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INTRODUCTION

This book is an attempt to decipher regional district economic disparities during the state-restructuring events that occurred after the entry into the ASEAN Free Trade Agreement (AFTA) in 1992 and the governmental decentralization policy in 1999. Following the financial crisis in 1997, Indonesia's political arrangement shifted from a centralized regime to a decentralized government system. The new system delegates political, administrative, and fiscal autonomies to provincial and districts level. The decentralization process increased the Indonesian administrative size from 26 provinces with 292 districts in 1997 to 33 provinces with more than 491 districts in 2012.¹

This book examines the determining factors for Indonesia's development from a centralized government regime to the state-restructuring period. This book has adopted an empirical approach by using growth theory and the historical institutionalism approach in order to examine the impact of state restructuring. However, the impact would be determined by institutional capacities and the governance level of local governments to exploit opportunities from state restructuring processes as it would affect the rate of growth and economic development.

State restructuring refers to the creation of more logical organization where the state operates more efficient and effective (Young 2002). In this sense, the book defines state restructuring as a politico-economy shift of state organization and operation through two events (AFTA and

decentralization) that accelerates state management and service delivery through the participation of stakeholders, management of production factors, and state administration to achieve development goals. This study worked with the hypothesis that decentralization and AFTA would provide local district authorities ample opportunities in which to accelerate economic growth through authority over resource allocation and mobility. Furthermore, state restructuring provided opportunities in which to accelerate economic growth through the promotion of property rights and lower transaction cost. The book investigates how the state restructuring policy would affect regional economic convergence and what are the economic growth determinants. The main argument for this book is that state restructuring institutional changes would be able to explain regional economic divergence through path dependence and inherited past institutions within individual regions.

The nature of the research question has meant that the study required the use of a variety of quantitative and qualitative analytical methods. The deductive research questions which are utilized in this study were formulated through a critical review of relevant literature and current conditions in Indonesia. This study examines Indonesian regional district development by using the municipality and regency (*kota* and *kabupaten*, respectively) as the spatial unit of analysis. The dynamics of regional development in Indonesia should be understood and viewed through statistical analysis before one can begin to discuss the variations in state restructuring effects.

The use of both quantitative and qualitative analytical methods enabled a much more comprehensive analysis and enhanced the validity of the research as one method served as a test on the other's accuracy and veracity (Read and Marsh 2002). The quantitative method, which utilizes an econometric analysis of local endowment, explored the determinants of economic growth. This exploration was crucial in understanding the local economic structure and institutional arrangements as the basis of the qualitative study. The qualitative method featured the use of in-depth interviews in order to clarify the role of local endowments and institutional arrangements in terms of economic growth.

RESEARCH BACKGROUND

Since the 1990s, following the decline of oil and gas production, there is a shift of deregulation in the manufacturing sector. At the same time, the

emergence of manufacturing sector in the ASEAN region accelerates the ASEAN FTA between the association's member countries. This marks the shift of Indonesia economy towards a non-oil industrialization that lasted until 1997. The Asian Financial Crisis (AFC) that struck Indonesia resulted in the fall of the New Order regime and provided the path of decentralization on politics, economy, and administration. Both events shifted the state management, strengthened regional governments and improved public participation in national development process. At the same time, Indonesia became more involved with the global economy through trade integration and cooperation.

Thus, it is important to conduct economic and political analysis at the district level as it is crucial to our understanding of the impact of trade liberalization and decentralization on economic growth disparities. The implementation of AFTA and decentralization led to a shift in the decision-making process from government-centric to multi-stakeholder governance (Jessop 2002) and also economic growth only in certain regions, which Brenner (1999) called "the spatial selectivity of special regions". Regional disparities are more pronounced in developing countries due to higher political and social issues discontent in these lagging countries (Rodríguez-Pose and Gill 2006).

This is illustrated with persistent economic growth divergence among districts in Indonesia. Despite a decade of decentralization in which the Indonesian central government transferred significant political and administrative authority to the district level, government services and public reform have barely improved (von Luebke 2009). Instead, von Luebke's study demonstrated that there was a continuity of non-transparent and elite-centric agreements on public employment, government contracts, and party list positions despite decentralization efforts.

One reason for this lack of development was the persistent socio-political challenges. In the local jurisdiction, for instance, there has been a significant increase in the number of provinces and districts due to the decentralization process. Supporters of this regional administrative division argue that as the geographical area is too large with poor infrastructure, decentralization as it is has failed to provide access to health and education services for people in remote areas (Fitriani, Hofman and Kaiser 2005). Other reasons for further regional administrative division were made on the basis of religion, ethnicity, and bureaucratic and political rent seeking (Booth 2011; Fitriani, Hofman and Kaiser 2005).

Another issue is how direct elections have been criticized as monopolized by local elites. At the early stages of the government decentralization process, there were a number of former civil servants who successfully won elections at the district levels. Since the decentralization process started in 2001, 70 per cent of the new regional heads were bureaucrats and the general public by 16 per cent. Meanwhile, only 10 per cent of the regional heads secured a second term and only 12 per cent of the regional heads were from the Armed Forces (Malley 2003). These leaders were seen as part of the New Order regime which continued to exploit resources for self-enrichment or wealth accumulation to boost status rather than regional development.

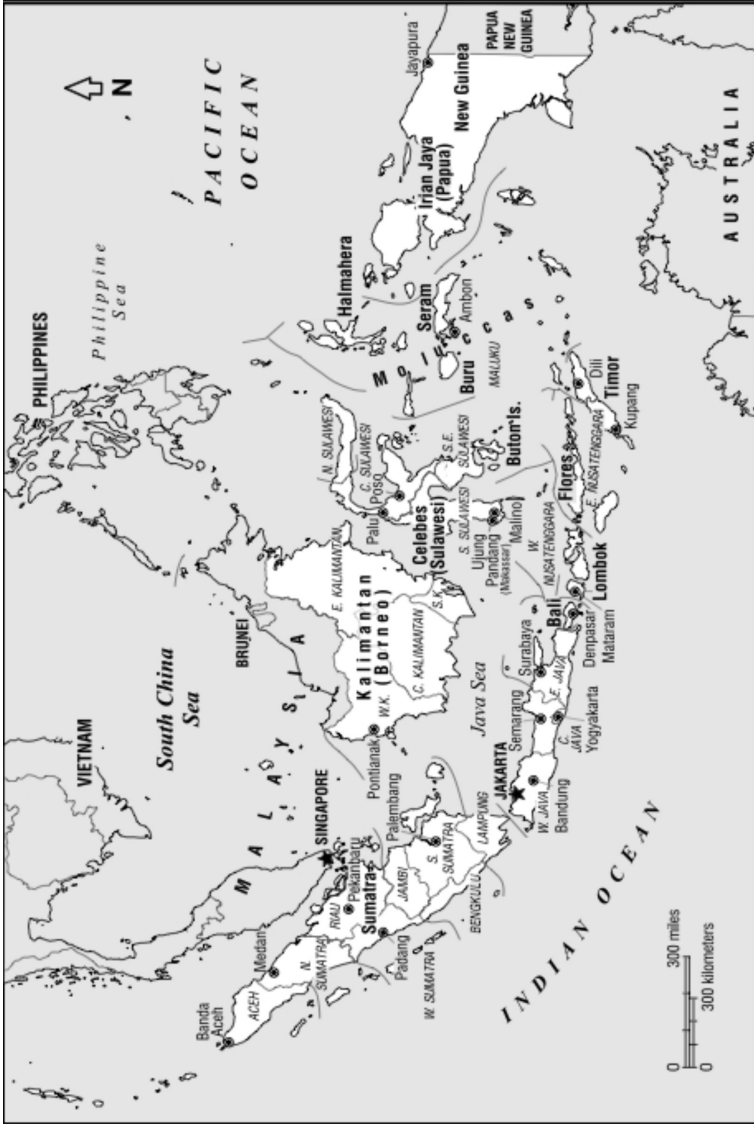
On the other hand, AFTA is expected to accelerate Indonesia's industry and trade competitiveness. However, the literature predicts that trade liberalization would increase imports in lagging countries and thus ineffective industries will struggle to compete with cheaper and higher quality imported products. Furthermore, Rodríguez-Pose and Gill (2006) argued that trade liberalization increased the development gap for regions that were lagging in manufacturing industries as these industries tended to be located near industrial complexes and urban areas.

At the local level, the effect of this trade liberalization becomes more significant when the size of regions is considered. In Indonesia, with more than 400 districts and each with different local economic structure, the effect of trade liberalization will be widely varied (Feridhanusetyawan and Pangestu 2003). Logically, districts with a large economic base and higher trade rates will gain wider market access from trade liberalization, while poorer regions with less efficient products will struggle to penetrate the market and compete with other regions. Thus, poorer regions potentially become market destination for import products. This is similar to Ramasamy's argument (1994) that in the early stages of AFTA, the agreement might increase inter-ASEAN imports to 60 per cent.

REGIONAL DEVELOPMENT: THE THEORETICAL DEBATE

This section frames the theoretical debate in which the empirical studies are presented in this book. To examine the equalization of regional development, we approximate using regional convergence. Regional convergence refers to the declining gap of regional economic growth due

FIGURE 1.1
Map of Indonesia



Source: Bertrand (2004). Reproduced with kind permission of Cambridge University Press.

to advance regions having lower growth rate compared with lagging regions. Thus, in the long run, there is a converging economic growth between these regions. The discourse in economic convergence is rooted in neoclassical economic perspectives where development is encouraged by open market and free trade, thus allowing the factors of production, such as labour and capital, to mobilize in locations where they are most efficient (Williamson 1965). More recently, the convergence analysis has dominated econometrics modelling approach as it acknowledges the features of neoclassical analysis (labour–capital), whilst adopting the new growth theory by allowing the possibility of increasing returns as a result of technology (Barro 1991, 2000).

On the other hand, persistent uneven development in Indonesia suggests the failure of neoclassical economy to explain this economic disparity leads us to revisit the literature on economic divergence perspective such as location theories (von Thünen 1966; Weber 1929; Hoover 1948; Losch 1954), the cumulative causation, and growth centre theories (Myrdal 1957; Hirschman 1958; Perroux 1950). Since the 1990s, divergence theories expanded rapidly by elements of trade, cultural, knowledge spillovers and local innovations including the New Trade Theory and New Economic Geography by Krugman (2003), dynamic models by Quah (1993, 1996), and Institutional Economic Geography (Scott and Storper 1987; Cooke and Morgan 1998). While the notion of innovation models emerged from the industrial clustering and agglomeration phenomenon that emphasizes on the institutional arrangements and actor networks including Collective Learning (Capello 1999), New Industrial Spaces (NIS) (Storper and Scott 1988), Industrial Districts (Lagendijk 2006), and Flexible Production System (Piore and Sabel 1986). These literature later led to the emergence of studies on how to create innovative cities via learning regions (Pike, Rodríguez-Pose and Tomaney 2006) and creative cities, based on the works of Scott (2011), Pratt (2009) and Peck (2005).

Recently, there is a growing study on the importance of local socio-culture institutions to support local economic growth, particularly through the studies on community (Rodríguez-Pose and Storper 2006), property development and housing (Doak and Karadimitriou 2007) and technological innovation (Taylor 2009). Turning to comparative politic literature, the historical institutionalism approach emphasizes the importance of past knowledge and culturally bounded institutional shifts on local responses and adjustments (Thelen 1999, 2004). Institutional

analysis highlights how previous institutions determined the local level governance and the creation of a new development path. This study also examines the networks of relationships among the local government, NGOs, and academics to illustrate how such factors influenced the shift in economic mode. By acknowledging path dependence and historical differences, this study sought to argue that local policies are bound by antecedent institutions and past knowledge. This approach enabled the elucidation of the economic policies and growth divergence amongst districts.

As these studies abandon the assumption of diminishing returns in neoclassical economic literature, the studies provide evidence that regions are uneven and that the determinants of economic growth range from land, interregional economy, and other institutional factors.

RESEARCH LOCATION: INDONESIA, BATAM AND BANDUNG

Indonesia was chosen as a case study in the current research because of its rich district-level statistical datasets. Available data include socio-economic statistics covering gross regional domestic product (GRDP), population, levels of education, road accessibility, and fiscal data. Furthermore, detailed data on plant-level manufacturing and complete AFTA tariff data for the periods under observation were available from the Central Bureau of Statistics (Badan Pusat Statistik). The development of the manufacturing industry in Indonesian regions varied widely depending on the type of industry.

The dynamics of the Indonesian economy was useful to study the effect of state restructuring prompted by trade liberalization and decentralization on regional development. In order to establish the argument for this book, statistical analysis was first employed to provide evidence of divergence in regional development. Thereafter, this study examines the extent of the effect of trade liberalization and decentralization on regional divergence across the periods under observation. Finally, the study explores the role of institutions, along with state restructuring, in determining the pathways for regional development. In the latter, particular focus is directed towards embedded institutional capacities that influenced the effect of state restructuring on local regional development. The current study explains the effect of state restructuring induced by trade liberalization and

decentralization based on the variations in the development of regional districts.

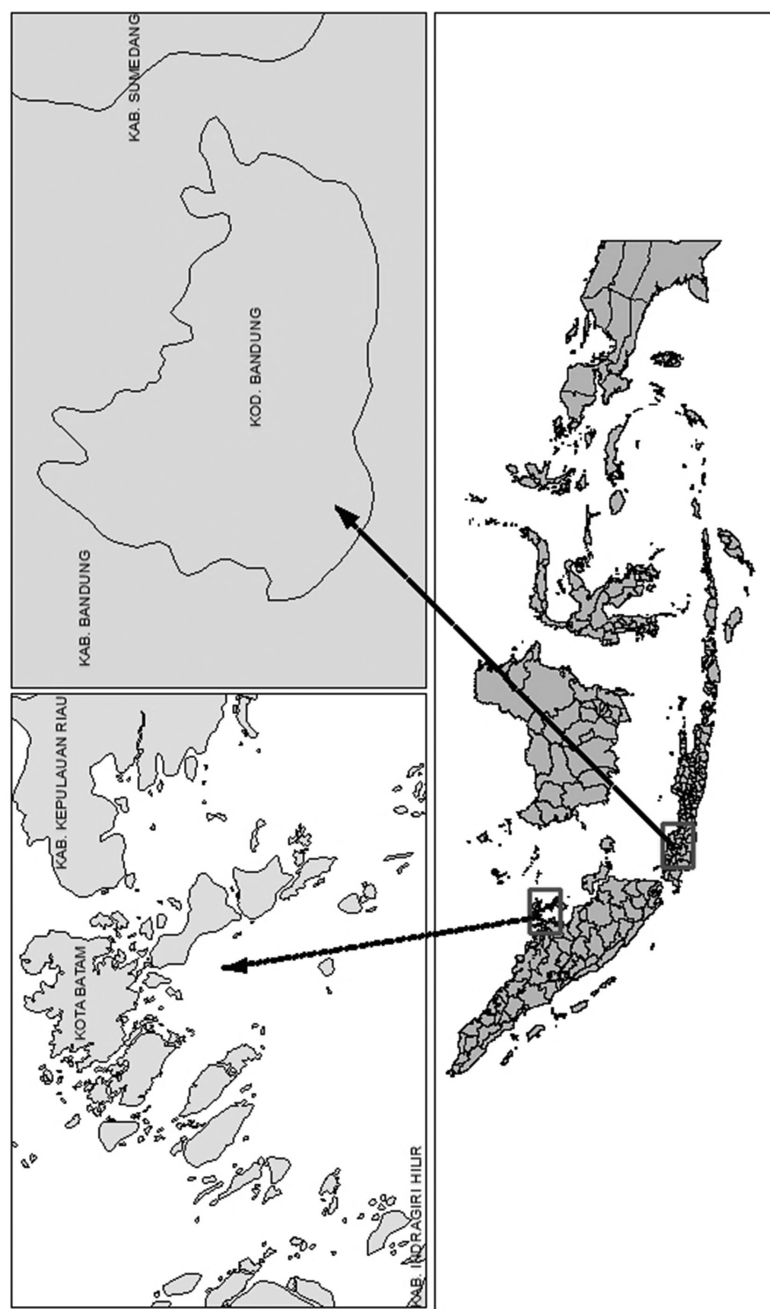
The variation of economic dynamic should be viewed as a continual and evolving process that progresses along development paths. However, this process might be intervened by the presence of politico-economic events such as AFTA and decentralization as a disturbance. Thus, these events serve as an opportunity for a new development path.

In order to explore the impact of the institutional arrangements on regional development during the state restructuring period, specific regions were used as case studies. As Indonesia is a culturally and economically diverse country, two districts — the cities of Batam and Bandung — were selected as case studies as both cities have large and significant manufacturing industries that were established prior to the decentralization process. (See Figure 1.2 for their location within Indonesia.) Batam received official support from the central government in 1978 following the creation of a manufacturing bonded zone by the central government (Keppres No. 41/1978; Phelps 2004). Meanwhile, the Bandung manufacturing industries were accelerated by the Paket Oktober (Pakto) 1992, a policy from the central government which provided funding and land for manufacturing activities in the city (Fromhold-Eisebith and Eisebith 2002). Both policies were successful in initiating manufacturing development and economic growth in respective cities.

Furthermore, both cities are adjacent to major metropolitan centres for market and infrastructure access. Batam was seen to be geographically close to Singapore and was expected to receive a portion of Singapore's manufacturing plants following the Singaporean government's decision to have a more service-oriented economy in order to position itself as Southeast Asia's financial hub (Kumar and Siddique 2013). On the other hand, Bandung is located just over 2-hour drive (122 km away) from Jakarta and it is also the capital of West Java Province. In addition, the city of Bandung was part of the Bandung regency before decentralization.

Batam was the only city with a special economic zone in Indonesia for more than three decades, and its development was heavily dependent on state policy. The city also symbolized the location where trade liberalization encountered regional autonomy in the post-decentralization period. In addition to exploring the relationship between actors and institutions on the process of policymaking and development plans over the study periods, this research also analysed how historical institutions and path

FIGURE 1.2
Map of Batam and Bandung



dependence determined the city's current policies and future paths. On the other hand, the Bandung industrial region gradually developed into a service-oriented and creative city through education, business and concentration of creative projects. The presence of universities and proximity with Jakarta leads to the emergence of highly skilled young professionals who live in Bandung and market their products in Jakarta. As Bandung and Batam were similar in terms of economic structures, their relationship with the central government, and in terms of market access, the working hypothesis for the study — where institutional arrangement of each city might influence the impact of state restructuring — becomes more feasible to study.

THE STRUCTURE OF THE BOOK

This book is divided into three main parts: the first part introduces background research and methodologies as part of the research design. As the empirical studies were based on distinct methodologies and research aims, the specificities of the methodology are explained in each of the chapters presenting the methods used. The literature review chapter revisits the discourse on economic convergence and the impact of state restructuring in order to contextualize the research question of this book.

The first part of the book also explores the impact of state restructuring literature. The main argument for decentralization is the development in the regions, including efficiency in the allocation of resources, income distribution, and macroeconomic stability (Musgrave 1959). Furthermore, to understand the significant institutional changes of decentralization, the study should also consider the supply side of decentralization such as the local government capacity (Prud'homme 1995) and the economic dividends that are the result of decentralization processes (Rodríguez-Pose and Bwire 2004).

Trade liberalization influenced trade structures such as the agricultural commodities and the manufacturing sector; they also influenced economic convergence (Rodríguez-Pose 2005). Furthermore, Sjöberg and Sjöholm (2004) pointed out that trade liberalization affected economic growth through economy agglomeration of spatial concentration, market scale and supplier access. Furthermore, institutional arrangements of international multilateral trade agreements also determine the trade effect on member countries through trade creation and diversion. Studies show that regions

with abundant infrastructure and especially in border regions will have higher economic growth (Juan-Ramón and Rivera-Batiz 1996; Paelinck and Polèse 2000; Elliott and Ikemoto 2004).

The second part of the book described the theoretical framework and empirical context of the research. Furthermore, it discusses a wide range of classical and contemporary literature on regional convergence as the foundation for this study. Chapter 3 illustrates the political and institutional shift at the districts in the state-restructuring period, which was stimulated by the supranational agreement in AFTA and policymaking and public services in decentralization. This chapter presents the challenges faced by national and local actors in responding to these state restructuring.

The final part consists of analysis based on data gathered as part of this study. Chapter 4 explores the dynamics of Indonesia's regional convergence through economic, geographical, and sectoral analysis and answers the first research question as to whether the state restructuring affected regional disparities. The chapter found persistent economic disparities among regions and the uneven geographical location of manufacturing industries. Specifically, the result reveals that disparities are more pronounced at the district level than at provinces. This suggests that the decentralization of policymaking and governance process have higher effect at the local level.

Chapter 5 elaborates on the effect of AFTA and decentralization on regional district convergence by using a large set of statistical data and econometric analysis. The research shows a mixed effect on regional economic growth — decentralization reduces regional economic growth, and AFTA has an insignificant effect. One possible explanation is the reluctance of the central government to devolve a larger tax base to bolster its own source revenue (OSR) and the limited balancing power of intergovernmental transfers (IGT), including the unattractiveness of the AFTA CEPT tariff and poor AFTA institutional capacities.

Chapter 6 studies the effect of past institutions and institutional changes on state-restructuring on the regional disparities. The differences in regional growth are explained through the remaining importance of past institutions to influence local development path trajectories. However, institutional learning is possible through the mobilization of actor networks that shaped local policies and resources allocation. The last chapter summarizes the research findings and policy implication of the effects of AFTA and decentralization on Indonesian regions.

The following chapter discusses relevant literature and contextualizes the research into the present discourse.

Note

1. BPS website, <www.bps.go.id>.