Governance and Poverty Reduction: Evidence from Newly Decentralized Indonesia.

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Abstract

This study is the first attempt to systematically examine the impact of bad governance practices in Indonesia on poverty reduction. Indonesia is a country that has endured bad governance for a long period, but also has sustained significant poverty reduction. Prior to the onset of the economic crisis in mid 1997, the problem of bad governance in Indonesia was apparent but mostly ignored because it was compensated by high economic growth. The advent of the economic crisis, however, has highlighted the seriousness of the problem. This study focuses on the impact of bad governance on the poor, the people who are most vulnerable to the impact of bad governance. By assembling scattered anecdotal evidence on how past and current practices of bad governance in Indonesia have hurt the poor, this study shows that the adverse impact of bad governance on the poor is real, systematically affects many people, and undermines the efforts to reduce poverty in the country. More systematic evidence on how bad governance affects poverty reduction indicates that indeed regions that practice better governance experience faster poverty reduction and *vice versa*.

Keywords: governance, corruption, poverty, Indonesia

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1. INTRODUCTION

The ongoing economic crisis in Indonesia, which started in mid 1997, has brought back attention to the issue of poverty reduction. High economic growth during the previous three decades has been successful in reducing absolute poverty in the country. Between the early 1970s and the onset of the crisis, the official poverty rate was reduced by more than 50 percentage points. Due to the crisis, however, the poverty rate doubled, wiping out many years of progress and putting the issue of poverty back into prominence.[1]

At the same time, in searching for the causes of the crisis, the issue of governance was brought into the limelight. The hypothesis put forward was that bad governance – popularly known as KKN (corruption, collusion, and nepotism) in Indonesia – has weakened the Indonesian economy, making it prone to suffer from periodic crisis. Corruption was a notorious trademark of the New Order regime, which was famous for tolerating petty corruption by low level officials as a means to supplement their meager salaries as well as promoting mega corruption by twisting government regulations to support the interests of the first-family and their cronies. Often this was accompanied by collusion with businesses – domestic as well as foreign entities – at the expense of the general public. Nearing its final years, the New Order corruption reached its nadir point through the practice of nepotism. Family members and close friends of the first-family were appointed in executive as well as legislative positions.[2]

Bad governance during the New Order and its successor governments has made Indonesia for a long time tops the list of the most corrupt countries in the world. However, prior to the onset of the economic crisis in mid 1997, the problem was mostly ignored. This is primarily because the economy was expanding, which was a result of the high economic growth experienced by the country. For most people, this was enough to compensate the losses and inefficiencies due to the bad governance. The advent of the economic crisis, however, has highlighted the seriousness of the problem. The People Consultative Assembly (MPR), the highest representative body in

[1] See Suryahadi, Sumarto, and Pritchett (2003).

[2] See King (2000) and McLeod (2000).

Indonesia, even issued a decree on the need to create clean and good governance in the country. Efforts to achieve this, however, have so far proved difficult and elusive.[3]

Recent thinking on poverty reduction and governance argues that both are interrelated. Bad governance has made poverty reduction efforts ineffective,[4] while poverty reduction projects provide a fertile ground for corruption.[5] The consensus that emerges from this line of thinking is that good governance is necessary for poverty reduction efforts to be effective.

The reminder of this paper consists of the following. First, it reviews theories and definitions of governance and its links with poverty reduction and corruption. Next, it discusses the existing literature on governance, poverty, and corruption, both internationally and in the Indonesian context. Then, it proceeds with our research on governance and poverty in Indonesia, compiling scattered anecdotal evidences on how bad governance has hurt the poor as well as conducting more systematic analysis on how governance affects poverty reduction. Finally, this paper provides conclusion and policy recommendation based on the findings.

2. THEORIES AND DEFINITIONS OF GOVERNANCE, POVERTY REDUCTION, AND CORRUPTION

2.1. Governance

Governance is an old concept that originates from early democratic political theory that discusses what the relationship between the rulers and the people they ruled should be like. For instance, in the 19th century Woodrow Wilson defines a government that practices good governance as "a government that can properly and succesfully ….. with the utmost possible efficiency and at the least possible cost of either money or of energy" (cited in Laporte 2002:3).

However, only in the past decade or so did governance gain significant attention in the international policymaking arena. This was motivated by a concern that bilateral and multilateral assistance from the developed to developing world had failed to reach its goals (i.e. reducing poverty, promote sustainable economic growth, etc.). This was

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[3] See Hamilton-Hart (2001) and Sherlock (2002).

[4] See Blaxall (2000), Eid (2000), and Gupta, Davoodi, and Alonso-Terne (1998).

[5] See, for example, Woodhouse (2001).

because of poor administrative capacity of the developing countries' governments to administer these projects and widespread corruption. From this, donors concluded that good governance is essential for the success of their assistance in the developing world. Since then, they have begun linking development assistance to the adoption of good government practices by the developing countries.

There are several definitions of governance that are put forward by different bilateral and multilateral lending agencies. Some of them are described here. The World Bank (1992) defines good governance as:

> A public service that is efficient, a judicial system that is reliable, and an administration that is accountable to its public ..… Good governance, for the World Bank, is synonymous with sound development management ..... [It] is central to creating and sustaining an environment which fosters strong and equitable development, and it is an essential complement to sound economic policies.

Furthermore, the World Bank (1992) defines three different dimensions of governance: First, the form of a political regime (parliamentary or presidential, military or civilian, and authoritarian or democratic). Second, the processes by which authority is exercised in the management of a country's economic and social resources; and third, the capacity of the government to design, formulate, and implement policies, and, in general, to discharge governmental functions.

In 1995, in a speech that outlined his country's new policy on foreign assistance to developing countries, the United States Vice President Albert Gore, Jr. as cited in LaPorte (2002: 4) states the five principles of good governance, which are: (1) The administration of the state must be honest and transparent; (2) The administration of the state should be streamlined and as efficient as possible; (3) The government must decentralize as many functions as possible and deliver services as close to the people as possible; (4) Democratic states must make provisions for the security of their people; and (5) Democratic states must rely on an open and modern judiciary.

Meanwhile, the United Nations Development Program (UNDP 1997) defines governance as:

> The exercise of economic, political, and administrative authority to manage a country's affairs at all levels. It comprises of the mechanisms, processes, and institutions through which citizens and groups articulate their interests, exercises their legal rights, meet their obligations, and mediate their differences.

Finally, the World Bank economists Daniel Kaufmann, Aart Kraay, and Pablo Zoido-Lobation (1999) define governance as:

> ….. the traditions and institutions by which authority in a country is exercised, including (1) the processes by which governments are selected, monitored, and replaced, (2) the capacity of the government to effectively formulate and implement sound policies, and (3) the respect of citizens and the state for the institutions that govern economic and social interaction among them.

In sum, governance is a multidimensional concept which consists of political, economic and sociocultural variables that determine whether public policy designed by the government could achieve its intended goals and improve the welfare of society. From the various definitions of good governance above, Kinutha-Njenga (date unknown) conclude that the practices that are considered to become criteria that a country is practicing good governance are as follow:
(1) The government of the country is democratically elected and promotes/protects human rights and the rule of law; (2) There is a strong and healthy civil society movement in the country; (3) The government of the country is able to create and implement effective public policy; and (4) The government of the country organizes the country's economy along the premise of free, competitive, and efficient markets.

2.2. Governance and Poverty Reduction

Along with the new thinking on governance, donors also incorporate a new thinking on poverty and the relations between these two variables. They recognize that poverty is a multidimensional concept and is not limited to economic terms alone. Beside a lack of income, the poor also suffers from a lack or a complete absence of services (public utilities, public transportation, health care, education, credit, etc.) and a lack of participation in social, economic, and political decisions at the local, regional, and national level. Because of this, the poor often feel that they are excluded, and helpless when their rights are violated and exploited by the wealthy and the powerful (Eid 2000).

Drawing from the experience of more than fifty years of development assistance to developing countries, developed countries and multilateral lending institutions now conclude that good governance is a necessary prerequisite for poverty reduction, because of the following: Firstly, without good governance, the scarce resources available are not generally put to their best use in combating poverty. This is often due to a lack of transparency, rampant corruption, and an uncertain legal system which hinders the economic growth that could help pull the poor out of poverty. Secondly, good governance is necessary if all aspects of poverty are to be reduced, not just through an increase in income, but also through empowerment and increasing the economic, political and social opportunities for the poor (Blaxall 2000; Eid 2000).

To accomplish these goals, institutions that support governance need to be reformed and strengthened. In the past decade, donors have created governance support programs that assist developing countries in reforming their civil service and strengthening their institutions, with the hope that improved governance will create an economic and political climate that will increase economic growth in these countries and eventually draw the poor populace out of poverty. For instance, the World Bank started its governance program in 1992 and the Asian Development Bank (ADB) started a similar program in 1997. On a bilateral level, USAID formally launched its governance program in 1995, while DFID (United Kingdom), CIDA (Canada) and GTZ (Germany) started their governance program in the early 1990s.

The focus of these programs are: civil service reform both at the central, regional and local government levels, legal and judicial system reform, legislative institutions reform, capacity building of NGOs and other civil society organizations, and government efficiency and effectiveness reform (LaPorte 2002; Eid 2000). On improving the welfare of the poor, the World Bank's governance reform program has four aims: (1) Empowering the poor; (2) Improving the capacity of the poor by improving basic services; (3) Providing economic opportunities by increasing access to markets; and (4) Providing security from economic shocks and from corruption, crime, and violence (Blaxall 2000).

It is hoped that through these programs, the goal of lasting poverty reduction and improved governance in the developing world can be finally achieved.

2.3. Corruption

Corruption, as the opposite of good governance, is defined by the World Bank as the abuse of public office for private gain. Corruption scholar Robert Klitgaard hypothesizes that corruption is more likely to occur in an environment where officials have monopolistic control over state resources and a high level of discretion over who can gain access to those resources, while at the same time the mechanisms for holding these officials accountable for their actions are weak or non-existent.[6] It is widely recognized today as a symptom of poor governance and a major obstacle to poverty reduction efforts. While in the past, some argued that corruption could increase economic efficiency in countries with burdensome regulations and a dominant government role in the economy,[7] today most scholars studying corruption believe that it curbs economic growth, degrades social and political institutions, and hinders efforts toward poverty reduction. Especially for the poor, corruption could create adverse consequences for them, both directly and indirectly.

There are some avenues through which corruption makes poverty reduction efforts ineffective: (1) Corruption diverts funds for poverty reduction to the pockets of corrupt officials; (2) Corruption twists the budget allocation away from poverty reduction to other projects more closely associated with the interests of corrupt officials' (3) Corruption creates a high-cost economy, obstructs the creation of a healthy and conducive economic environment, which is essential for the poor to work and do business; (4) Corruption jeopardizes the property rights of the poor, since corrupt officials often force the poor out of their homes and off their land, so that they can be used for development projects sponsored by the developers who bribed them; and (5) Corruption prevents the poor from getting justice in the court, since corrupt court

[6] Klitgaard (1998).

[7] This is commonly known as *the grease hypothesis*.

officials sell their decisions to the highest bidder, which makes court decisions biased toward wealthier parties.

Corruption also hurts the poor indirectly through:

(1) Increasing the prices of goods and services that need to be paid for by the poor; (2) Reducing incomes of the poor by way of semi-legal and illegal taxes and levies; (3) Diverting support measures provided for the poor from the hands of the poor to ineligible parties; (4) Creating asset-ownership inequality, since the wealthy can influence the government to pursue policies that will increase their wealth (such as favorable tax treatments and exchange rates) that are not available to the poor; and (5) Discouraging the poor from making new investments or opening new businesses, because they know that the well-connected business people will always win government projects and contracts due to corruption. As a result, they can not increase their living standards, but remain poor.

In sum, there is a strong consensus that good governance is necessary for poverty reduction efforts to be effective and for reducing corruption.

3. LITERATURE REVIEW

3.1. Cross-Countries Macroeconomic Studies on Governance and Corruption

There has been an explosion of literature that studies the impact of corruption and governance on economic growth and various economic and social indicators in the past decade or so. These studies use cross-country data on corruption and data on perceptions of governance collected by both commercial firms that measure political risk for their clients (such as Political Risk Services, Inc) and by International Governmental and Non-Governmental organizations (The World Bank, Transparency International).

A landmark World Bank study done by Kaufmann, Kraay, and Zoido-Lobaton (1999), which for the first time combined the various governance and political risk indices that measure variables such as political rights, civil liberties, government effectiveness, regulatory burden, rule of law, and graft/corruption into a single index found that good governance does matter for economic outcomes. For example, they found that one-standard deviation increase in any one of the governance indicators caused between a two and a half, and four-fold increase in per capita income, between a two and a half and four-fold decrease in infant mortality, and a 15 to 25 percent increase in literacy. This study shows with clear evidence that good governance is very crucial for economic growth and improved social indicators.

Another study by Rajkumar and Swaroop (2002) found that efficiency in public spending reduced child/infant mortality and increased educational attainment and is positively related to governance. It is more effective if governance is good and less effective if governance is poor. They conclude that well-functioning public institutions are critical for translating public spending into effective services.

Several studies that have linked corruption and good governance with economic and social indicators find that there is an inverse relationship between them. Good governance increases these indicators while corruption decreases them. For instance, Gupta, Davoodi and Alonso-Terne (1998) found that an increase of corruption by one standard deviation is associated with an increase in Gini coefficient of about 4.4 percentage points and a reduction in income growth for the bottom 20% of population by 7.8 percentage points per year. Meanwhile, Gupta, Davoodi and Tiongson (2000) found that better health and education outcomes-measured by child mortality and drop-out rates-are correlated with lower corruption, while countries with high corruption have worse health outcomes compared with countries with low corruption.

Finally, Huther and Shah (1998) found that decentralized countries have better governance than the more centralized countries. They shows that citizen participation and public sector accountability go hand-in-hand with decentralization of public sector decision making. Decentralized countries are more responsive to a citizen's preferences in service delivery and strive harder to serve people than centralized countries. Furthermore, fiscal decentralization goes hand-in-hand with an increase in the human development index and a decrease in income inequality.

However, to conclude that decentralization per se will increase public participation and accountability and result in better public services is a fallacy. A study done by Crook and Sverrison (2001) found that only in countries with well-established public participation schemes, local government that practices good governance and is capable in delivering good quality services to the public, and functioning checks and balances mechanisms from both the central government and the general public, that decentralization could be considered successful. In contrast, decentralization without a local government that practices good governance and is accountable to the public would not be successful in achieving its intended goals.

3.2. Empirical Evidence from Governance and Corruption Research in Indonesia

Since the fall of the New Order, there has been a lot of interest in finding out about the numerous aspects of corruption in Indonesia, the exact level of corruption in Indonesia and its implications for Indonesians, especially for the poor. There is also a strong interest to find out whether anti-corruption and good governance reform proposals created by the Indonesian government since "reformasi" began in 1998 has made any impacts on actually reducing the level of corruption. Regional autonomy, that has been implemented in Indonesia since 2001, has also helped to focus attention on corruption and governance at the local level, since many parties have feared that along with fiscal decentralization, corruption will also be decentralized from the central to the local level. Both the donor agencies, research institutions, and civil society groups have conducted several studies on the above topics. Some of their findings are summarized below.

Research on the impact of anti-corruption reforms in Indonesia has shown that, so far, they have been ineffective in actually reducing corruption in Indonesia. In fact, one could argue that since 1998 corruption has actually gotten worse. For example, corruption has now spread into the parliament, the institution that is supposed to be a watchdog on the executive branch. While the Indonesian government has made changes that has promoted democracy and free press in the country, instituting legal reforms[8], and creating greater fiscal and financial transparency, Hamilton-Hart (2001) finds that these reforms have been ineffective in actually reducing corruption in Indonesia. Furthermore, they have failed to result in successful prosecution of any major defendants that were accused of corruption. She believes that these reform measures are ineffective because corruption has become so entrenched in Indonesia that no one within the Indonesian government is really interested in seriously fighting corruption because such an act would only hurt their own rent-seeking interests.

[8] For example by creating new bankruptcy court and the appointment of *ad hoc* judges from outside the bureaucracy.

Sherlock (2002) confirms this conclusion by pointing out that the two new bodies dedicated to monitor and fight corruption – the Indonesian Ombundsman's Commission (KON) and the State Official's Assets Auditing Commission (KPKPN) – were given neither adequate funding nor effective power to conduct thorough investigations and prosecute corrupt officials by the government decrees that mandate their creations. He hypothesizes that this is done deliberately so that these commissions would only become "toothless tigers" that would not seriously combat corruption in Indonesia and, therefore, the practice of corruption done by government officials in all levels would continue uninterrupted. Thus, he concludes that merely creating new anti-corruption bodies would not have any actual impact in reducing corruption if there is no political will to make sure that these bodies would function effectively as stated in the statutes that created them.

The Partnership for Governance Reform in Indonesia (PGRI) has conducted a national opinion survey on how public officials, businesses, and the public at large, perceived the level of public sector corruption in Indonesia.[9] The study found that 75% of the public regarded public sector corruption to be very common and that 65% of respondents reported that they have experienced corruption involving public officials. The institutions that are perceived as corrupt by the people sampled are the traffic police, custom officials, and the judiciary. The study estimated that about 48% of all public officials have received unofficial payments, with bureaucrats from the Departments of Housing, Industry and Trade, and Home Affairs as more likely to receive such payments. It is also found that corruption imposes high cost on the society: up to 5% of household income was used to pay bribes to public officials and 35% of business enterprises reported that they have not made new investments due to the high cost created by corruption.

The Institute for Economic and Social Research (LPEM) at the University of Indonesia recently conducted research on the business climate in 60 district/city governments (LPEM 2001). It conducted interviews with the owners and managers of 1,736 medium and large-sized companies. The study finds that regional autonomy has increased business uncertainty and the cost of doing business at the local level (measured through the increase in the unofficial payments made by businesses). It also

[9] PGRI (2001).

finds that extra payments made to government officials does not necessarily reduce economic efficiency but rather increases it, since often businesses have to spend more time and paperwork when they are dealing with government officials, even with the unofficial payments. However, the report also discovered that the frequency that unofficial payments must be made is lower in the districts that have better regulations and better governance, so there is evidence that good governance does decrease corruption. However, the ability of the districts to generate their own revenue does not correlate with better governance, because of the these districts are more prone to higher levels of unofficial payments and corruption.

Another regional-level business climate survey was conducted by the Regional Autonomy Implementation Monitoring Committee (KPPOD) in 2002. It selected 90 regions (68 districts and 22 cities) and measured the business climate of these regions by measuring their security, economic potential, human resources, local government's culture, infrastructure quality, local government's regulations (Perda), and regional finances. The study used both primary sources (interviews with business executives, journalists, and economic experts) and secondary sources (news accounts and information from the public). It found that regions that attract more businesses are more likely to have better security, better local government's culture and regulations, and better human resources, which confirms the assertion that good governance is necessary condition for businesses to invest in a region.

Finally, a study on how public participation affects the level of corruption in local government projects, using the World Bank's Kecamatan Development Program (KDP) as a case study shows that corruption occurred in KDP projects because of the existence of incentives and opportunities to commit corruption. These included a monopoly over the decision-making process, lack of transparency, and low probability of getting caught and punished. Village people who are well informed about KDP, its goals, and are participating in its planning, are more likely to challenge corrupt practices done by local government officials (Woodhouse 2001). Thus, this study confirms that if the public are actively involved in the planning of government projects that are intended to benefit their communities, they are more likely to speak up when they detect corrupt practices. This hopefully will deter corrupt practices occurring in the future.

3.3. Some Possible Flaws in Governance and Corruption Studies

There are several caveats that one needs to consider when reviewing these studies. First, the data that is required to construct a good governance study is often hard to find (and for the prevalence of corruption, objective data is impossible to find). Even if found, often it would not satisfactorily explain all the dimensions of good governance, since as noted above, it is a multidimensional concept with multiple interpretations. Since there is no single variable that could measure governance, subjective or proxy indicators are used instead to measure it, which means that the variables the studies used are not really the ones that the studies intended to measure. As a result, an inexperienced researcher could be "fooled" by the data, that is, they may think they are measuring one thing when in fact they are measuring another, or they could think that they are measuring a direct, first order effect between two variables when in effect they are second or third order variables (Dethier 1999:37-38; Kaufmann, Kraay, and Zoido-Lobaton 1999:2).

On the other hand, if a study only focuses on a single country, these problems could be minimized because it is possible to focus the study on a small number of policy variables that are easier to observe. However, at this time single country governance studies are not as plentiful as cross country studies, even though the number of these types of studies is growing (Dethier1999: 46-47).

In regard to the studies about governance in Indonesia mentioned above, the fact that the LPEM and KPPOD studies are based on the opinions by a selected panel of experts (such as business owners, journalists, and NGO leaders) that might not be representative of the general public as a whole could cause concern. This is because some of them might possess opinions that are not shared by the public at large or they may have information that is either out of date or inaccurate regarding the regions that are being studied. This may occur because they lack a comprehensive understanding of these regions. The PGRI study has more validity because its sample is derived from the general public instead of a group of experts, however it is only a public opinion study regarding the pervasiveness of corruption in Indonesia and does not ask more specific questions about certain aspects of governance and corruption (such as the quality of local regulations) that are being asked in the other studies.

4. GOVERNANCE AND POVERTY IN INDONESIA: EMPIRICAL EVIDENCE

This paper is the first attempt to review the relationship between good governance and poverty in Indonesia, where the paradox has been very profound. During the three decades of the authoritarian New Order Government in Indonesia starting in the late 1960s, the country endured various forms of blatant bad governance. Petty corruption as well as mega-corruption were incredibly entrenched and pervasive in the bureaucracy. Yet, at the same time, the country enjoyed a very significant reduction in absolute poverty. This reduction in poverty was driven mainly by high economic growth experienced by the country during this period.

The paradox between bad governance and poverty reduction experienced simultaneously by the country makes the effort to sort out the impact of bad governance on poverty a difficult undertaking. Therefore, the strategy adopted in this study is to utilize variations across districts in their governance practices and the poverty reduction that occurred. The adoption of a wide-ranging decentralization and regional autonomy policy starting in 2001 is beneficial to this strategy as such a policy tends to enhance differences across regions. The first part of this section provides a prologue on the decentralization and regional autonomy policy. It is followed by anecdotal evidence of how the practices of bad governance hurt the poor. The final section investigates the impact of governance on poverty reduction using district level data.

4.1. Prologue: Indonesia's Decentralization

Indonesia's decentralization and regional autonomy policy – which is stipulated in Law No. 22/1999 on Local Government and Law No. 25/1999 on Central-Regional Fiscal Balance, which both were enacted in January 2001 – involves not only administrative but also political and fiscal decentralization. Figure 1 describes the basic structure of authorities and functions of the central, provincial, and district governments stipulated in both laws. These laws have reversed the New Order's centralized approach. Now the responsibilities and functions of the district governments are by and large expanded, while those of the central and provincial governments are reduced.

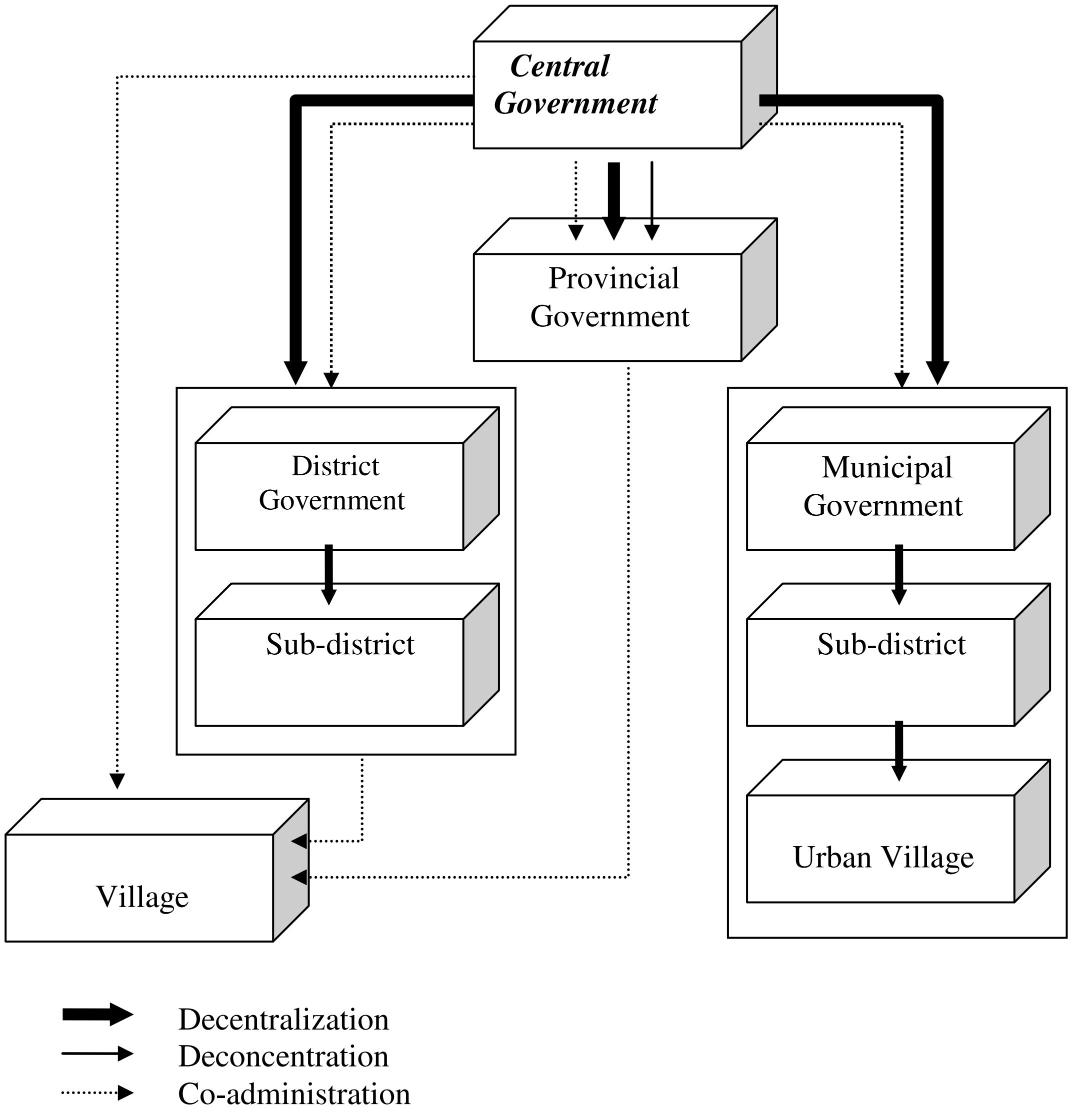

Figure 1. Basic Structure of Government Authorities According to Law No. 22/1999

According to Law No. 22/1999, all government authorities are now the authority of autonomous region, except for five authorities which remains with the central government. These are: foreign affairs, defense and security, justice, fiscal and monetary affairs, religious affairs, and other authorities.[10] Authorities of provincial governments include all authorities with inter-districts coverage, authorities delegated

[10] There are many critiques about this clause because of its ambivalent nature.

by the central government, and all authorities beyond the capability of district governments.[11]

Since the emphasis of decentralization and regional autonomy policy lies with the district governments, authorities given to the districts are very wide-ranging. In this respect, Law No. 22/1999 grants authorities to district governments which include all other authorities which have not been covered by the central and provincial governments. These include: public works, health, education and culture, agriculture, transportation, industry and trade, investment, environment, land, cooperative, and labor matters.

In line with the expanded local government authorities and functions prescribed by Law No. 22/1999, Law No. 25/1999 sets a new inter-governmental fiscal framework, by drastically changing the disbursement arrangement. A much larger transfer in the form of *Dana Perimbangan* (the equalization fund) replaced the Subsidy for Autonomous Regions (SDO) and the Grants to Local Governments (*Inpres Kabupaten/Kota* and *Inpres Desa*) programs. The equalization fund consists of three parts:

1. **Revenue sharing.** The intended purpose of this component is to overcome/reduce vertical imbalance/inequality. This component is introduced in response to the demands of the rich-resource regions for a fair share of revenues extracted from their regions.
2. **General allocation fund (DAU).** This is a block grant intended to equalize fiscal capacities of regional governments to finance their expenditure needs. The law specifies that DAU should at least make up 25 percent of the central government revenue and must be distributed among local governments by a formula which takes into account regional needs and potential capacity. In the fiscal year 2001, DAU accounted for around 74 percent of the equalization fund.
3. **Special allocation fund (DAK).** This is an earmark grant that is developed to finance special needs that either cannot be determined by formula used for DAU allocations or categorized as national priorities and commitments.

[11] Specifically, authorities of the provincial government are regulated under Government Regulation (*Peraturan Pemerintah*) No. 25, 2000 regarding the Authority of the Central and Provincial Governments as Autonomous Regions.

4.2. Bad Governance in Action: Anecdotal Evidence

4.2.1. Pre-Crisis Era

This section presents anecdotal evidences on how bad governance hurts the poor during the pre-crisis era. One source of the anecdotal evidences discussed was Montgomery *et al.* 2002, which focus on the agricultural sector, i.e. the sector where most of the poor in Indonesia find their livelihoods. In February 1999, the agricultural sector had the highest sectoral poverty rate as well as held the largest number of poor people in the country. The agriculture sector's 1999 head-count poverty rate was 39.7%, and more than 58.4% of the total of poor people gave their primary field of occupation as agriculture.[12] During the economic crisis, agriculture was the only sector to absorb large numbers of the newly unemployed. While other sectors shrank, employment in agriculture rose by 13% or 4.6 million people in just one year, from 34.8 million in 1997 to 39.4 million in 1998.

During the 1980s and much of the 1990s, there was growing concern about the welfare of farmers, based on perceptions that farmers received an increasingly smaller percentage of the final prices for their goods. Incentives to supply the market seemed to be falling over time. Indonesia's economy was not an internal free trade area. The problems fell into two categories, price distortions and non-price distortions. Provincial and district taxes (*pajak*) and levies (r*etribusi*) on agricultural trade led to distorted prices. Some of the taxes and levies were legal, but many were not. Among non-price distortions, regulatory controls on national, provincial and district agricultural production and agricultural trade created local monopolies and monopsonies. Other controls such as central government livestock inter-island shipping maximum levels and quota rights presented barriers to entry and restricted competition. Once the regulations were abolished or could be ignored, monopoly and monopsony power disappeared.

Provincial and district governments do not have the authority to tax income or assets. All of them have therefore turned to taxing trade. Regulations authorizing provincial or district governments to apply taxes or levies are officially issued by local parliaments (DPRD). But in the past, most such regulations were drafted by local administrations, then approved by DPRDs without serious review. Seldom were elements of civil society presented with a chance at hearings or feedback on draft

[12] See Pradhan *et al.* (2000).

revenue legislation before enactment. Trade levies and charges for government-provided services became an important revenue base available to local governments. They became dependent on this restricted fiscal base. Local levies called *retribusi* had a more serious impact than local taxes. Such levies were originally intended by law to be a form of cost-recovery to government, a user-charge for facilities or services provided. Over time *retribusi* levies were extended to include compensation to government for extraction of non-renewable natural resource products (since all natural resources belong to the people of Indonesia). The definition of natural resource products (*hasil bumi*) then was extended to include agriculture, which is renewable and not owned by government. In fact *retribusi* levies became a trade tax on goods shipped outside of a district. Levies mushroomed. Trucks were stopped at *retribusi* posts every few kilometers along the road. The levies were against physical quantities traded, with no link to profitability, net income or value-added. Ability-to-pay (the level of income of the original producing farmer) was also not taken into account. Methods of collection (stopping trucks along isolated rural roads) led to abuse; much of the money collected did not make its way into official coffers. Agricultural product prices became badly distorted by *retribusi* levies. The impact of levies was highest for products from forestry, livestock and fisheries.

The first significant reform of local taxes and levies came with the passage of a central government revenue Law No. 18/97 that restricted the types of local taxes and *retribusi* levies permitted. It reduced regional taxes from the existing 42 to 9. It also reduced *retribusi* levies from the existing 192 items to only 30.

Government at all levels created, inspired and supported local monopolies, monopsonies and inter-regional trade quotas for the favored few. These distortions drove wedges between farm-gate prices (driving them lower) and destination market prices (driving them higher). The price difference ("rent") was to the advantage of the holder of the monopoly, monopsony, or quota right. Benefits of these price wedges were shared with the people who gave such rights. Many were specifically created to benefit the children or cronies of the then first-family. The following describes several specific examples of the practices of bad governance.

Oranges from West Kalimantan. Until the early 1990s citrus production was increasing rapidly in West Kalimantan, from just 76,000 tons in 1988 to 199,800 tons in

1991/92. Almost all West Kalimantan's citrus production was shipped to Java. In 1991 the West Kalimantan Governor issued a decree stating that PT Bima Citra Mandiri (a member of the Bimantara group controlled by a son of the then first-family) was appointed to be the official "coordinator" of all citrus trade. All citrus trade had to pass through KUDs (*Koperasi Unit Desa*, Village Unit Cooperatives). Farmers could sell only to KUD-appointed collection-traders, who were then required to sell to Bima Citra Mandiri for inter-island trade. Farm-gate prices dropped precipitately. Exports from the province fell by 63%. Angry orange producers brought truckloads of oranges into Pontianak and dumped them in front of government offices in protest. Many orange producers abandoned their trees, not tending them since. The 1991 monopsony right granted to PT Bimantara Citra Mandiri was abolished by a Governor's decree that "encouraged" (but no longer required) marketing through KUD cooperatives. But the orange trade has never recovered.

Required local processing of cocoa and cashew nuts in South Sulawesi. Cocoa and cashew nuts are important export crops for Sulawesi. They are particularly important in isolated upland poverty districts that do not have much flat or gently rolling land suitable for rice or other grain cultivation. For instance in Polmas district, in the hilly northwestern part of South Sulawesi, there were 27,764 hectares of cocoa, grown by 43,361 families in 1998, about 30% of all Polmas farm families. Polmas had a smaller area of cashew (2,914 ha) but it was the main source of income for another 6,700 poor upland farm families. In another poor area surveyed, Bone district, cocoa was important for 25,192 farm families (27% of all farm families), who operated 10,490 hectares of cocoa trees. In Bone, cashew was the main source of income for another 11,706 families (13%) who tended 9,050 hectares of cashew trees.

South Sulawesi's smallholder plantation crop producers were faced with a regulation that required cocoa beans and cashew nuts to be processed within the province. The largest cashew nut processing factory in Ujung Pandang benefiting from the regulation was PT Citra Sekarwangi Agro Persada, part of the Citra group and owned by a daughter of the then first-family. Cashew nut buyers wanted unprocessed cashew nuts (for export in the raw state to lower-cost processors in India) and were willing to pay higher prices than South Sulawesi's cashew processing factories were willing to pay. Also the main cocoa bean importing country, the United States, wants only unfermented cocoa beans. Required local processing in this case was not value-adding but instead was value-subtracting.

After experiencing the impact of *de facto* deregulation, the cocoa bean and cashew nut processing industries tried again in 1999 to ask government to force high-cost local processing. It requested the government to impose a 20% to 30% export tax on unprocessed cocoa beans and cashew nuts to help guarantee supplies of raw materials to existing (favored) processing factories. By this time elements of civil society were more vocal about the impact of government-created marketing restrictions. Many saw this move as one-sided, helping local processing firms but harming farmers, forcing down the farm-gate price received. The Cocoa Association of Indonesia (*Askindo*) objected strongly to the proposal, as did both the Indonesian Farmers Union (HKTI) and the Association of Indonesian Food and Beverage Producers. Only the Cashew Nut Industry Association of Indonesia supported the move to impose an export tax. The secretary-general of this association stated that the farm-gate price of cashew nuts was rocketing upward, benefiting the farmers, to the detriment of processors. As of July 2001, it appears that the lobbying by the Association has not been successful and there are no new export taxes on cashew nuts. There are also no new export taxes on cocoa beans.

Clove Marketing. Cloves were an important source of income for upland farming areas in Sulawesi. For instance in impoverished Polmas in South Sulawesi, cloves were the main source of income for 2,000 farming families (growing 882 ha). In another district studied in South Sulawesi (Bone), cloves were also important, grown by 5,776 families operating about 4,000 hectares. Cloves were even more important in North Sulawesi. A total of 43,000 hectares was planted to cloves, but by the period just before deregulation only 20,000 ha were productive, producing just 7,000 tons. The remaining 23,000 hectares of clove plantations had been largely abandoned because of the disincentive effect of low farm gate prices.

Before deregulation, clove producers were required to sell their clove output to a much-criticized Clove Marketing Board (*Badan Penyangga Pemasaran Cengkeh* or BPPC), controlled by another son of the then first-family. Clove prices at the producer level plummeted, but clove prices to the *kretek* cigarette manufacturers in Java did not fall commensurately. There was suspicion of super-normal profits made by the BPPC monopsony right holder, whose accounts were never made transparent.

The measures taken to break the power of the clove marketing board appear to have been both complete and effective. Presidential Decree No. 21/1998 established the right of all farmers to sell cloves to anyone, and for traders to buy cloves from all agents at a freely determined market price. An instruction letter from the Minister of Industry and Trade supported this Presidential Decree. The National Clove Board wound up its affairs by the end of June 1998, after which time supervision of clove trade became the responsibility of the Director General of Domestic Trade. A site investigation in North Sulawesi showed no residual trace of the Clove Support and Marketing Board monopsony. Farmers and traders said the trade is now free from interference by the government.

Smallholder Tea Processing in West Java. Tea is an important export crop for Indonesia. Exports in 1998 earned $108 million. West Java is the most important producing province. In the 1980s PT Tehnusamba Indah, a company controlled by a crony of the then first-family, built four tea-processing factories in West Java, a region known already to have excess processing capacity (tea area had declined over the years). Farmers said Tehnusamba's factories offered lower prices than competitors for fresh tea leaves and so they declined to sell to them. In 1990 the Governor of West Java issued a letter instructing District Heads to implement *rayonisasi,* or market "rationalisation", which prescribed area allocations for the collective buying of fresh tea leaves. The District Heads in turn issued letters telling farmers near Tehnusamba factories to sell only to Tehnusamba, thus creating a local monopsony position.

The letter from the Governor of West Java requiring this geographic market allocation for fresh tea-leaves has never been formally withdrawn. Also district government market-area-allocation letters in favor of Tehnusamba have not been cancelled. But farmers now disregard these instructions and sell to whomever they want. This is one example where legislation was created to benefit private parties with political clout.

Inter-Island Livestock Trade. Inter-island livestock trade is important for farmers in the dry provinces of West and East Nusa Tenggara. These relatively poor islands export livestock, mostly to Java. In 1998 NTT had a large livestock population of 803,000 head (almost all cattle). Producing slaughter cattle for market was important to more than 200,000 NTT farmers (although this is merely a rough estimate). In NTB the large livestock population was 470,000 head and was a major source of income for more than an estimated 150,000 farmers. Mostly of NTB's cattle were on Lombok Island (280,000 head).

Livestock trade was subject to both local trade taxes and inter-island shipping quotas. By mid 1997, just before the crisis, East Nusa Tenggara cattle farmers and traders had to pay a total of US$ 40 per head through 16 different kinds of taxes and levies, amounting to about 13% of the farm-gate value of a slaughter animal. On Lombok Island in West Nusa Tenggara farmers and traders paid 24 different taxes and *retribusi* on livestock trade: 3 to central government, 9 to the province and 12 to the district. The total cost was about $31 per head in taxes and levies, or 5% of the $570 farm-gate value of a typical slaughter animal. In Bima (Sumbawa Island), traders and farmers had to pay the same 3 central and 9 provincial taxes and levies, plus 18 district charges. In South Sulawesi traders bringing cattle from Bone to Ujung Pandang (5 hours away) had to pay 31 different taxes and levies along the road. Of these, 6 were legal and 25 illegal. Twenty of the posts charging illegal levies were police and military checkpoints. The sum paid represented about 4% of the farm gate value of the typical animal. A tandem-trailer truck carrying 18 head of cattle from Bone to Ujung Pandang had to be prepared to pay $228 in taxes and levies.

Until deregulation in 1998, the Ministry of Agriculture's Director General of Livestock set inter-island livestock trade quotas. These severely limited the number that could be marketed to at most about 5% to 6% of the local livestock populations. In fact, a well-managed herd in NTT should be able to reach between 10% and 13% off-take from a stable livestock population (ACIAR, January 1998) under extensive grazing, not intensive stall-feeding management systems. Each year the DG issued a letter giving provinces annual maximum quotas for shipments. He even determined destinations (not permitting NTT to ship to East Kalimantan despite high prices and a shortage of beef for instance). Trade was restricted. The cattle quota for NTT kept decreasing each year, from 67,000 head in 1994 to only 41,000 head in 1997. The livestock populations were increasing, but the opportunity to market was decreasing. Livestock (and meat) prices in

Jakarta rose and farm-gate prices in the outer islands fell as a result of this quota system. A large price wedge was formed, that benefited only the inter-island shipping quota-right holders.

4.2.2. Decentralization Era

Efforts to reform various market distortions that proliferated in the 1980s and 1990s gained momentum between 1998 and 2000, in particular after the fall of the New Order government. This is understandable as many of the distortions were created by or related to the then first-family or their cronies. These reforms have had some successes, resulting in improving prices received by farmers. However, the implementation of a wide-ranging decentralization and regional autonomy policy – which granted much power to district government – starting in 2001 seems to have reversed the trend. Various forms of market distortions, which have been dismantled previously, now have revived. The only difference is that now most of the distortions are created by the district governments rather than the central government as has been the case in the past. This section discusses some examples of the new forms of bad governance but with same adverse consequences for the poor.

The costs of transporting goods from North Sumatra to Jakarta.[13] The abundant agricultural commodities from the Karo district in North Sumatra are mostly perishable goods. Therefore, it is crucial to secure smooth and rapid distribution of these goods to maintain both the quality and the selling price at the consumer level. Consequently, farmers and traders will make every effort to expedite the delivery of these goods to the buyers, even if they have to pay various taxes and levies *en route*. These additional charges will add to the distribution cost, and eventually will lead to a higher price at the consumer level. The amount of the levies extracted is determined by measuring the tonnage of the truck at various weighing stations along the routes. Table 1 illustrates the number of weighing bridges and the amount of taxes and levies paid by a truck driver at each location traveling from Kabajahe, Karo district to Jakarta. A truck driver who regularly carries oranges from Kabupaten Karo to Jakarta reports that there are at least 16 truck weighing stations and several other levy checkpoints that have to be passed along the route. The table shows the number and amount of "fines" paid by truck

[13] Summarized from Usman *et al.* (2001b).

drivers – both those who comply and those who do not comply with the weight limit at each station.

TABLE 1
The Costs Incurred by Truck Drivers at Weighing Stations on the Way from North Sumatra to Jakarta

Province	Number of Stations	Amount of fines	Remarks
1. North Sumatra	4	Rp5,000 – 10,000 for each ton of excess weight	Per ton of excess weight
2. Riau	2	Rp60,000, paid by all, irrespective of weight trucks.	Fines have to be paid by both complying and non-complying vehicles, plus additional road levies: -Rp2,500 (6-ton truck) -Rp3,500 (8-ton truck)
3 .Jambi	2	Rp60,000, paid by all trucks	Plus additional road levies: -Rp2,500 (6-ton truck) -Rp3,500 (8-ton truck)
4. South Sumatra	5	Fine of Rp15,000 for each ton of excess weight	In addition to the possibility of receiving a fine, there are also road levies: -Rp2,500 (6-ton truck) -Rp3,500 (8-ton truck)
5. Lampung	3	Fine of Rp15,000 for each ton of excess weight	In addition to the possibility of receiving a fine, there are also road levies: -Rp2,500 (6-ton truck) -Rp3,500 (8-ton truck)

It is estimated that the total amount of levies (official and non-official) paid to transport oranges from Kabanjahe to Jakarta ranges from Rp268,500 to Rp1,008,500. Paying the lowest amount would only be possible if the truck complies with its permitted capacity. Nevertheless, even when trucks comply with the regulations frequently drivers still have to pay levies. As a result it is common for truck drivers prefer to carry loads that exceed the trucks legal capacity. The estimated value of the load of one 8-ton truck of oranges transporting approximately 120 baskets @ 65 kg at the farm gate price of Rp1,800 for grade A, B, C, and D oranges is Rp14,400,000. Hence, the total value of the transported goods paid out in taxes and levies is between 2% to 7%.

Heavily taxed plantation sector in North Sumatra.[14] While the North Sumatra provincial government has not profited directly from the plantation sector, the commodities produced in this industry have been the target of various levies, at the both the local (*kabupaten)* and the central level of government. Levies are imposed on the plantation industry starting at the production level, through to distribution and marketing of their products. According to the latest inventory released by the management of the Association of Indonesian Rubber Producers (Gapkindo) in North Sumatra, there are at least nine kinds of official levies imposed on rubber commodities (see Table 2).

TABLE 2
Types of official levies on rubber commodities in North Sumatra

Activities	Types of levies	Tariff and location	Remarks/Problems
Production support	Land and Building Tax	Rp60-130 thousand/ha	Tax valuation too high, annual increases
	Street lighting Tax	10% of total electricity capacity used, in certain *kabupaten/kota*	Tax base too high. Also applied to electricity generators installed in the premises.
	3. Ground and Surface Water Levies	Rp2-5.4 million/month	
	4. *Hinder Ordonantie* Tax	Rp4.2 million/year in Deli Serdang Rp1.75 million/renewable	
Processing	5. Fees for taking Effluent Samples	Rp450 thousand/sample, 3 samples/month in South Tapanuli	The official charge from the Department of Health Laboratory is only Rp44 thousand/sample.
Marketing	6. Market Levies	Rp6/kg in Asahan Rp20/kg in Langkat Rp3/kg in Deli Serdang	
	7. Compulsory Contributions from Plantation Estates	Rp10/kg in Asahan	
Others	8. Levies on the logging or use of Rubber Timber	Rp300/m3 in Deli Serdang	
	9. Compulsory Third Party Contributions	Voluntary at provincial level	
	10. Levies from the Department of Manpower		

Sources: Gapkindo North Sumatra, 2001.

[14] Summarized from Usman *et al.* (2001a).

Non-Tariff Trade Restriction in North Sulawesi.[15] The implementation of decentralization and regional autonomy has resulted in several major changes in the way that local governments exercise their autonomous rights. One of these changes has been that local governments are creating a larger number of new local laws. In the case of North Sulawesi, so far only the provincial governments have begun to create regulations that result in non-tariff barriers. However, there are also indications that district governments are also proposing to create non-tariff regulations at this level. The following is an example of non-tariff barrier found in the Province of North Sulawesi concerning regulation on pharmacies, outlined in the Governor's Decree No.4dz/03/891, 13 September 2001 (Temporary Postponement of the Establishment of Large Pharmacies in North Sulawesi). The Province of North Sulawesi has placed restrictions on the ownership of pharmacies by those who do not reside in North Sulawesi, with the aim of protecting local entrepreneurs. The following is a summary of the contents of the Governor's Decree:

1) Licenses for Large Pharmacies in the Province of North Sulawesi are only to be issued to those large businesses with a central office, which own or control assets, and whose owners reside in North Sulawesi. However, these licenses are not to be issued to those who reside outside of the Province of North Sulawesi, even though they may own and control assets within the province. Instead they are to be accorded the status of Large Pharmacy Branches or Representatives.
2) Large pharmacies must own a building or business location in accordance with the stipulations on ownership status.
3) Large local pharmacies are to be given priority as partners with the government in acquiring pharmacies with a value of up to Rp4 billion.
4) The establishment of Large Pharmacy Branches has to be based on the recommendation of the North Sulawesi Association of Large Indonesian Pharmacies.
5) The management of the North Sulawesi Association of Large Indonesian Pharmacies is to be comprised of members of the organization who originate from within the region.
6) Apart from the managers, local residents are to be prioritized in the staffing of the Large Pharmacy Branches.

[15] Summarized from Usman *et al.* (2001a).

7) The Large Pharmacy Branches will be encouraged to form partnerships with large local pharmacies in order to distribute their products throughout North Sulawesi.

This situation suggests that there is some justification for emerging concerns regarding policies discriminating against people from outside the region in the interest of 'local sons' at the expense of the consumer as they have to pay higher prices resulting from the less competitive market.

Organized Thugs in West Java.[16] Until now, the government could not resolve the problem of illegal fees in the streets imposed by both thugs and corrupt police officers. For instance, research in Jonggol and Purwakarta districts shows that the practice of thuggery in the street is very common in which each truck is required to pay Rp 300,000 per year to the thugs. These thugs are organized in groups that control specific areas. As evidence that a passing truck has "paid" the fees, usually a sticker that states the codename of the head of the thug groups is posted at the truck's body. Trucks also became targets of illegal fees when they enter the main market in Jakarta. Fees at the terminal also tend to be higher than what is stated in the official rules, with an excuse of covering the salary of part time/volunteer workers. The rampant thuggery and illegal fees that are illicitly "supported" by the district government and the police shows the weak supremacy of the law and protection of society, especially that of the poor.

Bureaucrats Interests Above that of the Poor in Budget allocation in West Nusa Tenggara.[17] Conceptually, public policy of the government of the district of West Lombok in West Nusa Tenggara is focused on increasing the welfare of the poor people living in the district. This is done by strengthening the human capital through investment in health and education and improvement of economic conditions of the poor through "the people's economy", which correlates with the purpose of regional autonomy. However in practice, this noble mission is not carried out as planned, this could be seen in the budget allocation that still puts the bureaucrats' interests above others.

Some of the district government's budget allocation policy could be seen in the 2002 district budget (APBD). In 2002 the government of the district of West Lombok allocated Rp 2,6 billion for offical car purchases and Rp 780 million for official

[16] Summarized from Usman *et al.* (2002).

[17] Summarized from Mawardi *et al.* (2002).

motorbikes purchases. In addition, there was a huge increase in the allocation to the district parliament (DPRD) from Rp 2 billion (equals to Rp 3,8 million per month for each DPRD members) in fiscal year 2000 to Rp 3,4 million (equals to Rp 6,4 million per month for each DPRD members) in fiscal year 2002. At the same time, budget allocation for the general public interests that supposed to be the main priority of the district government tends to be ignored, for instances:

1) The allocation for the village development fund which was Rp 10 million in the 2000 budget was not included in the 2001 district budget, with the excuse that the government "forgot" to include it. In the 2002 budget year the fund had been allocated, but until April it had not been received by the villages.
2) In 2002, the West Lombok district allocated 2,5% of its budget for the health sector, which is much smaller than the amount set on in the agreement made in August 2001 between the Health Ministry and all the district heads/majors in Indonesia. This agreement states that the district/city governments will allocate at least 15% of their budget for the health sector. According to health experts, the budget allocated for the health sector by the district/city governments today has sharply decreased from Rp 4-5 billion per year to only Rp 2-3 billion per year. This decline is confirmed by the statement of health center staff that after regional autonomy:
    - Shipment of medicine to the health centers take longer now than before regional autonomy, additionally the amount shipped is much more limited.
    - The operational fund for the health centers today is only about Rp 15 million for each health center. In the past years the operational fund for each health center was Rp 50 million, which included program assistance from the central government.
    - Most of the districts in West Nusa Tenggara are classified as areas prone to malaria and dengue fever endemics. It is very ironic that the district government budget for the health sector does not allocate additional funds to handle the problem of malaria and dengue fever.

4.2.3. Social Safety Net Program During the Crisis Era

Other examples of how bad governance has made the poor at lost can be seen from the implementation of the social safety net programs. In an attempt to negate the potential negative social impact of the recent economic crisis, in early 1998 the government of Indonesia established social safety net programs. The programs were intended to protect both the traditionally poor and newly poor due to the crisis, which may not be able to cope with impact of the crisis without outside help. The programs were created based on four strategies: ensuring the availability of food at affordable prices for the poor, supplementing purchasing power among poor households through employment creation, preserving access to critical social services, particularly health and education, and sustaining local economic activity through regional block grant programs and extension of small scale credits.

Unfortunately, however, in many cases the target groups have been largely missed by the programs, both in terms of low coverage and being only loosely targeted in practice. The programs were plagued by problems in targeting the beneficiaries and delivering benefits to intended target groups. The programs suffered from both the problems of undercoverage – i.e. there were a large number of the poor who were not covered by the programs – and leakage – i.e. there was a large proportion of program benefits which went to the non-poor.[18] Figure 2 shows the coverage of various social safety net programs among the poor and non-poor population.

[18] See Sumarto, Suryahadi, and Widyanti (2002).

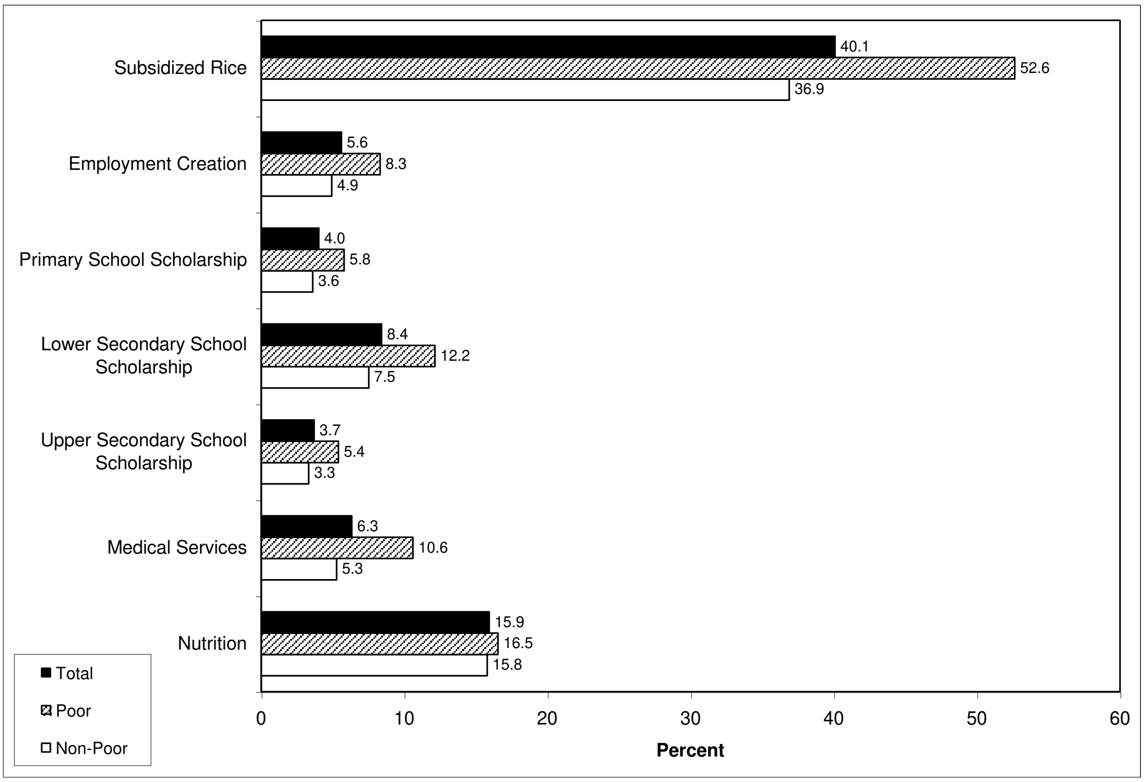

Figure 2. Coverage of Various Social Safety Net Programs

The leakage of benefits of these programs to the non-poor is clearly a lost for the poor. Due to this leakage, in some cases the poor receive less benefits than they actually entitled to, while in other cases some of the poor were completely left out from receiving the benefits of the programs. Studies on the implementation on the Indonesian social safety net programs have pointed out that in many cases the leakage occurred due to bad governance at the lowest distribution points. For example, in the sale of subsidized rice program, once the rice reached the village level, it was up to the village officials how to distribute the rice to the target group. Even though they have a list of eligible recipients, upon which the rice allocated to the village is based, often time the officials decided to distribute the rice to a much larger number of people, resulting in lower than stipulated rice receipt by each recipient, including the poor.

Another illuminating example is the health program. In this program, free medical and family planning services were provided for the poor, identified through 'health-cards' which were distributed to eligible households. A health card given to a household can be used by all members of the household to obtain free services from designated hospitals, clinics, and health care centers for medical and family planning purposes, including pregnancy check up and birth delivery. However, in practice, households which owned health-cards did not always use the cards when a household member visited a designated provider.[19] Of all health-card owners who went to public hospital, only 60 percent used their health cards, while for community health center the proportion was 52 percent, for village midwife 12 percent, and for other health facilities 31 percent. It turns out that the large degree of non-use of health-cards is that because some health providers refused to honor the free services for health-card owners. The reason is because the providers were not reimbursed based on the numbers of actual services performed, but instead they received an advance lump sum payment based on a predicted demand for services.[20] This practice certainly hurt the poor who were in need of medical services.

4.3. The Impact on Poverty Reduction: More Systematic Evidence

4.3.1. Methods and Data

Measuring good or bad governance quantitatively is difficult as it has many facets and requires a high degree of subjective judgment.[21] Therefore, the most common method used to measure governance is to survey selected individuals, who are deemed knowledgeable about the situation in a certain country or region, and ask them to rank the governing practices in a country or region on a predetermined scale. The answers of all surveyed individuals in a country or region can then be used as the basis for forming an index of governance in the country or region.

Since the implementation of a wide ranging district level regional autonomy policy in Indonesia, starting in January 2001, there has been growing interest in measuring good governance at the district level. Although the regional autonomy policy is still relatively nascent, there are already some large-scale national-level surveys on measuring district governance. The results of two of these surveys have been made public – they have been discussed in the previous section – and will be used in this

[19] Even though the health-card was meant only for the poor, only 35 percents of all the health-cards distributed were given to the poor (Saadah, Pradhan, and Sparrow 2000).

[20] See Saadah, Pradhan, and Sparrow (2000).

[21] See Dethier (1999).

study. There have been numerous other similar studies conducted on a smaller scale or in more localized settings.[22]

The first large scale survey was conducted by KPPOD (*Komisi Pemantauan Pelaksanaan Otonomi Daerah* or the Regional Autonomy Implementation Monitoring Committee), a body formed by the Indonesian Chamber of Commerce (KADIN). KPPOD was formed following a growing concern that since the implementation of the regional autonomy policy the district governments have rushed to issue many local regulations (Perda) that impose new taxes and levies in order to raise local revenues (PAD).

The business community was among the most adversely impacted by this trend, which has negatively influenced the investment climate in the regions. In an attempt to counteract this trend, KADIN through KPPOD created a ranking of districts based on their friendliness to the business environment and investment climate (KPPOD 2002). A yearly award is presented to the best performing district. It is hoped that the ranking and award will, on the one hand, provide an incentive to the district governments to create an environment favorable to business and, on the other, act as signals to the business community in locating their investments.

The ranking is based on a composite of district indices on local regulations, security, culture, and infrastructures. There are three indices on local regulations, each look at the aspects of production, distribution, and others. In each aspect, each district is assessed based on whether it has local regulations which are considered as “highly distortive”, “distortive”, “acceptable”, or “supportive” to the business environment. There are two indices on security, with the first aspect focusing on law and order (“non-existent”, “weak”, “existent”, “good”), while the second aspect focuses on security disorder (“very high”, “high”, “medium”, “low”). The cultural aspects include both society’s attitudes and bureaucratic culture, assessing whether they are “disruptive”, “less conducive”, “conducive”, and “very conducive” to the investment climate. Finally, the infrastructure indices include both accessibility (“very difficult”, “difficult”, “sufficient”, “good”) as well as quality of infrastructure (“very bad”, “bad”,

[22] Another large-scale national-level survey has been conducted by the World Bank and Gadjah Mada Univerisity. However, at the time of writing this paper, the results have yet to be made public.

“sufficient”, “good”). KPPOD calculated these indices for a sample of 90 districts from all over the country.

Among these indices, the one that is most relevant to the measurement of good governance, and hence will be used in this study, is the index on bureaucratic culture. This index is an approximation of a measure on the “quality” of district bureaucracy. Assessing whether the bureaucracy is “disruptive”, “less conducive”, “conducive”, and “very conducive” to the investment climate provides an indication of the overall quality of the bureaucracy. In their report, KPPOD explains that this bureaucratic culture index measures the degree of openness and cultural values adhered to by the district government as stipulated in its development policies, in particular those related to investments. In addition, this index measures the quality of public services from the local government to the business community. In measuring this index, KPPOD used panel judgment and expert choice methods.

The second large-scale survey was conducted by LPEM (*Lembaga Pengkajian Ekonomi and Masyarakat* or the Institute for Social and Economic Research) at the Faculty of Economics, University of Indonesia. As part of a study on the impact of the regional autonomy policy on the costs of doing business, they created six indices on additional costs, regional autonomy, government, infrastructure, pre-crisis security, and post-crisis security aspects (LPEM 2001). The indices scale from 0 to 100, with a higher index number indicating better quality or more favorable conditions for business. From these six indices, they then created a composite of cost of doing business index. LPEM studied the data from 60 districts and used the composite index to rank them based on their friendliness to the business community.

Among these indices, the index on government was the one that most closely related to the measure of good governance and, hence, will be used in this study. Four indicators were used to measure the index on government. Those are: (1) general behavior/attitude of government and bureaucracy when dealing with the private sector (“disruptive”, “neutral”, “conducive”); (2) progress toward the relationship between private sector and government bureaucracy (“same”, “easier”, “harder”); (3) checks and balancing mechanisms within the government bureaucracy (“existent”, “non-existent”); and (4) the proportion of senior manager’s time spent when dealing with government bureaucracy (less than 15%, between 15% and 25%, between 25% and 50%, and above

50%). The purpose of this government index is to measure business uncertainty due to the behavior of government.

Since the purpose is to assess the impact of governance on poverty reduction, this study also uses data on district level poverty rates, which were obtained from Statistics Indonesia (BPS). The official poverty statistics in Indonesia are calculated in three-year interval, based on data collected through the National Socio-Economic Survey (SUSENAS). In particular, this study uses the 1999 and 2002 data, which cover the periods of both the KPPOD and LPEM studies. The analyses are conducted using two approaches. The first approach is using descriptive analysis, which is meant as an exploration of the relationship between governance and poverty reduction. In the second approach, a multivariate analysis is conducted to confirm the relationship indicated from the descriptive analysis.

4.3.2. Descriptive Analysis

Using the district governance indices from KPPOD and LPEM and district poverty rates from BPS, this section analyzes the impact of governance on poverty reduction. The focus is on the performance of districts in reducing poverty between 1999 and 2002 and how this has varied with different levels of governance, as defined by both KPPOD and LPEM.

Table 3 shows the proportional change in poverty reduction from 1999 to 2002 by KPPOD's index of bureaucratic culture. The table shows that none of the districts in the sample has a bureaucratic culture which is considered as disruptive to the business environment. Most of the districts, 61 out of 87, have a bureaucratic culture which is considered as conducive, while the rest are almost evenly divided between those which are less conducive and very conducive.

TABLE 3
District Level Poverty Reduction Between 1999 and 2002
by KPPOD's Index of Bureaucratic Culture

Index of Bureaucratic Culture	Poverty Reduction (%)		Number of Districts
	Mean	Std. Dev.	
Disruptive	-	-	0
Less conducive	-3.41	31.53	12
Conducive	-6.95	60.66	61
Very conducive	-15.06	56.41	14
Total	-7.76	56.45	87

On average, the districts in the KPPOD sample have a poverty rate in 2002 which is proportionally around 7.8 percent lower than the poverty rate in 1999. Dissagregated across categories of bureaucratic culture, there is a clear indication that good governance affects districts' performance on poverty reduction. The districts which have a less conducive bureaucratic culture have an average poverty reduction of 3.4 percent from the original rate, while those districts with conducive bureaucratic culture have an average poverty reduction of around 7 percent, doubled of the rate of the former group. Further doubling in the rate of poverty reduction was experienced by the districts with a very conducive bureaucratic culture. These districts on average experienced a 15 percent reduction in their poverty rates during the period.

However, this evidence that districts with better governance experienced higher rates of poverty reduction has to be discounted by the presence of large standard deviations within each category of bureaucratic culture. These large standard deviations make the mean of the poverty reduction rate for each category statistically insignificant from zero. Similarly, the differences in poverty reduction rates across categories are also statistically insignificant.

Table 4 shows the same proportional change in poverty reduction from 1999 to 2002 among the districts in the LPEM study on cost of doing business. Since the LPEM index of government is a continuous number ranging from 0 to 100, the districts are grouped into four quartiles of the index.

TABLE 4
District Level Poverty Reduction Between 1999 and 2002
by LPEM Index of Government

Quartile of Index of Government	Poverty Reduction (%)		Number of Districts
	Mean	Std. Dev.	
I (lowest index)	-2.72	66.96	15
II	-5.94	71.53	15
III	-13.88	46.78	15
IV (highest index)	-6.34	40.94	15
Total	-7.22	56.68	60

On average, the 60 districts in the LPEM sample have a poverty rate in 2002 which is proportionally around 7.2 percent lower than the poverty rate in 1999. The 15 districts with the lowest index of government, the quartile I districts, have an average rate of poverty reduction of 2.7 percent. Like in the KPPOD sample, the average rate of poverty reduction doubles in the next two quartiles, where the rate of poverty reduction is 5.9 percent in the quartile II districts and 13.9 percent in the quartile III districts. However, the average rate of poverty reduction among the 15 districts with the highest index of government, the quartile IV districts, is only around a half of the average rate of quartile III districts.

Furthermore, similar to the KKPOD sample, there are large standard deviations in the rates of poverty reduction within each quartile of index of government. As before, the presence of these large standard deviations make the mean of poverty reduction rate for each quartile is not statistically significant from zero and the differences in poverty reduction rates across quartiles are not statistically significant either.

4.3.3. Multivariate Analysis

The findings in the previous sub-section provide indications that governance affects the rate of reduction in poverty at the district level. These results, however, are based on simple descriptive analysis, uncontrolled from possible effects of other variables. In this sub-section, a multivariate approach is exercised to control for the effects of other variables. In the KPPOD report, in addition to the various indices used to rank districts, they also publish district level data on Gross Domestic Regional Product (GDRP), routine and development budget, local revenues, and total population.

Based on these data, Table 5 shows the regression results of change in poverty rate on two dummy variables of district governance, per capita GDRP, per capita routine and development budgets, and per capita local revenues. The sign of all coefficients of these variables makes sense, but only the coefficient of the dummy variable on conducive bureaucratic culture which is statistically significant. It should be noted, however, that the estimation has relatively low coefficient of determination (10 percent) and F-statistic (1.46). This probably has to do with the presence of noise in the data, and relatively small number of observations.

TABLE 5
Regression Results of District Level Change in Poverty on Governance Indicator

Independent Variable	Coefficient	Standard Error
Dummy of conducive bureaucratic culture	-0.0652	0.0273
Dummy of very conducive bureaucratic culture	-0.0444	0.0347
Log of GDRP per capita	-0.0128	0.0139
Log of routine budget per capita	0.0049	0.0251
Log of development budget per capita	0.0176	0.0173
Log of local revenue per capita	0.0075	0.0089
Constant	-0.3272	0.2163
Number of observations	87	
R-squared	0.0986	
F-test	1.46	

Nevertheless, the regression results confirm the indications from descriptive analysis that governance affects the rate of reduction in poverty achieved by districts. Districts which have conducive bureaucratic culture have a reduction in poverty rates which is 6.5 percentage point higher than that achieve by districts with less conducive bureaucratic culture. Similarly, districts with very conducive bureaucratic culture tend to have higher rate of poverty reduction than districts with less conducive bureaucratic culture but the coefficient is not statistically significant and its magnitude is smaller than the coefficient for districts with conducive bureaucratic culture.

The coefficients of the other variables indicate that – with a note that these coefficients are not statistically significant – economic growth tend to enhance poverty reduction but government budget tend stifle it. The coefficient of GDRP per capita has a negative sign, which indicates that districts with higher GDRP per capita tend to experience faster poverty reduction. This also implies that districts which strive for higher economic growth will achieve faster reduction in poverty. On the other hand, the coefficients of government budget (both routine and development) and local revenue variables have positive signs. These indicate that taxes and government spending are counterproductive to the efforts to reduce poverty, or at least they do not contribute to poverty reduction.

5. CONCLUDING REMARKS

It is a public knowledge that bad governance is a serious problem in Indonesia. For a long time the country has ranked highly on the list of the most corrupt countries in the world. Prior to the onset of the economic crisis in mid 1997, the problem of governance was apparent, but it was mostly ignored. The expanding economy due to the high economic growth was enough for most people to compensate the lost and inefficiency due to bad governance. The advent of the economic crisis, however, has highlighted the seriousness of the problem. Some initiatives to create clean and good governance in the country have been put forward and tried. These efforts, however, have so far proved difficult and elusive.

This study focuses on the impact of bad governance on the poor as well as on efforts to reduce poverty. As the group of people who are in the weakest position and who are most powerless in influencing decisions that affect their lives, the poor are the most vulnerable to the impact of bad governance. For example, when in the 1980s and 1990s the government decided to create various marketing boards for agricultural commodities, which would only benefit select government cronies at the detriment of the farmers, the poor farmers had no choice but to live with it. Occasional protests fell on deaf ears or, even worse, they were met with suppressions.

There were efforts to reform this with some successes between 1998 and 2000, made possible in particular by the fall of the New Order government. However, these were short-lived. In 2001, when decentralization and the regional autonomy policy was started to be implemented, various forms of market distortions which are detrimental to the poor were reincarnated. The only difference this time is that they were mostly created by the regional governments, rather than by the central government as they were in the past. The adverse effects on the poor, however, remain the same.

By assembling scattered anecdotal evidence on how current and past practices of bad governance in Indonesia has hurt the poor, this study shows that the adverse impact of bad governance on the poor is real, systematically inflicts many people, and undermines efforts to reduce poverty in the country. More systematic analyses on the impact bad governance has on poverty reduction – using both descriptive and multivariate analyses – show some indications that indeed regions that practice good governance experience faster rate of poverty reduction and *vice versa*. However, more efforts are needed to separate noises from signals in the data as well as to collect better data and indicators of good governance to firmly establish the relationship between governance and poverty.

In theory, decentralization can provide the impetus for poverty reduction and good governance, because civil society has the opportunity to monitor the way the government behaves more closely and also to bring the concerns of the poor closer to the government. However, if the decentralization policy is only to be exploited as a means of providing the regions with legitimate tools to increase the burden on the community without the compensation of better public services, the general public will have ample reasons to oppose the implementation of the decentralization policy. Signs of such 'opposition' towards local government policy are becoming apparent. If this continues to occur, decentralization may present a serious threat to the development of both national and regional economic and social development.

Therefore, in terms of policy implication, clear guidelines need to be established at the national level to ensure appropriate regulation of markets and good governance by local authorities. This should be followed by incentives (disincentives) and systematic reforms which will encourage (discourage) government apparatus with reward (credible threat), both at the local and central level, in practicing good (bad) governance. At the same time the civil society needs to establish a consensus and build a coalition to combat bad governing practices, through for example media-campaigns, class-action, and evidence-based publications.

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