REGIONAL DEVELOPMENT, ENERGY AND THE ENVIRONMENT IN INDONESIA

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WHY DECENTRALIZATION FAILED:
THE ROLE OF INSTITUTIONAL FACTORS

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Indonesia's rushing decision to decentralize in 2001 produced disappointing results in terms of regional growth and welfare improvements. This was not only due to lack of preparation and inappropriate policies, but also due to weak local accountability, widespread local capture, lack of voices or people's participation, and absence of proper incentive system for local leaders. A model is developed to show the role of these institutional factors in decentralization, in which multiple equilibria can be generated. It is revealed that the type of local leaders will determine the decentralization outcome, and allowing greater people's participation is critical for welfare enhancement and minimizing local capture. This theoretical proposition is supported by the empirical evidence based on a field survey. A serious institutional reform is therefore needed.

INTRODUCTION

The inadequacy of supporting infrastructure and the lack of preparation surrounding the 2001 decentralization policy made it prone to various pitfalls. Even with the potentials for stronger growth (due to a low base after the 1997 financial crisis), most regions failed to match the economic growth and welfare improvements that they achieved prior to the decentralization. More seriously, the questionable functioning of local democracy as an accountability mechanism led to a widespread incidence of elite capture of local governments that constrained the achievement of the benefits of decentralization (Azis, 2008). Some ten years after decentralization, the presumption that local democracy would impose accountability pressure on elected officials did not seem to be well in place. Limited participation, low welfare and low level of development in many regions, combined with poor quality of local leaders were among the important factors that led to such an outcome.

It is argued in the paper that the achievement of the benefits of decentralization depends very much on the local accountability and other institutional settings, e.g., local capture,

voices or people's participation, and the incentive system for local leaders. Since welfare achievement post decentralization has been limited, and Indonesia's decentralization is irreversible, a serious institutional reform is needed to motivate local officials to maximize the net benefits of decentralization.

DECENTRALIZATION HAS NOT BEEN WELFARE-IMPROVING

The interrelation between democracy and welfare is complex, but some believe this should not obscure the central fact that development is beneficial to democracy (Przeworski and Limongi Neto, 1997). It is further theorized that once democracy is in place, wealth tends to sustain and raise the survival rate of it. This explains why wealthy countries are generally more democratic than less wealthy countries.[1] But the Indonesian experience, at least so far, did not match with such a claim. From the economic growth perspective, the experience after the 2001 decentralization has been disappointing. Majority of provinces experienced a decline in the growth rates of Gross Regional Domestic Product (GRDP), consistent with the lackluster GDP growth (see Table 1.1).[2] With such a trend, the socio-economic conditions have not improved as expected.

While GRDP growth reflects the dynamics of the regional economy, it does not capture the extent to which the regional development performs and provides welfare for most people, as it is not based on the concept that places people and their wellbeing at the center of development. The latter is better captured by the Human Development Index (HDI). Aside from the problems of HDI comparability, the progress of HDI during the post-decentralization period turned out to be not significant. In some provinces the index in 2007 was even lower than in 1996.

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[1] A study by John Londregan and Keith Poole (1996) showed that statistically wealth produced an effect on democracy. Doubling per capita income would increase the degree of democracy in a moderately authoritarian country by 30 percent, while the effect on both, extremely authoritarian countries and relatively open societies would only lead to a small increase in the level of democracy (around 5 to 15 percent).

[2] On PPP basis, the comparative trends of GDP indicate that Indonesia had the worst post-1997 crisis performance among the Asian nations.

TABLE 1.1 *GRDP Growth Before and After Decentralization*

Provinces	Pre-Dec Gr 1993-1996	Post-Dec Gr 2001-2007	Provinces	Pre-Dec Gr 1993-1996	Post-Dec Gr 2001-2007
NAD	1.74%	0.26%	Kalbar	9.25%	4.73%
Sumut	9.18%	5.61%	Kalteng	9.58%	5.59%
Sumbar	8.08%	5.61%	Kalsel	9.25%	4.96%
Riau*	4.76%	4.22%	Kaltim	8.00%	2.10%
Jambi	8.49%	5.75%	Sulut****	8.10%	5.02%
Sumsel**	8.26%	4.69%	Sulteng	8.51%	7.06%
Bengkulu	6.66%	5.55%	Sulsel*****	7.94%	5.63%
Lampung	8.51%	5.20%	Sultra	6.59%	7.45%
DKI	8.99%	5.71%	NTB	7.80%	3.70%
Jabar***	8.15%	5.24%	NTT	8.57%	4.74%
Jateng	7.19%	4.99%	Maluku	6.82%	4.64%
Yogya	7.91%	4.48%	Malukuta	5.23%	4.59%
Jatim	8.26%	5.36%	Papua******	14.19%	0.66%
Bali	7.86%	4.66%	Total	8.13%	4.88%

Source: Author's calculation based on BPS data
* Includes Kepri
** Includes Babel
*** Includes Banten
**** Includes Gorontalo
***** Includes Sulbar
****** Includes Irjabar

Which policies caused such a failure? Some were within the jurisdiction of local governments (e.g., collection of unnecessary fees, misuse of funds, white-elephant projects), but a lot of it was also due to inappropriate policies at the center (e.g., drastic cut of fuel subsidy, high interest rates, misallocation of resources, super tight budget, lack of a stick and carrot system). To a certain degree, this also reflects the inadequacy of supporting infrastructure and the lack of preparation. But more seriously was the failure of the functioning of local democracy as an accountability mechanism, allowing a widespread incidence of elite capture that constrained the achievement of the benefits of decentralization.

Given the disappointing outcome, one may be tempted to develop a counterfactual scenario in which transfers of some functions and funds to local governments are done in stages, not in a big-bang manner like the 2001 decentralization policy. The probability that such a scenario will produce a more favorable outcome is higher, as the capacity of regional governments can gradually develop, especially in low-

welfare districts where institutions are very limited or non-existent. More importantly, the ability of local people to adjust to the new autonomy can also improve over time.

The role of society in the region is critical as their capacity to participate in the process holds the key to the success of decentralization. Greater participation raises the probability that the policy is welfare-enhancing. However, the capacity of each society to take advantage of the opportunity is not the same; it all depends on the degree of political awareness. Among the important determinants of such awareness is the level of education, which in turn is influenced by the level of welfare. The greater is the number of poor segment of the society, the smaller the political awareness and participation. Voices are consequently limited, so are the outcomes of decentralization. This institutional issue is discussed next.

INSTITUTIONAL FACTORS AND LOCAL CAPTURE: MODEL FRAMEWORK

Theoretical supports for decentralization originate in the *informational advantage* and *coordination (policy enforcement) capability* of local government. Although informational advantage can be secured by adopting a pro-market policy, a market system alone may not be sufficient to establish an effective coordination at the local level unless the decision making is decentralized. Other justifications for decentralization include: raising efficiency through reduced transaction costs, diffusing social and political tensions, strengthening people's participation, and ensuring political and cultural autonomy. But the most important pre-condition for the success of decentralization is to establish *local accountability* through effective check-and-balance. It also implies that the use of local information (region's informational advantage) is critically needed. Indonesia's rushing decision to decentralize was largely driven not by these theoretical assertions that require perfect information, rather by the desire of the new government to win voters' supports. Local accountability was not seriously considered. Thus, the disappointing results since 2001 are, to some extent, already expected.

Decentralization also carries some risks. There is a risk that local governments will create entry barriers in order to generate local-own activities or simply to raise local own revenues (PAD or *Penerimaan Asli Daerah*). This has happened in many districts after the 2001 decentralization.[3] The general tendency that a collusion among interest groups can be more cohesive at the local than national level, and is more difficult to break, may cause the implementation of local projects less efficient because of the insistence that they must be executed by the locals (*putra daerah*).[4] The evidence in several regions showed that there was indeed an implicit rule imposed by some regional government to use *putra daerah* in some local projects. Decentralization also carries the risk of undermining problems created by externalities.[5] Then there is a risk of macroeconomic instability similar to what happened in many Latin American countries during the 1970s and 1980s (i.e., rising local debt and fiscal deficits). The evidence so far showed that such a risk has not been a problem in Indonesia, although a different kind of negative effect has been felt, i.e., due to high interest rates, many regions tend to place their funds in the central bank certificate (SBI, *Sertifikat Bank Indonesia*), instead of spending them for the badly needed infrastructure.

All of the above are serious, but a more significant risk is the spread of *local capture*, i.e., vulnerability of local government to capture by local elites, especially in regions with high degree of income disparity. Since the possibility of power sharing between contesting parties is typically smaller at the local than at the national level, in general the likelihood of capture by elites is greater at the local than at the national level. Lack of operational details about what the region should do, as was the case in the early

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[3] From 2001 to March 2008 there were 10,467 new fees (*retribusi*) imposed by regions through regulations (Perda or *Peraturan Daerah*). Of that number 1,902 was considered improper. To avoid excessive assignment of fees, a new mechanism was introduced through some Articles in Law No. 32, 2004, i.e., a shift from 'repressive' to 'preventive' approach, meaning that any proposed new fees ought to be reviewed and evaluated first by the Ministry of Home Affairs and the Ministry of Finance before they can be implemented.

[4] When a specific project is related to an important target such as poverty alleviation, the inefficiency causes not only the target being unmet but income disparity also worsens as only selected local interest groups can benefit from the project.

[5] Pollution-generating activities in one district create external diseconomies in others (e.g., upstream activities in Siak river in Riau caused pollution in the downstream), or, infrastructure development in one district provides benefits to other districts.

stage of Indonesia's decentralization (the tasks of districts were not clearly specified in Law No.22, 1999) also contributed to the greater likelihood of capture at the local level. Meanwhile, lack of clear performance indicators made it difficult to evaluate whether most benefits of decentralization had gone to majority of people or only to local elites. It was not uncommon to find cases whereby district heads became *raja kecil* (small kings) who were accountable to neither central authorities nor local constituencies. Voices and accountability pressures were limited. Yet, they are central to the functioning of democracy. They depend critically on the pressures imposed on elected officials by local voters, through the way they vote, exercise voice and respond to the actions of local officials.

The extent and severity of accountability and local capture problems depend on the following factors: (1) Pre-existing distribution of power at the local level, e.g., allocation of social and economic power within communities; (2) Lobby and campaign contributions by wealthier groups; (3) Fairness and regularity of elections; and (4) Transparency in local decision-making processes. Establishing these conditions may require institutional and bureaucratic reforms, yet it is precisely this type of reform that is most difficult to conduct. Overcoming institutional factors is always more difficult than choosing the policy itself. It is complicated, involving a strong path-dependence, and often frustrating. Absence of this reform, higher local capture produces lower benefits of decentralization.

Literature on institutional perspectives also stresses the importance of *participatory* process. The degree of political participation differs between countries and regions. One of the most determining factors is the initial welfare condition represented among others by HDI and the level of poverty and income inequality. Greater inequality and larger proportion of the poor imply a smaller fraction of informed voters or lower political awareness (*concavity*, i.e., upward mobility at lower end tends to raise political awareness more significantly than at higher end). When awareness is low, critical voices and the process of check-and-balance are

constrained. This can limit the quality of public services and the welfare outcome of decentralization in general. (see Azis and Wihardja, 2008).

All of the above are associated with *quality* factors. Each of them can be adversely affected by the intensity of local capture. While quality is important, however, the number and size of activities and public services also influence the overall performance of decentralization. The *quantity* that local government can generate depends not only on the size of the budget but also the management of it.[6]

FIGURE 1.1 *Framework of Analysis: How Local Capture Affects Welfare*
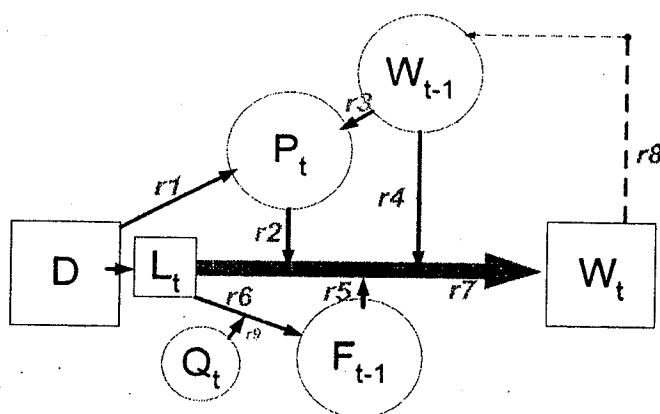
D = Decentralization
L_t = Local capture at time t
W_t = Welfare effect of decentralization at time t
W_{t-1} = Welfare at time t-1
P_t = Participation rate at time t
Q_t = Quality of leader at time t
F_{t-1} = Available development fund at time t-1

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[6] Note, for example, that revenue decentralization and central-local financial transfer without clear expenditure assignment are likely to fail the "money follow function" principle. They are not welfare enhancing, especially when the capacity of budget management is limited and are prone to corruption and overprovision.

The role of local capture in determining the welfare outcome is summarized in Figure 1.1. How the spread of local capture (L_t) during *PILKADA* determines the welfare outcome (W) is influenced by the extent of people's participation (P_t), the initial level of welfare (W_{t-1}), and the size of local budget (F_t). The extent of participation is influenced by the initial welfare, namely through informed voters and high political awareness. How local capture influences budget that can be made available for local development is determined by the quality of local leaders (Q_t).

Denote ó for accountability-related local capture, å for participatory, and ð for welfare measures such as inequality and poverty condition, where ó, å and ð are determinants of the *quality* of decentralization outcome. The *quantity* is denoted by F, reflecting the size and management of local budget. Thus, the welfare outcome is:

$$W(.) = W(\sigma, \pi, \varepsilon, F) \tag{1}$$

Under a standard condition,

$$\frac{\partial W(.)}{\partial \sigma} < 0; \qquad \frac{\partial W(.)}{\partial \pi} < 0; \qquad \frac{\partial W(.)}{\partial \varepsilon} > 0; \qquad \frac{\partial W(.)}{\partial F} > 0$$

Decomposing (1) into quality and quantity factors:

$$W(.) = H.(\sigma, \pi, \varepsilon).F(\sigma)$$

where $\dfrac{\partial H(\sigma, \pi, \varepsilon)}{\partial \sigma}$ and $\dfrac{\partial F}{\partial \sigma}$ are the marginal quality and quantity, respectively. Thus,

$$\frac{\partial W(.)}{\partial \sigma} = \frac{\partial F}{\partial \sigma} H(.) + \frac{\partial H(.)}{\partial \sigma} F(\sigma) \tag{2}$$

In most cases

$$\frac{\partial H(.)}{\partial \sigma} < 0$$

The effect of local capture on the quantity of local activities can be negative or positive depending on the quality (type) of local leaders. If the leader is of a favorable type, e.g., motivated to foster regional welfare (Type-A), the first term of equation (2) is positive. Otherwise, it will be negative (Type-B). Thus, the net effect of rising local capture on the benefit of decentralization is uncertain.[1] What

is certain is, somewhere between the two equilibrium cases there exists a critical value of F such that the effect of rising local capture leads to

$$\partial W(.) \big/ \partial \sigma > 0$$

When this occurs, the system produces a backward-bending curve shown in Figure 1.2 with multiple equilibria, i.e., L, M, and N.

FIGURE 1.2 *Relation Between σ and W: Backward Bending Curve*
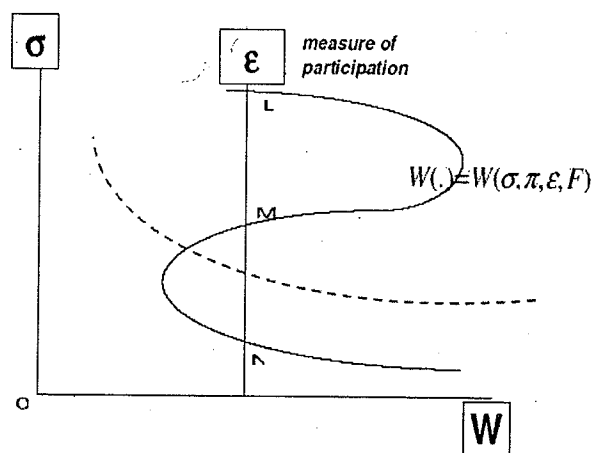
The goal is either to raise W given local capture, or, minimize local capture given W. The latter is equivalent to finding the lowest ó along the vertical line å. Reducing income inequality and poverty will facilitate the attainment of the goal since shifting the bending curve leftward will guarantee a new equilibrium with lower intensity of local capture (e.g., N1 and N2 in Figure 3). Recall that lower inequality and poverty tends to raise political awareness that eventually reduces the intensity of local capture.

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[7] The field survey demonstrates that the results are ambiguous; some leaders were able to take advantage of capture for the benefit of local development (Type-A), others failed to do so (Type-B).

FIGURE 1.3 *New Equilibrium Achieved By Lowering Inequality and Poverty*
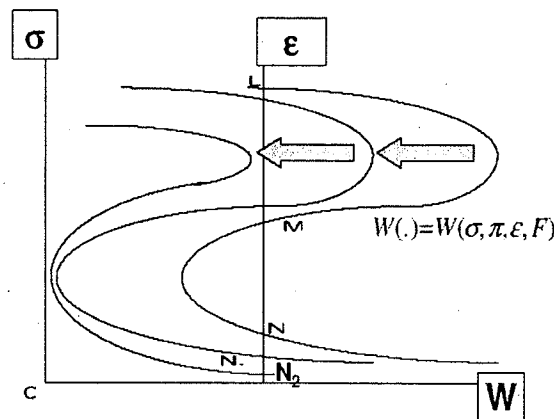
Another policy direction to insure low local capture is to raise participation; this can be shown by a rightward shift of the vertical line. As depicted in Figure 1.4, this turns out to be superior as it produces lower capture and higher welfare at the same time. The low capture is supported by greater accountability. In reality, this can be achieved when the following are present: (1) Clear specifications of the tasks of regional government; (2) Clear performance indicators with appropriate incentive systems ; (3) No conflicting regulations, e.g., laws on mining, forestry, and environment; (4) Conducive distribution of socio-economic power, i.e., not dominated by wealthy powerful groups; (5) Transparency in decision making; and (6) Fair and open direct election of regional officials and representatives (*PILKADA*).

FIGURE 1.4 New Equilibrium Achieved By Raising Participation
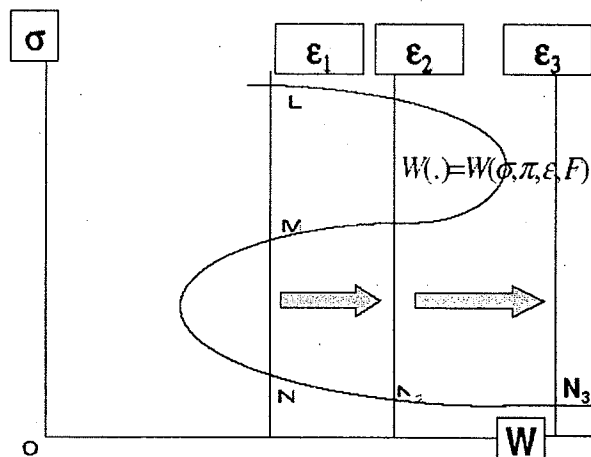
As local capture during *PILKADA* is widespread, the question is: what happens with the quality and quantity of the welfare outcome of decentralization? The following typology of local leader can be derived:

TABLE 1.2 *Typology of Local Leader and Decentralization Outcome*

	$\partial F/\partial\sigma > 0$ Type-A Leader	$\partial F/\partial\sigma = 0$ Type-B Leader
$\partial H(.)/\partial\sigma > 0$ **High participatory or low inequality/ poverty**	*complete progress*	*propitious*
$\partial H(.)/\partial\sigma < 0$ **Low participatory or high inequality/ poverty**	*incomplete progress*	*deviating*

Considering a common case whereby local capture causes deterioration of decentralization quality ($\partial H(.)/\partial\sigma < 0$), or the probability of $\partial H(.)/\partial\sigma > 0$ is very small, even with a type-A leader the expected outcome is not a "complete progress." The latter can be achieved only if there is a high participatory process with a favorable initial welfare condition.

EMPIRICAL EVIDENCE: RESULTS OF FIELD SURVEY

As argued earlier using Figure 4, greater and more widespread participation is superior to other alternatives as the welfare outcome is higher given a level of capture. What is the empirical evidence of it? The field survey in five districts (Balikpapan, Yogyakarta, Prabumulih, Sragen, and Manggarai Barat) confirms that this is indeed the case.[1] Using the *Analytical Network Process* (ANP) in each of those districts, the results show that for all districts, participation is ranked highest, while poverty is ranked second and inequality is ranked third among factors affecting welfare. The results are found robust. Azis and Wihardja (2008) also

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shows that participation rate is positively correlated with the progress of the district, although participation level in post-decentralization period is endogenously determined by various social indicators in the pre-decentralization period (Table 1.3). This suggests that the cause and causality between participation and progress of a district can be a two-way process.

TABLE 1.3 *Testing the Local Capture Model: Results of the Field Survey*

Districts/Indicators	Social Conditions	Participation	Progress
Balikpapan	8.91 (Good)	8.67 (High)	Complete
Yogyakarta	8.375 (Good)	8.5 (High)	Complete
Prabumulih	5.8 (Moderate)	4.67 (Low)	Stagnant
Sragen	5.4 (Moderate)	4.5 (Low)	Deteriorating
Manggarai Barat	4.5 (Bad)	3.167 (Low)	Deteriorating

Out of the five districts studied, two of them -Manggarai Barat and Sragen- are experiencing a deteriorating progress (Azis and Wihardja, 2008), which, as it is postulated above, means that these two districts are experiencing negative effects from increasing local capture on their socio-economic performance in the post decentralization era. This supports the claim that factors contributing to negative local capture are incompetent leadership, uninformed/uneducated citizens due to high poverty level and inequality, and low participation level. One district - Prabumulih- is experiencing a stagnant progress. In this case, low quantity and quality of leadership is present in a relatively good social conditions but a low participation level. This may be because Prabumulih is an oil-and-gas producing region. The other two districts are experiencing complete progress, which, as it is claimed by the model, means that they are experiencing positive effects from increasing local capture. The result supports the claim: factors that contribute to positive local capture are competent leadership, politically informed/educated citizens due to low poverty level and inequality as well as high participation level.

The two districts that experience deteriorating progress are poorly developed regions with high poverty rates of above 20%, poor basic infrastructures, and low-quality of human resources/ lower-than-average literacy levels of below 90%, as

well as low HDI of below 70. Their economic conditions are characterized by low per-capita GRDP excluding oil and gas of below Rp.6 million and low ratios of local revenues to total local budget of below 8% that implies high dependency to the central government's funds. Moreover, besides having low social and economic conditions, these less developed districts also tend to have low participation levels and high intimidation levels than those of the more developed regions.[2] However, these might be endogenous effects of having low educated and politically unaware that elect bad quality local leader and no access to "de facto" political power (Acemoglu, 2008 and Acemoglu & Robinson, 2008).

Figure 1.5 shows that there is a correlation between initial social condition-participation level and the net effect of local capture on welfare. Districts with high initial social condition and participation level tend to exhibit positive net effect of local capture on welfare while the reverse is true. It is also shown that there is a correlation between initial social condition-participation level and quantity-quality of local leadership (Figure 1.6). Districts with high initial social condition and participation level tend to exhibit high quality-quantity of local leadership while the reverse is true.

In order to test the causality of social conditions and participation level on the net effect of local capture on welfare, HDI 1999, Human Poverty Index (HPI) 1999, Infant Mortality Rate 2000, and Literacy Rate 2003 are plotted against the net effect of local capture on welfare indicator obtained from the field survey (Figures 7 to 10). It is shown that high HPI 1999 is associated with negative net effect of local capture on welfare, low quality-quantity local leadership, and low participation level. Other plots, except for literacy rates, show the relationships between these social indicators in 1999/2000/2003 and institutional elements in 2008, supporting the hypothesis that low social conditions are associated with low quality institutions. Literacy rate for Prabumulih is very high while

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[9] "Intimidation level" is defined as the degree of intimidations by local governments from speaking up against regulated policies or expressing one's own opinions.

local capture tends to be negative, local leadership is low quality and quantity, and participation rate is also low. All the above show some evidence on how pre-decentralization social indicators affect institutions in the post-decentralization period.

FIGURE 1.5 *Positive effect of initial social condition and participation on local capture*
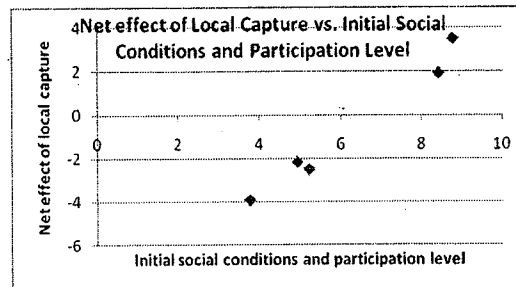

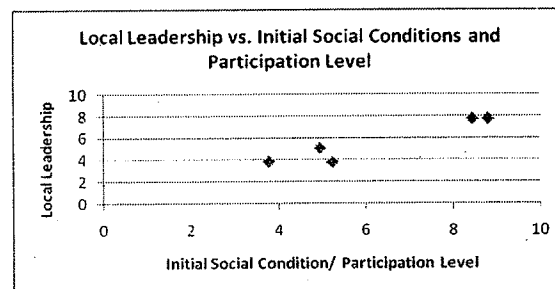FIGURE 1.6 *Positive effect of initial social condition and participation on local leadership*

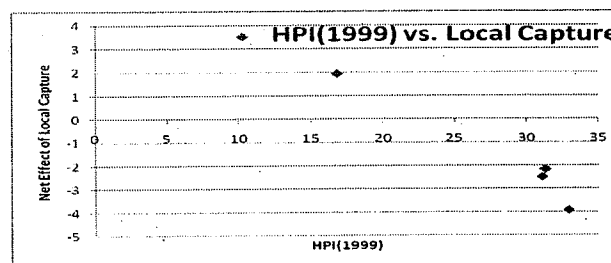FIGURE 1.7 *Human Poverty Index 1999 vs. Local Capture, Negative Effect*

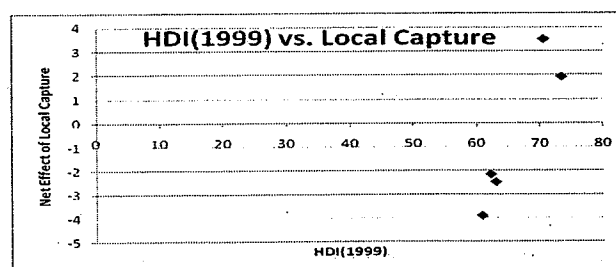FIGURE 1.8 *HDI vs. Local Capture, Positive Effect*
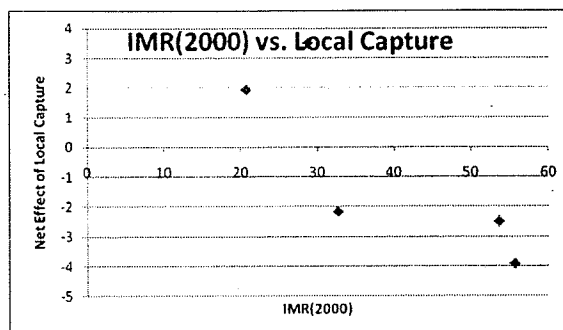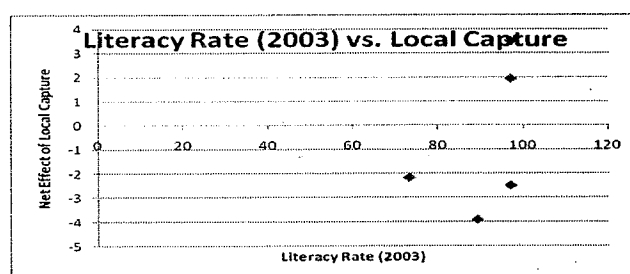

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FIGURE 1.9 *IMR v.s Local Capture, Negative Effect*

FIGURE 1.10 *Literacy rate vs. Local Capture, Ambiguous Effect*

CONCLUDING REMARKS

The disappointing result of Indonesia's rushing decision to decentralize in 2001 was not only due to lack of preparation and inappropriate policies at the central and local levels of government, but also, more importantly, caused by weak local accountability, widespread local capture, lack of voices or people's participation, and absence of proper incentive system for local leaders. The model developed in the paper focuses on these institutional factors. The possibility that local capture can generate positive welfare effects (thus, multiple equilibria) provides a more complex yet useful analysis with direct policy implications. More specifically, allowing greater people's participation can be superior to other alternatives as the welfare outcome will be higher and the level of capture is lower. This theoretical proposition is supported by the empirical evidence based on a field survey. Since welfare achievement post decentralization has been limited, and the decentralization policy is irreversible, a serious institutional reform is needed to provide incentives for, and motivate, local officials to maximize the net benefits of decentralization.

While useful and important, however, the above analysis has yet to consider the learning process and the role of incentive mechanisms that can lead to different dynamic paths with respect to welfare outcome and the quality and behavior of local leaders. When these are taken into consideration, the analysis ought to treat institutions *endogenously*, a subject matter that was discussed in Azis & Wiharja (2008).

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