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ABSTRACT

Ten years after the crisis, Indonesia is still struggling to solve the problems in four major issues: economic stabilization and recovery, democratic transition and political reform, decentralization of political power, and the redefinition of national identity. This paper will explain the major changes in the political sphere, and how they affect the effectiveness of government in delivering economic recovery. This paper argues that democratic transition and decentralization affects economic recovery through the quality and effectiveness of governance. These changes have had mixed results in the economic policymaking. On the one hand the new system provides more check-and-balance mechanisms. On the other hand, it delays the decision-making process and creates new patterns of rent-seeking activities. This paper discusses these changes in two main parts. First, it quantitatively evaluates the impact of this transformation on the quality of institution and government effectiveness using the available and widely used Governance Indicators. Second, it provides a qualitative description on the process and outcomes of the political transformation.

Keywords: Indonesia, Asian financial crisis, institutional change, democratic transition, decentralization, governance index.

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Introduction

In many ways, the Indonesian economy has relatively recovered from the 1997 economic crisis. By 2006, the economy has grown at 6-6.5 percent per year, while inflation has been kept at single digit, despite an episode of two-digit inflation at the end of 2005 following the sharp increase in fuel prices. However, some other aspects are yet to return to normal. The economic growth has been mainly driven by consumption and monetary sector. Real sector has yet to fully recover. This has significant impact in the labor market, as 11 percent of the labor force is still unemployed. Consequently, 17 percent of the population still lives below the poverty line.

The magnitude and complexity of the crisis explain these mixed achievements. The 1997 crisis, although started as a financial crisis, has turned into a more complicated, multidimensional crisis. In addition to economic problems, the country has also had to deal with the socio-political changes. To sum up, ten years after the crisis, Indonesia is still struggling to solve the problems in four major issues: economic stabilization and recovery, democratic transition and political reform, decentralization of political power, and the redefinition of national identity.¹

Each of those problems is a serious challenge, let alone they happen simultaneously. It is difficult to disentangle each from the other, as well as draw the causality among those factors. We can draw any arrows from any one point to the other, and we will always find valid arguments about causality. For example, economic collapse has brought an end to the strong central autocratic government, which paved the way for democratic transition and decentralization movement. However, changes in the political landscape have also affected the speed and quality of economic recovery.

¹ Deutser (2002:6) refers to these as the 'four horsemen of Indonesia.'

The combination of economic and political changes has also been marked by a series of separatist and sectarian conflicts, as part of the reinvention of the Indonesian identity. Obviously, dealing with a series of conflict has shifted some of the economic and political resources away from productive activities. Conflicts have also deteriorated the business climate, discouraging international investors to put their funds in the country. On the other hand, political transformation and decentralization have weakened the capacity of the central government to deal with the situation. The fact that the government is still facing budget constraints to finance the security operation has complicated the matters more. Figure 1 presents the illustration of this problem.

For the purpose of this paper, we would limit the context by discussing only the arrows which come from the second and third factors to particularly the first one. This is illustrated in figure 1 by the solid, thick arrow. Specifically, this paper will explain the major changes in the political sphere, and how they affect the effectiveness of government in delivering economic recovery. I would look at a particular link that democratic transition and decentralization affects economic recovery through the quality and effectiveness of governance.

The paper is presented as follows. The second section provides a snapshot on the quality of government institution after the crisis using some governance indicators. The third section explains the major changes in the political landscape. The fourth section continues the discussion on the decentralization of political power. The fifth section discusses how those changes can affect the quality of government institution. Some case studies are presented in this section. Finally, the sixth section concludes the whole discussion.

The indicators of governance

This section provides a snapshot of the quality of governance in Indonesia after the 1997 crisis. The snapshot is presented using the World Bank's Governance Indicator ². The indicator provides a measurement on the performance of a government in six components: voice and accountability, political stability, government effectiveness, regulatory quality, rule of law and control of corruption.³

Figure 2 shows Indonesia's individual score in each component since 1996 to 2005. Using 1996 as the base year (the earliest available data before the crisis started), Indonesia scores lower in 2005 in all aspects of governance except voice and accountability. If instead we use 2000 as the base year –after the peak of the crisis has been passed – we can see several things. First, there has been a slight but perhaps insignificant progress in the rule of law and efforts in controlling corruption. Second, the scores on government effectiveness and regulatory quality got worse after 2000, but have relatively returned to the 2000 level in 2005. Third, political stability score has improved in 2005.

Diagrams in figure 2 show the country's position compared with the other countries. Some other crisis-affected countries are specifically noted: South Korea, Malaysia, the Philippines and Thailand. The diagrams show individual country scores in 2005, while the dots represent the above countries' score in 1996. We see that Indonesia's voice and accountability score was the lowest in 1996. But it shows a big jump in 2005, placed it above Malaysia who

² Kaufmann, Daniel, Aart Kraay and Massimo Mastruzzi (2005). "Governance Matters V: Governance Indicators for 1996-2005". World Bank Policy Research September 2006.

³ The indicators reflect the statistical compilation of responses on the quality of governance given by a large number of enterprise, citizen and expert survey respondents in industrial and developing countries, as reported by a number of survey institutes, think tanks, non-governmental organizations, and international organizations. Each country receives a score between -2.5 (poorest) and 2.5 (best) on each component.

scored better than Indonesia (and itself) in 1996. While the other ‘IMF patients’ (South Korea and Thailand) also scored better in 2005 than in 1996, Indonesia’s is the biggest improvement.

But that seems to be Indonesia’s only achievement. Indonesia consistently has the worst score among the abovementioned countries in the other components. In terms of government effectiveness, Indonesia scored almost the same as the Philippines in 1996. But in 2005 the gap between the two widens because Indonesia performed much worse than its neighbor. Similarly, in terms of regulatory quality and control of corruption, Indonesia, the Philippines and Thailand scored almost the same in 1996. Again, in 2005, Indonesia becomes the worst performing countries in the group.

In the next sections we would go beyond this snapshot and discuss more about how changes in the political landscape have had anything to do with the quality of the governance.

Democratic transition and political reform

Pre-crisis political landscape

Prior to the crisis, the Indonesian political landscape since 1966⁴ had these following characteristics. It was an executive-heavy government under the presidential system. The executive, with the president acts as both the head of state and head of government, had almost all the veto power on a policy. The parliament did exist, but its role was merely a rubber-stamp institution. Moreover, within the executive, power was concentrated around President Suharto’s circle.

⁴ The year when General Suharto took over the power from Sukarno. The period under which Suharto became the country’s president (1966-1998) was referred to as ‘the New Order,’ while the period during Sukarno’s leadership (1945-1966) was called ‘the Old Order.’

The parliament was a bicameral one. The low chamber, called the People Representative Council (*Dewan Perwakilan Rakyat*, DPR), performed the traditional parliamentary role such as, at least in theory, supervising the executive and creating legislative products. The DPR consisted of around four hundred elected members from political parties who were contestants of the general election, and another one hundred non-elected members representing the military.⁵ After 1971, only three parties were allowed to contest in the general election every five years. One was the government's party *Golongan Karya* (Golkar) who virtually always won around 90 percents of the seats. The other two were pseudo-oppositions, *Partai Demokrasi Indonesia* (PDI, the Indonesian Democratic Party) and *Partai Persatuan Pembangunan* (PPP, the United Development Party) who shared the less 10 percent seats.

The high chamber, called the People Consecutive Assembly (*Majelis Permusyawaratan Rakyat*, MPR), consisted of another five hundred non-elected members. They were appointed by the executive, supposedly representing the marginalized groups that were not represented by political parties. But in practice, the basis of appointment of non-elected members was how close they were with the executive. Under the 1945 Constitution, the MPR is the Supreme Body of the state. The Assembly has the power to select (and give mandate) to the president and vice-president. Consequently, it also has the power to withdraw the mandate.

With that parliamentary composition and procedure of presidential appointment, it became obvious how Suharto can maintain his power for more than three decades. General election that was held once every five years was no more than a formality. Moreover, the constitution itself did not impose a clear restriction on the presidential term.

⁵ In the New Order Indonesia, the military played an active role in day-to-day politics. This is explicitly mentioned in the doctrine of 'dual function.' In addition to possessing 'free seats' in the parliament (up to one-fifth of total seats), it was also common for active military to assume civilian posts such as head of local government, minister and other government posts.

Immediate impact

The 1997 economic crisis was very deep that it severely de-legitimated the political power of the New Order government. A combination of grass root protests, high-level political maneuvers and international pressure led to the resignation of Suharto in May 1998. That means Suharto only served his sixth term as president for two months. He was 'reelected' as president in March 1998. Vice president Prof. B.J. Habibie immediately stepped up to take over the presidency. An MPR Special Session in November 1998 provided formal and constitutional legitimacy for Habibie to assume presidency, as well as mandating him to hold an election in 1999.

The Habibie administration was short-lived, lasting only until the 1999 general election. In October a special session of the MPR rejected his accountability speech. This virtually wiped out his chance to contest in the election, although some politicians from Golkar still wanted him to do so. Nevertheless, in its short period, the Habibie administration had provided a step forward in the democratic transition by granting freedom of press, revising the electorate law that allowed a multi-party election, and reducing the number of free seats in the parliament allocated for the military.

The 1999 election was considered as the first open, democratic, multi-party election in Indonesia since 1955. Forty-eight parties participated in the election, including the three 'old' parties Golkar, PPP and PDI who had transformed into a new party, *Partai Demokrasi Indonesia Perjuangan* (PDIP, the Indonesian Democratic Struggle Party).

PDIP won the popular vote and majority seats in the DPR by 153 seats out of 500 (31 percent). Golkar finished in the second place with 120 seats (24 percent). The other 462 contested seats were shared among nine other parties, plus 38 'free' seats that were still

maintained by the military and police. In addition to the 500 parliament members, there are 195 uncontested seats allocated for regional and group representatives in the high chamber, to form a 695-member MPR. Note that most of the 195 members of the high chamber were also affiliated in some ways with the political parties.

Although the 1999 election has brought radical changes in terms of the number of contestants, the procedures of presidential election was unchanged. The president would still be elected by the parliament members. That means even though PDIP was the biggest party in the parliament, it did not automatically lead its chairwoman, Megawati Sukarnoputri, to assume the presidential seat. Two things were blocking her way. First, PDIP did not secure an effective majority in the parliament. Second, the Islam politicians raised a sentiment against a female president.

A high-level political maneuver successfully changed the results, with Abdurrahman Wahid, a moderate Islamic leader and long-time pluralism activist, were installed as the president. Megawati herself was elected as the vice-president.

The following impact

Abdurrahman Wahid led a government with a small effective support from the parliament. His political vehicle, *Partai Kebangkitan Bangsa* (the Nation's Awakening Party, PKB) won only 51 seats in DPR, plus another 6 in the high chamber (only 8 percent of total MPR seats). That means he inherited a big political debt to the political interests that had made him president, which he had to repay by accommodating those interest in the cabinet formation.

As Anggoro (1999:314) wrote, such cabinet bear several consequences. First, it had to be a large cabinet. With 35 ministerial positions, by no means it could be an efficient cabinet. Second,

political considerations outweighed professionalism in the appointment. Wahid himself admitted that when he formed the cabinet he consulted four political leaders: his deputy Megawati, Akbar Tandjung (chairperson of the Golkar party, the second largest power in the parliament), Amien Rais (chairperson of the MPR, the most influential figure in the party coalition to install Wahid as president), and General Wiranto (the military chief). Third, it would have lack of coordination as the cabinet members came from (and represented) different political interests. The ministers may also have dual loyalty; to the president as well as their party leaders.

It did not take long for the cabinet to have their internal conflicts. During the first year, Wahid has fired three of his ministers. It was not the last time, because in the following year he reshuffled his cabinet several times. His erratic style of leadership had also eroded his political support in the parliament, as well as deteriorated his relationship with Megawati. Only after a year, the parliament members had started an attempt to impeach him from power. Following more than two years of bad relationships, the MPR finally impeached Wahid in July 2001, on the basis of corruption allegation. The MPR installed Megawati as president, and elected Hamzah Haz, chairperson of PPP and a conservative Muslim leader as her deputy.⁶

Although Megawati's PDIP has a majority seats in the MPR, that was not enough to provide a strong, unconditional support. That means she had to do the same thing as his predecessor did: forming a coalition cabinet. On the positive side, Megawati's leadership role did not expose her to strong rejections as happened to Wahid. This has made Megawati's administration can perform more and better than its predecessor. Nevertheless, the administration was also subject to the same problems as Wahid's. The main problems are coordination among ministers from different political interests, and multiple loyalties of the cabinet members. This

⁶ See Djadjiono (2001) for a detailed report on the event.

became apparent approaching 2004, when four of her cabinet members, including vice president Hamzah Haz, contested her in the next general election.

Further changes and the 2004 election

One of the political reform agendas was amending the 1945 Constitution. The effort was started during Wahid's administration, but was realized and finalized under Megawati's administration. There are several major changes in the amended constitution. First, some clauses regarding human rights were made more explicit and detail. Second, limitation of presidential term was made clear; the president can only be in power for a maximum of two five-year periods. Third, it brought changes in the structure of MPR. Non-elected seats were abolished. A new bicameral parliamentary system was introduced by creating a new body, Local Representative Council (*Dewan Perwakilan Daerah*, DPD), which is parallel to the Senate in the United States. Members of DPD are all elected. They represent the Indonesian provinces; with each province has four DPD members. Fourth, direct presidential election was introduced.

In 2004, the second general election after the crisis was held. It was a relatively democratic and peaceful election, despite many had feared that this could be a violent one. Twenty-four political parties participated in the parliamentary election. Surprisingly, under heavy pressures from every direction, Golkar won the popular vote (22 percent) and most seats in the parliament (127 of 550). PDIP, winner of the 1999 election, became the runner-up (19 percent of popular votes and parliamentary seats or 109 seats).

In addition to the parliamentary election, Indonesia held a direct presidential election for the first time in history. Five pairs of president-vice president joined the race for the presidential election, including Megawati as the incumbent president who paired with Hasyim Muzadi, a

moderate Muslim leader. The shrinking popularity of PDIP was also translated in the presidential election. Megawati lost to Susilo Bambang Yudhoyono and Jusuf Kalla, duet (also popular with the abbreviations SBY and JK). Both were ministers under Megawati administration. SBY was also a former military top person, formerly served as the military Social and Political Commander and the military fraction in the DPR during the Suharto era. JK was a businessman and long-term politician from Golkar.

Interestingly, SBY main political vehicle was a new party, the Democratic Party (*Partai Demokrat*, PD). The party only won 56 seats in the parliament (10 percent). This was not supposed to be a problem since in theory, under the new political landscape, the president's position is strong since the MPR can no longer impeach the president only on political basis. The president needs to commit a serious constitutional mistake to provide a basis for impeachment. Moreover, the president no longer receives the 'mandate' from the parliament.

However, in practice, coming from a small party, SBY still needs to satisfy different political interest in the parliament, in order to minimize negative noise from the parliament. He did this with the same way as his two predecessors did: forming a large, coalition cabinet to accommodate as many interests as possible. Hence, the old problems facing this kind of coalition cabinet still exists. But there was a second way by which SBY hoped to 'tame' the parliament: installing his deputy Jusuf Kalla to be the chairman of Golkar, the biggest party in the parliament. This effort was somehow successful. At least until the second year of their term, opposition from parliament members over some government policies can be well-maintained.

But that did not make the administration a fully effective one. Coordinating cabinet members from various political interests is still a big problem. Coordination problem even exists between the top two persons, the president and vice-president. In many times, their partnership

looks shaky. Many decisions they made without consulting each other. It is true that both still need each other to increase their political capital. But they also try to look for any chances to increase their individual popularity.

Lacking of strong political machine, SBY relies on his personal charisma and popularity. This had successfully brought him the majority votes in 2004. However, it also means that he has to work very hard to maintain it. As the results, he tends to make safe decisions to avoid being unpopular. Meanwhile, as chairman of the largest party, JK obviously has large political capital and strong bargaining position. With one eye on the 2009 election, JK needs to find the perfect position for his party; not a fully government party so it can avoid receiving the bad credit if the current government fails to deliver, but also not an opposition so it can still gets the credit for what the current government achieves.

Decentralization

As Indonesia is very diverse in geography, culture, natural and human resource endowment, it is very nature if the authorities of Indonesia have attempted to decentralize its administrative structure to the lower level of government. The decentralization experiments in Indonesia have been done several times and could be tracked back to the colonial era. However, none of them has been successful. In colonial times, the decentralization efforts was started by the formation of first municipalities in 1905, the first districts (“*gewesten*”) in 1910, and the first province on Java in the 1920s.

As soon after the proclamation of independence, Government of Indonesia (GOI) established Law 1/1945 on regional economy, that specified that Republic of Indonesia as a unitary state. Meanwhile, as a political move in opposition to The Republik Indonesia, the Dutch

created some Indonesian republics outside Java, labeled the United Republics of Indonesia—a federal state within a commonwealth with the Netherlands. In 1950, the United Republics was dispersed with the establishment of the 1950 constitution that reverted to a unitary state.

Afterward, the GOI attempted to revive the decentralization by issuing Law No 1/1957. Nevertheless, the rebellion attempts in Sumatra, Sulawesi and West Java have abandoned the revitalization of regional autonomy in Indonesia. It was not up until the establishment of Law 5/1974, the issue of regional autonomy was started to rise again. While this law provided the basic principles of the autonomy of local government, the law did not granted local government sovereignty in managing its fiscal and political policies. This decentralization system tended to be directed to deconcentration rather than decentralization, since most of administration function in the region was still carried and directed by the central government. Before the crisis Indonesian government was very centralistic and top-down. Local governments do exist, but their role was mainly an extension of the central government. Major decisions, including budget allocation, were made by, and in, the center.

Political decentralization

The situation has dramatically changed after the Soeharto regime was stepped down in May 1998. Unlike the former authoritarian regime, the new government did not have the kind of national unifying power as the earlier regime had over the country. The democracy wave has not only stepped down Soeharto regime, but also has disgraced the centralistic style of New Order. In addition, some foreign agencies, such as the World Bank, the U.N. Development Program (UNDP), Deutsche Gesellschaft fur Technische Zusammenarbeit (GTZ), and the U.S. Agency for International Development (USAID) has also regarded the decentralization as a part of the democratization process and played a critical role in bringing and supporting the introduction and

the establishment of decentralization in Indonesia. Meanwhile, the long-suppressed regional separatist in East Timor, Aceh, and Papua and the discontent of some resource-rich regions has re-emerged and threaten the national integrity.

Facing these extraordinary circumstances, the Soeharto's successor Presiden Habibie who intended to prolong his position and prevent disintegration had embraced the decentralization policy. In 1999, the Habibie government enacted the basic laws on decentralization, Law 22 of 1999 on Local Autonomy and Law 25 of 1999 on Fiscal Relations between Central and Local Governments. While the former transferred some authority to regional governments and built regional political processes, the latter support such regional autonomy by granting fiscal resources at the disposal of local governments.

This decentralization policy was very rapid in the process of its arrangement, very tight in its deadlines of implementation, and very radical in its extents of changes. In condition of short available time, the draft of the law was only discussed among limited group of bureaucrats and academics who were known proponents of decentralization, with little input from the politicians and even less consultation with the regions. The results were that within two years the central government would transfer all its major responsibilities (except for foreign affairs, defense, trade policy, monetary policy, fiscal balance and religion) and 2 million its civil servants or 2/3 of central government workforce to regions. Along with these transferred, local government would also be granted new financial resources. All these process was described as "big bang" decentralization.⁷

The state of affairs prior the decentralization policies was taken place, especially the political motivation, has definitely influenced the final design of the basic laws decentralization

⁷Bert Hofman and Kai Kaiser (2002). "The Making of the Big Bang and its Aftermath: A Political Economy Perspective." Paper presented at "Can Decentralization Help Rebuild Indonesia?" Georgia State University, May 1-3 2002, Atlanta, Georgia.

system. Instead of a mean to relax the central government's burden on managing the administration by shortening the bureaucracy and providing better public goods and services to local people. Post-crisis decentralization was mainly designed to make local people and elites happy so the tendency to ask for independence can be reduced. This is reflected by the design to transfer the effective power to the district level government, not provincial. The reason was districts are too small to ask for independence, while the size of a province may be large enough to demand independence.

Amazingly, the process has been considered as quite successful. International community has considered that Indonesian has been able to manage this unprecedented decentralization and minimized its negative effects. However, the arrangement of decentralization laws that has not passed through blue print and white paper stage and jump directly to the law drafting has resulted confusion and debate about the law itself and its interpretations, and thus it brought some following consequences.⁸ Furthermore, there are three prominent issues among many confusing and debatable issues in the law 22/1999: devolution of government authorities, formation and amalgamation of new local governments, and the local executive-legislative relationship.

On the devolution of government authorities, the utilization of residual approach that listed only the detailed functions of central and provincial government and left the rest to local government has appeared an unclear of authority division between central and local government. As a result, it has created "gap" between the central government obligatory functions and the local government ones, and the discrepancy between functions for the central government and sectors for local governments. In this case, as the function of local government can be freely determined by themselves, the function could either be very extensive or very narrow. As a

⁸ Bambang Brodjonegoro (2004). "Three Years of Fiscal Decentralization in Indonesia: Its Impacts on Regional Economic Development and Fiscal Sustainability." presented at the International Symposium on Fiscal Decentralization in Asia Revisited, Hitotsubashi University, Tokyo.

result, this condition might have created dispute between center government and local government. In addition, the abolishment of hierarchical relationship between province and district government--local government would only account for its measures to the local parliament but not to the governor anymore, might have also made the coordination problem become more severe as district government tend to unwilling to coordinate with central government as well as province government.

After decentralization, there has been an increasing trend of the formation and amalgamation of new local administrations, districts as well as sub-districts. The law 22/1999 has been assumed as a permit of the formation and amalgamation of new local governments without any obligatory consequences. As a result, the numbers of new districts and municipalities have increased to more than 10% every year. The high increase in the number of new local administrations later on has generated concern on economic efficiency, problems on optimal size and capacity. Along with the possible extension of corruption, the relatively high setting cost of new local government system and the high reliance of local government to fiscal transfer from central government have been the examples of economic inefficiency resulted by the formation of new local administrations. Thus, the formation of new local government seems to be seen more as a mean to satisfy the local elites rather than economic efficiency.

The unclear of new decentralization basic law has also influenced the relation between local executive and legislative. In law 22/1999 the local legislative to some extent has immense authority, ranging from hiring, evaluating and firing the head of local executive to influencing the local budget. As a result, the local parliament (DPRD) becomes the most powerful body at the local level. The strong legislative is needed to execute check and balance activities, but its excessive authority could become one of barriers in creating good governance and effective local

administration. In its negative side, this condition could create either collusion or persistent conflict between local executive and legislative. In the end, along with the problem of devolution of government authorities, formation and amalgamation of new local governments, it create poor quality of basic public service delivery to local people.

Fiscal decentralization

Parallel to the devolution of authority and transfer of center government civil servants and public service facilities, central government has also decentralized its fiscal sources and authorities. After implementation of decentralization, source of district government fund is drew from the local own sources (PAD), the intergovernmental transfer from central government (the revenue sharing, general allocation fund (DAU), and specific allocation fund (DAK)) and fund from provincial government. Based on law 25/1999, central government is required to transfer a minimum of 25% of domestic revenues to its sub-national level, 90% of which is to be distributed for district government. As a result the proportion of local government spending in total national expenditure has increased dramatically from 17 percent to 30 percent in the first year and this share would probably increase to over 40 percent overtime.⁹

Like in process of political decentralization, the process of fiscal decentralization in Indonesia has been also quite smooth although there has been still many questionable problems surrounding the process. The problem is lying on the basic principle of “fiscal decentralization”. In order to lessen the effect of “fiscal spillover” outside the taxing government’s jurisdiction, the tax based transferred to local government is usually limited to the tax on the immobile properties, local consumptions, and so forth. As a result this condition may create a shortage of local government revenue and others derivative problems.

⁹ Hofman and Kaiser, *ibid*

The limited tax based has made local government heavy dependence on the intergovernmental fiscal transfer from central government, especially DAU. In fact, as reveal by Brodjonegoro (2004) the DAU is basically local government budget because of its foremost role. Later on this condition creates three other derivative problems. First, it create disincentive to local government to intensify the collection of local own revenue (PAD). Second, the application of hold-harmless provision that guarantees every local government to receive the grant not less than the previous allocation might have undermined equalization purpose of the DAU establishment. Third, although it might have been small, the existence of lump-sum component that guarantees certain similar amount of grant to all local government has been considered considerable amount by the proponent of new local government and it has created incentive to the formation of new local government. All these derivative problems have been the outcome of the unclear formula of DAU. The distribution of DAU has always been determined by political influence.

In addition, the heavy reliance on DAU has also created weak local taxing power and deteriorated the local investment climate. The law 25/1999 and law 34/2000 has not given a significant local taxing power because the decentralization in Indonesia was designed to be the expenditure-lead decentralization financed by transfer.¹⁰ In fact, the central government has been very unwilling to transfer one or more of their taxes to the local government. This limited local taxing power along with the limited amount of intergovernmental transfer and the small amount of existing tax and charge revenues have stimulated local government to find out other sources that unfortunately illegal and disruptive. To generate additional revenue, local government tend to impose and create additional charges, levies and fees since it is easier than

¹⁰ Brodjonegoro, *ibid.*

intensifying the collection of legal local taxes and charges revenue up to the optimal level through better local tax administration system and law enforcement.

From another point of view, the creation additional charges, levies and fees is also seen as the local governments' reaction of the period of centralized government under new order. The authority to manage the local own source revenue (PAD) as one opportunity for local government to become "the master of its own domain".¹¹ In fact, the local government thought that they were being control by central government since local government was tended to be treated just as "tools" of central government directives, without adequate capacity to implement their own power. However, these additional taxes unfortunately has become excessive and burdensome to local business and discouraged foreign investment.

Ironically, at the same time the economic recovery is still slow. All these problems of post-crisis fiscal decentralization have to some extent has deterred economic recovery. While the obligation to allocate large amount of DAU has undermine central government capacity to stimulate economic growth and maintaining economic stability, limited amount of DAU compare to local government expenditure needs as result of transfer of central government personnel and function has also made the structure of local budget is usually dominated by routine expenditure instead of development expenditure. In addition, the repercussion effect between tax revenue and economic growth has also created concern on the sustainability fiscal.

To solve the problems above, the government of Indonesia has tried to amend the Law 22/1999 and Law 25/1999 by issuing the Law 32/2004 and Law 33/2004. In these laws, the province has some authority to control the district government and there has also improvement in the amount of intergovernmental fiscal transfer and the improvement of formula to calculate the

¹¹ Widjajanti I. Suharyo (2003). "Indonesia's Transition to Decentralized Governance: an Evolution at the Local Level." *SMERU Working Paper* (June).

intergovernmental fiscal transfer. However, the basic principle problems still remind. The division of central and sub-national functions is still unclear and there is still lack of coordination between central and sub-national government, and even among the institutions or department within the central government, such as the rivalry between ministry of finance and ministry of home affairs.

Discussion

Three things summarize the changes in the Indonesian government institution after the crisis. First, the power structure moved from an executive to legislative heavy. Before 1997, the parliament was merely a rubber-stamp institution. More than 90 percent of its members were either appointed by the executive or members of the ruling party. The 1999 election brought a significant change in the power structure. The parliament now possesses a greater veto power and becomes more influential over a government policy or decision. Somehow, the swing of power structure is considered too radical because currently it makes the government system a presidential one with parliamentary logic.

Second, power concentration moved from a heavily concentrated to a fragmented one almost dramatically. Before 1997, power was concentrated in the executive, particularly around the president's inner circle. After the crisis, especially after the 1999 election, the multi-party system has made the power more fragmented. Fragmentation occurs not only within the parliament but also within the executive since the president needs to form a coalition cabinet to accommodate as many political interests as possible.

Third, due to decentralization, local governments now have more power. The democracy wave has disgraced the centralistic style of New Order and forced the new government to

decentralize it political and fiscal authority. Unclear division of authority in the basic decentralization law and the strong resistance of local government to previous centralize regime has made local government feel free to determine their function and authority by themselves. The function could either be very extensive or very narrow. At the end, it may create dispute between central and local government, poor public service delivery and low economic growth.

What is the impact of this change in political landscape on the governance quality and, in the end, economic recovery? There are two competing arguments. The first set of arguments claim that concentrated decision-making powers are likely to “give rise to chronic problems and welfare loss, with citizens, investors, and foreign actors facing an uncertain and potentially volatile policy environment”.¹² Consequently, more functioning parliament, more fragmented, and more decentralized power should provide more check and balance mechanisms. This should create pressures for the government to be more transparent and accountable. Higher score of Indonesia’s voice and accountability index since 1996 suggests that the political change has relatively successful in this sense.

On the other side of argument, democratic governments – the ones in which power are less concentrated and less centralized may also be inefficient. Democratic process can result in lengthy decision making process about important policies. Democratic governments are also vulnerable to public pressures favoring short-term public spending over longer-term investment. Meanwhile, stronger or authoritarian governments are more able to take difficult decisions in long-term national interests. This is often referred to as ‘the authoritarian advantage.’

The other way to look at these contrasting views is to argue for a non-linear relationship between the institutional setting and governance problem. Both heavily concentrated and heavily fragmented types of government are likely to be seriously problematic. There is a certain level of

¹² MacIntyre, Andrew (2003). *The Power of Institutions*. Ithaca and London: Cornell University Press, p. 29.

power concentration in which the potential governance problem can be minimized. MacIntyre refers to this view as the “power concentration paradox.”¹³

Figure 4 is a simplified illustration of the power concentration paradox. The existence of the ‘optimal level of fragmentation’ is more conceptual. As MacIntyre admitted, there is no theoretical basis to specify the inflexion point; a more realistic approach is to think it as a range rather than a specific point.¹⁴ Nevertheless, this view provides a reasonably good and realistic framework to explain the real life situation.

We can apply the power concentration paradox approach to provide a stylized explanation of the dynamics of institutional setting. Before the crisis, Indonesia was located in the far left of the horizontal axis, with high level of potential governance problem. The crisis drifted the country along the horizontal axis towards the extreme right. This extreme change means the potential of governance problem remains relatively at the same level, despite a more democratic political environment. The situation is illustrated by two dots along the curve in figure 4.

To go beyond theoretical discussion, next we shall present some case studies in which political fragmentation and decentralization created problems in the policy decision making.

Privatization of State Owned Enterprises

Privatization of a long list of SOEs is part of the agreement with the IMF. This is perhaps the most sensitive economic reform program. Although the government has been relatively committed to implement the policy, rejection from the parliament and even within the government itself delayed the sale of several SOEs.

¹³ MacIntyre, *ibid.*

¹⁴ MacIntyre, *ibid.*, p.34.

There are some arguments against privatization. The first group of arguments claims that it is not the privatization per se that is problematic, but what motivated it. In an ideal situation, the primary objective of privatization is to increase the value of the enterprise. However, during the crisis the main objective has been to help financing government's budget deficit. Consequently, the government tended to sell the SOEs at lower prices than its potential value. A second group raised the nationalism issue. This group also criticized the decision to sell some 'strategic' enterprises such as state-owned telecom companies to foreigners because the country's secrecy could be at stake. A third group concerned the potential job loss that follows the sale of an SOE.

In many cases, oppositions to privatization had only successful in creating noises. To some extent they could cause delays. But an extreme case was the collapse of the deal between the government and Cemex, a Mexican cement producer, over the sale of PT Semen Gresik. The deal was finally collapsed because the local government and community of West Sumatra and Central Sulawesi rejected that local companies PT Semen Padang and PT Semen Tonasa, subsidiaries of PT Semen Gresik, were included in the deal. The government did not take a firm decision over this dispute. Instead, they revised the deal to exclude the local subsidiaries. Finally, after seven years of dispute and controversies, Cemex decided to sell their ownership at the local company and leave the country.

There is also a fourth group who opposed the sale of a number of SOEs, not because they oppose privatization, but rather because they did not gain from the sales. These groups are legislative politicians from which the government had to get permission before any deals with potential investors were made. Although they did not lead the whole privatization process to

collapse, they were quite influential in delaying the sale of some companies, such as Indosat, the state-owned telecommunication company.

The impact of those noises, delays, and scrapped transactions was lower international market confidence over the country's economy.

Local regulation and investment climate

Since the introduction of decentralization, there has been a high increase in the number of local regulations. Regional Autonomy Watch (KPPOD) reported that an average more than 30 local regulations per year has been endorsed by local governments and most of these regulations are established to increase local governments' own sources of revenue.¹⁵ An estimation shows that around 60 percent of the new taxes and charges were executed without get review from central government, and thus in direct contradiction to law.¹⁶ Although Law 34/2000 restrained the establishment new local taxes and levies, it is difficult to overturn these taxes and levies since the process of regulation arrangement has been pass through the proper procedures and approved by local parliaments.

These local taxes and levies have impeded the revival of regional economic activities and created high-cost economic. Around 40 percent of the newly formed revenue instruments were imposed on goods or factors in the primary sector¹⁷ while KPPOD has also reported that 85% of 5,140 companies surveyed answered that providing services to local government personnel accounted around 2-10 % of their production costs.¹⁸ Other study found that the "service fees"

¹⁵ KPPOD (2003). "Regional Investment Attractiveness: Business Perception", Jakarta: Komite Pemantauan Pelaksanaan Otonomi Daerah (KPPOD) and Asia Foundation.

¹⁶ Blane D. Lewis (2006). "Local Government Taxation: an Analysis of Administrative Cost Inefficiency." *Bulletin of Indonesian Economic Studies* 42(2):213-34.

¹⁷ Lewis, *ibid.*

¹⁸ KPPOD, *ibid.*

for local government personnel was also present in the new order era and the companies embodied these fees in their cost calculation, the problem is not on whether the 2-10% of cost is huge or not.¹⁹ The eventual problems is indeed more on unlimited amount of the service fees imposed by local government employees, security allowances that demanded by military/police that makes companies difficult to calculate the predictable cost calculations.

Controlling corruption

The 1998 economic crisis has not only stimulate decentralization but also raised the issue on the controlling the corruption. Most people in Indonesia believe that the centralistic style of Soeharto regime and the cost of corruption have finally culminated in the economic crisis. These public perceptions have forced the politicians to incorporate regional autonomy and the fighting of corruption as the important part of Indonesia's official reform. On the political side, the decentralization law was also stimulated by the popular public belief to decrease corruption in the central government.²⁰

However, decentralization really will reduce the corruption and increase economic growth? If decentralization is carried out properly, it will not only enhance public participation, but also national's political unity and economic efficiency. Yet, if it is accomplished poorly, it may create macro volatility, rather than less corruption and the fall down of social safety net. There has been two competing argument on the relation between corruption and economic efficiency. On one hand, the first view argues that in order to avoid bureaucratic red tape, corruption is needed to enhance economic efficiency because it operates as lubricate money. On

¹⁹ Kazuhisa Matsui (2005). "Post-Decentralization Regional Economies and Actors: Putting the Capacity of Local Government to the Test." *The Developing Economies* 43 (1): 171-89.

²⁰ Ari Kuncoro (2002). "The New Laws of Decentralization and Corruption in Indonesia: Examination of Provincial and District Data." *European Regional Science Association (ERSA) Conference Papers* 2.

the other hand, the second view argues that because of the bureaucrats' unrestricted power on the regulation, the deadweight of regulatory burden may endogenously, instead of exogenous, set by corrupt bureaucrats so that they are able to arrange the structure and the magnitude of aggravation on firms to extract maximum bribe possible.²¹

In the past, corruption was moderate-high. But it was more centralized and predictable. Hence it did not create too much problem for business climate. The negative impact of corruption was lesser in the condition of centralized political systems like in the new order period than in the system where the power and authority are fragmented.²² The important feature of corruption in Indonesia was that the whole power structure including government employees was constructed base on the patron-client relationship, especially around the Soeharto families and his cronies. Here, the government personnel allowance and their performance appraisal is mainly determined by the discretion of superiors, and thus emerging the network of patronage and personal loyalty.

Although this structure generated a persistent corruption, the economic growth during the new order period was high. This might happen because the condition of political stability at that time was able to create certainty for business activities. Most costs related with corruption and bureaucratic red tape could be foreseen and measured as part of transaction cost. In addition, to reduce business uncertainty from harassment of lower level bureaucrats, businessmen have tried to involve Soeharto's children in numerous private businesses or other families of importance figures, such as governors and local military commanders.²³

²¹ Kuncoro, *ibid.*

²² Natasha Hamilton-Hart (2001). "Anti-Corruption Strategies in Indonesia." *Bulletin of Indonesian Economic Studies* 37(1):65-82.

²³ Kuncoro, *ibid.*

After the crisis, corruption has been more decentralized, less certain, and involves more players (politicians, political party). As explain above, decentralization has granted more authority and opportunity to local governments to create many new local regulations. This regulations—licenses and levies—imposed by local government bureaucrats has stimulated bribes by firms in Indonesia.²⁴ While this new regulations may either reduce or increase transaction firm depending on the local government behavior, the business uncertainty was in fact increased after the implementation of decentralization.²⁵ As a result, Business players need to pay more but can not approximate the costs since the new regulations are very numerous and its involves not only central government bureaucrats, but also local government official, politicians and political parties as well.

Concluding remarks

The 1997 economic crisis has created a new institutional setting and political landscape. The democratic transition has both the positive and negative sides for the country in delivering economic reforms. In the short and medium term, the challenge for the new government is to minimize the cost of democratization so the speed towards full economic recovery does not have to be at stake. In the longer term, the challenge is how to make the democratic political institution more favorable to equality and better distribution of economic development.

²⁴ J. Vernon Henderson, and Ari Kuncoro (2004). "Corruption in Indonesia." NBER Working Papers Series 10674.

²⁵ Kuncoro, *ibid.*

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Figure 1.

Framework of analysis

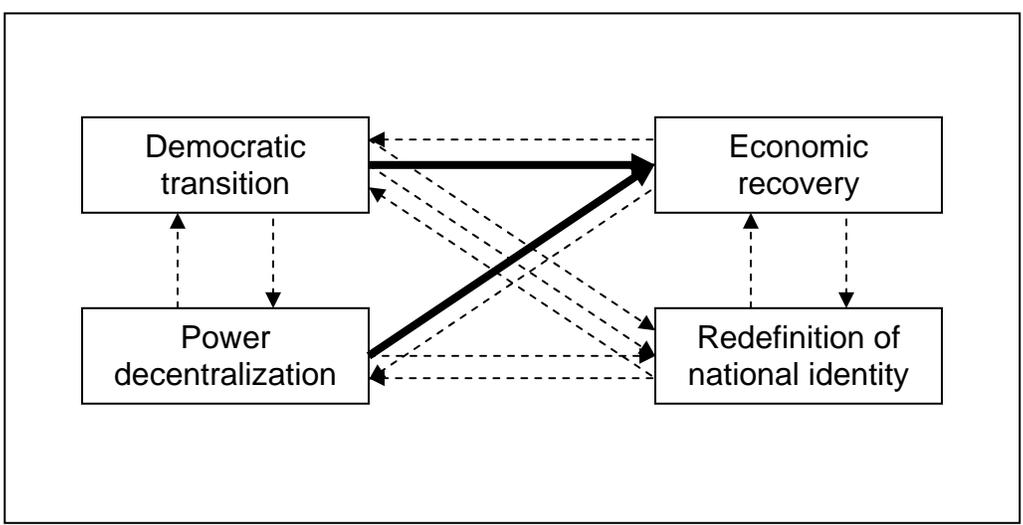
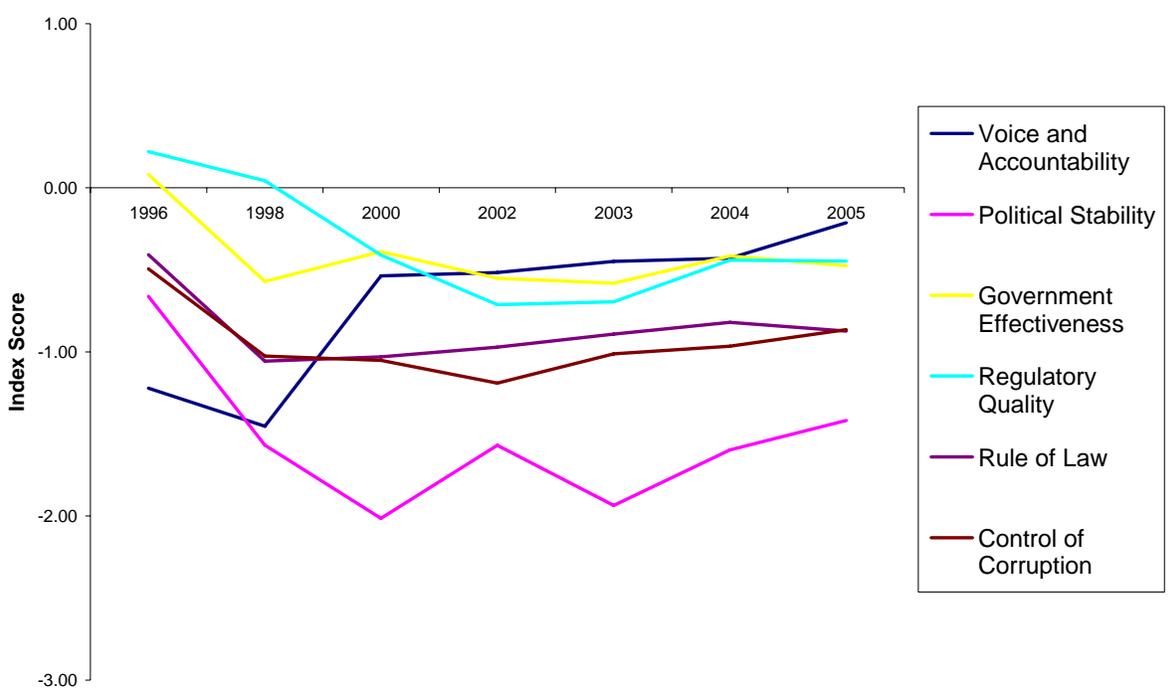


Figure 2.

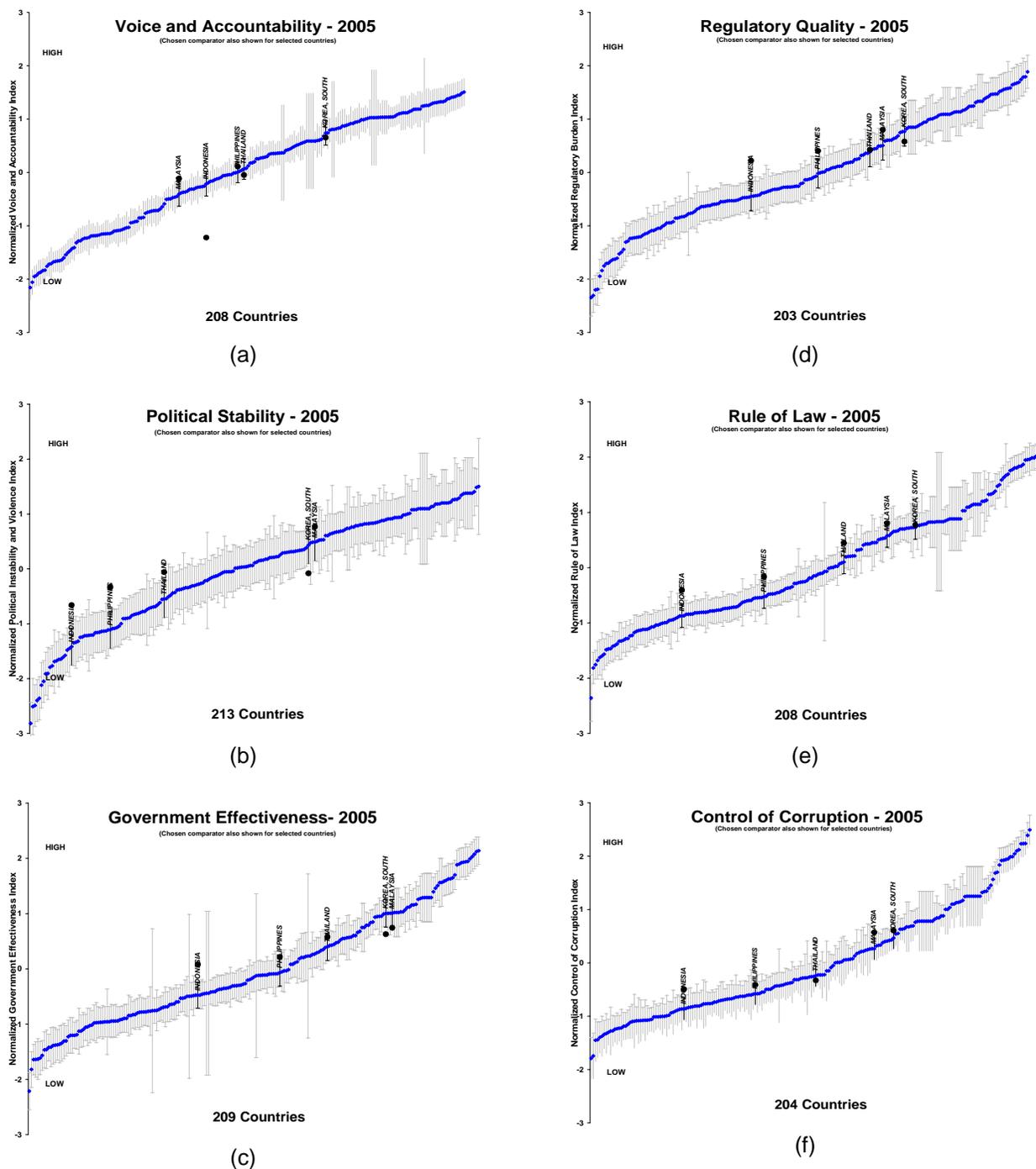
Indonesia: Indicators of Governance Quality, 1996-2005



Source: World Bank's Governance Indicator (Kaufman, Kraay and Mastruzzi 2005). Data available on <http://www.worldbank.org/wbi/governance/excelgraphs>

Figure 3.

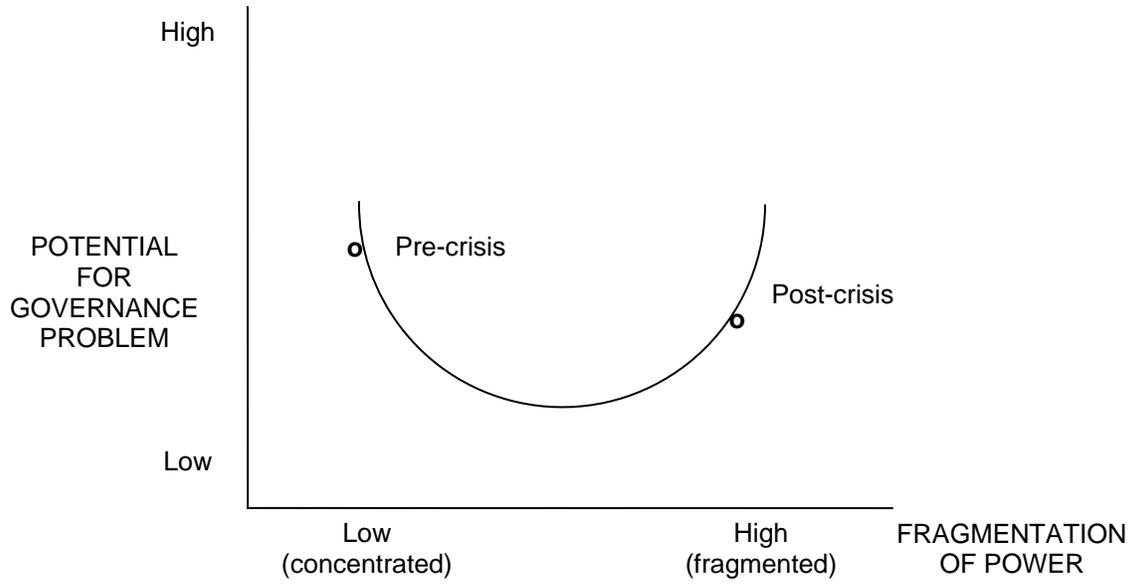
Comparison of various governance indicators, 1998 and 2005



Source: World Bank's Governance Indicator (Kaufman, Kraay and Mastruzzi 2005). Data available on <http://www.worldbank.org/wbi/governance/excelgraphs>. Note: blue dots represent the indicators in 2005. Black dots represent the indicators in 1996.

Figure 4.

Indonesia: the power concentration paradox



Source: adopted from MacIntyre (2003).