

# Decentralization in Indonesia

TPM XXI: Developing Small  
Manufacturing in Rural Indonesia  
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# Outline of Presentation

- Purpose of decentralization and its mechanism
- Case of decentralization in Indonesia
- Factors that hinder the benefits of decentralization
- Policies suggestions?

# Brief Overview of Decentralization in Indonesia

- Political and economic decentralization were started in 2001 after the fall of Suharto.
- Its main purpose is to improve the ability of local governments to respond to local conditions.
- Furthermore, it also aims to serve as a national development policy that can yield national development outcomes
- Thus, when decentralization yields development-enhancing policies at the local level, then the sum of the effects of these policies could improve the economic performance for the country as a whole

# Links between decentralization and national economic performance

- What can decentralization do?
  - ❖ Produces greater participatory policy-making
  - ❖ Lower inflation through fiscal and monetary grants competition
  - ❖ More responsive taxation and public spending
  - ❖ Increases allocative efficiency
- Through what mechanism?
  - ❖ By having political decentralization, local governments gain autonomous control over some local policies.
  - ❖ Under economic (fiscal) decentralization, local governments gain the ability to levy their own taxes

# Effects of Fiscal Decentralization

- It increases individual welfare since local governments are better at discerning the preferences and needs of their constituencies (greater consumer efficiency)
- Greater producer efficiency:
  - A particular budget can yield larger quantities or better quality of services and infrastructure in decentralized system relative to a centralized system where high transaction and administrative costs are prevalent.
  - Services or infrastructure can be put in place at a lower cost

# Decentralization in Indonesia

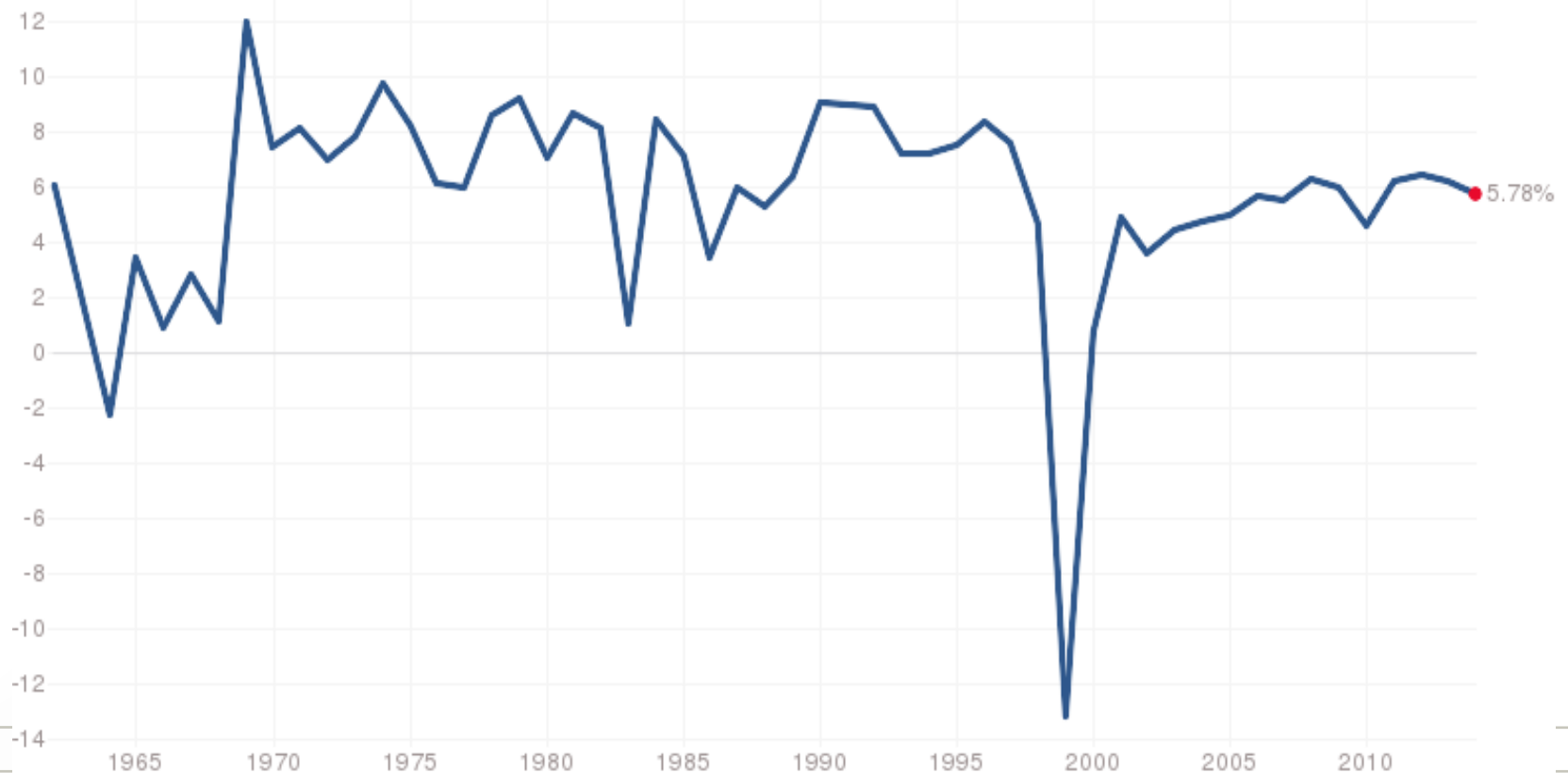
- Generally, the decentralization law in Indonesia is much more political than economic.
- Local revenues still come primarily through grants from the central government known as DAU (*dana alokasi umum*, general allocation grants)
- Nevertheless, the local taxation capabilities were expanded and local districts do have autonomous control over their own budgets.

# Decentralization in Indonesia

- The local governments have unprecedented responsibility for “all areas of government except for foreign policy, safety, law, monetary and fiscal policy, religion, and other matters”

# Does decentralization produce the desired outcomes in Indonesia?

## Indonesia's GDP Growth Rate (1960-2013)





# Does decentralization produce the desired outcomes in Indonesia?

- So, why hasn't decentralization improve Indonesia's economic trajectory?
- In our proposals, we identify three factors and will be addressed in this conference: the broken culture, government dysfunction, and leadership deficiency.
- For this presentation, I explore 2 reasons:
  - Heterogeneity in endowments or resources across jurisdictions (districts)
  - Factor immobility

# Heterogeneous Districts

- Analysts had shown that competition among districts for resources (capital and labor) provides a market-like incentive for the local governments to provide good policies.
- This means that for the local governments that respond to “market demands” to provide good policies will attract capital (and labor), while those that fail will not.

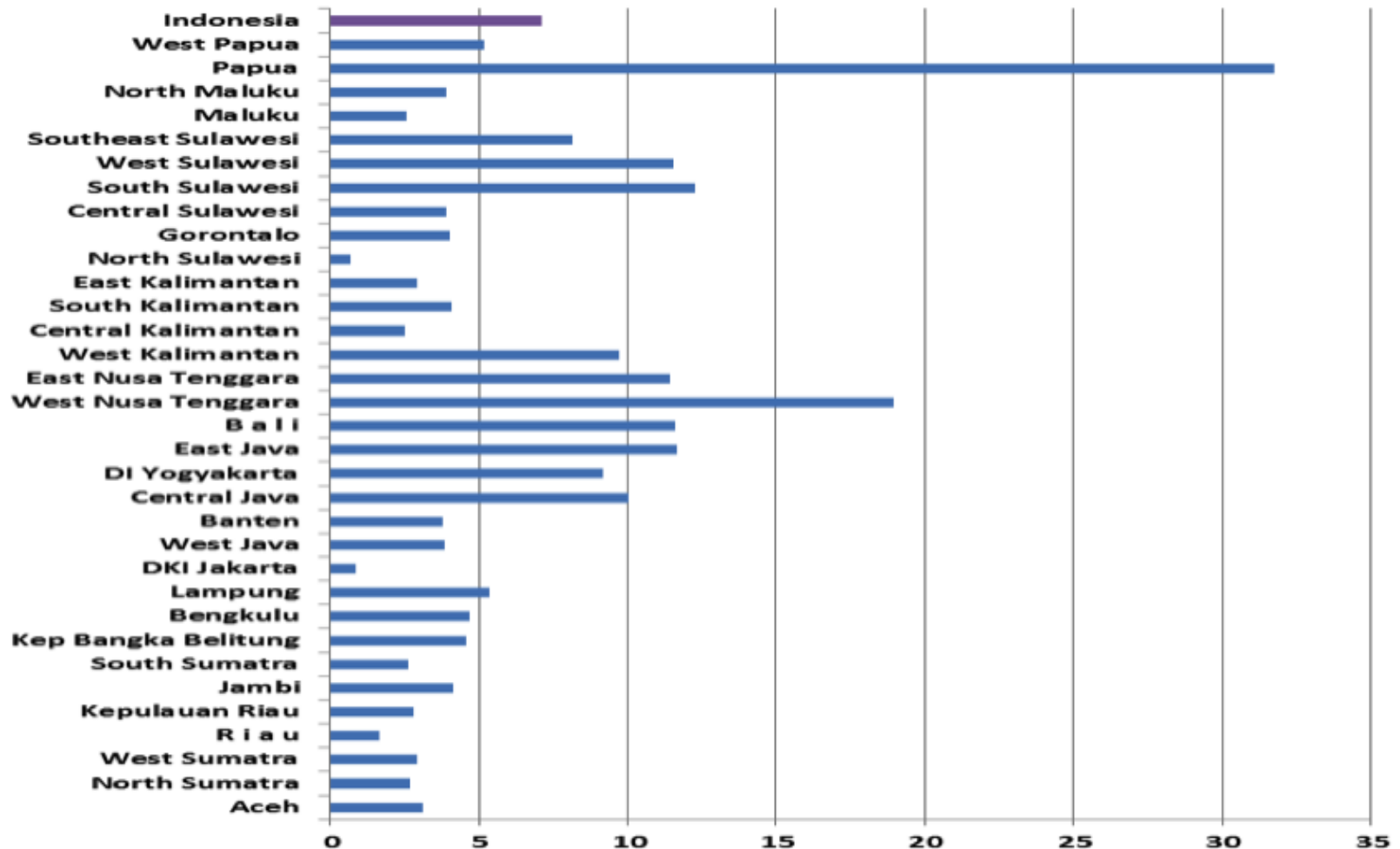
# Heterogeneous Districts

- However, this will only occur when the districts are sufficiently similar for competition.
- When the playing field is not balanced, governments from the backward regions are more likely to adopt predatory behavior since implementing good policies are not likely to attract capital or labor.
- Now, are Indonesia's regions similar enough for such competition to take place? They are not

# Heterogeneous Districts

- There are geographical differences. Proximity to key trade routes has been an important factor for regional development.
- There are also differences in human capital endowments (literacy level)

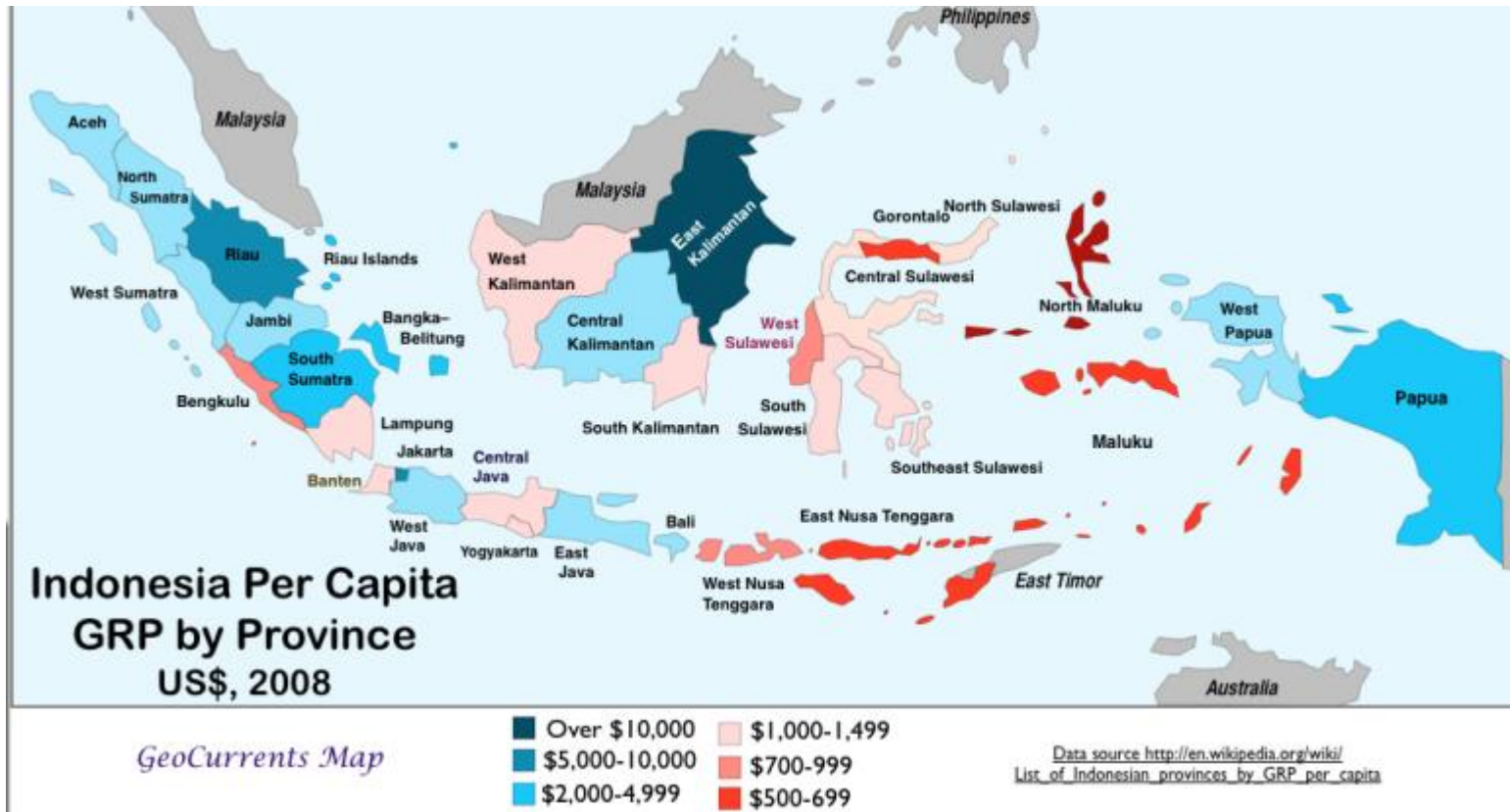
# Indonesia Illiteracy Level by Province



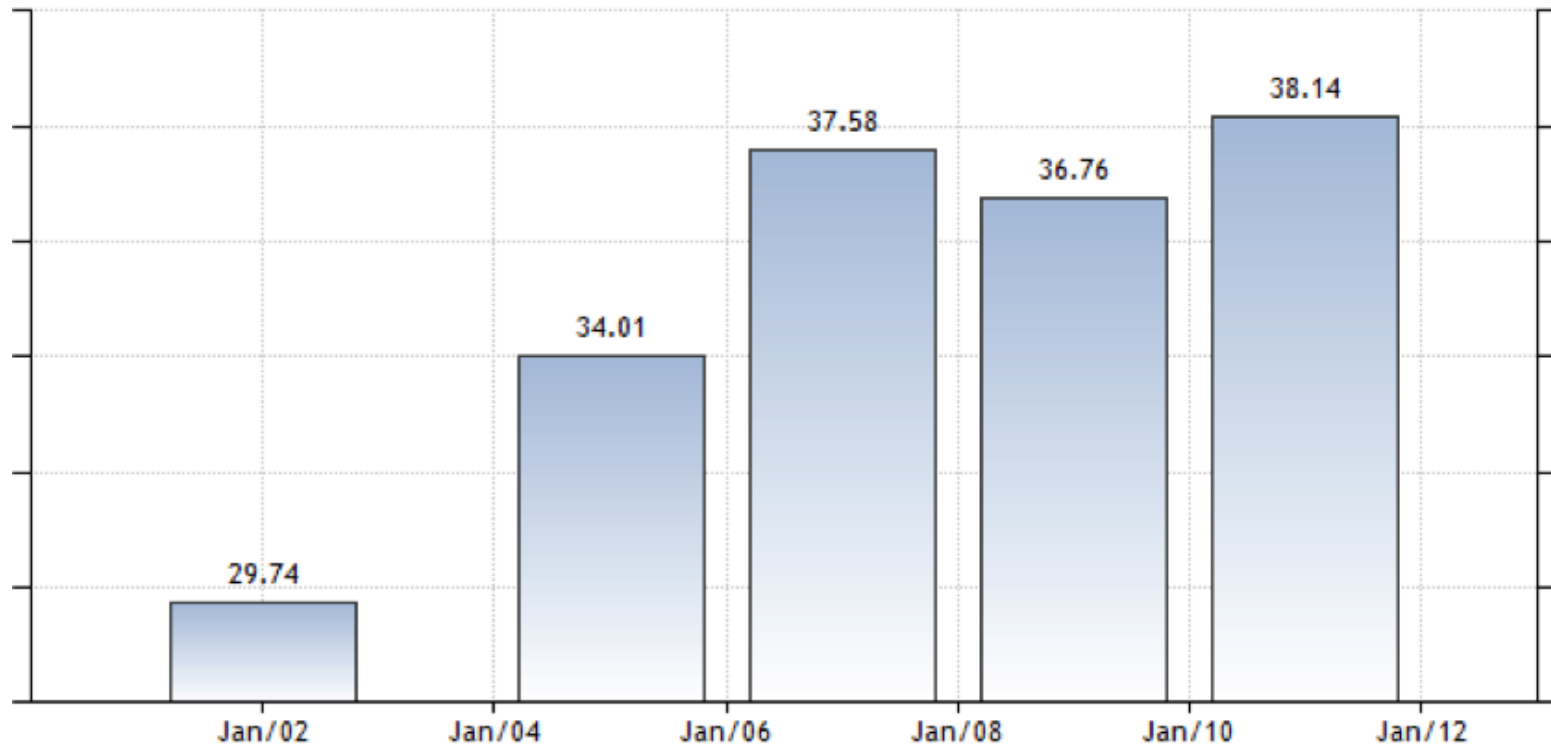
# Convergence Theory

- Some may argue that poorer economies per capita income are more likely to grow at faster rates than the richer economies due to the law of diminishing returns.
- Thus, if this theory is right, heterogeneous districts are not the causes behind the absence of competition among districts.
- Is this true in Indonesia?

# Indonesia's GDRP per Capita by Province



# Indonesia's Gini Index





# Heterogeneous Districts

- The data so far indicates that there is no evidence of convergence across districts.
- It is more likely that inter-jurisdictional heterogeneity hinders the local governments to have the ability to compete, which in turn would lead to an improved economic outputs.
- Or, competition is already present in spite of the heterogeneity, but we have not observed the effect yet.

# Factor Mobility

- Now, let's assume that all the districts are sufficiently similar.
- Can we now believe that inter-jurisdictional competitions are achieved?
- There's one more assumption that we need to realize before competitions are establish: factor mobility

# Factor Mobility

- Mobility comes in 2 forms: responsive and anticipatory
- Responsive mobility: People can move from regions with bad and corrupted local governments to another region with better government.
- Anticipatory mobility: Firms can choose which districts with the best regulatory environment to site their production facility
- Districts can only compete only if it is possible to draw productive resources (labor or capital) away from other jurisdictions.

# Responsive Mobility

- Are Indonesia's factor of production mobile?
- One way to test this is to measure how willing the labor are to move across districts.
- 2008 Indonesian Survey Institute

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	Answer	Number	%	% of Valid
Question: if you had the opportunity to move to a different region to obtain better work, would you do so?	Yes	954	37.44	39.49
	No	1462	57.38	60.51
	Don't Know	132	5.18	
	Total	2548	100	100

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# Responsive Mobility

- What are the factors that drive these labor to move?

Possible factors	Effect on moving
Education Level	positive
Improved household economic conditions	negative
Income Level	negative
Unemployed	positive
Corruption Perception	NA
Anti-Corruption Efforts	positive

- These results call into question the idea that labor mobility is sufficient to force local governments to compete with one another to provide good policies
- No evidence that offering good policies will attract labor from other jurisdictions.

# Anticipatory Mobility

- Now, let's consider the mobility of productive assets in Indonesia
- There are some which are quite immobile (i.e. mineral and agricultural resources).
- Some are mobile (financial services firm)
- A firm which is mobile can simply move to another region with relatively small costs compared to the immobile ones.

# Indonesia's national economic output

Component of GDP	2004	2005	2006	2007	2008
<i>Immobile</i>					
Agriculture, Livestock, Fishing, and Forestry	329,124.60	364,169.30	433,223.40	541,592.60	713,291.40
Mining	205,252.00	309,014.10	366,520.80	441,006.60	543,363.80
Industry (Petroleum)	94,263.40	138,440.90	172,094.90	182,324.30	242,061.40
Electricity, Gas, and Water	23,730.30	26,693.80	30,354.80	34,724.60	40,846.70
TOTAL	652,370.30	838,318.10	1,002,193.90	1,199,648.10	1,539,563.30
<i>Mobile</i>					
Industry (Non-Petroleum)	550,079.20	621,920.40	747,444.40	886,329.60	1,138,670.10
Construction	151,247.60	195,110.60	251,132.30	305,215.60	419,321.60
Commerce, Hotel, and Restaurants	368,555.90	431,620.20	501,542.40	589,351.80	692,118.80
Transportation and Communication	142,292.00	180,584.90	231,523.50	264,264.20	312,454.10
Finance, Real Estate, and Corporate	194,410.90	230,522.70	269,121.40	305,213.50	368,129.70
Services	115,740.90	141,071.40	168,459.20	193,954.70	226,223.60
TOTAL	1,522,326.50	1,800,830.20	2,169,223.20	2,544,329.40	3,156,917.90
Government Services	121,129.40	135,132.80	167,799.70	205,343.90	257,547.70
TOTAL GDP	2,295,826.20	2,774,281.10	3,339,216.80	3,949,321.40	4,954,028.90
Total Immobile, % of GDP	28.4	30.2	30	30.4	31.1
Total Immobile, % of Non-Government GDP	30	31.8	31.6	32	32.8

Figures in billions of rupiah, current prices. Source: Badan Pusat Statistik 2009.

# Anticipatory Mobility

- There are about 30% of Indonesia's private-sector GDP that are immobile.
- No evidence that this trend is declining.
- Although the majority of the GDP is mobile, there is still a substantial portion of Indonesia's economic output that is comprised of assets that are immobile.
- This calls into question the ability of districts to compete for resources.



# Conclusion and Policies' Prescriptions

- Summary: Indonesian decentralization program has not been able to improve the economic performance of the country as a whole.
- The problem of heterogeneous districts and factor immobility have been the reasons why competitions among sub-national units and good policies are not realized.
- One policy prescription is to increase the mobility of productive assets by developing and low-cost manufacturing sites in rural areas.