscal responsibility, service

delivery, social welfare, and institutional accountability. Bryson et al. (2017) argued that individuals working in public and mission-oriented organizations are motivated not only by financial rewards but also by intrinsic values such as public service, social contribution, and organizational mission. Therefore, remuneration should complement these intrinsic motivations and reflect the multidimensional responsibilities of public officials.

The challenge becomes greater when organizational performance is assessed using narrow and easily measurable indicators. Holmstrom & Milgrom (1991) argued that incentive systems based heavily on limited measurable outputs may distort behavior in multitask environments because agents tend to focus on activities linked directly to measurable rewards while giving less attention to other important responsibilities. Therefore, in regional governance, a remuneration system based primarily on PAD growth may therefore encourage revenue-oriented behavior without adequately accounting for governance quality, fiscal discipline, public welfare, and other dimensions of governmental performance.

Nevertheless, financial incentives remain relevant to individual effort. Dellavigna & Pope (2018) found that even under relatively modest incentive schemes, monetary incentives can influence individual effort and do not necessarily crowd out intrinsic motivation. Therefore, the design of public-sector remuneration should balance monetary incentives with the broader and multidimensional objectives of public service.

Taken together, the incentive literature suggests that public-sector remuneration should recognize the multidimensional nature of governmental responsibilities. Because regional heads are expected to simultaneously pursue fiscal performance, public service delivery, governance quality, and societal welfare, remuneration systems based exclusively on a single fiscal indicator may create unintended behavioral distortions. These considerations support the development of a multidimensional remuneration framework that integrates regional revenue capacity, demographic complexity, fiscal discipline, and welfare indicators within a broader institutional incentive structure.

The relationship between the remuneration of public officials and corruption has also received considerable attention in the political economy and public governance literature. Rather than attributing corruption solely to individual misconduct, this study emphasizes the roles of discretionary authority, accountability mechanisms, and institutional design in shaping the behavior of public officials. Klitgaard (1988) argued that corruption is associated with the interaction of monopoly power, discretion, and weak accountability, suggesting that governance outcomes depend not only on individual ethics but also on the institutional environment in which public officials operate. In regional governments, broad fiscal discretion combined with inadequate oversight may increase the risk of irregularities in PRM.

Empirical evidence suggests that remuneration may influence public officials' behaviour by altering the incentives associated with holding public office. Di Tella & Schargrodsky (2003) found that higher salaries may reduce incentives for corruption by increasing the opportunity cost of losing public office when misconduct is detected. Similarly, Van Rijckeghem & Weder (2001) argued that the relationship between potential illicit gains and official remuneration influences incentives for corruption. However, these findings do not suggest that remuneration alone can reduce corruption, as governance outcomes also depend on institutional quality, monitoring, and accountability mechanisms.

Remuneration may also affect the quality of political leadership by influencing the attractiveness of public office and officials' incentives to maintain their professional reputation. Higher compensation may attract more qualified individuals to public office and strengthen incentives to protect professional reputation (Cerqua et al., 2024; Pedersen et al., 2018). However, this relationship may not be linear. Fedele & Giannoccolo (2020) argued that excessively low remuneration may discourage capable individuals from entering public office, whereas excessively high remuneration may attract candidates with weaker public service motivation. Similarly, Cerina & Deidda (2017) suggested that higher income does not necessarily improve political quality when institutional governance and information systems remain weak.

These findings are particularly relevant to public-sector organizations, where performance involves multiple objectives, including fiscal sustainability, public welfare, administrative effectiveness, and equitable service delivery. Campbell (2018) argues that performance-based incentives can shape how public officials prioritize policy actions, while excessive reliance on easily measurable indicators may distort broader governance objectives. Hur (2018) similarly emphasized that financial incentives are only one factor shaping the behavior of public officials, alongside professional responsibility, institutional conditions, and public service orientation. Accordingly, remuneration reform should consider not only compensation levels but also the broader incentive structure through which accountability, governance quality, and public policy objectives are pursued. Taken together, the literature suggests that remuneration contributes to PSG by shaping incentives rather than directly determining governance outcomes. This perspective supports remuneration systems that consider multiple governmental performance dimensions rather than relying exclusively on a single fiscal indicator.

Fiscal decentralization is a mechanism for improving the efficiency and responsiveness of public service delivery by transferring greater fiscal authority to subnational governments. Oates (1999) argued that decentralization can improve resource allocation because local governments generally have better information about local preferences, economic conditions, and development priorities. By bringing decision-making closer to local communities, fiscal decentralization may contribute to public welfare.

However, decentralization can also create governance challenges. Rodden (2005) explains that when regional governments expect the central government to absorb the consequences of local fiscal decisions. This expectation may weaken fiscal discipline incentives and increase the risk of inefficient fiscal management and soft budget constraints. Similarly, Afonso et al. (2024) argue that excessive tax decentralization may create coordination problems and fiscal inefficiencies, although expenditure decentralization may improve public-sector responsiveness.

Therefore, fiscal decentralization does not automatically produce better governance or development outcomes. The effects of decentralization also depend on institutional quality, governance arrangements, and policy orientation. Hung & Thanh (2022) argued that economic growth alone cannot adequately capture human development because welfare outcomes are shaped by broader institutional and social factors. Accordingly, evaluating regional government performance solely through fiscal indicators may overlook important public-sector effectiveness and welfare.

These theoretical arguments are particularly relevant in Indonesia, where PAD disparities create considerable variation in regional revenue-generating capacity. Regions with stronger economic bases have greater opportunities to increase PAD, whereas those with weaker economic structures face more limited fiscal potential. Therefore, reliance on PAD as the primary performance indicator may therefore reinforce interregional disparities and create incentives to prioritize revenue generation over broader governance objectives.

Recent evidence from Indonesia indicates that regional fiscal performance is shaped not only by economic conditions but also by poverty dynamics and institutional quality. Higher poverty levels tend to weaken regional revenue capacity, whereas stronger governance contributes to improved fiscal outcomes (Priambodo, 2025). Therefore, regional revenue capacity alone therefore cannot adequately capture the complexity of regional governance. To align fiscal incentives with broader regional development objectives, a more comprehensive remuneration framework should incorporate complementary indicators, including fiscal discipline, demographic complexity, and welfare conditions, to align fiscal incentives with broader regional development objectives.

Classical theories of bureaucratic behavior further suggest that public officials do not always act exclusively in the public interest. Niskanen (1975) argues that bureaucrats have incentives to maximize the budgets they control because larger budgets may be associated with greater organizational influence, prestige, and career advancement. This perspective suggests that increases in regional revenue may encourage the expansion of expenditure and administrative authority without necessarily improving governance quality or public welfare.

These behavioral tendencies highlight the importance of incentive systems that extend beyond simple fiscal targets. Institutional mechanisms that promote fiscal discipline are essential for limiting inefficient budget expansion and encouraging public officials to pursue broader policy objectives rather than narrow organizational interests. Therefore, remuneration should reward not only revenue generation but also responsible fiscal management and accountable governance.

Recent empirical studies further support this perspective. Wilson (2021) argues that policies that emphasize fiscal performance while neglecting broader welfare objectives may generate unintended policy distortions. Similarly, Arapis & Bowling (2020) demonstrated that political incentives, institutional environments, and fiscal constraints, indicating that a single dimension of fiscal achievement cannot adequately explain organizational performance.

Therefore, reliance solely on PAD as a performance measure may therefore encourage revenue-oriented behavior while overlooking fiscal discipline, demographic complexity, governance quality, and societal welfare. These considerations support the development of a multidimensional remuneration framework that aligns public officials' incentives with broader regional development objectives.

By emphasizing the broader objectives of public policy, the welfare perspective broadens the evaluation of public-sector performance beyond fiscal achievements by emphasizing the broader objectives of public policy. In *Development as Freedom*, Sen (1999) argues that development should ultimately expand human freedom and improve societal well-being. From this perspective, public policy should be evaluated not only by its contribution to fiscal revenues but also by its effects on social welfare and human development.

This perspective is consistent with institutional economics, which emphasizes that development outcomes depend not only on economic performance but also on institutional quality and governance.

Acemoglu & Robinson (2012) argued that inclusive institutions create incentives for productive, accountable, and welfare-enhancing behavior, whereas extractive institutions tend to concentrate resources among political elites. Similarly, the World Bank Group (2017) highlighted governance quality and institutional accountability as important determinants of effective public policies and sustainable development outcomes.

In the context of regional financial management, these perspectives indicate that fiscal indicators alone cannot be adequately captured by fiscal indicators alone. Regional governments are expected to strengthen revenue capacity and improve public welfare through effective services and accountable governance. Therefore, a remuneration system focused exclusively on fiscal performance may therefore overlook these broader responsibilities.

Accordingly, welfare-oriented indicators, such as poverty conditions, can complement regional revenue capacity, demographic complexity, and fiscal discipline measures in a remuneration framework for regional heads. Such a framework would better reflect the broader objectives of regional governance and sustainable development.

Existing studies on the remuneration of public officials have advanced the understanding of the relationship between compensation and public-sector outcomes, including corruption, bureaucratic performance, regional revenue capacity, governance quality, and political leadership. Nevertheless, these dimensions are often examined separately and assessed using single performance indicators. This approach provides only a partial representation of regional heads' responsibilities within decentralised governance systems, where fiscal management, public welfare, demographic characteristics, and institutional accountability are interconnected.

Building on this literature, this study proposes a multidimensional remuneration framework that moves beyond regional revenue capacity as the sole basis for determining compensation. The framework integrates regional revenue capacity, proxied by PAD, demographic complexity, fiscal discipline, and welfare indicators within a broader institutional incentive structure. By combining these dimensions, the study seeks to provide an operational framework that better reflects the governance challenges of Indonesia's decentralized fiscal system.

METHODS

Based on the theoretical synthesis presented in the previous section, a multidimensional remuneration model for regional heads. The model is operationalized as follows:

$$\text{Remuneration} = \alpha(\text{PAD}) \times \text{Factor}_{\text{population}} \times \text{Factor}_{\text{fiscal constraint}} \times F_{\text{poverty}}$$

With α the PAD adjustment coefficient and PAD_i regional original revenue. The model integrates regional revenue-generating capacity, demographic complexity, fiscal discipline, and welfare conditions into a single remuneration equation. To maintain institutional continuity while accommodating the proposed reform, the coefficient α retains the basic remuneration structure established under the current regulatory framework. Specifically, α is applied to PAD as the base remuneration variable, consistent with the existing remuneration formula. While Government Regulation No. 109 of 2000 applies six layers of α coefficients, the proposed reformulation simplifies the structure into five layers, with uniform α coefficients applied to both provincial and regency/municipal regional heads.

Each component of the model represents a distinct dimension of regional governance identified in the literature review and is operationalized as follows. The α coefficient is differentiated according to the PAD scale, as presented in Table 4. Rather than applying a uniform coefficient across all regions, the proposed model introduces a declining α structure to reflect fiscal capacity differences.

Table 4 α Coefficient Structure

PAD Category	α
Up to IDR 250 billion	1.00
Above 250 billion IDR up to 1 trillion IDR	0.80
Above IDR 1 trillion up to IDR 5 trillion	0.60
Above IDR 5 trillion up to IDR 20 trillion	0.40
Above IDR 20 trillion	0.20

Source: Processed by the authors

The α parameter in this model is intentionally designed to decline as regional fiscal capacity increases. This approach is based on the principle of diminishing marginal utility, whereby additional resources at higher levels generate marginal benefits that are smaller than those at lower levels. Increases in PAD have a more significant effect on fiscal capability than in regions with already large fiscal capacities.

Consistent with the institutional incentive framework discussed in the literature review, reward systems that linearly increase based on a single performance indicator may generate distortions. If the remuneration of regional heads becomes excessively sensitive to PAD growth, fiscal policies may become overly oriented towards revenue expansion without adequately considering societal welfare impacts. Therefore, the declining α structure functions as a balancing mechanism to prevent opportunistic behavior in regional fiscal management. Accordingly, the declining α coefficient enables the remuneration model to preserve incentive compatibility while reducing structural disparities between regions with substantially different fiscal capacities.

Population is incorporated as a proxy for demographic complexity because regional heads governing larger populations generally face greater administrative demands, more diverse public service needs, and greater complexity in governance. The population factor is expressed as follows:

$$F_{(pop,i)} = 1 + \lambda \sqrt{\frac{Pop_i}{Pop_{nas}}} \quad (1)$$

With λ the population weighting coefficient, Pop_i Regional population, and Pop_{nas} national population. The square root function is used to ensure that the effect of population increases diminishes as the population size increases. Thus, although larger populations increase the population factor, the rate of increase in remuneration becomes progressively flatter. The model also incorporates the parameter λ as a population sensitivity coefficient to account for regional differences in demographic growth potential.

The λ parameter reflects the differences in regional demographic growth potential. Metropolitan and economically dynamic regions generally experience stronger natural and migration-driven population growth, whereas geographically remote regions may face structural constraints in attracting additional population. The λ parameter therefore allows remote regions to remain eligible for additional remuneration despite their relatively small populations.

In this study, λ is assumed to be identical across all regions to isolate the effects of the proposed remuneration framework and facilitate policy simulation. This simplifying assumption allows the analysis to focus on the multidimensional model's conceptual contribution. However, in practical implementation, the Ministry of Home Affairs could calibrate λ according to regional demographic and geographic characteristics through subsequent regulatory arrangements. The fiscal discipline factor is expressed as follows:

$$F_{(fiscal,i)} = \begin{cases} 1 & \theta_i \leq 0.30 \\ 1 - (\theta_i - 0.30) & \theta_i > 0.30 \end{cases} \quad (2)$$

With θ_i ratio of personnel expenditures to the total regional budget and θ^* statutory personnel expenditure ceiling (30%). The fiscal discipline factor operationalises the fiscal discipline requirements established under the HKPD Law by incorporating the personnel expenditure to total regional expenditure. This factor is intended to encourage regional governments to maintain expenditure structures consistent with fiscal sustainability and budgetary discipline.

This approach is particularly relevant in decentralised fiscal systems, where expenditure responsibilities may be more extensively transferred than revenue authority. Filippetti & Sacchi (2016) argued that public spending tends to be more decentralised than revenue-generating mechanisms, highlighting the importance of effective budget constraints at the regional level. Under these conditions, weak expenditure controls may contribute to fiscal imbalances, budget rigidity, and inefficient allocation of public resources. Incorporating fiscal discipline into the remuneration framework strengthens the alignment between regional leadership incentives and SFG.

In the proposed remuneration framework, θ represents the ratio of personnel expenditure to total regional expenditure (APBD). When θ is at or below the statutory threshold of 30%, the fiscal discipline factor equals one, and no remuneration adjustment is applied. When θ exceeds the threshold, the excess proportion reduces the fiscal discipline factor, resulting in a corresponding reduction in remuneration. The welfare factor is expressed as follows:

$$F_{poverty,i} = \begin{cases} 1, & \phi_i \leq \phi_{nas} \\ 1 - (\phi_i - \phi_{nas}), & \phi_i > \phi_{nas} \end{cases} \quad (3)$$

With ϕ_i regional poverty rate and ϕ_{nas} the national poverty rate. Both poverty rates are expressed in decimal proportions. The welfare factor functions as a safeguard within the proposed remuneration framework by limiting incentives to increase PAD without considering household welfare and broader social outcomes. This factor compares the regional poverty rate with the national poverty rate.

When the regional poverty rate is lower than the national rate, remuneration is not penalised. When the regional poverty rate exceeds the national rate, the excess poverty rate reduces remuneration. This

mechanism is intended to align fiscal incentives with broader welfare objectives rather than revenue expansion alone.

This is consistent with the literature on public-sector incentive literature suggesting that excessive reliance on narrow and measurable fiscal indicators may distort governance priorities. Holmstrom and Milgrom (1991) argued that public officials may devote greater attention to activities associated with measurable rewards while giving less attention to broader and less measurable objectives. Similarly, Cassar (2019) argues that incorporating a prosocial mission into an incentive structure may increase agents' effort and that highly motivated principals may provide stronger incentives for broader social objectives. Incorporating welfare indicators into the remuneration formula provides a mechanism for balancing fiscal incentives with societal welfare considerations and may reduce the risk of fiscal moral hazard in regional governance.

RESULTS AND DISCUSSIONS

A simulation was conducted using 23 regional governments, including provinces, regencies, and municipalities. The regional governments were selected to maximise variation in fiscal and socioeconomic characteristics rather than statistical representativeness. The sample includes regions with high, medium, and low PAD capacities; the highest, median, and lowest PAD rates; and major municipalities on Java with fiscal capacities comparable to those of several provinces outside Java. This variation allows the examination of the proposed remuneration model under diverse regional conditions.

As a benchmark, the financial entitlements of regional heads were first calculated based on the provisions of Government Regulation No. 59 of 2000 and Government Regulation No. 109 of 2000, as presented in Table 5.

Table 5 Simulation of Financial Entitlements of Regional Heads Under Existing Regulations (In IDR)

Regional Government	Salary	Minimum operational expenditure	Maximum operational expenditure	Minimum financial entitlement	Maximum financial entitlement
Special Capital Region of the Province of Jakarta	3,000,000	1250,000,000	81,281,624,290	1,253,000,000	81,284,624,290
Central Java Province, Indonesia	3,000,000	1,250,000,000	23,314,039,299	1,253,000,000	23,317,039,299
North Sumatra Province	3,000,000	1,250,000,000	10,874,251,995	1,253,000,000	10,877,251,995
Bali Province	3,000,000	1,250,000,000	5,372,057,407	1,253,000,000	5,375,057,407
Highland Papua Province	3,000,000	750,000,000	679,476,160	753,000,000	682,476,160
Badung Regency	2,100,000	600,000,000	14,534,153,473	602,100,000	14,536,253,473
Surabaya Municipality	2,100,000	600,000,000	13,194,505,752	602,100,000	13,196,605,752
Bandung Municipality	2,100,000	600,000,000	6,178,534,374	602,100,000	6,180,634,374
Depok Municipality	2,100,000	600,000,000	3,522,801,681	602,100,000	3,524,901,681
Denpasar Municipality	2,100,000	600,000,000	2,727,268,379	602,100,000	2,729,368,379
Balikpapan Municipality	2,100,000	600,000,000	1,951,924,454	602,100,000	1,954,024,454
Malang Regency	2,100,000	600,000,000	1,810,727,590	602,100,000	1,812,827,590
Mojokerto Regency	2,100,000	600,000,000	1,235,575,839	602,100,000	1,237,675,839
Sumedang Regency	2,100,000	600,000,000	1,036,597,866	602,100,000	1,038,697,866
West Kutai Regency	2,100,000	600,000,000	390,595,665	602,100,000	392,695,665

Table 5 Simulation of Financial Entitlements of Regional Heads Under Existing Regulations (In IDR) (Continued)

Regional Government	Salary	Minimum operational expenditure	Maximum operational expenditure	Minimum financial entitlement	Maximum financial entitlement
Rokan Hulu Regency	2,100,000	600,000,000	275,027,066	602,100,000	277,127,066
Tebing Tinggi Municipality	2,100,000	400,000,000	516,630,923	402,100,000	518,730,923
Sarolangun Regency	2,100,000	400,000,000	467,325,810	402,100,000	469,425,810
Deiyai Regency	2,100,000	400,000,000	459,405,768	402,100,000	461,505,768
North Kayong Regency (NKRK)	2,100,000	400,000,000	243,814,882	402,100,000	245,914,882
Supiori Regency	2,100,000	200,000,000	244,637,925	202,100,000	246,737,925
Intan Jaya Regency	2,100,000	200,000,000	232,424,006	202,100,000	234,524,006
Puncak Regency	2,100,000	150,000,000	189,000,000	152,100,000	191,100,000

Source: Processed by the authors

Table 5 shows substantial variation in regional heads' financial entitlements under the existing regulatory framework. These differences are primarily associated with variations in fiscal capacity, which remains the dominant factor in determining regional heads' operational expenditures under the current scheme.

Table 6 Comparison of Financial Entitlements and Proposed remuneration Reformulation (in IDR)

Regional Government	Maximum financial entitlement	Remuneration Reformulation	Growth
Special Capital Region of the Province of Jakarta	81,284,624,290	129,805,177,359	60 %
Central Java Province, Indonesia	23,317,039,299	83,037,233,955	256 %
North Sumatra Province	10,877,251,995	35,863,671,828	230 %
Bali Province	5,375,057,407	22,193,214,154	313 %
Highland Papua Province	682,476,160	1,425,750,753	109 %
Badung Regency	14,536,253,473	40,514,855,741	179 %
Surabaya Municipality	13,196,605,752	38,643,060,400	193 %
Bandung Municipality	6,180,634,374	25,156,073,584	307 %
Depok Municipality	3,524,901,681	14,589,821,038	314 %
Denpasar Municipality	2,729,368,379	10,773,837,376	295 %
Balikpapan Municipality	1,954,024,454	8,212,619,984	320 %
Malang Regency	1,812,827,590	7,039,648,536	288 %
Mojokerto Regency	1,237,675,839	6,495,051,273	425 %
Sumedang Regency	1,038,697,866	4,963,147,989	378 %
West Kutai Regency	392,695,665	1,997,345,974	409 %
Rokan Hulu Regency	277,127,066	1,540,634,064	456 %
Tebing Tinggi Municipality	518,730,923	1,045,910,931	102 %
Sarolangun Regency	469,425,810	1,017,316,563	117 %
Deiyai Regency	461,505,768	831,107,201	80 %
North Kayong Regency (NKRK)	245,914,882	541,466,325	120 %
Supiori Regency	246,737,925	108,108,513	-56 %
Intan Jaya Regency	234,524,006	109,428,240	-53 %
Puncak Regency	191,100,000	68,814,236	-64 %

Source: Processed by the author

Table 6 compares the maximum financial entitlements under the existing regulatory framework with those generated by the proposed model. The simulation results indicate that reformulation effects vary across regions, reflecting the multidimensional nature of the proposed remuneration formula.

The remuneration values presented in Table 6 represent the maximum annual financial entitlement generated by the proposed model rather than individual personal income. This study does not prescribe how this entitlement should be allocated among basic salary, performance incentives, operational

expenditure, or other remuneration components. Such allocations would remain within the regulatory authority of the Ministry of Home Affairs if the proposed framework were adopted. Accordingly, the analysis focuses on the overall remuneration ceiling, while the internal allocation of remuneration is left to future regulatory formulation.

Most regions, particularly those with relatively high fiscal capacities, experience substantial increases in remuneration. The simulation suggests that these increases are primarily driven by PAD growth and the use of a larger α coefficient than that stipulated under Government Regulation No. 109 of 2000. However, the increase is not proportional to fiscal capacity because the final remuneration level also reflects population, fiscal discipline, and poverty conditions. Consequently, fiscal capacity is no longer the sole determinant of regional heads' financial entitlements.

Conversely, several regions experience remuneration reductions. These reductions are primarily attributable to two factors: poverty rates exceeding the national average and personnel expenditure ratios exceeding the statutory threshold. Unlike the existing framework, which relies predominantly on fiscal capacity, the proposed model incorporates fiscal discipline and societal welfare. Consequently, remuneration may decline even in regions with relatively strong fiscal capacity when governance performance does not meet the established welfare and fiscal discipline benchmarks.

Therefore, the proposed framework therefore establishes a broader incentive structure in which remuneration is determined not only by the ability to generate PAD but also by fiscal management and welfare outcomes. Thus, the model functions not only as a fiscal reward mechanism but also as a governance incentive intended to encourage stronger budgetary discipline and social performance.

In the proposed framework, salaries are conceptualized as a proportion of the maximum annual financial entitlement, while the remaining amount constitutes operational expenditure. This approach allows the salaries of regional heads to be adjusted according to regional fiscal capacity while maintaining operational resources for executing executive responsibilities. Accordingly, the reformulated model produces different compensation structures that reflect each region's fiscal capacity, governance quality, and administrative complexity of each region.

Although the proposed remuneration values appear substantially larger than those stipulated under the existing regulations, these figures should be interpreted as institutional expenditure ceilings rather than personal compensation. The maximum financial entitlement includes both salaries and operational expenditures required to support regional executive functions. Therefore, the proposed remuneration framework should therefore be understood as an institutional financing mechanism that provides behavioral incentives for regional leaders rather than as an increase in individual income.

Excessive reliance on PAD growth as a remuneration indicator may result in unintended fiscal behavior at the regional level. Regional governments may prioritize short-term revenue expansion through aggressive local levies or licensing practices without adequately considering their broader economic and social impacts. Over time, such approaches may weaken investment attractiveness and reduce public trust in local governance institutions.

The proposed remuneration framework addresses this limitation by reducing the dominance of fiscal capacity as the sole basis for determining the remuneration of regional heads. Under the existing system, regions with stronger economic bases and greater PAD capacity may receive larger financial entitlements regardless of differences in governance quality or welfare conditions. Regions with weaker economic foundations may face greater administrative and developmental challenges while having more limited fiscal capacity. By incorporating welfare and fiscal discipline indicators, the proposed framework links remuneration to a broader set of regional conditions rather than fiscal performance alone.

The simulation results show that higher regional fiscal capacity does not necessarily result in higher income under the proposed model. Although PAD remains an important determinant, other variables, including poverty levels and fiscal discipline. Therefore, the resulting remuneration structure provides a mechanism through which fiscal performance is considered alongside broader governance and welfare conditions.

The proposed formula also allows the salaries of regional heads to be adjusted more flexibly than under the current regulatory framework. The compensation structure can change with variations in regional fiscal conditions and other model components by linking salary determination to the maximum remuneration entitlement. This mechanism may address the salary stagnation problem associated with the absence of periodic adjustments.

From an agency-theory perspective, the proposed framework aims to more closely align the interests of principals and agents. Regional heads, as recipients of public mandates, are expected to consider fiscal capacity, fiscal discipline and societal welfare. Therefore, remuneration functions not only as a reward mechanism but also as an institutional incentive intended to orient managerial behavior towards broader public objectives.

These findings contribute to the literature on public-sector incentive design by highlighting the limitations of remuneration systems based on single performance indicators. Rather than emphasizing fiscal capacity alone, the proposed framework links financial incentives to multiple regional governance dimensions. This approach is consistent with the broader public management literature, which suggests comprehensive performance incentive systems.

The findings also extend the literature on remuneration and corruption by shifting attention from compensation levels to remuneration design. While previous studies have largely examined whether higher income can reduce incentives for corruption, this framework suggests that remuneration conditions may also matter. Therefore, governance incentives depend not only on the compensation level but also on how compensation is linked to measurable dimensions of public-sector performance.

More broadly, the proposed remuneration framework should be understood as a component of the wider fiscal governance architecture rather than a policy concerning the welfare of public officials alone. The framework incorporates welfare and fiscal discipline indicators, the framework provides incentives that counterbalance an exclusive focus on regional revenue generation while supporting broader regional development objectives.

Remuneration reform is intended to complement rather than replace Indonesia's intergovernmental fiscal transfer (TKD) system. The proposed framework is designed to influence the behavior of regional heads through performance-based incentives, whereas TKD remains a principal instrument for addressing structural fiscal disparities, supporting public service provision, and financing development across regions. Accordingly, lower remuneration in some remote regions should not be interpreted as a reduction in IGF support. Rather, the remuneration adjustment operates at the level of regional leadership incentives, while the intergovernmental transfer system addresses structural fiscal disparities.

Overall, the reformulated remuneration framework can be understood as a multidimensional incentive mechanism that incorporates fiscal capacity, fiscal discipline, and welfare conditions into regional heads' remuneration within Indonesia's decentralized fiscal system.

CONCLUSION

This study demonstrates that regional heads' remuneration systems that rely predominantly on fiscal capacity indicators may create imbalanced incentives by placing greater emphasis on revenue generation than on broader governance responsibilities. This study proposes a multidimensional remuneration framework that integrates regional fiscal capacity, demographic complexity, fiscal discipline, and welfare indicators into a single remuneration formula to address this limitation. The simulation results indicate that remuneration can function not only as a mechanism for recognizing fiscal performance but also as an institutional incentive structure that incorporates fiscal discipline and welfare considerations.

Therefore, this study contributes to the literature on public-sector incentive design by highlighting that remuneration depends not only on compensation levels but also on how incentives are structured. By integrating fiscal capacity with demographic, fiscal, and welfare dimensions, the proposed framework extends approaches that rely predominantly on single fiscal indicators. The findings further suggest that remuneration reform should complement rather than substitute Indonesia's intergovernmental fiscal transfer (TKD) system. While remuneration is intended to influence regional leaders' behavior through performance-based incentives, TKD remains an important instrument for addressing structural regional disparities and supporting more equitable development.

From a policy perspective, the Government of Indonesia could consider revising Government Regulation No. 59 of 2000 and Government Regulation No. 109 of 2000 to establish a remuneration framework that better reflects contemporary fiscal conditions, governance complexity, and development priorities. The proposed framework could replace the current arrangement with a formula that incorporates regional fiscal capacity, population size, fiscal discipline, and poverty indicators. Any such reform should be implemented gradually and supported by clear operational parameters, transparent calculation mechanisms, and strengthened accountability systems.

This study has several limitations. First, the proposed framework is based on simulation and does not fully capture the institutional, political, and administrative complexities associated with policy implementation. Second, the model relies primarily on quantifiable indicators and may not fully capture the qualitative dimensions of regional governance that also influence public-sector performance. Third, several model parameters, including the population and poverty sensitivity coefficients, require further empirical validation across different regional conditions. Future research should empirically examine the behavioral effects of the proposed remuneration framework on regional fiscal performance, governance quality, and corruption risks. Such research should also incorporate broader institutional and political variables to assess the model's explanatory power and practical applicability.

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