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Green, Keith

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# Decentralization and Good Governance: The Case of Indonesia

Keith Green

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Indonesia began a process of rapid government decentralization in 1999 from a formerly strong centralized government structure. I review the history of decentralization in Indonesia and assess how Indonesia has fared in pursuing a decentralization policy since 1999. I illustrate how Indonesia meets several criteria of successful decentralization and how it fails the criteria in principle in other areas. Finally, I indicate the likely future challenges faced by Indonesia as it implements decentralization and provide some recommendations to improve the ongoing decentralization process.

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Recently, Indonesia held a democratic presidential election that brought reformist candidate Susilo Bambang Yudhoyono to power. Many within Indonesia are hoping for a continuation and an acceleration of reforms that began since the departure of the Suharto administration in 1998. One of the most important reforms began in 1999 is decentralization<sup>1</sup> of power from the central government to provinces and sub-provinces.

Many countries have embraced decentralization over the past ten years in regions as diverse as the newly independent states of Eastern Europe, Mozambique, Brazil, India and Indonesia. The decentralization literature promotes the good governance aspects associated with decentralization including local citizen participation, democratic elections and financial and political equity.

Decentralization was designed to bring a measure of autonomy to Indonesia's many culturally diverse regions. The success of decentralization in Indonesia is essential for a number of reasons. Decentralization promotes good governance by enabling citizen participation and democratic elections. Decentralization enhances political and economic stability in the fourth most populous country in the world. A well-governed and economically viable Indonesia would likely play a major role in the future direction of the Asia-Pacific region. This paper will illustrate the issues that Indonesia faces as it implements decentralization.

## DECENTRALIZATION AND GOOD GOVERNANCE

There are many definitions for decentralization. The World Bank and other authors have developed their own definitions of decentralization. The World Bank defines decentralization as “the transfer of authority and responsibility for public functions from the central government to intermediate and local governments or quasi-independent government organizations and/or the private sector”.<sup>2</sup>

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<sup>1</sup> Decentralization in Indonesia is virtually identical to use of the phrase “regional autonomy” in Indonesia and will be used interchangeably in this paper.

<sup>2</sup> See the World Bank Decentralization Net located at <http://www1.worldbank.org/publicsector/decentralization/what.htm>

The World Bank classifies decentralization by its three main forms of political, administrative and fiscal decentralization. Political decentralization incorporates local democratic elections for officeholders and a representative local legislature. Administrative decentralization grants the authority of local governments to hire staff and conduct local government affairs with a minimum of direct central government approval. Fiscal decentralization enables local governments to raise and receive revenue, make expenditures and issue debt for local purposes.

There may be many rationales for implementing decentralization within a country. The World Bank notes that decentralization has resulted from civil wars (e.g., Mozambique and Uganda), political crises (e.g., Indonesia, South Africa), as a response to regional or ethnic desires to have greater participation in the political process (e.g., Ethiopia), and by the desire to improve the delivery of public services.

The World Bank lists that at least five criteria are necessary for successful decentralization. These requirements are ensuring that local financial resources match the ability to provide local public services, the local community should be aware of the cost of services, the community should be able to express their desires in a meaningful way, there should be transparency and accountability of local government activities and the legal and institutional system should match the political objectives.

Decentralization presumes that local officials and citizens participate in the process and make rational and informed decisions based on their circumstances. The political process should include strong legislatures, multiple political parties and interest groups. Similar definitions have been provided for democratic decentralization including competitive political parties, free journalism and a culture of accountability (Crook and Manor 1998).

The outcome of decentralization should result in a more participatory government for citizens and improved delivery of public services because of the local participation and accountability. Under decentralization, public services should be performed at the lowest level of government whenever possible. Implementation strategies should include the use of sequencing decentralization to match finances at the local level with the performance of required public functions (Ahmad and Mansoor 2002).

There is no evidence in the economic literature of a direct relationship between economic growth and decentralization. However, there are links between good governance and positive economic growth<sup>3</sup>.

Decentralization is not always a silver bullet in the arsenal of good governance. The World Bank is very aware that there may be negative impacts with the application of decentralization in certain circumstances.<sup>4</sup> The World Bank comments that governments will likely fail to benefit from decentralization if there are inadequate financial resources at the local level to perform public services, if there is ineffective or inefficient local government administration, or if a lack of coordination exists between the local public and private sectors.

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<sup>3</sup> US Agency for International Development “Foreign Aid in the National Interest: Promoting Freedom, Security, and Opportunity” (Washington, DC 2002) illustrates a correlation between low levels of corruption and growth in purchasing power parity GDP.

<sup>4</sup> See World Bank Decentralization Net located at <http://www1.worldbank.org/publicsector/decentralization/what.htm>.

## **HISTORY OF DECENTRALIZATION IN INDONESIA**

Indonesia today is comprised of 30 autonomous provinces that contain districts and municipalities. Districts, located in rural areas, and municipalities, outside of rural areas, are the same level of government. The provinces have a governor who serves as the central government's representative and a representative parliament. The provinces and local governments are sub-national governments.

Dutch colonial rule introduced sub-national governments in 1905 and provinces in the 1920s. Decentralization or regional autonomy was granted in 1945 after Indonesia won its independence from the Netherlands. The Sukarno administration removed regional autonomy in 1957 after political agitation in several regions. Regional autonomy was revived in 1974 but never effectively implemented. The Suharto administration was very reluctant to give any significant authority to local governments until 1996. The 1996 attempt was essentially a failure because the central government failed to provide sufficient financial or personnel resources for decentralization.

The 1997 Asian financial crisis served as the catalyst for change in Indonesia. During and after the crisis the International Monetary Fund (IMF) and the World Bank insisted on governance reforms in combination with any financial assistance to the country. Student protesters numbering in the thousands and other forms of political unrest helped to remove the Suharto administration and led to his resignation on May 21, 1998.

Vice President Habibie assumed the presidency and began to institute reforms. These reforms included ending the small limit on the number political parties, allowing East Timor to vote on independence (independence achieved in June 2002) and overseeing the passage of laws authorizing the decentralization of government.

The call for decentralization came from many sources. Critics of the central government blamed it for the country's financial problems and pressed for decentralization. Local officials at the provincial and sub-provincial level supported the push for decentralization to gain greater control over local resources and activities. The sub-national governments especially remembered the way local governments had been treated for decades under the Suharto administration and were eager to take power from the central government. The IMF and the World Bank advocated decentralization as part of government reforms. Some local officials at the time even mentioned seceding from Indonesia.

Regional autonomy legislation was drafted in 1999 (Law 22 and Law 25) and implemented in 2001. The decentralization laws focused on empowering sub-provincial governments and were crafted without a well-developed transition or implementation plan. Different reasons have been proposed as to why decentralization was focused on the sub-provincial level. One rationale is that it was intentionally designed to create competition between provinces and lower levels of government and allow the central government to act as a mediator (McCarthy 2004). Another reason advanced by the World Bank in a June 2003 report highlights the desire of the President and the military to avoid political unrest that had historically occurred at the provincial level. In any event the local governments rapidly became autonomous and assumed responsibilities as outlined in the decentralization laws.

Provinces are responsible for coordinating functions among the local governments and performing certain roles that the sub-provincial governments are unable to perform.

The sub-provincial governments have the authority to perform all the roles that are not expressly assigned to the central or provincial governments. The central government retains the roles of defense, justice, police, finance, monetary policy and development planning.

## **DECENTRALIZATION IN PRESENT-DAY INDONESIA**

In many respects Indonesia meets the criteria for effective decentralization – a political party system with multiple parties, free press, local community awareness of service costs, and the ability of the community to express their public preferences.

Indonesia has adopted a party system and holds democratic elections. The recent election of President Yudhoyono is testimony that Indonesia can hold successful elections largely devoid of irregularities.

Indonesia has a free press that is widely distributed and read by the populace. Investigative journalism has been able to reveal corruption in some circumstances<sup>5</sup>. This is a vast improvement from the autocratic administration of Suharto where the press was highly restricted in reporting information adverse to government interests.

The legal system has been greatly improved from the Suharto administration. The judiciary has been granted independence and has tried and convicted many former Suharto administration officials, businessmen and family for serious crimes. In the past the judiciary would not have convicted or even put on trial administration officials or well-connected wealthy businessmen.

However, decentralization in Indonesian differs from the literature in several important areas. Local public service responsibilities are inadequately matched to local revenues and public accountability and strong legal institutions are not yet in place.

Decentralization in Indonesia is much more of an administrative decentralization rather than a fiscal decentralization. The central government continues to control a vast share of the revenues required for local governance under true decentralization. Local governments on average receive more than 80 percent of their revenues from the central government. This creates a disconnect between revenues received at the local level and expenditure decisions that are made locally.

Local governments are responsible for paying salaries that were previously paid for by the central government and paying for basic required services such as health and education. Consequently, local governments have increased spending responsibility without the additional locally controlled revenue base necessary to support extra spending.

Most central government assistance is provided to sub-provincial governments instead of provinces. Local governments receive shares of taxes, natural resource revenues that are returned to the region of origin and a general-purpose grant (DAU). The general aid formula (DAU) and other aids currently have the effect of granting more aid to less populated regions. This could encourage local governments to separate into smaller governments to reap additional benefits of central government financial assistance. There has been an increase in local governments from 300 to over 350

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<sup>5</sup> The Economist December 11 – 17<sup>th</sup>, 2004 “A survey of Indonesia”.

although there is no way to directly attribute the creation of additional local governments to the methodology of the aid formula.

The DAU aid formula from the central government is not strongly focused on combating poverty. The poverty aspect of the assistance formula in the DAU is not strongly based on the amount of poverty existing in a local area. If the region is poor in resources then the small amount of locally generated revenues combined with the funds received through the poverty methodology in the DAU formula is likely to be inadequate in reducing local poverty.

There is the very real danger of resource-rich provinces outperforming resource-poor provinces. Resource-poor regions receive approximately 80% of their funding from the central government. Resource-rich regions have the advantage of revenue derived from their resources as well as a DAU formula that provides aid in addition to the resource revenue. This could lead to vastly unequal economic growth occurring across the country. Presently, the central government has taken limited steps to curb this situation and the resolution of the aid disparity is likely to be politically contentious for all levels of government.

The decentralization process has led to the introduction of local laws, regulations and tax levies with little or no central government review. A survey of local taxes and charges implemented between April 2000 and June 2002 that were subject to review by the central government found that only about 40% of the new taxes and charges were actually submitted for review (Blane 2003a).

The implementing legislation for decentralization implies that any authority not explicitly given to the central and provincial governments are thereby provided to sub-provincial governments. Sub-provincial governments have been establishing laws and regulations that may run counter to good governance or the wishes of higher levels of government. Local governments have in effect realized that there was a void in authority and have been opportunistically filling that void to their benefit. The result of this is that no one government entity has a complete, comprehensive and unambiguous interpretation of the laws relating to decentralization.

There is no apparent decrease in corruption because of the decentralization. If anything corruption has maintained its grip in Indonesia and may have even grown stronger. Local officials have greater decision-making authority that can help citizens and businesses. These officials can now request bribes that were previously only available to more powerful central government officials. Moreover, there is little external formal review of local government expenditures and activities.

Local technical expertise or competence is questionable. The rapid onset of decentralization undoubtedly resulted in limited time to appropriately plan for the implementation of decentralization and assess its potential impact for each region. The central government has had to order local governments to rescind local laws harmful to business<sup>6</sup>. In addition, local governments are still in the process of fully implementing minimum standards for the delivery of public services. This could result in local governments at the same level providing different levels of service to the same or similar populations.

Former allies and beneficiaries of the Suharto-era have entered the democratic process at the sub-provincial level. Those who wielded power prior to the end of the

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<sup>6</sup> Straits Times April 25, 2002.

Suharto administration have harnessed the democratic process for their own financial and political gain. Local elections are expensive primarily because of political party machines and the bribery necessary in some circumstances to support a successful campaign for office. Additionally, media coverage in rural areas may be limited which further inhibits the transparency of elections.

Finally, the local press may be subject to undue influence by local politicians. (Hadiz 2004) If the local press can be compromised then a vital tool of accountability is unavailable to the local community.

## **THE FUTURE OF DECENTRALIZATION IN INDONESIA**

Indonesia is firmly on the road to decentralization. Local autonomy, transparency, and financial aid will be key to successful decentralization efforts. How Indonesia responds to these issues will provide the groundwork for the political and economic stability of the country.

Decentralization is perceived to greatly benefit the local regions that are granted autonomy. These regions are allowed a freedom in law and economy that was previously available only to the central government. Regional autonomy allows laws and regulations to be tailored to individual regions. The country is very diverse geographically and ethnically. The application of central laws in a "one size fits all" approach may have hampered regional growth and activities in the past. Autonomy should allow regions to create and implement legal and economic policies that are more efficient and applicable to their circumstances. However, this carries the danger that local governments may choose to ignore centrally promulgated laws and regulations that are disagreeable at the local level.

Jakarta will have to overcome a culture of mistrust between the central government and the provinces developed since the Suharto administration. Decentralization should help to reduce this distrust. However, this distrust was built over decades and is not likely to soon diminish.

Accountability and transparency will likely improve at least gradually because local officials have greater responsibility for activities. Those persons living in the autonomous regions should be able to exercise greater oversight and control of local officials over time.

Local governments receive intergovernmental assistance largely based on aid formulas from the central government. There are likely to be some adjustments in the aid to promote greater equity among the regions. However, the aid formulas may not change enough to substantially improve the current aid imbalances due to political compromises. Additionally, the central government has shown little desire to assign dedicated local revenues completely under local control.

If the aid formulas are changed in legislation the central government may have trouble providing additional funds. The central government revenue base is limited because less than the full potential amount of revenues is collected. Resources to collect taxes are limited and tax avoidance is common<sup>7</sup>. The central administration provides extensive fuel subsidies for citizens. In effect the central government, still responsible for

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<sup>7</sup> The Economist December 11 – 17<sup>th</sup>, 2004 "A survey of Indonesia".

many public sector activities, has less funding available to assist sub-national governments.

There is the danger that the central government, with the support of the military, may not pursue decentralization as strongly as they could because it would reduce their authority and provide limited benefit to their interests (central control over regions and resources). The central government may like to retain as much power as possible to influence local events and stifle secessionist impulses. The behavior of the military in Aceh province offers some evidence for this argument.

Many reformers in the government at the national and sub-national level support regional autonomy. However, there could be strong negative consequences if there is a perceived reduction in commitment to regional autonomy. It is entirely possible that a retrenchment of decentralization could stir political unrest in disaffected areas. Support for the rebels in Aceh province could continue and it could foster unrest in other provinces that feel the central government is unresponsive to local needs.

The policy of decentralization will likely have a mixed impact in the short run for several reasons. The reasons for the mixed impact are contained in the culture and geography of Indonesia where they have played and are likely to continue to play a significant role in the decentralization process.

The population of Indonesia is diverse and geographically scattered among many islands with their own traditions and languages. Indonesia has more than 13,000 islands, over 300 languages and over 20 cultural groups. If the President continues to promote the "One Indonesia" policy of his predecessor the policy is likely to have little more effect than past attempts because of Indonesia's large geography, multiple languages and cultures. The various populations may view regional autonomy with indifference or suspicion.

Corruption is a problem that has plagued Indonesia for decades. Corruption is rampant and touches almost every facet of Indonesian society. Unfortunately, already there is anecdotal evidence of corruption occurring more frequently at the local level. Transparency International (an international non-governmental organization devoted to combating corruption) ranks Indonesia a 2 on the Corruption Perception Index (CPI) out of 10. A rating of one represents an appearance of high corruption and a rating of 10 represents a highly clean business environment on the CPI. Granting regional autonomy puts more power in the hands of local officials and increases the ability of local officials to request and receive bribes and illegal gifts.

There is some anecdotal evidence of uneven development among the various regions. Some of this may be attributable to the resource-rich regions receiving greater revenues than the resource-poor regions via the intergovernmental aid formula. Significant care must be taken to ensure that funds for the different regions are distributed appropriately. If the allocation process is not consistently reviewed periodically to ensure fairness this could be a cause of political contention.

If local regions press for greater autonomy or certain groups openly rebel against the central government then the Indonesian government may feel justified in curtailing aid to the region. The provinces of Aceh and Papua are the most likely provinces to pursue armed rebellion against the central government. These actions would exacerbate many of the negative social conditions such as poverty and unemployment that currently exist in many of the regions.



The unlikeliest result of failed regional autonomy would be secession by one or more provinces from the country of Indonesia. It was widely feared that resource-rich regions would secede in the absence of a strong central government after the end of the Suharto administration. Indonesia was able to maintain cohesion by compromising with secessionist elements and allowing regional autonomy.

## **RECOMMENDATIONS**

Significant changes are needed in Indonesia to implement better governance. These changes should focus on fostering cooperation between the different levels of government with the aim to enhance service provision, ensure the democratic process is unhindered, provide dedicated local revenues, and promote a legislative and administrative culture of efficiency and responsiveness.

Cooperation between the different levels of government is essential to providing cost-effective and efficient public services. The inequitable distribution of central government aid and the ability of local governments to issue rules and regulations specific to their sub-national government hinders intergovernmental cooperation. Resource-rich regions may provide better services than resource-poor regions and there is no direct incentive to cooperate and provide services jointly.

The democratic process needs to become a natural and consistent aspect of government at both the national and sub-national level. Local government posts need to become fully competitive and strong measures taken to prevent vote buying and intimidation.

Provinces and sub-provinces need to receive true locally generated and collected revenues that have been sanctioned by the central government. Presently, this is the exception rather than the rule. There have been recommendations to distribute the property tax to local governments (Lewis 2003) or allocate a portion of receipts from the national income tax to local governments (Ryder 2002). Other ideas have advocated for resource-rich regions to receive reduced or zero funds from the DAU and instead have the DAU funds provided solely to the poorest regions (World Bank). Implementing these ideas would place greater responsibility on sub-provincial governments to spend money wisely because it is truly their own funds and not central government money.

Effective governance is not possible in a corrupt environment. Greater accountability and transparency will go a long way to creating a climate of honesty. The perceived climate of dishonesty is substantiated by the Transparency International rankings and can only negatively impact regional investment and economic growth.

A strong judiciary and dispute resolution is a strong underpinning to the legal framework of any society. Indonesia's judiciary is widely considered partial to the central government and inefficient. In the case of decentralization this means that disputes arising over the interpretation of law could be drawn out and the results unduly favoring the central government or ambiguous to one or both parties. However, the Indonesia Supreme Court is actively hearing cases that arise from central and local government disagreements. It is hoped that the Supreme Court will be able to render impartial and fair rulings.

The current decentralization laws should be further clarified through legislative action. Further clarification is necessary to clearly define sub-national authority and the authority that rests with the central government. Unfortunately, there are many vested interests that created the present situation and there may be political resistance to changing the status quo.

Provincial and sub-provincial activities should be formally reviewed on a routine basis. Currently, the local levels of government operate with significant autonomy to interpret laws as they see fit and on several occasions responding to central government information requests at their convenience.

## **CONCLUSION**

True democratic decentralization in Indonesia has not occurred and the present attempt has been co-opted to a certain extent by Suharto-era bureaucrats, politicians and business people. This situation is not too different from Russia after the fall of communism. It will likely take some of the reforms outlined in this paper and further technical assistance to bring better governance to Indonesia's decentralization effort.

Indonesian decentralization is mainly political and administrative decentralization. The political and administrative decentralization effort has had mixed results. Sub-national governments have used their newfound authority to implement conflicting rules and regulations and are in effect attempting to establish precedent that could be difficult to reverse in the future.

Fiscal decentralization will most likely be difficult to implement because of political pressure to maintain the status quo and a desire of the central government to retain financial control of revenues. However, the central government should use some of their financial control to promote equity among the various regions of the country.

Currently, Indonesia fails to fully meet the World Bank's criteria for successful decentralization. Indonesian local governments lack financial resources completely under their control to provide public services, accountability and transparency mechanisms are not fully implemented, and the legal system is not as effective as it should be in order to facilitate decentralization.

The decentralization being implemented in Indonesia continues to be vague and outcomes vary because the inputs (e.g., interpretation of laws, extent of local authority, central government aid, etc.) are highly dynamic and accountability is poor.

One victim of the uncertainties surrounding decentralization is business. It is difficult to invest in an area of Indonesia if one is unsure how to navigate a multitude of laws and taxes imposed by the central government, provincial and sub-provincial governments. The laws and taxes, sometimes implemented haphazardly, combined with perceived and actual corruption (bribery) creates an unfriendly business environment. This hampers investment and could continue to plague the country's chances for economic growth.

Decentralization can be improved in Indonesia. The several issues highlighted in this paper need to be addressed at both the national and sub-national level. Significant political effort and compromise at all levels will be required to make progress and improve upon the successes that Indonesia has already realized.

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