

The Impact of Indonesia's Decentralization Reforms Two Decades On

Introduction

Siwage Dharma Negara and Francis E. Hutchinson

Following the end of the New Order in 1998, Indonesia embarked on a far-reaching decentralization drive. Envisioned as a means of restoring political rights to citizens, disrupting the country's pervasive patronage networks, and quelling calls for regional autonomy, Jakarta devolved extensive governmental responsibilities to the subnational level.

To this end, sweeping changes were passed which curbed the power of the executive, revitalized the role of the legislature, and rolled back controls on political life. In addition, financial resources and administrative authority in a wide range of areas were devolved to local governments, namely municipalities and regencies.

These measures were drawn up in 1998, legislated in 1999, and implemented in 2001. The key provisions were the following: Law 1999/22 on regional government, which transferred a significant proportion of government responsibilities in areas such as education, health and infrastructure to the local level, and introduced elections for the local and provincial levels; and Law 1999/25 on the fiscal balance between the centre and the regions, which established the financial infrastructure to enable these changes (Ostwald, Tajima and Samphantararak 2016).

With these measures, Indonesia went from having one of the world's most centralized government structures to one of the most decentralized, with only a core set of responsibilities such as foreign affairs, defence, and monetary policy remaining at the centre. Early reviews carried out by organizations like the World Bank (2005) labelled Indonesia as a leader in Southeast Asia for the breadth and depth of its decentralization drive.

Two decades after the reforms were enacted, it is timely to review the effects of these changes. On the one hand, surveys have indicated broad-based support for the decentralization reforms (KPPOD 2017, 2021). However, much of this backing may have been derived from the decentralization's political rather than economic or service delivery implications. For example, the decentralization drive has: revitalized

Siwage Dharma Negara is Senior Fellow in the Regional Economic Studies Programme and Co-coordinator of the Indonesia Studies Programme at the ISEAS – Yusof Ishak Institute, 30 Heng Mui Keng Terrace, Singapore 119614; email: siwage_dharma_negara@iseas.edu.sg

Francis E. Hutchinson is Senior Fellow in the Regional Economic Studies Programme and Coordinator of the Malaysia Studies Programme at the ISEAS – Yusof Ishak Institute, 30 Heng Mui Keng Terrace, Singapore 119614; email: francis_hutchinson@iseas.edu.sg

regional identities that were suppressed under the New Order; reduced the predominance of Java in the country's life (Mietzner 2014); and diversified the country's elite by opening alternative pathways to national-level political office (Ostwald, Tajima and Samphantharak 2016).

Yet, on the other hand, the record in terms of economic growth and public service delivery is more mixed. The decentralization reforms have led to demands for the creation of new provincial and, especially, local governments (Patunru and Rahman 2014). However, the efficiency-enhancing effects of competition between subnational governments for investment, as theorized by early proponents of fiscal federalism (Thiebout 1956), have yet to fully manifest themselves. The new government structures have varying degrees of capacity, which, in turn, has complicated service delivery and increased the potential for inefficiency (Lewis 2014). There also appear to be issues with the design of fiscal transfers from the centre to local and provincial governments, as they are not sufficiently linked to economic growth and investment (Fadliya and McLeod 2010).

Nonetheless, greater autonomy for subnational governments has allowed for local initiative in areas such as business licensing, regulations, and the quality and extent of infrastructure (von Luebke 2009). Furthermore, the country's more decentralized governance structure has allowed for more participatory decision-making processes in areas like urban planning (Padawangi 2019).

Given the haste with which the decentralization reforms were developed and put into operation—a process some have called “building the ship while sailing it” (Buente 2004)—policymakers have had to amend key provisions. Conscious of the inherent difficulty of the central government communicating with an ever-growing number of local governments, the coordinating role of provincial governments was strengthened in 2004 (UNDP 2009). That same year, direct elections were introduced for leaders at the provincial and municipal levels. And in 2007, a government regulation was passed that sought to clarify the roles and responsibilities of the various levels of government. Its aim was to reduce overlap and provide a measure of oversight by central government ministries of activities carried out by subnational governments (Ostwald, Tajima and Samphantharak 2016).

Furthermore, due to the sheer number of requests for new local governments, a moratorium on their establishment was declared in 2009, before being rescinded in 2012 (Simandjuntak 2015). In its place, Law 23/2014 provides a crucial measure of central government oversight of new subnational governments, by allowing underperforming ones to be re-absorbed by their originating provinces or local governments (Articles 46–47).

Conversely, national policymakers have also wavered in their commitment to decentralization—a pattern broadly replicated elsewhere in Southeast Asia (Malesky and Hutchinson 2016). While relatively expansive in political and administrative dimensions, Indonesia's decentralization reforms in terms of finance have been partial, with key revenue-raising responsibilities retained at the centre (Shah, Qibthiyah and Dita 2012). In addition, the process has also been questioned and, at key junctures, very nearly reversed. In 2014, in the last weeks of the Susilo Bambang Yudhoyono administration, direct elections for local government leaders were very nearly abolished (Ostwald, Tajima and Samphantharak 2016).

Under President Joko Widodo, widely known as Jokowi, Indonesia's decentralization process has taken a new turn. The seventh president of the republic lacks a dynastic background, military career or wealth—itself an impressive indicator of the country's reconfigured political landscape following the reforms. Instead, Jokowi attained national office on the basis of his reputation as an efficient, effective, and pragmatic local government leader. These attributes have also shaped the contours of his presidency and its policy priorities.

Having been a small business owner earlier in his career, Jokowi has a deep appreciation of the impact of excessive regulation and inefficient government services on investment and employment creation. Consequently, he has consistently sought to reduce red tape, speed up licences and permits, and simplify regulatory requirements. Yet, despite notable initiatives such as moving many licence and

permit processes online, progress has been slow (KPPOD 2019). Consequently, Jokowi has been sensitive to complaints from investors about the travails inherent in Indonesia's licensing regime and the need to negotiate with bureaucrats at various levels of government (*Jakarta Post*, 14 April 2021).

The focus on ease of doing business has been complemented by the president's commitment to investing in physical infrastructure such as roads, bridges, dams and shipping routes to stimulate economic investment and, thus, reduce poverty. Recent statistics indicate that this is a pressing issue. While the official poverty rate declined from 11 per cent to just above 9 per cent over the course of his first term, many Indonesians remain vulnerable to sudden economic shocks. Millions are hovering above the poverty line and liable to fall below it if hit by illness in the family, a cyclical downturn, or some other misfortune like the current pandemic. However, infrastructure provision was a key responsibility devolved to local governments as part of the 2001 reforms.

This state of affairs is, in part, behind Jokowi's "authoritarian turn" (Power and Warburton 2020). A case in point is his decision to pass the Omnibus Law, which, to his critics, harks back to governance under the New Order. Through this measure, the central government seeks to reclaim authority from local governments, particularly with regard to the issuance and processing of business permits in sectors such as mining, energy and manufacturing (Maulia 2020; Temenggung et al. 2021). This centralization of licensing authority under the Omnibus Law is contrary to the principle of decentralization. Granting business permits without involving the local government may cause problems such as social conflicts that, in turn, lead to a weakening of the investment climate (KPPOD 2020).

Yet, while Indonesia's decentralization process has been a dynamic one, it is but a means to an end, the latter being that of enabling its state institutions and their policies to achieve development outcomes more effectively. Consequently, two decades is a relatively short period to gauge the impact of the 2001 reforms on the country's institutions and quality of governance. Nonetheless, as part of a collective and ongoing research process, this Special Issue seeks to provide a stock-take of the costs and benefits of the Indonesia's decentralization reforms thus far.

Given the complexity of the reform process, this exercise is best performed by evaluating the country's progress in specific areas of economic performance and service delivery. The papers in this issue of the journal are based on a series of webinars organized by the ISEAS – Yusof Ishak Institute's Regional Economic Studies Programme in late 2020. Subject experts were invited to submit manuscripts on their given area of expertise as it intersects with Indonesia's decentralization process.

In the next article, Yanuar Nugroho and Sujarwoto look at the extent to which decentralization has strengthened the capacity of the Indonesian state, as well as the ability of its government organizations to deliver development outcomes. Focusing on the structure of public administration and the provision of local public services, the authors find that decentralization has, in many areas, managed to achieve partial improvements. Yet, at the same time, it has failed to deliver in others. The capacity of local governments to deliver developmental outcomes has increased, but disparities and gaps remain. Looking at aggregate regions in Indonesia, there are serious gaps between local governments in Java and Bali on one hand, and those in Papua, Maluku and Nusa Tenggara Timur on the other.

Nugroho and Sujarwoto argue that weak local capacity in creating supportive regulations for improving access to and quality of public services, carrying public administration reforms, and setting up accountability mechanisms is the primary factor behind the disparity in the provision of social and basic services across the regions. Moreover, they also highlight weak policy coordination across ministries and between the central government and subnational governments. Consequently, there is a need to reconcile different interests between central and subnational governments if the decentralization reforms are to reap maximum benefits.

In the next article, Yogi Vidyattama examines the impact of the 2001 reforms on fiscal autonomy at the subnational level. He examines whether the reforms have allowed a bigger space for subnational

governments to generate their own revenue and fund their own initiatives. To this end, Vidyattama analyses the size and proportion of intergovernmental transfers from the centre to local and provincial governments since the start of the decentralization process. Using budget data from the Ministry of Finance, he finds that there has been a consistent transfer of revenue and expenditure responsibilities to local and, to a lesser extent, provincial governments. However, this has not directly translated into greater autonomy for these governments to develop their own programmes and deliver public services. This is because the larger budget transfers have been accompanied by dramatically larger staff payrolls. This means that local governments are required to absorb the cost of legions of civil servants whom the central government had previously paid. At the provincial level, governments have also had to take on additional tasks associated with supervising and coordinating local governments. This task constituted an extra, although not an overly sizeable, burden for provincial governments. Vidyattama also observes that local governments have been pushing for more control over their revenue by introducing various taxes and user charges. This widespread practice has resulted in a slight increase in revenue raised at the local level.

The following paper by Puspa Delima Amri and Mulya Amri examines the factors that determine competitiveness at the subnational level in Indonesia. Focusing primarily on local government level data from 1998 to 2016, they find significant correlations between competitiveness and fiscal decentralization measures. Local governments that were less dependent on transfers from the central government, less reliant on agriculture as opposed to industry or services, and were already more well off, were more likely to be competitive. They argue that one of the characteristics of Indonesia's fiscal decentralization process is that it places greater emphasis on redistribution, meaning that less productive parts of the country are given larger transfers. Ultimately, these local governments have become dependent on such transfers, without much incentive to become more productive. Thus, the authors find a significant correlation between a local government's productivity and its degree of fiscal autonomy.

In the subsequent article, Takayuki Higashikata analyses the effect of minimum wage increases on employment in Indonesia using plant-level panel data from 1994 to 2015. This exercise is pertinent as, following the 2001 reforms, the setting of the minimum wage was one of the basic responsibilities transferred directly to provincial governments and indirectly to local governments. Higashikata's analysis focuses on five neighbouring local governments in West Java province. Prior to 2001, all five had the same minimum wage. However, after the 2001 reforms, their minimum wages diverged. He finds a negative association between the minimum wage across the local governments and their employment levels, in which a 1 per cent increase in the minimum wage in real terms reduced the number of workers employed by manufacturing plants the following year by 0.53 per cent. The negative effects were mainly observed in large plants with more than 100 employees as of 1994, but not in small plants. Higashikata also shows that the fixed capital per worker was raised as the minimum wage increased in large firms. This finding suggests that large plants had substituted capital for labour because of the relatively higher costs caused by the minimum wage hike. Overall, the paper implies that policymakers need to carefully balance demands for increases in the minimum wage with the need to generate employment.

In the following article, Priasto Aji, Iqbal Dawam Wibisono and Asep Suryahadi show that decentralization has led to significant progress in improving the welfare of its citizens—as seen from increasing income per capita and decreasing poverty levels. However, at the same time, inequality has increased. Using spatial econometric models with data covering the 2002–19 period, they find that there has been a conditional convergence of per capita income levels across local governments in Indonesia. The authors argue that, despite this convergence, the gaps will not be eliminated entirely due to differences in factors of endowment. This finding implies that decentralization should be complemented by efforts to assist areas with low income per capita, high inequality and high poverty rates to improve their endowment factors and institutions. Moreover, they find a significant effect of education expansion, from primary to higher levels, for reducing poverty growth. This highlights the importance of improving

the educational attainment of the population to reduce poverty, which is the focus of the final paper of this Special Issue.

In the final article of this issue, Goldy Dharmawan and Daniel Suryadarma examine the quality of education across various local governments in Indonesia. Their argument is that the education system needs valid and objective information on student learning outcomes at a sufficiently disaggregated geographical level. Without detailed information on learning outcomes, policy reforms or higher public investments in education are unlikely to be effective. To provide an estimate of the quality of education in Indonesia, Dharmawan and Suryadarma observe differences in learning outcomes at the local government level at a key juncture. This was when the central government changed the manner of administering national examinations from paper-based to computer-based testing. They find that the quality of education varies significantly across local government areas. The gap in results between the highest-scoring and lowest-scoring local governments shows that children in the latter have been attending school with minimal learning outcomes. Moreover, within local government areas, the average gap in the level of learning between students enrolled in a low-quality school and those enrolled in a high-quality school is as much as six years of schooling. The authors also find that, over the course of one year, the average quality of education has increased slightly, and the variation in quality has declined slightly. These findings suggest that focusing on national averages masks significant heterogeneities between and within local government areas.

Twenty years on from the 2001 reforms, these six papers provide insight into some of the key governance and developmental challenges facing policymakers in Indonesia. Collectively, they indicate that Indonesia's decentralization reform process remains a work in progress. While development outcomes have improved over the past two decades, the country still faces very significant internal disparities in: key areas of state capacity, notably the quality of public administration and ability to raise revenue; as well as developmental outcomes, including per capita income, poverty levels, and educational attainment.

In addition, the papers also highlight a number of structural dilemmas that Indonesian policymakers have had to handle over the past twenty years and will need to do so in the future.

First, since the onset of the decentralization reforms, there has been a profusion of provincial and, particularly, local governments. However, a greater number of agents requires improved coordination between and across levels of government. For historical reasons, Indonesia's leaders decided to devolve the bulk of responsibilities to local governments, bypassing provincial governments. However, the sheer number of local governments and the diversity of policy initiatives passed by leaders at this level has led to a gradual strengthening of the role of provincial governments. And, as seen by recent measures enacted by the Jokowi administration pertaining to business licences, other policymaking responsibilities have been recentralized at the national level. In the years to come, the allocation of resources and responsibilities will be dynamic and frequently contested.

Second, decentralization is a multi-faceted process, and can be broken down into its constituent political, administrative, and fiscal dimensions. Reflecting history, choices, and the influence of interest groups, different countries devolve different dimensions to varying degrees. Available research and the findings of these papers indicate that, in Indonesia at this point, fiscal decentralization seems to have lagged relative to the other two dimensions. Consequently, leaders at the provincial and, particularly, local levels find themselves responsible for extensive regulatory and administrative tasks, as well as managing and supervising substantial numbers of public servants. Yet, the financial wherewithal to meet these responsibilities in a sustainable manner is lacking.

Finally, the papers indicate substantial disparities between provincial and local governments with regard to their ability to generate their own resources and deliver developmental outcomes. On one hand, greater autonomy is good for subnational governments with established capabilities, who then are able to attract investment and generate revenue or effectively administer their staff to provide public services

of quality. Yet, this then raises the question of increasing disparities as lagging regions are left behind. However, interventions or increased fiscal transfers by the central government risk further undermining the competitive dynamic or nascent capacity.

At the time of writing, the COVID-19 pandemic has afflicted Indonesia for eighteen months, with high numbers of cases and deaths, as well as many severely affected economic sectors. Given the lack of available data, this issue could not be addressed by the contributors. Nonetheless, given the virus' exacting requirements on state capacity and service delivery, it will constitute a reckoning for policymakers at all levels. Subsequent research on the impact of decentralization in the country will need to position 2020–21 as a milestone as influential as the 2001 reforms themselves.

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