

Decentralization, Regional Development and Public Sector Efficiency in Indonesia: From Inter-Jurisdictional Competition to Local Political Dynamics

Akhmad Syakir Kurnia

Department of Economics and Development Studies

Diponegoro University

akhmadkurnia@undip.ac.id

Brief Historical Trajectory to Present

Decentralization in Indonesia has been underway for almost 15 years since the enactment of Law 23/1999. Along its progression, law 23/1999 was amended twice with the latest is by Law 23/2014. The amendments were carried out in conjunction with Indonesia's political and economic dynamics concerning multilevel government system. Decentralization was initially adopted with a big bang approach in response to the political tension following the fall of long centralized government under Former President Suharto. Decentralization was among major agendas alongside democratic transition in the reformed Indonesia. In a situation and where democratic norms and institutions were weak, early period of decentralization resulted in acute stretched out corruption from central to sub-national governments. The period was dubbed with a period of decentralization anomaly that causes decentralization pessimism (See Nordholt, 2007).¹ Improved public service provision as the expected outcome of decentralization was very much uncertain.

Law 23/1999 was amended by Law 23/2014 allowing local citizens to select their local leaders both in the executive and legislative board through direct election. This had brought optimism for better public service provision as local election allows citizens to shape their own government and therefore it improves accountability. Accountability is essential for the decentralization as it is an apparatus through which decentralization promotes better public service provision. In the political science, it has been well accepted that the merit of decentralization is expected to come from improved accountability that has to be set against policy coordination under centralization. In conjunction with

¹ Given wide range interrelationship between decentralization and democratization, the anomaly of decentralization witnessed with severe corruption caused the democratic transition in Indonesia as protracted rather than consolidated (Bunte, 2009; Malley, 2000, 2003).

that, economics theory claims that improved accountability as a result of decentralization has to be set against spillovers between localities under centralization (See T. Besley, and S. Coate., 1999; Koethenbuerger, 2008; Seabright, 1996).

Nevertheless, several institutional obstacles in Indonesia have brought pessimism to the improved accountability and eventually improved public service provision. Among the major issues are money politics and “politik aliran”.² Given the large ideological diversity in Indonesia, a number of parties were established on an ideological basis leading to a so called “politik aliran” with high political fragmentation. In this situation and where democratic norms and institutions are weak, local provision of public services might be judged based on the political relationship with those in power not by virtue of citizenship.

Large political fragmentation is another issue that might hinder improved political accountability. It happened as politicians’ behaviour in a young democracy such as in Indonesia tends to bend the system of checks and balances. Party partnership in the local political structure also exhibits sophisticated patterns as a result of pragmatic party coalitions dealing with local leader elections (Pratikno, 2009). In this situation the legislature bargaining in an environment of highly dispersed political power is distorted in respect to improved efficiency. Therefore higher levels of political fragmentation tend to undermine the merit of political and fiscal decentralization.

Latest amendment to the Law on Sub-national government is passed with Law 34/2014. The law restructures the delegated affairs between national, provincial, local jurisdictions. This helps make clear distinction of the delegated affairs between provincial and district level of Government that is expected correct problems caused by inter-jurisdictional externalities. The problem of inter-jurisdictional externalities in local public good provision becomes a central issue confronting decentralized public service provision since it result in under-provision of public service provided that each local government is free rider.³

² Money politics refers to a condition where voters will exchange their vote for money rather than vote for candidates who will best act in their interests. Meanwhile, “politik aliran” refers to a situation where voters select a political party on the basis of ideological affiliation

³ Decentralization delegates the responsibility to provide a safe water supply to kabupaten/kota governments. Several local governments source their safe water supply from streams that flow through other local jurisdictions. The fact that the stream flows across local jurisdictions often causes inter-jurisdictional externalities problems especially poor water condition and stream conservation. Government regulation PP. No. 16/2005 on the developing water supply system has

In the theoretical literature, under-provision of public service caused by the problems of jurisdictional externalities can be eliminated by a so-called matching grant where its rationale is different from transfers aiming to correct a fiscal gap.⁴ In practice, Central Government allocate special grant (Dana Alokasi Khusus) for correcting the problems. However, institutional obstacles, weak central and local coordination, as well as under capacity of local governments hinder the optimal objective of this grant to correcting externalities problems. This grant is usually transferred from central to sub-national government couples months toward the end of fiscal year. Therefore, the grant fails to be optimally allocated resulting in a large current budget surplus (SILPA).

Decentralization and Economic Growth

Economic growth as expected outcome of decentralization does not take place at the center of the theory of fiscal federalism. However, A number of studies have been carried out to empirically investigate the impact of decentralization on economic growth (Zhang and Zou 1998); (Xie, Zou and Davoodi 2015) ; (Lin and Liu 2000); (Akai and Sakata 2002); (Iimi, 2005); (Jin and Zou 2005); (Thornton, 2007). Unfortunately, these studies did not find consistent results but conflicting arguments on how decentralization affects economic growth. Investigation to the effect of decentralization on economic growth in Indonesia have carried out by several Indonesian Scholars (See for example Aisyah, 2007; Mulyono, 2012) (See for example Mulyono, 2012; Aisyah, 2007). Similar with the other studies they did not find robust result and clear explanation on how decentralization affect economic growth.

delegated provincial governments to harmonize this issue. However, it does not work well as in Indonesia's multi-level government system, provincial governments do not have the political power to control local governments.

Another example of externalities in Indonesia is found in marine fisheries management. Prior to decentralization, marine fisheries management was centralized and accordingly the marine environment was open access for all local fishermen. Decentralization delegates marine fisheries management to local governments allowing local governments to set up fisheries management systems at the local level. This often causes externalities problems across local jurisdictions. Conflicts between fishermen often happen with fish-stock depletion as a central issue (Thanassoulis, 2008).

⁴ Fiscal gaps often arise as a consequence of the assignment of tax and spending powers. It is believed that taxation cost at the lower level of government is higher than that at the higher level of government. Accordingly decentralization applies only to spending power, while taxing power is still centralized, resulting in substantial fiscal gaps. As a result, fiscal gap transfers should be made for lower level governments.

The conflicting results on the correlation between decentralization and economic growth are likely due to possible misspecification in the empirical estimation model. As multilevel government system is complex, a measure to best approximate the degree of decentralization becomes a critical issue (See Ebel, 2002; Martinez-Vazquez, 2003; Stegarescu, 2005) Besides, lacks of knowledge on how decentralization promotes economic growth results in problems in testing its relationship (See Martinez-Vazquez, 2003).

Decentralization and improved public service provision

Provided ambiguity results from empirical investigation as well as lack of robust theoretical foundation that place economic growth as the expected outcome of decentralization, it is safe to focus on how decentralization promote public sector efficiency. Theoretical literature on fiscal federalism consider improved public sector efficiency as the main outcome of decentralization. Assuming that local governments know better local preferences, decentralized public service provision by local government will better match local preferences, and hence improve efficiency.⁵

Fiscal decentralization theory focuses on the explanation of how decentralized public service provision improve public sector efficiency. The theory shifts from traditional theory emphasizing on inter-jurisdictional competition to second generation theory emphasizing on a set of political institutions where political incentives and social welfare are aligned. By means of public choice perspective, the second generation theory assumes that public officials and politicians are rent seekers who always attempt to advance their own objectives and that these often diverge from social welfare. The theory takes inter-jurisdictional competition into a considerable account induced by informational spillover.

⁵ In the economics literature, efficiency is defined as a condition in a resource allocation where no one will be made better off without making anyone else worse off. This condition is well known as the Pareto efficient condition. In managerial practice, efficiency is often used in parallel with effectiveness. Both are used in performance benchmarking including the performance of decentralized governments (See Martinez-Vazquez, 2003). Both efficiency and effectiveness link inputs and outputs. However, they have different meanings although they are not always easy to isolate and measure. Accordingly, they are often used interchangeably. While acknowledging the difference, this study focuses on improved efficiency as the outcome of decentralization as in standard fiscal federalism theory.

Inter-Jurisdictional Competition: People Migration and Capital mobility

Early theoretical literature on decentralization from Tiebout (1956) to Oates (1972) emphasizes on inter-jurisdictional competition as the groundwork of the theory. According to Tiebout (1956), each jurisdiction competes with others to provide tax and public service options which are attractive to people to live in. Thus peoples' decisions where to live determines the formation of a jurisdiction and creates a market-analogue mechanism for public service provision. Thus migration between jurisdictions will lead to an efficient public service provision by matching supply and demand.

Expecting people migration as an engine to promote inter-jurisdictional competition and therefore improve public sector efficiency in Indonesia may be irrelevant. People migration to other jurisdictions is likely more motivated by seeking better jobs with better wage rather than looking for better public service provision that match to their preferences to live. A survey on more or less 2500 households in Kabupaten Jepara, Kudus and Demak conducted by UNDIP in collaboration with BAPPENAS-World Bank and CSIRO in 2008 to develop Agent-Based Modelling revealed that household tend to stay where they live in responding to several policy shock scenarios until a decision has to be made when it is not impossible for them to keep staying. And if they had to migrate they did not know where to go.

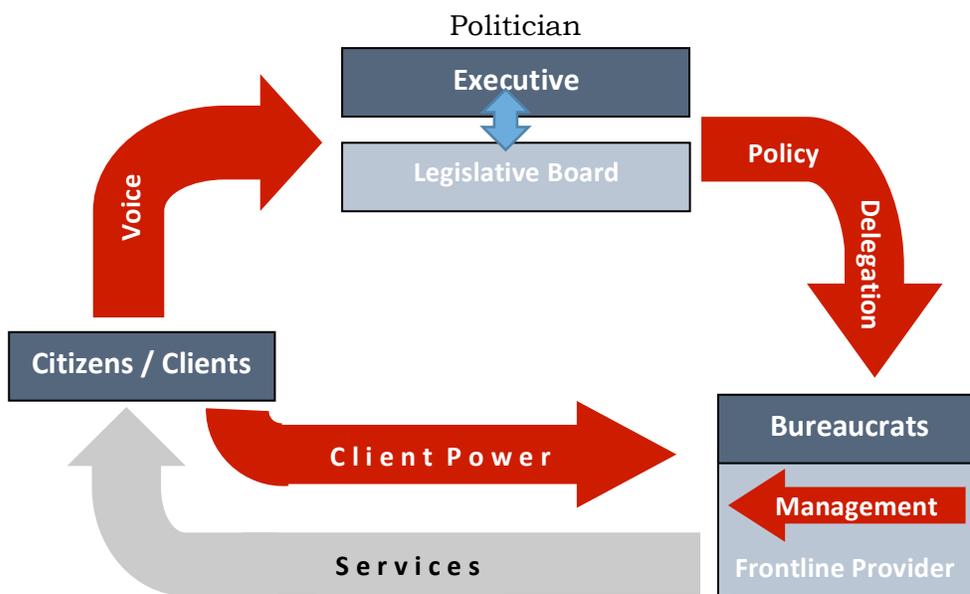
In addition, decentralization in Indonesia even creates barriers for people to migrate. Public officials and public service providers such as teachers, lecturers, doctors, and nurses are not easy to migrate inter-jurisdictionally due to complicated administrative problems. Investment licenses in a local jurisdiction is often obliged with a requirement to use local workers. These situation are confronting to market pre-serving decentralization that leads to a decentralization pathology - I borrow a terminology from Weingast (2009).

In a situation where people migration might not be expected to induce inter-jurisdictional competition, such competition is expected to be encouraged by capital mobility. Each local jurisdiction compete each other to attract capital to come in. Nevertheless, such competition is limited for improved public service related to investment affair, but not broader public service provision. In fact several policies dealing with easiness in investment licensing, easiness in doing business does not presented expected outcome. Indonesia is ranked 120 in the ease of doing business index 2014, and although the rank raised to 114 in

2015, it is still lower than Philippine and far away from Vietnam, Thailand, and Malaysia.

Local Political Dynamics and Improved Accountability

Figure below illustrates the flow of political accountability relationship for public service provision.⁶ Given fiscal and political delegation, the service provision is more compact compared to centralized public service provision. Compact enables clients to have more control over potential opportunistic behavior and thus it improves accountability.



Nevertheless, political accountability is complex as it involves multiple relationship between citizens, politicians, bureaucrats, and frontline actors such as doctors, nurses, and teachers, etc., who directly provide public goods and services to the citizens. The flow of accountability departs from Voice. Through voice citizens delegate their

⁶ A political accountability relationship is typically an agency relationship involving agents and clients/principals. Citizens as clients delegate their interests over the use of their own resources to agents who receive compensation for their efforts to carry out political preferences on behalf of the clients. There is an accountability problem between agents and clients in the contractual transactions. The problems emerge as a result of the key assumptions underlying the agency theory. First, there are always at least partially conflicts of interests between actors. Second, there is always asymmetric information between agents and clients. Subsequently, the asymmetric information causes latent opportunistic behaviours. Agents tend to exploit information they have over clients in order to advance their interest even at the expense of the clients.

preferences to politicians. Within a particular political institution, how the voice containing preferences is realized into services is conditional to the politicians-bureaucrats and bureaucrats-frontline providers accountability relationships. This complexity has been considered as an obstruction to gain the merit of decentralization especially in young democracy where institutions are weak. In the case of Indonesia, local political dynamics does not appear as an engine for improved public sector efficiency. Money politics characterizing local direct election (PILKADA) has been giving wide opportunity for agents to exploit their opportunistic behavior (Kurnia, 2013). Improved public sector efficiency of local government in Indonesia depends on the level of available potential resources to finance their expenditures, and this depends on existing economic capacity. Thus expected accountability from local political dynamics (PILKADA) fails to promote improved public sector efficiency.

Yardstick Competition

Yardstick competition comes into the literature of fiscal decentralization inherently with second generation theory. It emphasizes on a set of political institutions and politicians behavior that will gain improved public sector efficiency. Employing informational spillovers, yardstick competition enhances traditional inter-jurisdictional competition leading to improved efficiency (See T. Besley, and A. Case, 1995; F. Revelli, 2006; F. Revelli, and P. Tovmo, 2007)

Given informational spillover, citizens are able to compare and benchmark the performance of their jurisdiction using the performance of other jurisdictions. The mechanism works through political accountability relationship. The ability of citizens to evaluate and benchmark among jurisdictions performance affect their behavior to reward or punish incumbents/politicians. On the other hand incumbents/politicians whose objective is to hold the office will react and mimic other local government policies given the chance of being reelected. This leads to strategic interaction and competition among decentralized local governments. Using spatial econometrics, an investigation on 35 Kabupaten Kota in Central Java by Maulana and Kurnia (2015) fails to detect the presence of strategic interaction and yardstick competition.

Conclusion and Breakthrough Agendas

Provided that improved public sector efficiency is the main outcome of decentralized public service provision, it is crucial to focus on improved public sector efficiency as an evaluation of decentralization. Obviously, improved public sector efficiency is necessarily critical circumstances for economic growth. However correlating decentralization and economic growth lacks of underlying explanations on how the economy grows provided decentralized public service provision.

On the contrary, traditional and second generation theory of decentralization provide significant insight on how decentralized public service provision improves efficiency. Unfortunately weak institutions in the protracted decentralized and democratized Indonesia hinders potential merit of decentralization. Several agendas needs to address are following:

1. Enhance market-preserving decentralization by removing all regulatory barriers that cause decentralization pathology.
2. Increase political accountability to minimize potential opportunistic behaviour of political agents dealing with the flow of public service provision.

Bibliography

- Aisyah, S. (2007). *The Effect of Fiscal Decentralization on Economic Growth*. (Master), Institute of Social Studies, The Hague, The Netherlands.
- Akai, N., and M. Sakata. (2002). Fiscal Decentralization Contributes to Economic Growth: Evidence from State-Level Cross-Section Data for The United States. *Journal of Urban Economics*, 52, 93 – 108.
- Besley, T., and A. Case. (1995). Incumbent Behavior: Vote-Seeking, Tax-Setting and Yardstick Competition. . *The American Economic Review*, 85, 25 - 45.
- Besley, T., and S. Coate. (1999). Centralized Versus Decentralized Provision of Local Public Goods: A Political Economy Analysis. *National Bureau of Economic Research Working Paper*, 7081.
- Bunte, M. (2009). Indonesia's Protracted Decentralization: Contested Reforms and Their Unintended Consequences. In M. Bunte, and A. Ufen (Ed.), *Democratization in Post-Suharto Indonesia*: Routledge Contemporary Southeast Asia Series.
- Ebel, R. D., and Yilmaz, Serdar. (2002). On the Measurement and Impact of Fiscal Decentralization. *World Bank Policy Research Working Paper*, 2809.
- Iimi, A. (2005). Decentralization and Economic Growth, *Journal of Urban Economics*, 57, 449 - 461.
- Jin, J., and Zou, Heng-fu. (2005). Fiscal Decentralization, Revenue and Expenditure Assignments, and Growth in China. *Journal of Asian Economics*, 16, 1047 - 1064.
- Koethenbueger, M. (2008). Revisiting “Decentralization Theorem” – On the Role of Externalities. *Journal of Urban Economics*, 64, 116 - 122.
- Kurnia, A. S. (2013). *Decentralization and Public Sector Efficiency, a Political and Institutional Analysis*. Saarbrücken, Germany: LAP Lambert Academic Publishing.

- Lin, J. Y., and Z. Liu. (2000). Fiscal Decentralization and Economic Growth in China. *Economic Development and Cultural Change*, 49, 1-21.
- Malley, M. (2000). Beyond Democratic Elections: Indonesia Embarks on a Protracted Transition. *Democratization*, 7(3), 153 -180.
- Malley, M. (2003). New Rules, Old Structures, and The Limits of Democratic Decentralization. In E. Aspinal, and G. Fealy. (Ed.), *Local Power and Politics in Indonesia, Decentralization and Democratization*. Singapore and Illinois: Institute of Southeast Asian Studies and Center for Southeast Asian Studies, Northern Illinois University.
- Martinez-Vazquez, J., and R. M. Mc Nab. (2003). Fiscal Decentralization and Economic Growth. *World Development*, 31(9), 1597 – 1616.
- Maulana, S. J. and Kurnia. Akhmad Syakir. (2015). Strategic Interaction and Yardstick Competition among Decentralized Local Jurisdictions in Central Java Province, Indonesia: A Spatial Econometrics Approach. *Review of Urban and Regional Development Studies (accepted)*.
- Mulyono. (2012). *The Impact of Fiscal Decentralization on Regional Economic Development in Indonesia For the Periods 2005-2008*. (Master), Ritsumeikan Asia Pasific University
- Nordholt, H. S., and G. Van Klinken. (2007). *Introduction* H. S. Nordholt, and G. Van Klinken (Ed.) *Renegotiating boundaries: local politics in post-Suharto Indonesia* Retrieved from http://books.google.com.au/books?id=MeP-LBnI_LMC&printsec=frontcover&source=gbs_ge_summary_r&cad=0#v=onepage&q&f=false
- Oates, W. E. (1972). *Fiscal Federalism*. New York: Harcourt Brace Jovanovich.
- Pratikno. (2009). Political Parties in Pilkada, Some Problems for Democratic Consolidation. In M. Erb, and P. Sulistiyanto (Ed.), *Deepening Democracy in Indonesia? Direct Elections for Local Leaders (Pilkada)*. Singapore: Institute of Southeast Asian Studies.
- Revelli, F. (2006). Performance Rating and Yardstick Competition in Social Service Provision. *Journal of Public Economics* 90, 90, 459-475.

- Revelli, F., and P. Tovmo. (2007). Revealed Yardstick Competition: Local Government Efficiency Pattern in Norway. *Journal of Urban Economics*, 62, 121-134.
- Seabright, P. (1996). Accountability and Decentralisation in Government: An incomplete Contracts Model. *European Economic Review*, 40, 61-89.
- Stegarescu, D. (2005). Public Sector Decentralisation: Measurement Concepts and Recent International Trends. *Fiscal Studies*, 26(3), 301.
- Thanassoulis, E., Portela, Maria C. S., and Despic O. (2008). Data Envelopment Analysis: The Mathematical Programming Approach to Efficiency Analysis. In H. O. Fried, C.A. Knox Lovell, and S.S. Schmidt (Ed.), *The Measurement of Productive Efficiency and Productivity Growth*. New York: Oxford University press.
- Thornton, J. (2007). Fiscal Decentralization and Economic Growth Reconsidered. *Journal of Urban Economics*, 16(1), 64-70.
- Tiebout, C. (1956). A Pure Theory of Local Expenditures. *Journal of Political Economy*, 64(5), 416-424.
- Weingast, B. R. (2009). Second Generation Fiscal federalism: The Implications of Fiscal Incentives. *Journal of Urban Economics*, 65, 279-293.
- Zhang, T., and H. Zou. (1998). Fiscal Decentralization, Public Spending, and Economic Growth in China. *Journal of Public Economics*, 67, 221-240.