

**The practices of decentralization in Indonesia and its
implication on local competitiveness**

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Abstract

Indonesia has been undergoing a reform process. One of its features is the introduction of new decentralization guidance in 2001 under Law 22/1999 on regional governments and Law 25/1999 on fiscal balance between the central and regional governments and in 2004, they were replaced by Law 32/2004 and Law 33/2004. This thesis scrutinizes the practices of decentralization in Indonesia, which is commonly known as 'regional autonomy' under this new legal framework. Besides looking at the practices, it also attempts to reveal the impacts of decentralization practices on intraregional economic competitiveness, as it is becoming one of the objectives of decentralization policy in Indonesia.

A conceptual framework is made by exploring most recent development of the concept of decentralization and intraregional competitiveness to help analyse the practices of decentralization under the new laws and their subsequent. The general analysis suggests that decentralization in Indonesia is still undermined by various problems stemming from the design of legal framework and poor implementation such as poor institutional arrangement, lack of local finance and low human resource capacity.

Furthermore, a comparative case study is arranged to reveal the impacts of decentralization to intraregional competitiveness in two cities in Indonesia, Semarang and Surabaya. Because of some technical constraints to collect primary data needed, the analysis is based on secondary sources only. The objective of the case study to reveal the factors behind the difference investment growth trends between Semarang and Surabaya, especially related to the introduction of decentralization, could not be achieved here. However, the analysis may provide tentative answers to describe the impacts of decentralization on local competitiveness.

Several general implications can be drawn from the results: First, decentralization here is seen as an instrument to improve the performance of local governments in providing public services, including the services to business communities. Thus, the impacts of decentralization on local competitiveness, either positive or negative, depend on how decentralization is practiced. Second, in line with the problematic practices in Indonesia, the analysis found that decentralization –under the most recent laws- has not yet provide an appropriate level of support to improve local

competitiveness. However, the author inclines that local competitiveness will improve in parallel with the improvement of decentralization practices, as some cases suggest that better practices of decentralization are positively responded by business sector. Third, decentralization should be recognized only as a part of complex governance reform which is now effectively influencing economic development, especially local competitiveness in regions of Indonesia. Thus, the performance of local competitiveness can be affected not only by decentralization. So, it is too exaggerated to mention that decentralization determines local competitiveness, as the result suggests that decentralization is only partially impacted on particular aspects of governments' performance among other key factors for local competitiveness, such as national macroeconomics, other policies at national level and market conditions.

As a closing remark, the author proposes some recommendation for the Government of Indonesia in regards to improve their decentralization policy. To achieve its objectives, three important tasks needs first to be done: arrange the most effective way of how political, administrative, and financial authority that can be devolved; identify and create the conditions which are required for effectively sharing power and authority among governance institutions; and find the way of how capacity can be developed for effective participation by local governments and community groups in democratic governance.

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Chapter I

General approach of the thesis

I.1. Introduction

A decentralized governance as a replacement to centralistic government style has been widespread all over the world to be one of the main features of governance reform. Not only in advanced democracies such as US and the EU, decentralization in its various forms also has been the central focus of government reform in developing countries in Latin America, Africa and Asia as well.

When the centralized government everywhere has been recognized as a failure, decentralization is widely believed by its proponents to bring promising benefits. It is often suggested as a way of reducing the role of the state in general, by dispersing central authority and introducing more intergovernmental competition and checks and balances. It is viewed as a way to improve the responsiveness and efficiency of a government by taking the decision making process closer to the citizens. For example, it is believed to be easier now and more relatively efficient than before to provide public services (like electricity and water supply) in smaller market areas. In a nation with great diverse of ethnics which is a potential factor to conflicts and separatist movements, decentralization is also regarded as a way of diffusing social and political tensions and ensuring local cultural and political autonomy (Bardhan, 2002, p. 185). In most cases decentralization is often prescribed by international donors to their beneficiary countries as one of the reform requirements. Therefore, much attention and discussions are being given to investigate its impact to certain aspects of nation such as social, political and economic effects.

In most of Southeast Asian nations, decentralization has also been a central feature of fundamental transformation in the structure of government. According to White and Smoke, (2005, p.1), the initial progress of decentralization in some Asian countries is likely gone smoothly as in the case of Indonesia with the so called “regional autonomy”. Even though this may become a new progress to the decentralization development in Indonesia, it is too earlier to concluding the result.

Decentralization practice in Indonesia can be traced back before its independent day in 1945. During the course of the time, it took various forms and motives behind it. For example, in the days before independent, the first attempt to decentralize power had been practiced to maintain the efficiency of colonialist’s trading system. Under strict guidance from the colonialist, local leaders were only given very limited power. However, under the first president Soekarno there was an effort to create a proportional and balanced relation between central and local governments (Chalid, 2005, p.2). It is quite understandable since Indonesia

is a unitary nation with diverse ethnics and cultures scattered in thousands islands, decentralization is considered as an appropriate governing structure to manage and to embrace the diversity of the nation. However, before the law was ready to be implemented, because many parties were hardly contested the law, it was revoked. Subsequently, seeing that decentralization could be a threat to the nation's unity, under the late president Soeharto's regime, decentralization was practiced in the form of deconcentration. Thus, strong centralized government was maintained, until reform took place in 1998.

In reform era, the focus of decentralization process has been moved to the district level. The establishment of Law 22 /1999 concerning regional governments and Law 25/1999 which regulates fiscal balance between central and regional governments under former president Habibie, have changed the intergovernmental relations in Indonesia. It has been said that decentralization in Indonesia has moved from strong deconcentration practice to more devolved form (Smoke, 2007, p.141).

With these laws, local governments receive large transfer of authority and decision-making discretion from central government to develop and to govern their own regions. These deep changes have wide-spread effects in the way local authorities govern their regions. For instance, regions have to set new regulation to implement those newly empowered authorities. Some developments especially in local democracy seem to be real, such as on direct elections of the head of Kabupaten (region) and Kota (municipality) in 2004. It is believed that this process has encouraged democratic process in local levels and an improved of local governments' accountability to their constituents as a result of political decentralization (Satryo, et.all, 2005, p.8).

There are some motives behind the enactment of decentralization in Indonesia. The issues are ranging from social, political and economic motives. For example, international donors' pressures and unsatisfactory voices from regions to previous authoritarian regime have eventually forced the incumbent government to decentralize more power to local government. In economic recovery context, decentralization is an important part of developing regional competitiveness. As laid on the Indonesian Mid-Term Development Plan 2004-2009 (RPJM), one of the purposes of decentralization in Indonesia is to empower local economy by giving the local governments a wide discretion to build and to develop their regions' potential. According to Soesastro (2000), this can be done if the local governments have completely understood their potential competitiveness factors. By having sufficient and precise knowledge about the potential factors, it is easier for local governments to put in place sound regulations as one of the prerequisites to foster a favourable business climate in their territories (KPPOD, 2003, p.5).

However, the implementation of decentralization is not without problems which some obstacles begin to arise along with local practices of decentralization. Decentralization

process in Indonesia, which is commonly known as ‘regional autonomy’ (otonomi daerah), many argue that the rush and insufficient design and preparation of the laws - causing major flaws of the decentralization laws - were pointed out to be the major cause of the emerging problems. Amongst others, it is said that the decentralization laws did not take into account the inequality of regions’ capacity, so they can not be imposed effectively and conversely produce perverse effects, especially for poor and less developed regions. Furthermore, they have not a clear general framework which carried the goals of the reform (Alm, et. all, 2001, p.86).

However, those problems are considered as typical in a new decentralized country. The World Bank (2005) identifies three major decentralization problems in the new decentralized countries, especially in Asia. These problems are related to 1) the design of intergovernmental structure organizations, 2) financial mechanisms for money allocation to sub-national governments and 3) the accountability of local governments and their capacity to manage the newly received authority.

From the economic perspective, based on various surveys done after the implementation of the regulations (in January 2001), businesses have begun to complain about rapid establishment of various local taxes and charges imposed by local authorities¹. Those charges were reported to burden their operations and make them less competitive (Fauzi, 2003, p.7). Consequently, if this condition constantly occurs, business climate in the regions could be inhibited and eventually lowers the regional competitiveness. Thus, regional competitiveness has been becoming the centre of attention in recent years, especially as decentralization policy is effectively imposed.

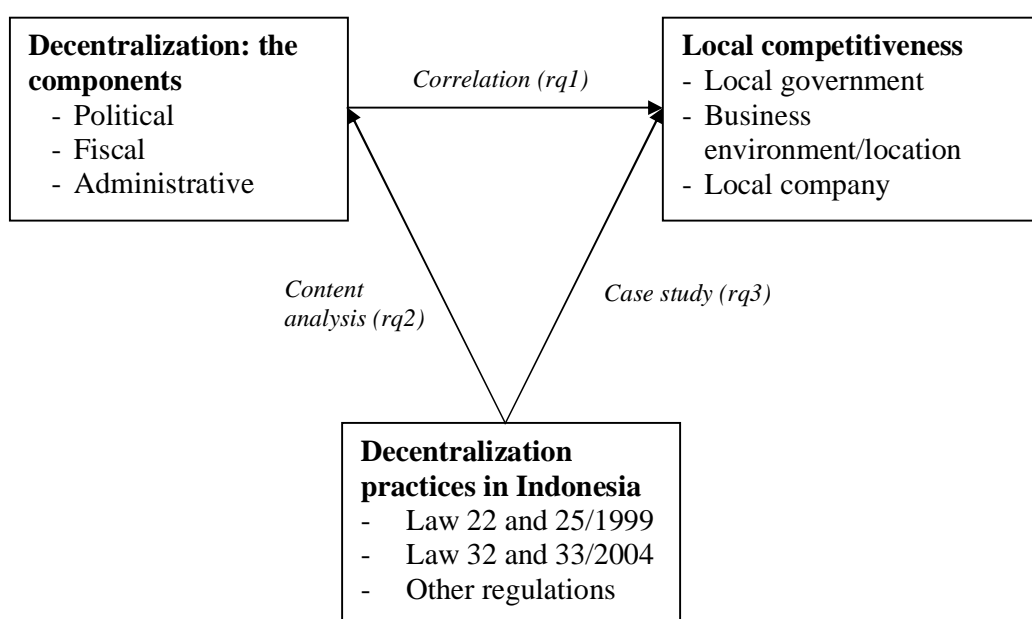
Sound business climate can be associated with investment attractiveness and to the competitive advantage of respective regions (WEF, 2006, p.3). It can be said that there is a desired level of competitiveness to be created in macro-economic level (Porter, 1990, p.158). Even though it is still debatable, competitiveness in macro-economic context is frequently presented by government as a central goal of economic policy. For instance, some experts describe it as a ‘dangerous obsession’ because a state is not the same as a private firm (Krugman, 2004, in Martin, 2005, p.2-1). Although this is an important part of the discussion of competitiveness, this issue is beyond the focus of this thesis. Therefore, it should be noted that the analysis will be focused on competitiveness at local (intra-regional) level.

To study the competitiveness at regional level, an analysis of competitiveness within decentralization is arranged and presented in this thesis. It attempts to reveal how far the

¹ See for example surveys by various NGO and donor countries such as USAID (2001, 2002), Kemitraan (2003), and SMERU (2005). Some of their researches include the observation of economic effect of decentralization, especially in doing business and investment. There are some main reports used in this thesis later on.

decentralization practices in Indonesia penetrate and influence the regional competitiveness system. This regional competitiveness is built by three competitiveness sub-system, namely: government competitiveness, location/business environment competitiveness, and local firms' competitiveness. The impacts of decentralization practices is analysed by identifying how the components of decentralization influence these three sub-systems. Empirically, a comparative case study is designed to put the decentralization practices in Indonesia into the conceptual framework. In a diagram, this conception can be drawn as follows:

Figure I.1. Problem Framing



I.2. Problem Statement

As explained in the background section, there are two major concerns of this thesis. These problems are complementary between one and another. First attention is given to reveal the nature of implementation of decentralization in Indonesia. Secondly, the investigation is focused on to the extent decentralization process is being connected to local competitiveness in Indonesia.

I.3. Research questions

Recalling the above mentioned problem, the main research question in this thesis is: *What are the implications of the introduction of the decentralization laws (UU no. 22 and 25/ 1999 and their subsequent laws) on local (intraregional) economic competitiveness in Indonesia?* To answer this main question, several sub-research questions can be formulated as follows:

- a. What are, according to the literature, the components of decentralization that will support the intraregional economic competitiveness?
- b. How are the practices of decentralization in Indonesia according to the laws ((UU no. 22 and 25/ 1999 and their subsequent laws) and, in how far do they support successful decentralization?
- c. What are the impacts of the introduction of decentralization laws to the local (intraregional) competitiveness in Indonesia?

I.4. Methodology

The objective of this thesis is to explain the correlation of implementation of decentralization in Indonesia to local competitiveness level. Therefore, the research will be both descriptive and explanatory qualitative analysis. The operationalization of this approach will be done throughout several steps. First, a conceptual framework of decentralization and also its connection to local competitiveness is drawn based on existing literature. This conceptual framework will help to analyse the content of the decentralization laws in Indonesia.

Second, a content analysis of decentralization laws in Indonesia is conducted. To do this, the conceptual framework from previous chapter is being used to analyze the decentralization laws and their subsequent laws and other relevant regulations.

To generate empirical data from the field, some interviews have been tried to arrange, but without results. Therefore, for practical reason, secondary data which represents information gathered from the interviews is employed. In this case, some surveys on various issues of decentralization which had been done by several domestic and international agencies comprising NGO and donor countries, universities, think-tanks and government agencies, such as The Indonesian National Development Planning Board (BAPPENAS) (KPPOD,2003, 2005; USAID, 2001,2002; and SMERU, 2002, 2004) are used.

I.5. Case study selection

Besides using survey results, a time series statistic data concerning investment growth will be used as initial figure to describe the trend of investment before and after the implementation of decentralization policy. Thus, an analysis of the factors behind the trend will be presented. To do this, a comparison study of two cities in Indonesia is conducted. This approach

compares cities which are similar in some aspects in order to find explanations for their particular differences (Hague and Harrop, 2004, p.82).

The selection of the cities is based on some purposive criterions. First, those cities in average have similar potentials and conditions. It means that they share common basic condition, such as the population, economic growth, political, social and cultural stability, geographical size, infrastructures and factor endowments (natural resources). This criterion is needed in order to provide unbiased investment data and to avoid misperceived data. For example, we avoid using resource rich regions because the investment growth could be high in those regions and it seems to reflect positive correlation. However, if it is scrutinized closer, except the factor of natural resources attractiveness, the investment growth data is unlikely to explain the other factors why investment growth is recorded high on those cities, especially when it is linked to the local competitiveness indicators.

Second criterion, the cities should not be in a condition which tends to show bias data on investment growth. For example, there are no calamities such as ethnic conflicts or natural disasters, especially in respective year of used data. And finally, as it has addressed above, although they have similar conditions and potentials, they are differing in investment growth. This implies that one region should have higher or better investment growth against another. By this way, the use of this design is to isolate the factors responsible for the investment growth differences between them (Hague and Harrop, 2004, p.83).

I.6. Structure of the thesis

This thesis is organized as follows. This first chapter provides a general approach to the subject of this thesis. Then, the second chapter will present a conceptual framework of decentralization and local competitiveness based on literature review. This framework then will help to analyze the decentralization laws and also the possible correlation between the variables (decentralization and local competitiveness). Subsequently, the third chapter will elaborate the practice of decentralization based on the existing laws in Indonesia and how far they support successful decentralization.

The fourth chapter will be used to elaborate a case study to discuss the impact of introduction of the decentralization laws on local (intraregional) economic investment competitiveness sector. The last chapter, the fifth chapter, will serve as conclusion of the discussion on this thesis.

Chapter II

The conceptual framework of decentralization and intraregional economic competitiveness

This chapter will answer following research question:
What are, according to the literature, the components of decentralization that will support the intraregional economic competitiveness?

II.1. Introduction

Decentralization term has been used in sloppiness and inconsistently due to the many of its applications to meet various objectives. Therefore, to solve this problem '*it must be defined in context or as pertaining to its particular application*' (UNDP, 1999, pp.26). Moreover, as Cheema and Rondinelli (2007) argue, many of the failures of decentralization are due less to inherent weaknesses in the concept itself than to government's ineffectiveness in implementing it (p.9). Therefore, we should be careful to define and to use the decentralization concept as it is often distorted by linguistic and conceptual problems. This is important to gain consistency on this thesis. To move further into the discussion, we arrange this section as follows: first, we briefly elaborate some methodological problems related to the definition, and then describe the forms and types of decentralization and its potential benefits, as emerged from the most recent literature. This needs to be done in order to get a common knowledge in defining and reading the 'decentralization' word within most recent conception every time we see it in the proceeding discussion and reduce the misconception possibility. Second, we present the components of successful decentralization. As the main part of conceptual framework in this thesis, in the third place, we elaborate the competitiveness concept and consequently, how it is being related to decentralization.

II. 2. General concept of decentralization

II.2.1. Methodological problem in defining decentralization

When first exploring the concept of decentralization from the existing literature, during the time course, it is found that there is no common definition on understanding of decentralization. Its development has taken on increasingly more diverse and varied meaning, objectives and forms. Thus, the use of decentralization term often leads to confusion especially for those who use the terms.

Indeed, there are some methodological problems in defining decentralization, especially in regard to the language usage, as pointed out by one of the prominent decentralization authors, Diana Conyers (1983) that '*...the language used in development studies...is plagued by ambiguities and inconsistencies, which lead to confusion, misunderstanding, and conflict of*

discourse'¹. Linguistic biases could occur as it is often used in many languages other than English, such as French and Spanish. For instance, there is different definition of decentralization between Anglophone and Francophone literature. There is also a problem in confining decentralization scope within a language, such as the careless attention of French specialists to use the word 'decentralization' to mean only 'devolution'.

Moreover, decentralization is also used by many people with their various objectives and preferences. As a result, those issues may eventually blur the clarity of the concept. These kinds of problem actually have been addressed by many authors of decentralization such as Diana Conyers and recently by Cohen and Peterson. They call for more studies to reduce those misconception and confusion².

Due to the widespread of development aid from western countries, the Anglophone definition is often used by international development agencies such as the United Nation and the World Bank to conduct their projects and studies in developing countries, including Indonesia. Consequently, it makes the Anglophone literature is better developed and widely used than the Francophone one. In order to prescribe decentralization as a reform project across different countries, they should have a general approach of decentralization to gain consistency and clarity of decentralization concept. Some efforts to fulfill this intention have been carried out, as they will be mentioned briefly latter in this section.

Until the late 1980s, there was growing agreement to explain decentralization based on the conceptual terminology developed by Rondinelli, Nellis and Cheema³. They define decentralization based on the classification of decentralization by form and type. Briefly, forms of decentralization are classified on the basis of objectives: political, spatial, market and administrative. Then, each of them is divided into types. The most elaborated approach of types is found in regard to 'administrative decentralization,' namely: deconcentration, devolution, and delegation.

However, as the concept of governance is expanded to the broader notion, it has also influenced the rationale, objective and forms of decentralization. To capture this change, Cheema and Rondinelli (2007) update their previous works by proposing a redefined concept. They categorized the decentralization practices into four forms: administrative, political, fiscal, and economic. Along with this redefinition, some international development organizations such as the World Bank and UNDP have also produced their own approach of decentralization. For instance, UNDP (1999) already recognized the ambiguity and inconsistency of the use of decentralization term and calls for a methodological approach of

¹ Conyers (1983, p.594), in Cohen and Peterson (1996, p.9)

² Cohen and Peterson adapt the problems of linguistic biases from Diana Conyers and they identify some major methodological obstacles to define decentralization properly.

³ G. Shabbir Cheema and Dennis A. Rondinelli, eds., *Decentralization and Development: Policy Implementation in Developing Countries* (Beverly Hills: Sage Publications, 1983), in: Cohen and Peterson, 1996, p.10)

defining decentralization⁴. There is no common definition proposed within this study. However, it suggests a methodological approach of defining decentralization based on its particular application or context (1999, p.26).

The World Bank's decentralization briefing note (2005) has gone further to redefine general approach of decentralization. It claims that it provides '*a broad overview to the several types of decentralization that can occur across countries and even within the same country and sector*' (p.1). There is an important progress to point out, as their studies become more critical in highlighting strengths and weaknesses of the prescribed reform approaches, such as decentralization in developing countries, instead of just blindly and carelessly force the agendas to their beneficiaries and resulted in unsatisfactory outcomes, or even in failed results⁵.

II.2.2. Form and type of decentralization

In general, decentralization can be defined as transfer of authority and responsibility from central government to the lower level governments or to quasi-independent government agencies such as state owned companies or to private sector (Cheema and Rondinelli, 2007). Therefore, it is principally different from a federal system. The word 'transfer' shows that the authority that the local governments retained is coming from the central government. It is a power that being delegated from the higher level of government (Hunter, 1977, p.3). In contrary, constitutional law in a federal system has divided the spheres of the power which each tier of government gets. In other words, the power in federalism, which the each level of governments has, including the local governments, comes from the constitutional law and therefore can not easily revoked as in decentralization in a unitary state.

The Cheema, Nellis, and Rondinelli first work divided (1983, in Cohen and Peterson, 1999,) the forms of decentralization based on the objective of decentralization, as follows:

1. **Political** forms of decentralization are typically used by political scientist interested in democratization and civil societies to identify the transfer of decision-making power to lower-level governmental units or to citizens or their elected representative.
2. **Spatial** forms of decentralization is a term used by regional planners and geographers involved in formulating policies and programs that aim at reducing excessive urban concentration in a few large cities by promoting regional growth poles that have potential to become centers of manufacturing and agricultural marketing.

⁴ United Nation Development Programme (UNDP). (1999). Decentralization: A sampling of definition. Working paper prepared in connection with the Joint UNDP-Government of Germany evaluation of the UNDP role in decentralization and local governance.

⁵ The author saw those critical views of decentralization in most recent studies and papers produced by the World Bank. For example, the working paper by Kimr (2008), criticizes that most of the claimed benefits of decentralization is not valid in developing countries for some reasons.

3. **Market** forms of decentralization are generally used by economist to analyze and promote action that facilitates the creation of conditions allowing goods and services to be provided by market mechanisms sensitive to the revealed preference individual.
4. **Administrative** decentralization is the focus of lawyers and public administration professionals seeking to describe or reform hierarchical and functional distribution powers and functions between central and non-central governmental units.

In their most recent work, Cheema and Rondinelli (2007) divide decentralization into four general forms: administrative, fiscal, political and economic. It would be useful to recognize them in detail in order to become aware of their existence in a particular situation. Based on the forms of authority that are being delegated, decentralization can be divided into four forms:

1. **Administrative decentralization** refers to the redistribution of authority, responsibility and financial resources from central government to local or regional governments or other decentralized unit such as semi-autonomous public corporations, regional or functional authorities.
2. **Political decentralization** includes organizations and procedures for increasing citizen participation in selecting political representatives and in making public policy; *devolution* of powers and authority to local units of government; and institutions and procedures allowing freedom of association and participation of civil society organizations in public decision-making, in providing socially beneficial services, and in mobilizing social and financial resources to influence political decision-making.
3. **Fiscal decentralization** includes the means and mechanisms for fiscal cooperation in sharing public revenues among all levels of government; for fiscal delegation in public revenue raising and expenditure allocation; and for fiscal autonomy for state, regional, or local governments.
4. **Economic decentralization** includes market liberalization, deregulation, privatization of state enterprises, and public-private partnerships. It is the shift of responsibility for functions from the public to the parties outside the governmental structure, or the private sector. This is the form that allows functions which were previously monopolized and primarily held by government to be carried out by businesses, community groups, cooperatives, private voluntary associations, and other nongovernmental organizations. Market decentralization usually takes two forms: privatization and deregulation.

Besides being divided based on the kind of authority that is transferred, decentralization can also be classified based on the degree of discretion that is transferred and to whom the authority is transferred. It can be divided into at least four types:

1. **Deconcentration** of responsibilities from central government ministries and departments to subnational and local levels. Thus, the central government still retains strong authority.

2. **Delegation.** It refers to the transfer of responsibility from central government to semi-autonomous organizations not wholly controlled by the central government but ultimately accountable to it. The example for this form is the creation of public enterprises or corporations.
3. **Devolution.** Devolution happens when central government transfers full authority for decision making, finance, and management to quasi-autonomous units of local government. In this type, local governments have clear and legally recognized geographical boundaries over which they exercise authority and within which they perform public functions. Further, they also have power to mobilize resources to perform their tasks.
4. **Transfer** of responsibilities to nongovernmental organizations. The example for this type of decentralization involves contracting out partial service provision, administrative functions, and deregulation or full privatization.

Considering the focus of this thesis, the latter type of decentralization will not be elaborated further, as it falls beyond the focus of attention. However, in practice, all countries have a combination of these types, ranging from a focus on deconcentration and delegation with limited power devolution to much more focus on devolution of political, financial, and administrative authority to directly elected local governments.

II.2.3. The potential benefits of decentralization

A lot of claimed benefits of decentralization can be found in its vast literature. Among others, the potential benefits which will be elaborated below are the most claimed by the proponents of decentralization. However, it is crucial to keep the word ‘potential’ while mentioning the benefits of decentralization as their evidence is mixed in practices. Practices over more than two decades suggest that these are not the only possible outcomes of decentralization policies⁶. In some cases, those benefits are likely to be real, while in the other cases; they might be not the result. The potential benefits of decentralization are as follows:

1. In the broader context of governance, decentralization can enhance the ‘fundamental principles of good governance’ which include political openness, participation, tolerance, administrative and bureaucratic capacity and efficiency. It is also seen as a way of increasing the capacity of local governments by delivering public sector modernization (Grindle, 2007, p.66).
2. It perceived as improving political representation to diverse political, ethnic, religious, and cultural groups without disrupt the state’s stability. Thus, it can be seen as a way to

⁶ Grindle, 2007, p.61, in: Cheema and Rondinelli, 2007.

improve the popular participation of citizens in development process and brings the policy-making process closer to citizens. This is the most important rationale, especially in a country with a high degree of social, political, and cultural diversity.

3. It enhances the creativity and innovation of all governance institutions in responding to public needs through public sector entrepreneurship⁷. It could help improve the equality of regional development, empower communities, and mobilize private resources for investment in infrastructure and facilities⁸.
4. From the economic rationale, decentralization is believed to deliver allocative-efficiency of resources that benefit the citizens. Allocative-efficiency is a condition where the limited resources in public sector are allocated at the wishes of the citizens and therefore brings the maximization of the net benefit. Allocative-efficiency can be created through the distribution of functional and expenditure responsibilities to the different levels of government. This assignment should depend on the relative competence of different levels of government to carry out a particular functional area. Thus, to assign these responsibilities, there are four considerations: 1) economies of scale, 2) the presence of externalities, 3) heterogeneity of preferences and of circumstances, and 4) emulation (Kimr, 2008, p.12).

II.3. The components for successful decentralization

There are some important components of successful decentralization (World Bank, 2005, p. 9). By considering these components in the design of decentralization framework, it is expected that decentralization would bring its potential benefits; otherwise, it may have undesirable effects. In other words, they are the components which may make decentralization framework works. This section elaborates those components based on the World Bank's (2005) works⁹. It begins with the components in political decentralization and then move forward to fiscal decentralization and finally the administrative decentralization. These components will be used to analyze the decentralization laws in Indonesia and in how far they support a successful decentralization.

II.3.1. Political decentralization

Constitutional, legal and regulatory framework

Constitutional, legal and regulatory framework concerning decentralization in a country will ultimately stipulate '*how the decentralized systems are supposed to function*' (World Bank,

⁷ Grindle, 2007, p.64, in: Cheema and Rondinelli, 2007.

⁸ Serageldin et.all. (2000) in: Cheema and Rondinelli (2007, p.7)

⁹ The World Bank, Decentralization Briefing Note, eds. Jenny Litvack and Jessica Sheldon, World Bank Institute, 2005

2005, p.11). There are three platforms architecture underpinning the design of decentralization constitution framework:

1. The framework should explain the broad principles of the operation of decentralization and details the rights and responsibilities of all levels of government and their roles. The constitution also serves as the basis of establishing or changing the detailed rules.
2. Defining specific parameters of the intergovernmental fiscal system and also institutional details of local government structures, procedures, accountabilities and remedies.
3. There should be a series of regulations established in order to interpret and to detail the practices and measures of the law(s) operation, including the tasks that are shared between national and sub-national governments.

Furthermore, there are some issues that should be addressed in shaping the contents within these platforms. First, whether the items placed in the platforms come from a consensus of involved stakeholders or difficult negotiations between competing interests. Second, it is necessary to keep its consistency to the other existing laws to prevent confusion and contradiction with other laws. Third, it should recognize the differences of capacity among the level of governments and matching the degree of autonomy and the privileges given to the regions' performance. (The World Bank, 2005, p.13). Among others, the most important is that the legal and regulatory systems should have a single interpretation to minimize the discrepancy between the formal rules and actual practice. Ambiguity and complexity create openings for conflicting interpretation and confusion (World Bank, 2005, p.14).

Participation

Broad participation of citizens has two dimensions in a decentralization process: as a precondition for successful decentralization and as a goal that should be achieved through decentralization. Citizens can effectively influence the government by voicing their preferences if they have the ability to use the participation channels properly and to control the incumbent to comply with their wishes and make the resources are allocated efficiently. This is the precondition for successful decentralization. In the other hand, however, decentralization can provide broader channels of participation for citizens and makes the decisions of resource allocation are closer to citizens than the former centralized system of with limited citizens' participation. In this sense, local governments can enhance the resource allocation by base their decision from the information gathered from those participatory channels and consequently, improve their accountability and responsiveness to their constituents. Thus, the decentralization framework should ensure that these functions are properly addressed.

II.3.2. Fiscal decentralization

The decentralization effort includes the expenditure and revenue assignment to local level. The most extensive discussion may come within this aspect of decentralization because it arranges the distribution of responsibility to deliver the public services among levels of government and the resources to fulfill those responsibilities.

Expenditure assignment

There are some considerations of designing the fiscal decentralization policy. It is imperative to define as clearly as possible the expenditure responsibilities to enhance accountability and reduce unproductive duplication of authority and legal challenges (World Bank, 2005, p.19). In this case, following the principle of subsidiarity, the decision-making for a particular public service should be based on the geographical area that internalizes the benefits and costs of related service. It may lead to the grouping of roughly congruent services at each level of government. However, as Kimr (2008) noted, this principle is contradicted with the residual principle applied in unitary countries, where local governments are assigned particular functions by the central government.

The local governments should be assigned with some particular services that could better deliver locally. In areas of shared responsibilities, the roles should be clarified. Generally, the central government should be involved with overall policy, setting standards, and auditing; state/province governments should have an oversight function; and local governments should be involved in the provision of infrastructure and services.

An additional important consideration is that accountability is often best promoted by establishing clear and close linkages between the costs and benefits of public services, so that the amount of expenditure responsibility assigned to a particular level of government corresponds to the amount of revenues that each level has at its potential command.

The revenue assignments

The decentralization policy should balance the distribution between expenditure and revenue. In term of revenue sources, there are three sources of revenue for local governments: local taxes, intergovernmental transfers and sometimes, local borrowing. There are some considerations to design the policy concerning each of revenue sources.

Tax is one of the main revenue sources for central and local governments. Therefore they should be designed carefully to avoid adverse effects because of improperly design of tax policy. In setting tax policy, there are several notes to be addressed:

- Tax should have sufficient proportion for each level of government corresponds to their expenditures.
- There should be no overlapping tax between levels of governments which could harm or reduce citizens' benefit or taxpayers.

- The tax policy should not have adverse effect on the efficiency of internal common market. Uncoordinated setting of tax can disrupt the movement of mobile resources such as capital and tradable goods across the regions.
- The decentralized tax policy often comes with potential increase of administrative cost for the tax collection and management activities, especially tax with multi-district bases and mobile base across jurisdictions.
- Ideally, revenue collected should be enough to fulfill revenue needs (expenditure responsibility). Thus, tax assignments should be assigned to the level of government with responsibility for the related service. However, the tax setting must not be at the expense of efficiency of tax administration and national economic. Hence, the difficulty lies here, on the one side tax instruments have to make local governments become accountable for their revenue. While on the other hand, the instruments should keep the efficiency of tax administration and avoid national economic distortions.

Intergovernmental transfer and grants

The design of intergovernmental transfers and grants is usually established to address some specific problems such as fiscal gap or vertical imbalance between expenditure and revenue at sub-national government level. Furthermore, the transfers are important to correct fiscal inequality among the sub-national governments, improve the fiscal efficiency across jurisdictions, overcome spillovers and establish fiscal harmonization. The World Bank (2005) defines several characteristics of good design of intergovernmental transfers as follows:

- Transfers are determined as objectively and openly as possible, ideally by some well-established formula.
- Transfers are relatively stable from year to year to permit rational sub-national budgeting, but at the same time they are sufficiently flexible to ensure that national stabilization objectives are not thwarted by sub-national finances.
- The formulas are transparent, are based on credible factors, and are as simple as possible.

Sub-national borrowing

Local loans often raise issues on national macro concerns because they have potential effect to transfer the fiscal liabilities to the central government. Moral hazard problem becomes the centre of the argument. Access to financial markets by sub-national governments may involve either implicitly or explicitly central government guarantees that lead to imprudent action by lenders and sub-national governments. Ultimately, this creates unplanned fiscal liabilities for the central government. Thus, a well-designed regulatory framework is necessary to prevent the above mentioned problems. This action necessarily requires sub-national government to expose their liabilities and repayment capacity to the public, as well as the existence of penalties if there is excessive borrowing. Ensuring that sub-national governments have access

to their own sources of revenues that can be pledged as collateral is also necessary to reduce possible moral hazard.

The combination of the use of information systems, access to own revenues, public legislation, bankruptcy laws, and market decentralization offers an overall institutional incentive for a hard budget constraint at all tiers of government. Eventually, this condition permits borrowing to be decentralized. Sequencing fiscal decentralization prior to allowing sub-national borrowing might become one of the policy options.

II.3.3. Administrative decentralization

Civil service reform and decentralization

Decentralization gives the governments various channels to access citizens' preferences and to identify local conditions in order to match their activities to local needs and thus creates incentives to local politicians to be more accountable to their constituents. However, it is not an easy task to perform such issue especially in a newly decentralized country which is used to be centrally controlled. The levels of difficulties are arranged from providing sufficient level of capacity of human resource at the local level while at the same time preserving national standards of service delivery. The administrative decentralization framework should also be designed to avoid inequality of human resource distribution among regions, and at the same time reducing potential refusal of central mandates by local authorities. Hence, the design of administrative decentralization policy should deal with following issues:

- Inequality of local condition to attract human resources may lead to unequal redistribution. This can hamper efficient service delivery since local governments would need competent people in order to carry out new responsibilities. Therefore, the degree of local capacity determines the kind of human resources management strategies that will be feasible and desirable. This calls for the role of central government in shaping human resource policy without curtailing local options.
- The framework of administration decentralization has to provide incentives and discretion for local governments to tailor their own human resources needs to undertake their responsibilities.
- Local capacity is one of the most important factors in creating a well-functioning, decentralized civil service. The starting point for reforms varies from country to country. In countries where local government institutions are embryonic or exist only at an informal level, the institutional and legal framework will have to be created before any administrative reform or training is undertaken. More than training, however, incentives for self-improvement can have an important impact on local government performance.
- Regarding the inequality of region's ability to attract skilled civil servants, some possible options are to emphasize the capacity building in poorer areas and to create policies that

allow sub-national governments the flexibility to hire civil servants that matches the community's needs and budget constraints. Once more, this need to be synchronized with national policies.

- Increased citizen control and augmented information for policymakers are two of the most commonly recognized benefits of decentralization. The challenge is to balance these bottom-up pressures with some sort of accountability to higher levels of government in order to ensure that local policies are compatible with larger-scale national efforts. Benchmarks, essentially lists of responsibilities or standards to meet, can effectively balance these bottom-up influences. Clear path for information flows are the first step in ensuring coordination between different levels of government and citizens. Clear reporting procedures are needed from lower to higher levels of government (central government, in the case of regional administrations, for example) and across government agencies at the same level.

Information and monitoring in decentralized system

Accountability is a prerequisite for improving public sector performance, and information is the key to accountability. The systematic collection, analysis, and reporting of information are critical elements of decentralization programs because information can be used to verify compliance with policy goals, to analyze alternative outcomes, and to guide future decisions. Information on financial flows (that is, budgeting and expenditure reporting) and other inputs, outputs, and outcomes is essential both at the local level—to inform local constituents and to encourage public participation in the political process—and at the central level—to monitor and supervise local activities funded (at least partially) by central sources.

To improve financial accounting and reporting, detailed fiscal data should be regularly collected and reported for sub-national governments. Ideally, these data would be derived from uniform financial and reporting systems. At a minimum, these data should be collected and processed on a regular and timely basis. The development and implementation of financial reporting and information systems often require substantial technical assistance, training, time, and resources.

Local technical and managerial capacity

Decentralization always comes with inequality and disparity of capacity among various levels of government, especially in local governments' capacity. Thus, the decentralization policy should take into account this capacity gap and arrange the most appropriate policy to address it. In order to do so, it is useful to set out some of the relevant issues in objectively measuring local capacity. There are four general skill areas: identifying and analyzing local problems in order to plan appropriate responses, mobilizing and managing resources, communicating and coordinating policy implementation, and resolving local conflict.

The first task is to identify the specific tasks that local governments and citizens will need to carry out. The second task is to create appropriate, comprehensive indicators to measure local groups' ability to carry out the required functions. There are several issues to consider in measuring capacity: outputs or outcomes, variable ability, people or institutions, bureaucratic and technical infrastructure, and the role of civil society.

Conventional approach to decentralization puts capacity building first before decentralizing the responsibilities or revenues, because of suspicions about irresponsible spending, local corruption, regional inequities, and service collapse as well as by many central governments' reluctance to devolve authority. One of the arguments of decentralization is to increase local participation and hence local government leverage in gaining access to national resources and to encourage the development of public and private planning and management skill. Therefore, decentralization can be a good way to build local capacity which usually could be done through training and practice.

II.4. Competitiveness definition

In general, there are various explanations of defining competitiveness and also debates over the concept. For instance, competitiveness in its simplest definition is viewed only based on the exchange rate (Boltho, 1996). Others define it broader by focusing on structural factors which affect medium to long term economic performance (Fagerberg, 1996). The eminent work may come from Porter (1990) with his 'competitive diamond' concept.

Briefly, he argues that the competitiveness of a location as the productivity that companies located there can achieve. So, there are three key elements in his concept: productivity, location and company. All of them have been used to understand the drivers of sustainable economic prosperity at a given location. Thus, it should be noted that among these elements there are inter-correlations which influence each others. For example, geographical location is considered as a key determinant of company productivity. While in the same time, company's productivity becomes the key determinant of the level of prosperity a location can sustain over time. This puts a basis for concepts and theories explaining the source of prosperity and growth differences across countries.

II.5. Regional competitiveness in decentralization framework

Most of the literature discussing competitiveness has focused on the concept at the national level. However, some literatures have already shifted its attention to the importance of the sub-national level. Some authors of competitiveness become more aware that factors which determine the productivity of a company may differ significantly across sub-national regions with countries, explaining the reasons why there are large and sometimes persistent prosperity differences among them. Therefore, sub-national regions are the level where competitiveness is being determined, even though the other geographic levels, inevitably, influence the

business environment within sub-national regions. Therefore, it is important to consider the implication of the geographical boundary, especially for policy analysis of their different roles and priority issues for competitiveness.

More over, evidence is found that cities/regions do compete with each other to obtain investments and to promote themselves as a place for business activities. For example, some cities are performing better than others as they can generate more income and employment within their boundaries than others (Begg, 1999, p.4). Thus, it is important to establish an analysis of the factors which driving the region's competitiveness. For instance, 'good' policy can equip cities to adapt and to foster a dynamic economic environment; ill-judged policies can deter investment and trigger to the relative decline of such environment (Begg, 1999, p.9). There is also growing recognition to call upon governments to create an environment that supports rising productivity (Porter, 1998, p.23). This suggests that the capacity of a city to compete is shaped by interplay between the attributes of cities as locations and the strengths and weaknesses of the firms and other economic agents active in the regions, especially the local governments.

In terms of decentralization which divides government into different levels, the interaction between policies pitched at different levels and their effects will be much of the concern. Taking into account local competitiveness variable, the challenging task for decentralization policy will be to enhance the performance of individual cities, without destabilizing the national economy, but in the contrary supplement it. Thus, the key question becomes how policy for enhancing competitiveness should be assigned between tiers of government. In line with the subject of this thesis, the analysis below may partially address this question, especially on how decentralization delineates the roles of local governments in improving local competitiveness.

II.5.1. Intraregional competitiveness factors

To analyze the intraregional competitiveness factors, the analysis recognizes three sub-systems of the factors of competitiveness that build regional competitiveness as a whole. Each sub-system signifies the different role of each main actor in the intraregional competitiveness system. These levels are elaborated as follows:

1. Local governments' competitiveness sub-system: the argument for the existence of local government is to serve the communities where it belongs based on the wishes and needs of the communities. Thus, the government competitiveness is assessed through its performance in serving those needs and wishes. In the concept of governance, it also highlights the capability of a government to embrace the other actors, such as the civil societies and the private sector to participate in the development process. Thus, the principles of good governance such as responsiveness, broad participation, transparency, accountability and capacity for using resource efficiently are becoming the measurement

indicators. In short, governments' 'competitiveness' captures how efficient and effective a government can be when it serves its constituencies.

2. Business environment/location's competitiveness sub-system: This sub-system points out to the location in which businesses operate. The development between regions at a certain level will be different, thus creating the distinction between locations. Eventually, these differences will generate the attractiveness of a region for businesses. In this context, regions will compete to get economic resources they need to achieve prosperity. Much attention being given to create a favorable business climate within the regions. Thus, it is imperative to measure the competitiveness of the regions through the business environment they offer, such as the infrastructure, regulations regime, and community building which may support a rising productivity. The business environment factors are largely influenced by the government's performance and its civil society.
3. Firms' competitiveness sub-system: It is undoubtedly that the basic idea of competitiveness comes from the firms' level. Firms compete to each other in a zero sum game. Aside from the external environment in which businesses operate, the productivity of a company is also strongly influenced by the quality of its management itself– the ability of business leaders to manage their company efficiently. Thus, their competitiveness is measured through the productivity and the performance of the company's management.

II.5.2. Possible correlations between regional competitiveness' factors and decentralization components

The foregoing discussion points to a range of interplay between the components of successful decentralization and the three levels of competitiveness factors to explain the correlation between them. Therefore, this section provides possible correlation between both concepts. However, considering the limitation of place and time, the author realizes that the analysis presented below might not capture the whole picture of all dynamic inter-correlations between them. This will be a future work to explain.

II.5.2.1. The government 'competitiveness' and the components of successful decentralization

The main aim of decentralization policy is to enhance good governance practices at all levels of government. However, the level of government which is most affected by decentralization policy is the local government. The process of decentralization has brought significant new resources and power to the local decision-makers. Decentralization, in certain degree, also encourages the local governments to involve the civil society and private sector together to provide public services.

The advocates claim that one of the potential benefits of decentralization is to improve the responsiveness, accountability and capacity of local governments to act based on the wishes

of their people. Hence, it is believed that sound regulation setting in decentralization policy, which ensure public sector accountability, efficiency, transparency and free from corruption, would enhance governments' efficiency and thus avoiding the waste of public resources and regulatory burden, especially for the businesses sector. Thus, the 'competitiveness' of governments is very likely to be influenced by the practice of decentralization. However, it should be noted that these are not always positive. In this case, as an instrument of governance reform, the success and fail of decentralization policies lies on the design of its legal framework. Therefore, it calls for clarity of rights and responsibility of all levels of government and their roles as well.

Only when it is properly designed, decentralization could sharpen the need for defining the comparative advantages of each of the different actors. In the local level, local governments can specialize on the services which are specifically tailored only for their communities. This, likely, would improve the 'competitiveness' of local governments. However, potential threat of the negative effects still exists and can not be eliminated if it is poorly designed and implemented.

II.5.2.2. The business environment/location 'competitiveness' and the components of successful decentralization

To create a competitive business environment, regions are required to provide good quality of infrastructure, skilled human resources through education and trainings, ensuring healthy economic environment for competition and a supporting regulatory environment for the business sector to raise productivity. For instance, in the case of facilitating the development of specific industries, as in cluster-based program (Porter, 1990; Enright, 1998), the local investments tend to be become far more focused on the infrastructure, skills and capabilities required by the industries. Besides, the social and community development of the region also affect the conduciveness of a business climate. Above all, the level of governments' intervention to the local markets where the companies compete also plays a crucial role in shaping the attractiveness of region for businesses.

In general, the governance and policy influence resemble the local environment as a set of factors outside the direct control of the firm. These factors exert a significant influence on the attractions of the locality as a place of business by affecting the ease with which business can be conducted (Begg, 1999, p.8). This implies that regulatory regime and institutional design influence the competitiveness of a location.

In fact, decentralization does not touch these factors directly. The components of decentralization can only induce them through out governments' interventions, roles and performances. The design of decentralization framework will influence in the way each level of governments deploys policy concerning those factors. However, as the decentralization is directly affecting the governments' actions, the outcome of those actions will directly

influence the business environment. Consequently, at this competitiveness' level, there is a quite distance between decentralization and the competitiveness of local business environment. Therefore, direct link between them can not be drawn robustly.

Yet, if decentralization is seen as a part of regulatory regime's reform, especially at local level, the relation between them will be clearer. There is evidence that demonstrates how changes on regulatory regime can produce many influences on competitiveness. This also implies that the governments' roles in shaping competitiveness become more important, rather than leave the market mechanisms to build competitiveness alone¹⁰.

II.5.2.2. The local company 'competitiveness' and the components of successful decentralization

It is obvious that competitiveness is an attribute of companies. They compete in zero sum game to acquire markets and resources, measure competitiveness by looking at relative market shares or profitability, and use competitiveness strategy to improve their performance. Hence, competitiveness of a firm can be assessed based on its capability to reach the highest productivity through resources utilization and production process efficiency. Thus, the ability of business leaders to manage their company efficiently is crucial here. While business environment is heavily weighted by public policy, company is the part of competitiveness system that public policy has only limited influence. It is important to keep in mind that, as Krugman and Porter point out, it is actually the companies who compete to each other and generate prosperity, while nations or the regions compete to offer the location conduciveness for business.

Thus, to improve the regional competitiveness in a whole, the policy should also concerns about the competitiveness at firms' level. Only with a specific strategy, governments can improve the company's performance. The clusters strategy is a good example. This strategy fosters a geographic concentration of firms as well as suppliers and service providers of the same sector. It has been recognized as a significant factor to improve a company's performance. Unfortunately, if the objective of decentralization is confined only to improve

¹⁰ For example, Korean industries grew rapidly after a regulatory reform took place. This point is questioned by the author: why Porter puts the role of governments outside his 'competitive diamond', while the governments do have influence to shape the competitiveness of a nation not less important than the other elements of the competitive diamond. Eventhough Porter explains the interaction between the role of governments and the elements of competitive diamond, the author sees that government intervention should be included into those elements and cannot be separated from the 'competitive diamond'.

At whatever level of intervention, especially in developing countries, the governments still have important roles in shaping competitiveness. Moreover, the basic idea of competitiveness, at least in the classical economy theory, is based on the notion that competitiveness exists when there is a market failure, not in a perfect competitive market. Thus, the role of government is important to intervene the market failure through the competitiveness strategy in order to improve their position in the free trade. In short, the main aim of competitiveness strategy in this context is to help realize or build dynamic comparative advantages which, again, underlines the significance of government interventions.

the government performance, then it would far beyond the reach of decentralization policy to capture the competitiveness of firms into its arms. The summary of both concepts are explained on following Table II.1.

Table II.1 Summary of the variables

No.	Variable	Factors-indicators
1	Decentralization: components of decentralization	<p>Political decentralization:</p> <ul style="list-style-type: none"> a. Legal framework b. Participation <p>Fiscal decentralization:</p> <ul style="list-style-type: none"> a. Expenditure assignments b. Revenue assignments c. Intergovernmental transfer and grants d. Sub-national borrowing <p>Administrative decentralization:</p> <ul style="list-style-type: none"> a. Civil service reform and decentralization b. Information and monitoring in decentralized system c. Local technical and managerial capacity
2	Intraregional (local) competitiveness	<ul style="list-style-type: none"> a. Government competitiveness b. Business environment/location competitiveness c. Local company competitiveness

II.6. Conclusion

In general, the components of decentralization may support the intraregional competitiveness in a certain way. By dividing the intraregional competitiveness into smaller sub-system of competitiveness level, the analysis elaborates how each of sub-system is influenced by the components. The components of decentralization may support the governments' competitiveness by improving the effectiveness and efficiency of public services performed by the regional governments. This situation is appeared to be different when the analysis comes to explain the impacts of components of decentralization to the business environment/location's competitiveness. Briefly, as an instrument, the components may support to improve business environment indirectly. It depends on the design of the decentralization framework and how the components are adapted and translated by the governments into policies that influence the business environment. Finally, the most distance impacts of decentralization to local competitiveness can be found at firm level. Decentralization policy is only about to affect local companies' competitiveness if it is directed and is coupled with a particular competitiveness strategy such as clustering. However, as most of decentralization policy only directed to influence at governmental level, there is not much explanation can be given to reveal the impacts of the components of decentralization to the competitiveness of a firm.

Chapter III

The decentralization practice in Indonesia based on Law no 22 and 25 / 1999 and their subsequence laws

This chapter will answer following research question:

How are the practices of decentralization in Indonesia based on Law no 22 and 25 / 1999 and their subsequence laws and in how far they do support successful decentralization practice?"

III.1. Introduction

Decentralization is not a new policy for Indonesia. In the past, Law No.5 /1974 concerning regional government (*pemerintah daerah*) had orchestrated the relationship between central and regional government formally based on the principles of decentralization, deconcentration and co-administration (*tugas pembantuan*), however, in practice it was never realized under the New Order government and consequently, decentralization at that time was merely a deconcentration of authority and co-administration from central government to the lower levels of government¹.

Along with the reform that took place in 1998, the new decentralization laws were prepared under the escalating pressures of disintegration and demands for more democratic government from the civil societies and international donors at that time. As a result, Law No. 22 /1999 on Regional Government and Law No. 25 on Fiscal balance between central and regional government were enacted on May 1999 and became effective in January 2001, given two years of preparation period for all levels of governments to fully implement the laws.

Unlike their predecessors, the newest decentralization laws have different emphasize on how decentralization should be carried out. These laws are designed to devolve more powers to the district governments. Besides, as an emerging democracy country which has been engaging in a reform, this change is also accentuated by the western international donors' involvement that tends to promote decentralization as a means of devolution of powers to improve democratization.

As predicted by many observers, preparation time that was too short and hurried formulation causing potential flaws on the laws, the decentralization processes have inevitably started to produce adverse effects. For instance, during their short implementation period, several problems are identified, such as unclear division of authorities among the tiers of government causing a struggle for authorities among them, inefficient resource allocation caused by the low capacity and demoralization of civil servants within the regional governments, widening

¹ Municipality and regency in this law refer to the sub-region beneath the provincial level. In that time, municipality and regency are called as the second level region (*Dati II* in bahasa) and province as the first level (*Dati I*). Now, under the new laws, the attribution of *Dati I* is replaced by Propinsi (Province) and the regions under it, which previously called as *Dati II*, now becomes Kabupaten (district or regency) and Kota (municipality).

disparity among regions, and stronger primordial ties based on ethnic and religion. (Suwondo, 2002; Seymour & Turner, 2002; Yappika, 2006). Thus, in order to improve the decentralization practices, Law No.32/ 2004 and Law No.33/2004 were established under president Megawati to replace the previous laws (Alm et.al, 2001; Fattah, 2002; Yappika, 2006)².

In addition, to explain how these laws shaping the decentralization practices in Indonesia and how far they support successful decentralization, a content analysis of the laws is provided in this section. The analysis uses the framework of successful decentralization created in Chapter 2. This analysis is aimed to help to disentangle the complexity of decentralization in Indonesia, especially the problems which are derived from the deficiencies of decentralization framework design. A lot of points could be made in regards to the laws, however, because the limitation of place and time, the analysis may not be able to analyze all those features and the dynamic situation within this regulatory framework.

III.2. The practice of decentralization based on Law 22/1999 and 25 /1999 and their subsequent laws.

III.2.1. The constitution, regulatory and legal framework

Law No. 22/1999 and Law No. 25/ 1999 and subsequently, Law No. 32/2004 and Law No. 33/2004 constitute of '*how the decentralized systems are supposed to function* in Indonesia. So, as the constitutional, legal and regulatory framework they should clarify the broad principles of decentralization operation and detail the right and responsibilities of all levels of government and their roles. They should also specify the parameters of the intergovernmental fiscal system and also institutional details of local government structures, procedures, accountability and remedies. Moreover, the framework must provide the details and practical interpretation through the establishment of a series of regulations, especially those concerning the tasks that are shared between the tiers of the government³.

The first broad principles of decentralization is stated in Chapter I of both laws, which define the general provision of the autonomy regions and their definitions⁴. In the Article One, section (i) formally states that regional (provinces, districts, and municipalities) will have full autonomy to 'govern and administer the interest of the local people' within the boundary of the "unitary state of the Republic of Indonesia" and the decentralization practice will be

² For more detail elaboration of the political and economic background when the laws were prepared, see appendix 1.

³ Intergovernmental fiscal system will be explained under the fiscal decentralization to avoid the redundancy of analysis.

⁴ Afterward, for the practical reason and to use the available space efficiently, the author will not specify the articles in the main text of the thesis. Nevertheless, the analysis will still provide the general information about the caption to make it easier for everyone who interested to explore it further.

accompanied by the deconcentration and co-administration principle. In addition, Law 32/2004 mentions the local election agencies as an element for direct local election.

Chapter II of both laws constitute the administrative division of the various government levels in Indonesia. It states that the main administrative units are the provinces and therefore, still retains a hierarchical relationship with the central government (Article 2). Nevertheless, real autonomy is given to the *kabupaten* (district or regency) and *kota* (municipality) and they are not in a hierarchical relation to the province. The latter has only a coordinative role towards the districts/municipalities⁵.

The confusion starts here, when the provinces are also mentioned as one of autonomous regions, while at the same time they retain into hierarchical relationship with the central government. Consequently, it leads to a *de facto* deconcentration practice. It would be clearer if it is stated that the provincial regions are excluded from being called as autonomous regions, since the true devolution only occurs at the regency and municipality level as they are detached from the higher level of government, the province for example (Chapter III). Even after the establishment of the Law No.32/2004, this relationship remains unclear.

The laws also declare that for the reason of economic and governance efficiency, one or more regions can be merged if they can not perform the regional autonomy appropriately, or conversely, a new region can emerge once it has complied with the requirements⁶. However, an amalgamation of some regions into one region or a split into new regions, could be not right in the political sense, because it can raise potential threats of conflict of interest among the communities to get the power over the new formed regions (Amri, 2000; Seymour & Turner, 2002; Suwondo, 2002). Under the previous law, this stipulation has prompted a rapid formation of new regions within a short time. Thus, the new law brings tighter requirements for new region formations.

The most confusing part of this legal framework lies on the distribution of authority. Chapter IV of Law No.22/1999 sets out the new areas of responsibilities that the province and the regions gain under the decentralization. While the central government remains accountable for international politics, defence and security, the judicature, monetary and fiscal matters, religion and the other fields, the province and regional governments are granted with other authorities outside those six⁷. The further details are written in the Government Regulation

⁵ Based on this notion, hereinafter, the author uses the 'regional governments' term to call the district and municipality governments and thus, distinguishes it from the province governments.

⁶ The formation of regions is mentioned in the Chapter III article 6 of Law No.22/1999 and in the Chapter II article 6 of Law No.32/2004.

⁷ It is stipulated in the Law No.32/2004 in the Chapter III. Article 10, point 3 states the central government retains the six authorities without mentioning any other authorities as pointed out before in the Law No.22/1999. However, in the same chapter, point 5, it states that outside of the six authorities, the central government also have other authorities and they are not explained further, even in its annexes and in the PP No.38/2007. The author assumes that the other authorities are being referred to

(PP/Peraturan Pemerintah) No. 25/2000 concerning the authority of central government and the provision of provinces as autonomous region. However, this regulation is considered as not satisfying because the number of authorities of the central government and the provincial government are still numerous and characterized by a confusing distribution between tiers of government. This government regulation even contradicts with the law itself. Thus, it leaves the confusion of the stakeholders, especially for business sector and international investors (Seymour & Turner, 2002, p.43).

Subsequently, Law 32/2004 attempts to correct this deficiency by stating some new regulations, such as PP No. 38/2007 to clarify and to provide the detail of the distribution of authorities. In this regulation, aside from the six authorities which are maintained by the central government, there are thirty one other government tasks (*urusan pemerintahan*) which are distributed to the all tiers of government (Chapter II)⁸. Furthermore, it is explained that the division of the authorities is based on the principle of externality, accountability and efficiency by considering the harmonize relationship among all tiers of government (Chapter III, article 10)⁹. However, apart from those authorities bestowed to the regional governments, the authority regarding the investment has to be stipulated under specific law (Chapter III, article 5)¹⁰.

From the accountability perspective, the new regulations can improve the clarity of the authority distribution among the levels of government through the establishment of a series of specific regulations. However, the law is not equipped with such details. Hence, it is still open for biases and multi-interpretations which lead to confusion and conflicts of interest between the stakeholders. However, it is almost impossible to keep the law as clear as possible and to produce single interpretation which can lessen the gap of implementation, since it is the product of political negotiation which is always to a large extent of political compromise. Inevitably, most of the details are left to government regulations and thus, can be easily changed¹¹. Thus, it will be better if the distribution of authority is stipulated under a

the right of central government to set out policies and standards in the national level, rather than to administer and manage the sectors directly. This can be derived from the annexes of the PP No.38/2007.

⁸ The author use the word 'distributed' to leave it open to any form of power transfer because there is a different level of authority distribution between the province and regional governments.

⁹ The externality principle enable decentralization framework to take into account the spill-over effects of the provision of a public service beyond a jurisdiction. For example, service provision in water management may involve this principle since the water resources such as rivers are often passing some regions which may have competing interests upon the water resource.

¹⁰ It is confusingly since the Law No.32/2004 Article 14 point 1, letter (n), states that one of the obligatory tasks for the district/municipality government is to provide "administrative service related to the investment", but at the same time the authority of investment is specifically arranged within the Law No.25 /2007 concerning investment, which according to many parties, including the regional governments, tend to be centralistic.

¹¹ For example, some articles in the laws often state: "the other authorities shall be stipulated under government regulation or other laws".

separated law that has stronger legal basis than a government regulation which can easily be replaced or be changed without a parliamentary decision.

At the end, it can be concluded, however, that the new decentralization laws have made progress in taking up the platforms of legal framework to improve the accountability of the governments by clear-cutting the authority. Furthermore, the regulations issued under the new laws have also clarified the rights and responsibilities of each tier of government. However, despite these positive points, the legal framework has ignored some competing interests while shaping it¹². In addition, the introduction of delimitation of authority to the provinces and the regional governments, specific authorities of both governments, and strict requirements and monitoring mechanisms to improve the laws are often suspected as an attempt to reverse the decentralization processes.

III.2.2. Participation

Participation of the citizens in the development process is done through the elections of representatives who will act according to their wishes to influence the government's policy. In the case of decentralization, local election is the main and most established channel to voice the citizens' aspirations. Chapter V in Law No.22/1999 and Law No.32/2004 and other government regulations concerning local election already set up the direct local elections of Local Assemblies (DPRD) to facilitate citizens' participation. For instance, Law No.32/2004 states that the Local Assemblies have to accommodate, collect, consolidate and follow up the people's aspiration¹³.

Despite this arrangement, there are some concerns regarding the participation mechanisms. For instance, even though Law No.22/1999 was established with the spirit of democratization and participation, none of its articles stipulate the rights of citizens as a voter and as a constituent of the government. Furthermore, in its preparation, the law had ignored the poor political conditions of local governments and communities as a result of the centralization period. At the same time, the bad legacy of the New Order such as money politics, collusion, corruption and nepotism are still heavily embedded in the governmental behaviour. Thus, the decentralization of authority is also being accompanied by the 'decentralization' of corruption, collusion and nepotism to the local level. As an example, the creation of organization within the local government structure is often affiliated with particular interests of some groups who are close to the government rather than to improve the services to the community. Eventually, this all hinders public participation.

Indeed, Law 32/2004 opens the gate for greater citizens' participation, especially through the direct election of the head of the region. However, after the regional governments have been

¹² See appendix 1, especially in the section describes the political situation when the laws were arranged.

¹³ Law 32/2004, Article 45, point e.

elected, they can not be held accountable to their voters. Instead, they are accountable to the higher level of government.¹⁴ So, during the office term, there is no citizens' control over the performance of the government as there is no 'recall' mechanism provided for the incumbent governments if they perform badly. Consequently, the law does not elaborate in detail mechanisms of participation channels, other than the elections (Yappika, 2006, p.35).

Besides, based on a report by Yappika (2006), less attention is given by local governments to enhance the participation of citizens by the absence of the regional regulation to arrange the participation of citizens. This condition indicates that the governments, both at central and local level, still only have little commitment to involve the citizens into the election processes. At the end, the above mentioned evidence reflects that the legal framework of decentralization in Indonesia has not yet provided an appropriate level of citizens' participation.

III.2.3. Expenditure assignments

In recent decentralization, local governments now are eligible to draw the expenditure assignments. As discussed before, while the distribution of government authorities was unclear and full of vagueness in the Law No. 22/1999, since it is discounted the principle of efficiency, economy of scale and externalities effects, Law No. 32/2004 and PP No. 38/2007 attempts to remedy this weakness. The law outlines thirty one government tasks that should be maintained by the province and regional governments (chapter II). Then, for regional governments these tasks are divided into two types: obligatory and optional tasks. There are 26 obligatory tasks and 8 optional tasks (chapter III)¹⁵. Beside the explanation in the Annexes regarding this distribution of authorities, there is an inconsistency between the law and the regulation in mentioning the number of obligatory and optional tasks with the overall governmental tasks that should be given to the provincial and the regional governments.

This confusion is slightly relieved as the Annexes of PP No. 37/2007 provides details of the distribution of authorities and the degree to which each level of government retained. Chapter III, article 9 of the regulation elaborates that central government has power to set up national policy, norms, criteria and the minimum service standards concerning the tasks. The province has control over the interregional tasks and the tasks in provincial level. Regional

¹⁴ See Law No.32/2004 Article 27 point 2 and 3.

¹⁵ The use of term "task" in Law 32/2004 instead of "authority" as previously used in Law 22/1999 also raises a question concerning the level of discretion given by the law. Indeed, in this new law, the responsibilities of all tiers of government becomes clearer, but on the other hand, the new law confines the authorities of regional governments into 26 obligatory and 8 optional tasks. From the point of view of legal science, authority means the rights and powers of government to stipulate and to create a policy within the governance operation, yet what is called as the government tasks as in Law 32/2004 are the contents of the authority itself. Thus, Law No32/2004 has the potential to reduce the discretion of regional governments given before in Law 22/1999.

governments are responsible for the implementation of the authorities within their boundaries. They are elaborated in more detail in the Annexes. There are also interregional tasks that have to be maintained together among regions. At the end, there are also residual tasks that should be further elucidated in a separate law (Chapter IV, article 13). Then, to fulfil those tasks the province and regional governments shall receive the transfers of financial resources, facilities and infrastructures, and the personnel (Chapter II, Article 3).

Overall, it is likely that the regional governments have to carry out many responsibilities to administer, since the focus of decentralization in Indonesia lies on this level. The distribution of authorities is arranged by introducing more clarity on the various responsibilities. The law also starts to segregate an authority for each tier of administrations into different degrees of implementation, corresponding with the roles of each level of government should bear. Nevertheless, the distribution of authorities between the province and the regional governments remains unclear.

III.2.4. Revenue assignments

The revenue assignment is stipulated both in Law No.25/1999 and recently in Law No.33/2004. It is the usual struggle between tiers of government and also among the regions themselves. The previous Law No.25/1999 has the basis for this. However, because central government still dominates the revenue and allocation power, this opens the debate over how revenues should be shared and how allocation funds should be distributed. There are not many changes in the revenue allocation ratio between the previous law and the new one, especially in the revenue sharing fund (*dana bagi hasil*) between central government and regional governments¹⁶. Their compositions are almost the same, except on general allocation fund and other intergovernmental transfers, which will be elaborated separately. It should be noted that, even though it is heavily shared with regional government, the revenue sharing fund sources are coming from central tax. As the tax base is actually local, the fund is first transferred by regional governments to the central government before it is redistributed back to them.

In general, Article three of Law 25/1999 and Article five of Law 33/2004 set out the conditions for new sources of regional revenue after the implementation of decentralization. They consist of original local revenues, balance funds, regional loans and other legal revenues. Original local revenues consist of local tax, regional retribution, profit from locally owned enterprises and/or other local wealth, and other legal revenues¹⁷. Balance funds refer

¹⁶ The comparison between the Law No.25/1999 and Law No.33/2004 can be found in the appendix 1.

¹⁷ Law No.25/1999, Chapter III, section two, article 4 and Law No.33/2004, Chapter V, article 6. The original local revenue, especially for taxes and retribution is further detailed in the Law No.34/2000 about regional taxes and retribution (user-charges).

to the level of transfer between the central and provincial as well as district governments. They consist of a provincial and district share of the revenues from land and property tax, as well as the tax on acquisition of land, building rights and natural resources (forestry, public mining, fisheries, oil mining and gas). Intergovernmental transfers primarily consist of General Allocation Fund (*Dana Alokasi Umum*, DAU) which is previously called SDO and *inpres* funds and the Special Allocation Fund (*Dana Alokasi Khusus*, DAK) for the earmarked purposes.

Many argue that the sharing and funding allocation arrangements will not be sufficient to cover the regional governments' expenditure needs as assigned in the laws since it does not promote local revenue autonomy. Consequently, the regional governments' own tax revenue remains small (Seymour&Turner, 2002, p.36). A study found that most of the budget structure of local governments is dominated by the General Allocation Fund (DAU) and thus, original local revenue remains insignificant (Landiyanto, 2005).

Considerably, there are some negative consequences of this lack of finance: The regional governments will not be able to provide public services as required in the laws and the dependency to intergovernmental transfers remains significant. This makes local governments are prone to central interventions. The new tax regime under Law 25/1999 and Law 33/2004 also encourage the district and municipality level government to generate as much tax revenue as possible in order to ensure their service providing capabilities are sufficient. This condition would be disastrous for inter-regional trade throughout Indonesia, because over-taxation would hinder the economic growth. Indeed, some studies have revealed the evidence for these problems¹⁸. Unfortunately, even these problems are also already recognized by Law No.33/2004, the mechanisms and how it should be addressed according to the law remain unclear¹⁹.

III.2.5. Intergovernmental transfer and grants

As mentioned before, the intergovernmental transfer and grants consist of General Allocation Fund (*Dana Alokasi Umum*, DAU) to replace the Subsidy for Autonomous Region/SDO (*subsidi daerah otonom*) transfers and *Inpres* funds, and also a block grant of Special Allocation Fund (*Dana Alokasi Khusus*, DAK). These transfers remain the most important revenue resource for the regional governments, especially for the poor regions. While the

¹⁸ Alm, et.all (2001), Saad (2003), Lewis (2003).

¹⁹ Chapter III, article 7 of Law 33/2004 states that in the attempt of increasing their original local revenues, the regional governments are prohibited to create government regulations (*Perda*) that may produce high cost economy and hinder the mobilization of people, inter-regional goods and services flows and export and import activities.

magnitude of the funds transferred almost the same²⁰, it should be noted that there are differences in the calculation base method between these laws. When the previous law calculated the DAU based on the concept of relative revenue generating capability and needs, the new law determines the allocation of DAU for certain region based on the fiscal gap and basic allocation²¹. This new concept implies that DAU is no longer bearing the burden for the civil servant salary. Thus, the DAU can be used optimally for other development purposes or public services rather than only to pay the administrative cost of bureaucracy as it was previously.

However, the balance funds for revenue sharing still problematic as they remain similar to the previous one. Moreover, the sharing tends to favour the resource rich regions and leaves the poor-resources regions become relatively poorer because of inability to generate revenue. Thus, the disparity among regions remain grows.

III.2.6. Sub-national borrowing

Law No.22/1999 and the Law No.33/2004 allow the local governments to borrow development funds. It should be noted that concerning the local loans, the latter law provides in more details information and clearer explanation of sub-national borrowing than the previous. The explanation in Law 25/1999 concerning sub-national borrowing is rather short and left many weaknesses. For example, it did not provide a mechanism for central government to control the excessive borrowing, poor-defined sources of regional loans and there are no explicit penalties exist if the regional governments breach the law²². Conversely, Law 33/2004 prompts to create hard budget constraint for regional governments by elucidating some requirements and penalties²³. Unlike it predecessor, this law provides strict monitoring and control mechanism over the local borrowing and may resulted in the suspension of the transfer of balance fund to the respective regional governments if they are violated²⁴. Law 33/2004 also clearly confines the sources of regional loans²⁵. For example, as stated in the Chapter VIII, regional governments can not obtain direct fund from foreign sources anymore, but central government may grants a loan for regional governments that come from foreign sources (article 50 and 56).

In general, the arrangement of regional loans in the Law 33/2004 is likely to provide the requirement for hard budget constraints to control the sub-national borrowing. However, it

²⁰ For example, in Law 22/1999 the DAU allocation is determined as minimally 25%, and only slightly increased in Law 33/2004 to 26%, while the ratio of the DAU allocation between provincial and regional government remain the same: 10:90.

²¹ Law 33/2004, Article 27

²² Law No.22/1999, Chapter III, section four, articles 11-15.

²³ Requirements for local borrowing can be found in the article 54 and the penalti in the article 50.

²⁴ Law No. 33/2004, Chapter VIII, article 63 and 64.

²⁵ Law No. 33/2004, Chapter VIII, article 51.

should be noted that there are two potential weaknesses in this law: first, it does not prescribe the public legislations to disclose of the liabilities and repayment capacity of regional governments. Second, the existing regional loans regulations which are explicitly directing the regional government to fund over the revenue generating projects may exclude the non-revenue generating projects but they considered as very important to local development, such as the development of basic public facilities in rural areas²⁶.

III.2.7. Civil service reform and decentralization

Perhaps the biggest challenge to the successful implementation of regional autonomy in Indonesia is the human resource capability for government positions at the local levels, as well as in private business. This is a point raised by almost every author of Indonesian decentralization. Some of them argue that “the capability of human resources, especially those at the districts and municipalities level are not ready yet” (Seymour and Turner, 2002, p.44). The problems are in the level of education and the capacity of management. Thus, the role of central government to perform and to shape the human resource policy at the local level is crucial without curtailing the local options.

The only effort from central government to solve this problem is to deconcentrate the staff at the higher level to fill in the gap. Nevertheless, there is no legal framework as the basic to deploy such capacity building program, especially in the decentralization framework. These conditions may undermine the empowerment of local communities and civil servants to conduct a capacity building program in order to address the capacity gap.

However, as the local governments become more aware of this issue, more staff training, workshops, courses and other activities have been undertaken to improve the readiness of regional governments for autonomy. The capacity building program usually involves local universities and international donor resources. Yet, there is a cause of concern for the isolated regions which may simply miss out the capacity building program, since they can not easily access a university or hindered by limited funding to send teams elsewhere for training.

III.2.8. Information and monitoring in decentralized system

Law 25/1999 has insufficiently stipulated the mandate for information and monitoring of regional governments’ fiscal activities in very short and vague articles (article 27 and 28). It does not leave any detail of the monitoring mechanisms. In the contrary, Law 33/2004 has more detail elaboration about the monitoring mechanisms and how they should be carried out (article 101-104). It also gives a penalty for the regional governments who fail to meet the reporting requirements. The law also states that information regarding regional finance should

²⁶ For example, see PP No.107/2000 and article 53 of Law 33/2004

be available to the public, but it does not supply any additional information about the mechanisms of information disclosure, nor states that they might be regulated in a specific regulation.

III.3. Conclusion

From the analysis presented above, it is obvious that the decentralization framework in Indonesia to support successful decentralization practice is limited, given a number of obstacles to achieve the objectives of decentralization. It seems that most of the problems are stemming from the laws that orchestrate the practices of decentralization in Indonesia. Besides the framework design problem, this is supplemented by the implementation problems, such as poor-understanding of decentralization conception among implementing actors and insufficient capacity of the actors has caused poor-governance practices. In this case, while local corruption becomes the evidence, elite capture and the regional horizontal imbalance have also complicated the condition.

From the institutional perspective, the laws still leave much vagueness at implementation level. Many authorities have been devolved to regional governments, but unclear segregation remains in their assignments to various tiers of government. In term of public participation, recent decentralization legal framework has not yet provided an appropriate level of citizens' participation, other than the elections.

On fiscal issues, both expenditure and revenue assignments are defined to meet the fiscal needs with services requirements which should be provided by the governments. Unfortunately, they remain weak and do not establish a link between payments and benefits. As a consequence, they fail to match expenditure needs which eventually lead to excessive local regulations to extract more revenues. At the same time, this lack of finance is complicated with the combination of poor access to local borrowing and ineffective intergovernmental transfer' design to resolve fiscal inequalities among the regions, since it is still favoured rich-resource regions.

Extensive concerns have also been raised about the structure and implementation of civil services, especially in regard to human resource capacity. Lack of attention that is given to capacity building program to the local governments and local communities may hinder the improvement of governance quality. More efforts are needed to be done in order to provide sufficient level of local skills, experience, and education levels to deal with the new responsibilities. Some evidence shows that these conditions started to undermine the public services delivery in Indonesia; especially the services related to economic activities such as trade and investments. At the end, if these conditions are not addressed properly, they may deter local governments' performance and subsequently, the quality of public services delivery.

Chapter IV
Case study
The comparative analysis of two cities: Surabaya and Semarang

This chapter will answer following research question:
“What are the impacts of the introduction of decentralization laws on local (intraregional) competitiveness in Indonesia?”

IV.1. Introduction

After reviewing conceptual framework between decentralization and intraregional competitiveness and analysing the decentralization practices in Indonesia on previous chapters, subsequently, this chapter will provide a case study which utilizes the results generated from previous chapters. Briefly, the analysis seeks for possible impacts of decentralization practices in Indonesia to local competitiveness through a case study. However, due to some technical constraints to collect primary data needed, the analysis is based on secondary data analysis.

Following comparative case approach, this chapter will be organized as follows: Before entering further to the analysis, limitations related to the analysis in this part is elaborated, as most of them coming from data issues. The analysis begins by elaborating factors of similarity through the profile of the cities. Subsequently, a time series data of investment growth is presented to point out the factors of difference. Then, to reveal the impacts of decentralization on intraregional competitiveness as well as to explain their difference, some competitiveness indicators are used. The indicators will be combined with data related to decentralization practice. To wrap up the discussion, a general conclusion will be drawn at the end of the analysis.

IV.2. Data Issue

IV.2.1. Survey used in the analysis

This analysis utilizes available secondary data from various surveys conducted in Indonesia on regional competitiveness and the implementation of decentralization. The majority of the data will be drawn from two surveys: the regional investment attractiveness survey conducted in 2003 and in 2005 by the Regional Autonomy Watch (KPPOD) and the Governance and Decentralization Survey (GDS), conducted in 2002 and in 2004 by the World Bank and the Centre of Public and Policy Studies (CPPS) Gadjah Mada University. The previous one appears to be currently the only one which covers the national-wide business community perception on investment attractiveness of the regions in Indonesia, while the latter presents the evaluation of decentralization practice by communities' opinions also in national-wide scope. Subsequently, both surveys represent different but complementary empirical findings

regarding the impacts of decentralization from two perspectives: the business communities and the households in general.

IV.2.2. Data issue

Since this case study employs secondary data analysis, there are several issues identified regarding to its usage. First, there is a limitation of using existing data. This holds the risk that the data does not exactly cover the interest of the research, which might affect the validity of concepts on which conclusions are to be drawn on. Thus, following Babbie (2007), the *validity* problems in the analysis of existing data can be handled through logical reasoning. So, the survey result has been used to compliment the logical explanation of the analysis. Furthermore, using the data in cautiously might reduce the problems of *reliability* which usually embedded in the existing data analysis. To do this, investigating the nature of the data collection and tabulation is imperative to enable to assess the nature and degree of unreliability, so its potential impact on the research interest can be predicted. For practical reason, detail elaboration related to the survey characteristics and their main features is placed on Appendix 2.

Second, there are some data *availability* problems in Indonesia which may undermine data presentation and also the analysis. First, when decentralization policy is focused on regional (municipalities/regencies) level, data provided by BPS-Statistics Indonesia is mostly aggregated at provincial level. Thus, it is very difficult to find detail data concerning each municipality or regency. Second, the author found that almost all regional statistic offices in province level do not provide data related to municipalities/regencies under their jurisdiction. In this case, the Province of Central Java has more elaborated data on regional level (municipalities/regencies) than the Province of East Java. This implies that their data becomes somewhat incomparable.

Third, even when the data is available, it is often not well-standardized. It means that every province could have different data presentation which is sometimes incomparable to each other due to inconsistency in publication years and data type. One may get different data result of a similar subject, since it depends on the data sources or the agencies issuing the data. For instance, the author has discovered that there is different value in population data of selected cities issued by BPS and The Ministry of Interior, even it is in the same year. Since the thesis relies on these data, this has raised the author's concern that this thesis could suffers from data deficiency and poor data reliability, validity and availability which prevents the analysis to explain the subject sufficiently.

IV.3. Factors of similarity

Two cities are selected to be compared on this case study. They are chosen based on some purposive criterions. First, the cities in average have similar potentials and conditions. It means that they share several conditions, such as population, economic potential, political, social and cultural stability, and geographical size. Second, the cities should not be in a condition which tends to produce bias data on investment growth. This means that in the selected cities there are no calamities such as severe ethnic conflicts or natural disasters. The last criterion is the availability of data. It is important since in some regions, especially in small regions, certain data may be poorly recorded or even does not exist.

It is very hard to find a pair of city in Indonesia which has a quite similar condition, as some limitations are constantly occurring during the selection, especially when the selection involves cities that are located on different islands. As commonly known, there are five biggest main islands in Indonesia, namely from west to east: Sumatra, Java, Borneo (Kalimantan), Sulawesi and Papua (used to be Irian Jaya). Java becomes the most rapid grow island as a result of previous centralistic government. About 62% of total population of Indonesia is concentrated in Java, which approximately has only 6.9% of Indonesia's total land area. Furthermore, it will be more complicated to compare the cities located on different islands as geographical disparities remain a crucial problem in Indonesia, especially between Java and other islands. Therefore, based on those considerations, the searching was focused on cities on Java. For practical reason, cities (municipalities) administrative region are chosen instead of the regencies since the data of cities is better than the regencies, as cities are usually more developed than the regencies¹. This is to avoid more data availability and validity problem.

There are four biggest cities in Java, namely Bandung, Jakarta, Semarang and Surabaya. Jakarta is excluded from the list because it is the capital of Indonesia, which is simply incomparable to other cities. The nomination then goes to Bandung, Semarang, and Surabaya. This is also difficult selection as they have relative similarity. For instance, compared to Surabaya and Semarang, Bandung has the narrowest size, but the number of population is almost the same as Surabaya. While Semarang and Surabaya have similar area size in average, but differing in population density. However, when comparing these three cities, the population density is far greater in Bandung, than the other two cities, resulting in great disparity in population density.

Based on those considerations, two cities are selected, namely Semarang and Surabaya. Semarang is located on Central Java and functioned as the capital of Central Java Province, while Surabaya is located on East Java and also serves as the capital of East Java Province. It is also assumed that, as big cities in Java Island, they must share more or less common

¹ This problem identified when the author compared the cities and regencies data availability. The variation will be higher if cross-islands data is involved. Many data of the regions can not be compared each other, because of the poor statistical standardization system by BPS.

economic structure, growth, and other supporting factors for economic competitiveness such as large population, as it is not the case when we deal with the cities in other islands. Figure IV.1 shows the location of both cities in Indonesia archipelago and Table 1 below summarizes their characteristic in some aspects.

Figure IV.1. Indonesia archipelago



Despite their disparity in population and income, as big cities in Java, Semarang and Surabaya have large population more than one million inhabitants with Gross Domestic Regional Product (GDRP) per capita above of Rp.15.000.000 scattered within their similar area size. Furthermore, when the analysis comes to political, economic, and cultural aspects, the regions also share some similar aspects. For example, as the capital city of the province, the political and the administration activities of the government, both at province and municipality level, are concentrated in both cities. They are also the home for the Local Council and the Head of the Region. In cultural aspect, both cities share the same characteristic of high heterogeneity population consist of various ethnic groups.

In term of economic structure, there is no abundant specific natural resource found within both cities, as most of economic growth is mainly driven by some sectors which are commonly expected in urban area such as trade, processing industries, building constructions and services, while primary sectors such as agriculture and mining become less important (KPPOD, 2001, 2005)². This condition is reflected in the existence of well-established industrial zones and other business service facilities such as ports, shopping centres, bonded zones, transportation infrastructures, telecommunication stations and the concentration of GDRP on those sectors as a main driver of economic growth. For example, there are some well known industrial zones at Semarang such as Candi Industrial Zone, Integrated Tugu Industrial Zone and Tanjung Emas Processing Zone (TEPZ). In Surabaya, there are Rungkut Industrial zone which is known for its centralized waste treatment and Tandes Industrial zone

² See also appendix 3, table 2: The cities based on regional economic sectors in 2004.

at West Surabaya. They replace the previous Ngagel Industrial Zone which now has been converted into commercial zone.

Table IV.1
The cities based on some similar aspects

No	Remarks	Semarang	Surabaya
1	Population (people)	1.416.522	2.744.076
2	Area (Km ²)	373,69	350,54
3	Density (per km ²)	3,842.43	7,699.5
4	GDRP percapita (2004) (above Rp.15.000.000)	Rp. 17.597.383	Rp. 29.479.726
5	Status	Province capital	Province capital
6	Economic structure	Mainly based on trade, service and manufacturing sector	Mainly based on trade, service and manufacturing sector
7	Ethnic heterogeneity	Javanese, Chinese, Arabian, other ethnics	Javanese, chinese, Arabian, India, Madura, other ethnics
8	Economic supporting facilities	Industrial zones, bonded zone, Integrated economic zone, airport, international terminal handling harbour.	Industrial zones, bonded zone, Integrated economic zone, international airport, international terminal handling harbour.

Source: Statistics offices in province and other sources, compiled by the author, 2008

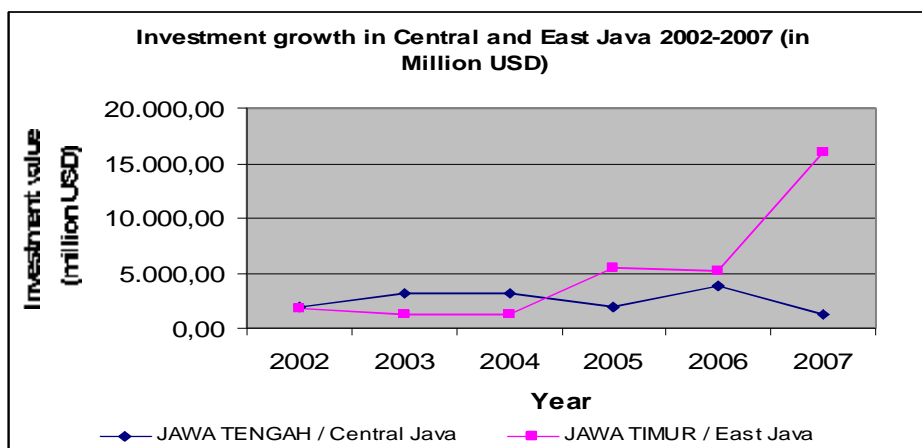
IV.4. Factor of difference

In focused comparisons, as pointed out by Hague and Harrop (2004), the units of analysis in this comparison method are normally selected to introduce variation into the dependent variable (p. 82). Thus, in this approach, cities are also being chosen because of their variety in investment growth. This variable, is assumed, reflects intraregional competitiveness as the dependent variable in this thesis. It is useful to first look at the investment trend in Central and East Java Province where both cities are the capitals for each province to get a general insight. Figure 1 below derived from a time series investment data of both provinces on 2002-2007. This figure shows the trend of investment growth within the province of Central Java and East Java. The selected years also describes the trend of investment in the first years of implementation until most recent development of decentralization.

Indirectly, these trends also represent investment condition in both cities, as most of economic activities, and investment usually concentrated in the capital city. For example, based on the

recapitulation of FDI development projects distribution in Central Java in 2005, most of the investment projects are located in Semarang as the capital city of the Central Java Province³. As shown in Figure 1, before 2004 both provinces has quite similar pattern. However, after 2004 the patterns begin to split up and subsequently shown differing trend in subsequent years. In 2002, the economic growth continues to recover from the crisis, and the investment trend for each province show even relatively modest growth. While in 2004 the investment growth in Central Java has considerably declined from 3.146,5 million USD to 1.856 million USD in 2005, the trend in East Java showed significant increase from only about 1.300 million USD to 5.474 million USD in 2005. This condition has been maintained until 2007, with the trend constantly shows East Java Province as the winner with very significant positive growth, and leave behind the negative growth on Central Java Province.

Figure IV.2. Investment growth in Central and East Java province 2002-2007



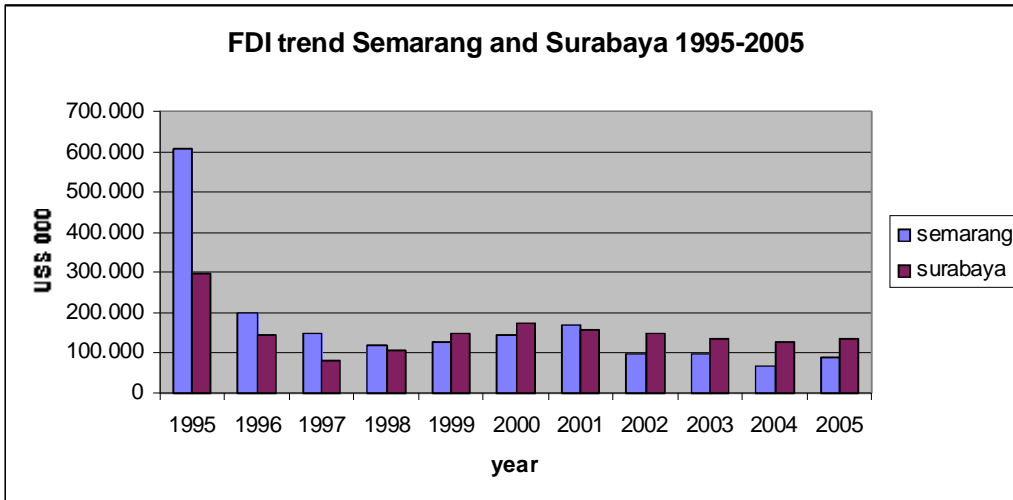
Source: Investment Coordinating Board (BKPM), 2008

Figure 2 and Figure 3 below reveal that the investment trend in Surabaya is likely better than in Semarang. For example, in 1995, even though the foreign investment in Surabaya was as not high as Semarang, but it did not fall sharply during the crisis. Interestingly, foreign investment in both cities already showed a sharp decline even before the crisis start. It should be noted that before the crisis started in 1997, indeed, there was a big amount of foreign investors flew away from Indonesia as they already predicted the future situation. This is different from the trend of domestic investments which was still grew up until 1997 and then following the economic crisis, they declined gradually and reach the lowest point in 1999 for Surabaya and in 2000 for Semarang. However, if the overall trend is scrutinized, Surabaya has more stable investment trend than Semarang, and it also recovers faster than Semarang

³ See appendix 3 on table 1: the recapitulation of the development of FDI projects distribution in Central Java in 2005

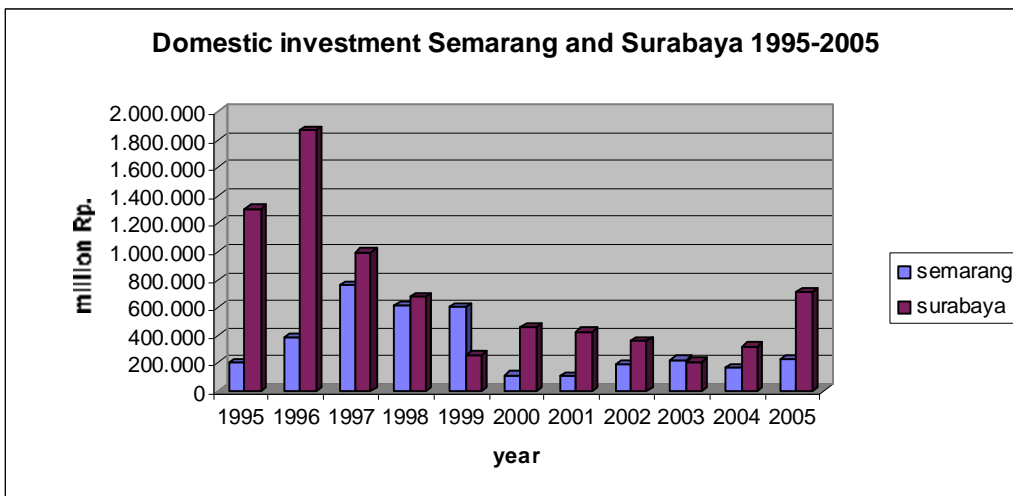
after the crisis even though in a modest growth. Thus, both trends in the province and city level are shared the same trend, show that Surabaya performs better than Semarang.

Figure IV.3. Foreign Direct Investments in Semarang and Surabaya 1995-2005 (in US\$ 000)



Source: Indonesia Investment Coordinating Board (BKPM), 2008

Figure IV.4. Domestic Investments in Semarang and Surabaya 1995-2005 (in Rp. 000.000)



Source: Indonesia Investment Coordinating Board (BKPM), 2008

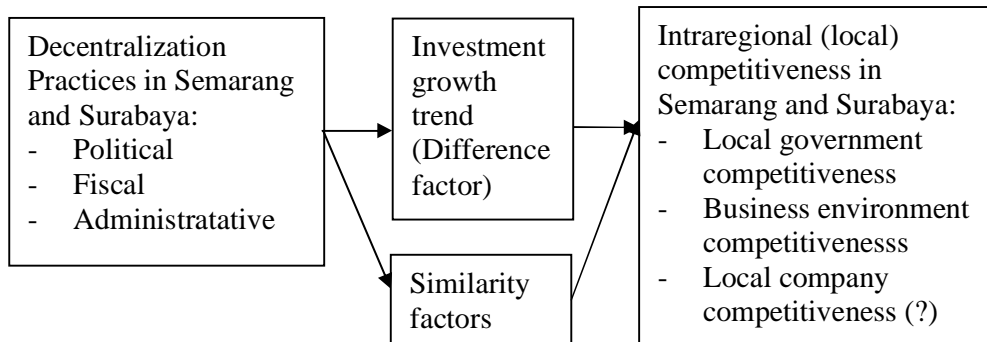
Based on the explanation above, there should be explanatory factors behind this competing trend of investment in both province and consequently, in Semarang and Surabaya. Thus, the next analysis will elaborate the factors which may influence the investment growth in Semarang and Surabaya. The analysis in this section will make use the result of business community's perceptions survey on regional investment attractiveness, established by KPPOD (Regional Autonomy Watch) in 2005. In general, the survey ranks the regions (municipalities and regencies) based on the evaluation of some factors which resemble the

regional investment competitiveness⁴. The investment competitiveness in the regencies/cities is assessed using five factors, namely institutional factors, security and socio-cultural factors, economic factors, labour related factors, and infrastructural factors⁵. Then, to follow the conceptual framework of this thesis, the factors are divided into three sub-systems of intraregional competitiveness (government competitiveness, location competitiveness and local firm competitiveness) as elaborated in the previous chapter. The result is as follows:

1. The government competitiveness sub-system will be analysed through the institutional factor, which consists of four indicators: a) legal certainty, b) apparatus and government services, c) local government policies, and d) local leadership.
2. The location/ business environment competitiveness sub-system will be analyzed through the compilation of 4 major indicators, namely: a) local political, socio-cultural, and security, b) local economy, c) manpower/labour, and d) physical infrastructure.
3. The local firm competitiveness sub-system will be elaborated through: a) the quality of managements, b) the quantity and quality of local suppliers and, c) well-developed production process, d) the capacity to produce value added products.

Based on survey result, the scores for Surabaya and Semarang can be found in Table 3 below. Unfortunately, given the limitation of this research and data availability constraint, the latter sub-system can not be explained in this thesis⁶. Thus, the analysis will only be focused on the two earlier sub-systems. The relation between variables is explained in the following scheme:

Figure IV.5. The case study design



⁴ In the survey, the regions are given a score range from 1 to 9 and then based on the score they are categorized into A to E ranks. The initial identification of relevant indicators, variables and factors, as well as the weighting of their relative importance, was made using the Analytical Hierarchy Process (AHP), through in depth interviews of business owners in various sectors of the economy (trade and services, manufacturing, mining, plantations etc.), as well as experts from academia and policy-making agencies assembled in focus groups. (KPPOD, 2005, p. 3). More detail can be found in appendix 3.

⁵ Originally, the factors then broken down into 14 variables and 47 indicators. However, for practical reasons, the analysis will make use the final score of each factor.

⁶ The data of company's performance, especially in local level has never been published in Indonesia. It needs deep and broad survey to gather the data in local company level, of which becomes the major obstacle and can not be executed in this thesis.

Table IV.2. Summary of factors influencing the regional investment competitiveness in Semarang and Surabaya based on KPPOD survey (2005)

No.	Indicators	Semarang		Surabaya	
		Ranks	Scores	Ranks	Scores
Government competitiveness⁷					
1	Legal certainty	E	--	E	--
2	Apparatus and service	D	--	E	--
3	Local regulation	C	--	C	--
4	Local leadership	D	--	D	--
	Overall rank and score	D	4, 97	E	4, 77
Location/business environment competitiveness					
1	Safety, political and socio-cultural condition	C	6,11	C	6,34
2	Local economy: economic structure and potential	A	7,71	A	7,60
3	Manpower: the availability, the quality and the incurrent cost	A	6,83	A	6,85
4	Physical infrastructure: the availability and the quality of	A	6,78	A	7,34
Local firms competitiveness					
1	The quality of management	N/A		N/A	
2	The quantity and quality of local suppliers	N/A		N/A	
3	well-developed production processes	N/A		N/A	
4	The capacity to produce value added products	N/A		N/A	

Source: KPPOD, 2005

IV.5. The impacts of decentralization on regional competitiveness

A common objective of decentralization everywhere including in Indonesia, is to bring the decision making process closer to citizens in order to improve responsiveness, efficiency and effectiveness of public services. In economic term, successful implementation of decentralization for the regions can be measured through the increase of local economic activity and the amount of investment flow entering the region. Yet, if it is poorly implemented, the negative outcomes may be the result.

Thus, it is imperative to look at the impacts of decentralization on intraregional competitiveness. After reviewing the factors concerning regional competitiveness of Semarang and Surabaya, the analysis will move further to reveal whether the introduction of

⁷ The scores related to the government factors can not be showed since the KPPOD is only showing the aggregate of the score in factor level, while the explanation is on the lower level of the variables.

decentralization is really impacted -either in positive or negative ways- the factors of regional competitiveness in both cities. To do this, survey results related to governance and decentralization are also introduced into the analysis. In regard to this, besides the other surveys, a bulk of data from the Governance and Decentralization Survey/GDS (2004) is employed⁸. It is also important to note that since the reform was initiated, recent decentralization in Indonesia so far have been practiced under two different series of laws. First, under previous Law No.22/1999 and Law No.25/1999 and then amended by Law No.32/2004 and Law No.33/2004. Thus, the analysis may capture the effects of this change.

IV.5.1. Impacts on institutional factors

Inevitably, decentralization regime under the new laws in Indonesia has shifted the power concentration from central to local governments by giving vast authorities to the municipal and regency governments to administer governmental tasks within their boundaries. Thus, the local governments now have eminent roles to determine the development in their own domain, including in local economy. Thus, it is expected that the services provided by local governments will be better than if they were provided by a distance central government. Decentralization is also often seen as a way to remove the hierarchical bureaucracy bottlenecks and assist local officials and the private sector to cut through complex procedures, when in fact the reverse can be happened.

Various studies of decentralization in Indonesia conducted in the beginning of implementation have revealed that there were not many positive changes in public services provision. In the most case, it tends to create adverse effects (Alm and Bahl, 2001, p.3). The increasing number of local taxes and user charges which is not accompanied by service improvement has been proved to create high cost economy. This is because local tax regulatory regime usually aimed for increasing their original income without calculating long-term impacts on economic sustainability, especially for business climate.

The same problem remains to occur under the newest laws. A recent study found that decentralization in general has continued to wield legal uncertainty for business sector. The study noticed that local (legal and illegal) levies and un-harmonized regulations have made companies difficult to calculate the predictable cost calculation for their operation (Perdana and Friawan, 2007, p.24). The overall findings of KPPOD (2005) survey also tell similar results. Among the indicators of institutional factors evaluated, legal certainty is the key weakness. Eventually, after the fourth year since the implementation of regional autonomy in January 2001, business communities perceived that the government performance in the

⁸ Some data and analysis that have been used in this thesis are coming from major decentralization survey in Indonesia and usually conducted in a large scale. The major survey comes from SMERU research institute, Regional Autonomy Watch (KPPOD), and the World Bank.

regions of Indonesia are still not very encouraging for business sector, as institutional problems remain severe⁹.

The other problems related to local regulation include illegal levies, bribes, excessive bureaucracy for permit-related matters, and inadequate local regulations. In addition, government corruption and lack of transparency remain major problems for businesses of all sizes. Some of the worse recorded scores are related to the transparency and corruption in the process of local procurement. In this case, the questions relating to transparency of information on tenders, fairness of decision making and illegal side payments are recorded as the lowest averages in the survey. Fortunately, the percentage of local regulations with potential to distort business activity is declining from year to year (KPPOD, 2005, p.12).

The absence of real involvement of entrepreneurs in the local decision making process and the poor 'socialization' of business-related local policies also becomes the major business complaints. Lack of involvement of the business community may explain why regulations fail to meet the businesses' expectations. 61.3% of respondents stated that they have never been involved in the process of drafting local regulations. However, an improvement is made in this indicator compared to 2004 when 86.4% of respondents said they were never involved in formulating local policies¹⁰. Business licensing services are also problematic. For example, around 15% of respondents in this research say they have used a One Stop Shop service centre to arrange various business permits but such services remain rare.

At the end, the role of local leadership from the head of the region to clean up and simplify business licensing procedures and other actions to improve the services to business activities will be expected by business community. The willingness of local leader to embrace local business to participate in development process and to change the policy's course towards businesses also becomes some important parts of leadership role. However, as KPPOD (2005) revealed, it seems that business sectors should wait for this to be real, especially in Surabaya and Semarang, since both cities get low score in this factor.

In a whole, those above mentioned problems are an undeniable picture which proves that decentralization in Indonesia does not come yet with satisfactory outcomes in improving the governments' performance and bureaucracy efficiency in delivering public services, especially for business sector. These are the most important reasons why Surabaya and Semarang are shared similar poor result of government effectiveness and efficiency. Nevertheless, a study on investment climate by Regional Economic Development Institute (REDI) discloses some interesting results which may describe the different growth in both provinces. The study, which was conducted in 2002, revealed that in all aspects which are becoming the subjects of the study (licenses bureaucracy procedure, levies and user charges imposed by local governments to businesses, and local policy direction and orientation to the

⁹ See appendix 3, table 3: the summary of overall score of regional competitiveness factors

¹⁰ See Appendix 3, figure 1.

businesses), local governments in East Java perform much better than those in Central Java (Fauzi, 2003)¹¹.

However, while KPPOD and REDI survey is based on business communities perceptions, different opinion is revealed by Governance and Decentralization Survey (GDS) which focused on evaluating the effects of decentralization to the quality of public service provision and governance by households and various local governments elements. Based on the survey, the respondents in both cities relatively share the same opinion. In overall, the local governments' services are better than from the previous years¹². Furthermore, they also revealed that in average, the public service in education and health are improved than before.

This differing between the surveys' result may represent the policy orientation of local governments towards the business sector in their area. The negative perception revealed by business communities shows that most of local governments in Indonesia still perceived the business sector as one of 'income sources'. As a result, the licensing policy which should be functioned as a regulatory instrument is often misused as a 'commercial commodity' by the governments. This condition certainly opens up greater opportunities for local governments' personnel to commercialize the licensing regulation and also tends to create more 'middle-men' (*calo* in Indonesia) in the licensing processes. The middle-men existence in order to smooth the businesses to obtain permits without doubt undermines the outcomes of some endeavours to improve licensing system (Fauzi, 2003, p.3).

IV.5.2. Impacts on safety, political and socio-cultural factors

In a diverse nation like in Indonesia, the pressures created by political, ethnic, religious, and cultural groups which are seeking greater autonomy in decision-making and stronger control over local resources become the rationale for central governments to decentralize power. The 1997 crisis in Indonesia had brought severe instability in political and socio-cultural factors at national level, thus also affecting the regional level. Severe macroeconomic stability and complicated by the upheaval of the crisis have also add some serious security problems which damaged the business activities and their assets, giving the rise of security volatility. The political and socio-cultural instability also occurred as more separatist movements and some ethnic and religious conflicts were happened. In addition, strong disappointment expression from resource rich regions which demand for more independent from central influence to manage their resource had also added the complexity of the problem at that time. In political context, the rising democracy was dominated by the struggling over powers among political elites; bring the political tension to the already ailing economy.

¹¹ For detail report, see Fauzi (2003): Business perception on investment climate in the regional autonomy era. Report presented in PEG-USAID conference: decentralization, regulatory reform, and investment climate, in Jakarta, August 12, 2003.

¹² The quality of government service to the community in GDS is measured through the cost, time, and procedure in administrative service performed by the sub-district level and being perceived by the respondents. See appendix 3, table 4-6

As a respond to this situation, decentralization has become one of the policies to relax the socio-cultural and security tensions as a result of the multi-dimensional crisis in Indonesia, especially concerning local demand for more determination roles in their own domain. On the first implementation of decentralization, security issues became the major concern of business communities when they decide to locate their business in a certain region (KPPOD, 2001). However, along with the crisis recovery process, Governance and Decentralization Survey (2004) and IRDA (2003, 2004) studies captured that security is not an urgency problems anymore, as the community reports better security and political stability compared to 2001. The KPPOD survey in 2005 was also showed that the confidence of business operators to security and political conditions begins to recover. It is reflected in the weight distribution among the regional competitiveness indicators. The weighted average of the indicators on previous survey had been concentrated in the security, political and socio-cultural indicators, while in most recent survey the weighted average becomes more dispersed to other indicators such as institutional factors and physical infrastructure. However, it should be noted that security is not included into the authorities that are delegated to local governments, so it is still the central government's responsibility. In fact, local governments are still obligated to keep their area secure and safe.

Conversely, some problems related to the openness of the local community emerge. KPOOD found that cultural constraints such as the resistance of the local community to the new business activities are also increased during the introduction of decentralization since local chauvinism is tightened. Furthermore, the existence of traditionally-held land (*tanah ulayat*) and conflicts stemming from the community claims on land needed for business activity is also appeared. This condition is occurred most in rural (district) areas, while urban (municipality) areas tend to accept the new business activities in their region. This is because urban communities are already used to modern economic activities or their economy orientation has moved toward to trade and industrialization (KPPOD, 2001, p.4).

In political perspective, a general comparison of investment competitiveness also demonstrates that regencies were slightly more conducive than cities. Cities tend to have more complicated politics, as well as more frequent demonstrations that disrupt commerce and threaten security (KPPOD, 2005, p.18). However, the major problem related to decentralization in this factor is coming from the *strained relations between the executive and the legislature*¹³ which disrupt the service to the business communities. The above mentioned condition is also likely to occur at Semarang and Surabaya, since they share similar score on this factor based on KKPOD survey.

¹³ Note that decentralization also has brought power tension between the executive and the legislative bodies. The unclear of new decentralization basic law has also influenced the relation between local executive and legislative. In law 22/1999 the local legislative to some extent has immense authority, ranging from hiring, evaluating and firing the head of local executive to influencing the local budget. As a result, the local parliament (DPRD) becomes the most powerful body at the local level. This condition creates potential conflict between the executive and legislative.

IV.5.3. Impacts on local economy: economic structure and potential factors

It is obvious that the claimed benefit of decentralization is to achieve higher economic growth. The improvement of economic output of the regions is often represented by the growth of Gross Regional Domestic Product (GRDP) value. The value of GRDP indicates the potential market in the regions for businesses to sell their product and grow. The KPPOD survey has found that cities were more attractive than regencies, as cities generally scored higher due to higher per capita income.

In 2004, the average GRDP per capita in cities was Rp 16.5 million, while the average GRDP per capita in regencies was only Rp 13.5 million per year. High scoring cities and regencies were those that have been able to expand their manufacturing base and trade in services, while low performing areas remained more closely tied to agricultural commodities. Thus, decentralization still has not significant effects on local economy, especially in Surabaya and Semarang. For instance, the figure revealed by GDS shows that the community tend to have negative opinion of economic condition. They feel that after decentralization their economic condition is getting worst, mostly because of higher staple needs price. For this, 56 % of household respondents in Surabaya and 47% in Semarang share a similar view about this, even though about 10% of them said that the economic is going better nowadays¹⁴.

This condition actually reflects what has been happened in national context. The post-crisis fiscal decentralization somehow has contributed to undermine the economic recovery. In the central level, the obligation to allocate large amount of DAU has weaken the central government capacity to promote economic growth and maintaining economic stability. In the same time, insufficient DAU budget compared to local government expenditure needs as a result of central government personnel transfer and function has also made the structure of local budget is usually dominated by routine expenditure instead of development expenditure. The budget deficit without doubt deters the capacity of local government to allocate more budgets to develop the sectors that needed most by the communities and consequently, it is resulting in poor public service delivery.

IV.5.4. Impacts on manpower/labour factors

Labour conditions in the regions in Indonesia in 2005 were cause for considerable concern. This can be seen from the average score achieved for the labour factor, only 5.38. In 2005, labour productivity dropped to Rp 21.5 million per worker from an average output of Rp 25 million per worker in 2004. Since the 1998 economic crisis, minimum wages have also risen sharply, by more than 30% compared with pre-crisis levels. While cities significantly outperformed regencies for quantity and quality of labour, the top performers in both categories shared similar attributes. These include a commitment to strong educational

¹⁴ See appendix 3, table 7-8.

systems, value-added industries that demand more productive workers, competitive minimum wage rates, and a large percentage of working age population. In this factor, Surabaya and Semarang have relatively high score, as they more committed to provide better education for the citizen. In line with the result of KPPOD (2005), GDS (2004) also reveals that the governments in both cities are committed to make the education sector as their first priority development program by allocating most of development budget into education and health sector. This policy may explain why the households in GDS (2004) feel that there is service improvement on both sectors better than in 2002. It is obvious that when local governments put more attention on certain sectors by allocating more budgets, as described above, the outcomes will soon be felt by the community.

IV.5.5. Impacts on physical infrastructure factors

By decentralization, local authorities are required to provide certain services by the legislation that created them or by the constitution, and specific funding arrangements have to be put in place to ensure that both capital and recurrent cost are met. Consequently, they play a key role in maintaining social infrastructure and services, and in ensuring that critical infrastructures, such as roads, schools, hospitals, bridges and other needed facilities are provided for the communities to support their activities. This notion has become more important in the economic activities, as the availability and quality of infrastructure is one of the keys for sustainable growth in economy and investments as well.

Based on KPPOD survey in 2004, there is a significant difference between regencies and cities in investment competitiveness of the physical infrastructure indicators. However, it should be noted that along with the development of cities, numerous problems can arise that offset some of the advantages of infrastructural development. Although major cities, such as Semarang and Surabaya, scored well on infrastructure, they scored very poorly on institutions, security, and politics.

In general, both cities and regencies with strong infrastructure scores were able to use long-term planning and management to maintain existing facilities, while gradually expanding access to meet the demands of future economic growth. The KPPOD 2005 survey also showed that development of infrastructural resources and maintenance and expansion of current assets remains a significant problem for cities and regencies throughout Indonesia. In particular, the rapidly increasing demand for energy has not been accompanied by a proportional improvement in the electric power infrastructure.

In this case, the revenues assignment on fiscal decentralization in Indonesia has prevented local tax, local borrowing and other local own revenue sources to become important sources of revenue in order to fulfil local expenditure need. As a consequence, local infrastructure development is often strangled by fund deficits and constantly suffers from poor quality which is unfavourable for business activities. This depiction can be seen as one of the reasons

why Surabaya has better investment climate than Semarang. After the fourth year of decentralization, there is no significant improvement on infrastructure development in Semarang such as the airport which is only limited for domestic services. Furthermore, even though Tanjung Emas harbour is prepared to be international harbour for the gate of central java's trade activities, it is still poor managed and its productivity can not be compared to the other main harbours such as Tanjung Priok in Jakarta and Tanjung Perak in Surabaya with their status as international harbours (BKPM, 2007). Unfortunately, further data about infrastructure development on both cities can not be obtained during the research.

IV.6. The impacts of decentralization on Foreign Direct Investment

Despite a comparative case presented above, this section will generate specific analysis of the role of decentralized governance for attracting foreign direct investment (FDI). It is important to look at the effects of decentralization to foreign investment, since foreign investments are more vulnerable than domestic investments against local business environment changes. For example, there often more complicated business procedures for foreign companies than domestic companies to operate their business. Foreign companies are also should dealing with multilayer bureaucracy than domestic companies. which are originally based on that respective country or region. Therefore, decentralization has important effects on the potential of countries to attract FDI.

According to Kessing et.all (2007), decentralization operates along both a *horizontal* and a *vertical* dimension. The horizontal dimension of decentralization has divided the state territory into smaller districts or regions with some autonomy in governmental decision making. Thus, the local governments are being perceived to be 'closer' to their constituency, both physically and in terms of accountability.

Also, potential competition and benchmarking, between the regions such as has been done by KPPOD, becomes feasible whereas this is not feasible under a unified central administration. In the policy debate, these aspects of horizontal segregation play an important role. In the traditional view it is argued that horizontal disintegration into smaller regions may also have some disadvantages, as it becomes more difficult for the fragmented regions to cope with inter-regional spillovers and economies of scale in the public sector (Kimr, 2008, p.11). But it is frequently maintained that there are beneficial effects stemming from inter-regional competition dominate, in particular with respect to attracting FDI. As the World Bank argue, horizontal segregation 'permits a degree of institutional competition between centres of authority that can . . . reduce the risk that governments will expropriate wealth' (World Bank, 2004, p. 53, in Kessing et.all, 2007). To a large extent, this reasoning is rooted in the view that bureaucrats and politicians are have a tendency to misuse their power to extract revenues, and investment projects that are owned by foreigners may become the targets for extractive activities. However, competition between jurisdictions for mobile factors of production

restricts such opportunistic behaviour of bureaucrats and politicians as the mobile factors are footloose in nature (Weingast, 1995; Qian and Weingast, 1997; Hayek, 1939; Tiebout, 1956 in Kessing et.all, 2007).

Decentralization in a unitary country implies that there will be a horizontal disintegration and competitive governmental decision making on the regional level, but this condition is confined by the efficiency argument. An efficiency point of view suggests that only some, but not all decision rights should be allocated to local or regional governments for the reasons of scale effects and difficulties with the internalization of inter-regional spill-over effects or general public goods. Thus, some decisions will remain to be made on more aggregate levels, for example, by the national level government.

The creation of local governments and the process of horizontal segregation are typically accompanied by a process of vertical disintegration. When choosing locations, investors will deal with the governmental decision making of the governments level where the company resides. This implies that they will be subject to the jurisdiction of all such government tiers. An analysis based on horizontal segregation standpoint which is particularly focused on the benchmarking, competition and accountability features of inter-regional competition usually fails to recognize this implication.

Kessing et.all (2007) identifies that the vertical disintegration of governmental decision making becomes the major source of disadvantages of decentralization. Some potential problems are identified when the private sector has dealings with several tiers of government. Problems of rivalry between the different tiers, coordination failures, and free-riding incentives between government decision makers from different government tiers are the most commonly known issues in decentralization. From fiscal aspect, there are common pool problems between tiers of governments when making independent tax and expenditure decisions. At the end, there are moral hazard problems from joint accountability of politicians from different vertical tiers.

Those above mentioned problems affect a country's attractiveness as a location for FDI in several ways. For instance, suppose governments are tempted to extract revenue from existing investment projects that are owned by foreigners. In this case, a common pool problem that may increase the amount of extractive activity emerges, as governments from several tiers are able to extract revenue from the same investment project.

The elaboration of empirical evidence in this thesis already showed whether decentralization with its components has positive or negative effects on the level of FDI inflows. The descriptive analysis by various survey used in this thesis provides novel evidence in this respect. The findings suggest, in line with the theoretical perspective, in some ways, the potential benefits and positive views of decentralization are not working appropriately as expected. By employing various decentralization survey results in this work, the analysis

derives insights as to which aspects of decentralization are conducive to FDI and which turn out to be rather problematic.

The vertical dimension of decentralization, measured by the number of government tiers in a country, is tentatively found to affect FDI negatively. On the other hand, fiscal decentralization, if appropriately designed to create self-sufficiency for local government may have the potential significant positive effects. In this case, expenditure assignment is found to be correlated with more FDI, while revenue assignment appears to have a negative influence on FDI.

IV.7. The impact of decentralization on governance indicator

When previous section elaborates the effects of decentralization to intraregional competitiveness factors, this section present a brief of quality of governance in Indonesia after the 1997 crisis using the World Bank's Governance Indicator¹⁵. The indicator provides a measurement on the performance of a government in six components: voice and accountability, political stability, government effectiveness, regulatory quality, rule of law and control of corruption.

As showed by Perdana and Friawan (2007, p.3), since 1996 to 2005, Indonesia scores lower in 2005 than from the starting year (1996) in all aspects of governance except voice and accountability. If we scrutinize the trend, there are some explanations about it: First, there has been a slight but perhaps insignificant progress in the rule of law and efforts in controlling corruption. Second, the scores on government effectiveness and regulatory quality got worse after 2000, but have relatively returned to the 2000 level in 2005. Third, political stability score has improved in 2005¹⁶.

But how is the position of Indonesia compared to other countries? The survey also presents the country's position compared with the other countries, such as South Korea, Malaysia, the Philippines and Thailand. They have been chosen as they were also the crisis-affected countries. Based on the comparison, it seems that Indonesia's voice and accountability score was the lowest in 1996¹⁷. But it shows a big jump in 2005, placed it above Malaysia who scored better than Indonesia (and itself) in 1996. While the other 'IMF patients' (South Korea and Thailand) also scored better in 2005 than in 1996.

Unfortunately, except for the voice and accountability indicator, Indonesia consistently being the worst performer among the above mentioned countries. For example, in terms of

¹⁵ Kaufmann, Daniel, Aart Kraay and Massimo Mastruzzi (2005). "Governance Matters V: Governance Indicators for 1996-2005". World Bank Policy Research September 2006. The indicators reflect the statistical compilation of responses on the quality of governance given by a large number of enterprise, citizen and expert survey respondents in industrial and developing countries, as reported by a number of survey institutes, think tanks, non-governmental organizations, and international organizations. Each country receives a score between -2.5 (poorest) and 2.5 (best) on each component.

¹⁶ See appendix 3, figure 2

¹⁷ See appendix 3 for the diagrams.

government effectiveness, Indonesia got almost the same score as the Philippines in 1996. But it becomes wider in 2005 because Indonesia's performance becomes much worse than its neighbour. The same figure also showed by the other components such as regulatory quality and control of corruption, when Indonesia becomes the worst performing countries among its regional peers.

Indeed, some events have changed the political landscape in Indonesia. As Perdana and Friawan (2007) point out, at least there are three post-crisis major changes in the Indonesian government institution which influence the quality of government institution. First, the power structure moved from an executive to legislative. The 1999 election brought a significant change in the power structure. The parliament now possesses a greater veto power and becomes more influential over a government policy or decision. Somehow, the swing of power structure is considered too radical because currently it makes the government system a presidential one with parliamentary logic. Second, power concentration moved from a heavily concentrated to a fragmented one almost dramatically. After the crisis, especially after the 1999 election, the multi-party system has made the power more fragmented. Fragmentation occurs not only within the parliament but also within the executive since the president needs to form a coalition cabinet to accommodate as many political interests as possible. Third, due to decentralization, local governments now have more power as most of authorities which are used to maintain by central government now being devolved to them. However, unclear division of authority in the basic decentralization law and the strong resistance of local government to previous centralize regime has made local government feel free to determine their function and authority by themselves. Eventually, it may create dispute between central and local government, poor public service delivery and low economic growth.

IV.8. Conclusion

Decentralization without doubt has brought many changes in most of the Indonesia's political, social, and economic landscapes. In this analysis, the impacts of decentralization are mainly identified in the intraregional economic competitiveness, by taking the investment sector in two cities of Surabaya and Semarang as a case study. While the research is suffering from data deficiency, the secondary data and studies used in the analysis are restricted with data reliability, validity and availability issues. As a consequence, the main objective of the case study to reveal factors behind the difference investment growth trends between Semarang and Surabaya, especially when it is related to decentralization, can not be achieved here. However, this does not mean that the analysis is useless, since the analysis may provide tentative answers to describe the impacts of decentralization on local competitiveness.

In addition, the analysis has come up with some interesting general findings. Various studies used in the analysis suggest that in term of competitiveness, decentralization practice in Indonesia still have less support to the regional competitiveness development. The

institutional problems stemming from the flaws of basic decentralization laws themselves, moral hazard in local governments personnel, and lack of capacity of local governments to exercise the tasks remain become the major reasons why the public service provision, especially in local level has not been improved than before. This is reflected by the modest, or rather negative assessment towards the performance of government service in the eyes of business communities. In the contrary, a positive opinion regarding the public service is perceived by the households. In brief, they assume that the service provided by the government, to some extents, is already better than before. This contrasting opinion signifies that the governments still consider the business sectors as the object to extract revenues, rather than equal partner to build the regions. Thus, the policy orientation of the local governments toward the business communities is only treating the communities not more than as a commercial commodity.

The other competitiveness factors such as local economy, labour, physical infrastructure development, and security and socio-cultural also tell some interesting stories. While security and socio-cultural factors perform better, there is no significant development on quality improvement and the availability of physical infrastructure. At the same time, lack of capacity of local governments to improve quality of human resource is reflected on the declining labour productivity. It may stems from the insufficient local budget which eventually hampers the development process. As a consequence, business environment in respective region will be less attractive for investors.

Decentralization elements in general have also positive and negative impacts to foreign investment. From the vertical dimension, the creation of multi-tiers government structure have negative effect, as the investors have to deal with multiple bureaucracy and regulations within each of the tiers. However, in horizontal dimension, the fragmentation of administration into more regions may foster the competition and prevent excessive revenues extraction activities from the regional governments.

The potential threat comes from the insufficient revenue assignment that may provide incentive for more revenue extraction activities by the governments to local business sectors. From the perspective of governance quality in Indonesia, decentralization have not provide significant changes to the performance of six governance indicators, except for voice and accountability which was better because of the democratic election in 1999. At the end, it seems that the decentralization has brought benefits in term of democracy and political freedom in Indonesia, but the impact of this process on regional economic growth remains doubtful. Therefore, it calls the need to continue to promote the growth of new business activity in order to create work opportunities in the regions.

Chapter V

Conclusion, recommendations and reflection

V.1. Introduction

In this thesis, local competitiveness is the focus of decentralization policy. The main question is: did the implementation of decentralization enhance local (intraregional) competitiveness? However, as the factors were explored, the relationship between decentralization and local competitiveness is rather uncertain and blurred. Hence, decentralization policy does affect the quality of local government, but it might not have direct causal relation with local firm competitiveness. The only way to describe their relation is that the outcome of decentralization process is likely to influence the quality of local governments and their performance, which is one of the essential elements for competitive region.

The case study in this thesis, even though limited only to use secondary data, describes this relationship. The competitiveness indicators show that competitiveness of a region to attract investment largely depends on the performance of local government to create and provide an enabling environment within their boundaries for business to wield prospective growth through higher productivity. Unfortunately, the case study could not explain the influence at firm level, as data was not available. The answers that could be drawn, however, will be further elaborated in the following section. The third section will present some recommendations. This chapter concludes with a final section, containing reflections.

V.2. Conclusion of the analysis

This section presents the answers for each research question in chapter I. It would be easier to draw a complete picture of the research results by arrange them into a particular section.

What are, according to the literature, the components of decentralization that will support the intraregional economic competitiveness?

To answer the question, intraregional competitiveness is divided into smaller sub-systems of competitiveness levels. Then, the analysis elaborates how each of the sub-systems is influenced by the overall components. The components which are identified here consist of political, fiscal and administrative elements of decentralization. The conceptual framework shows that those components may have the potential to support governments' competitiveness by improving the effectiveness and efficiency of public services performed by the regional governments. Subsequently, components of decentralization may support business environment indirectly through the governments' policies that influence the quality of business environment. Finally, it is very unclear and difficult to find the impacts of

decentralization to competitiveness at firm level, since decentralization policy is usually designed only to influence governments' actions.

How are the practices of decentralization in Indonesia based on Law no 22 and 25 / 1999 and their subsequent laws and in how far they do support successful decentralization practices?

Under Law no 22 and 25 / 1999 and their subsequent laws, Indonesia has a very different approach of decentralization practices than the past. In general, the legislation has shifted the decentralization practices from deconcentration into the devolution of authorities. The main feature is the elimination of hierarchical relationships between local governments and higher levels and defined their responsibilities. In 2004, Law 32/2004 and 33/2004 replaced the previous laws, partly as reaction to problematic performances. Nevertheless, some crucial problems remain unsolved, such as the confusions over authorities' distribution, lack of local finance, and low capacity of local governments to execute new responsibilities.

Some evidence has led the analysis to conclude that decentralization framework in Indonesia has not yet provided appropriate institutional and fiscal arrangements to support successful decentralization. Under Law no. 22 and 25 and also their subsequent laws, some major obstacles are constantly occurring during implementation. Flaws in legal framework remain, therefore critical issues need to be addressed. Yet, at implementation level, insufficient capacity of the actors which is sometimes accompanied by bad-governance practices has undermined the effectiveness of decentralization to improve public service provision. In this case, while local corruption becomes epidemic, elite captures and regional horizontal imbalances have also complicated the condition.

On fiscal issues, expenditure and revenue assignments do not establish a corresponding relation between each other and ignore the link between payments and benefits. They fail to match expenditure needs which eventually lead to excessive local regulations.

What are the impacts of the introduction of decentralization laws on local (intraregional) competitiveness in Indonesia?

This question is answered through a case study which compares the investment sector in two cities of Surabaya and Semarang. The investment sector here represents intraregional competitiveness performance of the regions. Since the analysis utilized secondary data analysis, it constantly suffered from several issues, such as reliability, validity and availability of the data. Consequently, the objective of the case study to reveal the factors behind the difference between investment growth trends of the two cities, especially when it is related to the introduction of decentralization, was not achieved. However, the analysis may provide

tentative answers to the impacts of decentralization on local competitiveness, as it has come up with some interesting general findings.

Briefly, the analysis suggests that in terms of competitiveness, decentralization practice in Indonesia still give less support to regional competitiveness development. In line with decentralization practices and their inherited problems, rather negative assessments towards the performance of government service are revealed by business communities. Conversely, households express a more positive opinion regarding the public services. This contrasting opinion signifies that governments still consider the business sectors as the object to extract revenues, rather than equal partner to build the regions. Thus, the policy orientation of local governments towards business communities is only treating the communities not more than as a commercial commodity.

The analysis also suggests that the creation of multi-tiers government structure in decentralization has some negative effects to foreign investment, as investors have to deal with more bureaucratic burdens. The potential threat also comes from insufficient revenue assignment that may provide incentive for more revenue extraction activities by governments to local business sectors. However, in horizontal dimension, the fragmentation of administration into more regions may foster the competition and prevent the excessive revenues extraction activities from the regional governments. At the end, it seems that the decentralization has brought benefits in term of democracy and political freedom in Indonesia, but the impact of this process on regional economic growth remains doubtful. Therefore, it calls the need to continue to promote the growth of new business activity in order to create work opportunities in the regions.

What are the implications of the introduction of the decentralization laws (UU no. 22 and 25/ 1999 and their subsequent laws) on local (intraregional) economic competitiveness in Indonesia?

Finally, as explained by the answer of each research question, it can be said that the introduction of decentralization into local economic competitiveness has partially influenced its performance. The most significant effects can be seen at governments' policies towards the factors which determine intraregional competitiveness. As a concluding, several general implications can be drawn from the results: First, decentralization here is seen as an instrument to improve the performance of local governments in providing public services, including the services to business communities. Thus, the impacts of decentralization on local competitiveness, either positive or negative, depend on how decentralization is practiced. Second, in line with the problematic practices in Indonesia, the analysis found decentralization –within the recent laws- has not yet provided an appropriate level of support to improve local competitiveness. However, the author inclines that local competitiveness will

improve in parallel with the improvement of decentralization practices, as in some cases, evidence suggest that better practices of decentralization are positively responded by business sector. Third, decentralization should be recognized only as a part of complex governance reform which is now effectively influencing economic development, especially local competitiveness in regions of Indonesia. Thus, the performance of local competitiveness can be affected not only by decentralization. So, it is too exaggerated to mention that decentralization determines local competitiveness, as the result suggests that decentralization is only partially impacted on particular aspects of governments' performance among other key factors for local competitiveness, such as national macroeconomics, other policies at national level and market conditions.

V.3. Recommendations

Now, decentralization is irreversible and it has become the point of no return for Indonesia's governance reform. Thus, to enhance the function of decentralization as an instrument to achieve the objectives of decentralization, three important tasks needs first to be done: arrange the most effective way of how political, administrative, and financial authority that can be devolved; identify and create the conditions which are required for effectively sharing power and authority among governance institutions; and find the way of how capacity can be developed for effective participation by local governments and community groups in democratic governance. If these issues are properly addressed, it is likely that decentralization in Indonesia will create the benefits, including the improvement of intraregional economic competitiveness. Those tasks can be done through the following steps:

1. As the political, social and economic stability is going better nowadays, it is the time for the government to improve the weaknesses of its legal framework. To put the items in the legal framework, the government should involve other stakeholders, such as civil societies and private sector, in order to address their aspirations. By this way, they will have a greater motivation to implement the policies. Furthermore, the accommodation of stakeholders' aspiration into the laws will reduce disagreements which can undermine the implementation.
2. On fiscal matters, the government should set up long term policies which provide incentives for local governments to intensify their own revenue sources by adding the value of the service. This can be done, for example by improving the quality of services, increase efficiency and effectiveness of the services delivery and providing enough supporting infrastructures for the services. Another example, the central government should be acquiesced in giving local governments strong tax bases, especially in certain areas where local governments are directly responsible for the service provision of that particular services, such as in education and health. At the same time, check and balance

power between executive and legislative bodies in local level should be established in order to ensure that the available resources can be effectively and efficiently allocated.

3. Human resource problems remain major crucial issues which hamper the successful implementation of decentralization in Indonesia. Lack of capacity, skills, education and experience to deal with new responsibilities are amongst the issues. Therefore, a comprehensive capacity building program is needed for both local governments and for the other stakeholders such as civil societies and private sector. In this respect, the assistance of central government to transfer skills and knowledge needed by local entities will be crucial, especially for those less-developed regions which often have only limited resources to improve their capacity. This will needs mutual understanding between the central and local governments. On the one hand, local governments should receive the assistance from the government and need to accept that in the transition period they will probably require the help of those with more experience. In turn, the central government should address these issues with carefully planned support.
4. In relation with intraregional competitiveness, the practices of decentralization in Indonesia may affect competitiveness performance. It is understandable since most of the factors that build intraregional competitiveness are heavily embedded into areas where decentralization plays a crucial role. The effectiveness of government is an example. Thus, both concepts will likely develop in a parallel way. In other words, the better decentralization is implemented, the more local competitiveness is improved and developed.
5. As a closing suggestion for further works on this subject, there should be more elaboration and comprehensive conceptual framework to grasp more powerful argument towards the analysis. More real data collection and field research need to be done in order to reduce data problems and to fulfil appropriate data needed by the analysis. Consequently, if these weaknesses are addressed properly, the analysis will present a more solid evidence to build strong and sound arguments to answer the problem, especially in exploring correlation between both interesting concepts of decentralization and competitiveness.

V.4. Reflection

This thesis attempts to reveal the possible impacts of recent decentralization practices in Indonesia on its intraregional competitiveness. Thus, a conceptual framework is created by combining recent development of decentralization concept combined with the competitiveness concept. As common in social sciences, the concepts of decentralization and competitiveness are changing during the course of time. Such development sometimes leads to academic debate, discursion and even, contradictions.

Nevertheless, in practice, we found that sometimes theories could not explain the events, or it turned out that the arguments are no longer valid in a particular situation. It is always challenging to mention and to examine all of this in a case study. However, because of time and place limitations, it is impossible for the author to introduce all complexities and correlation of both concepts. Thus, the conceptual framework presented here should be seen as an initial attempt only for further works.

The empirical insight is drawn through a case study of two cities in Indonesia by making use of comparison method. Even though the analysis in case study suffers from data problems and consequently can not achieve its main objective, it presents some tentative answers for the main problem in this thesis. The impacts of decentralization practices on intraregional competitiveness in Indonesia are described here. In general, it is showing that decentralization practices under the dynamic of recent legal framework have not yet provided appropriate level of support for local competitiveness to improve. This is because some problems such as in institutional arrangements, capacity of human resource and less effective implementation of decentralization policy in Indonesia remain to hinder the achievement towards successful decentralization practices and benefits.

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Appendix 1:

The comparison between the old (Law 22/1999 and Law 25/1999) and the new (Law 32/2004 and Law 33/2004) decentralization laws in Indonesia

In what political and economic context the decentralization laws are implemented?

1. The political background of Law 22/1999 and Law 25/1999

The history records that the decentralization practices in Indonesia are performing such restlessness swing of the pendulum moving from decentralization to centralization and vice versa. Perhaps, as commented by most of authors of decentralization, the departure point of new decentralization practices in Indonesia can be traced back when the 1997 Asian crisis hit Indonesia. At that time, the economic instability, skyrocketed price of staple needs, and mass unemployment have triggered a multidimensional crisis, including in political and administrative governance which eventually leads to the reform. Growing dissatisfaction to the incumbent government upon crisis management and three decades long of centralistic regime is a combination of a time bomb and its trigger which eventually exploded and brought the force of all communities, especially from the intellectual communities, student activists and other elements to form people's power to collapsing the regime, resulting the resignation of President Suharto in May 1998 and soon replaced by his vice president, B.J. Habibie to run the government until the next election.

The downfall of President Soeharto's regime or commonly known as "the New Order" period had often been said to open the floodgate of democracy after long repression of centralized government style. This period was accentuated by various important events of democratization process. For example, the proliferation of new political parties is encouraged under the establishment of Law 2/1999 on political party which also marked the end of the domination of Golkar as the strongest party at the elections. The crisis had also prompted strong pressure for more devolution of power to local level. The wave of dissatisfaction comes from local entities as a result of centralization policy of natural resources exploitation without involving local communities and governments. This condition may potentially drags Indonesia into

disintegration and national identity crisis as more separatism activities rise at that time¹.

Facing these extraordinary circumstances, Presiden Habibie who intended to prolong his position and prevent disintegration had embraced the decentralization policy. In 1999, the Habibie government enacted the basic laws on decentralization, Law 22 of 1999 on Local Autonomy and Law 25 of 1999 on Fiscal Relations between Central and Local Governments. While the former transferred some authority to regional governments and built regional political processes, the latter support such regional autonomy by granting fiscal resources at the disposal of local governments. This decentralization policy was very rapid in the process of its arrangement, very tight in its deadlines of implementation, and very radical in its extents of changes.

In the process of drafting the laws, the decentralization team under two different ministries (Ministry of Internal Affairs and the Ministry of Finance) appointed by the president had only very limited time to arrange these important laws without proper consultation to the stakeholders and thus, the draft of the law was only discussed among limited group of bureaucrats and academics who were known as the proponents of decentralization, with little input from politicians and even less consultation with the regions.

In May 1999, one month before the national election of 1999 was to be carried out; Law 22/1999 on regional government and Law 25/1999 on fiscal balance between central and local governments were enacted and will become fully effective in January 2001, after giving two years preparation period. In brief, the laws stipulate that the central government would transfer all its major responsibilities (except for foreign affairs, defence, trade policy, monetary policy, fiscal balance and religion) and 2 million its civil servants or 2/3 of central government workforce to regions. Along with these transferred, local government would also be granted new financial resources. All these process was described as “big bang” decentralization.

However, as mentioned before as these laws were prepared under the two different ministries and within very limited time, these two laws suffer from uncoordinated items among their articles as some political interests actually lie behind them². On

¹ For example, separatism movements in Aceh and Papua.

² The state of affairs prior the decentralization policies was taken place, especially the political motivation, has definitely influenced the final design of the basic laws decentralization system. Instead of a mean to relax the central government’s burden on managing the administration by shortening the bureaucracy and providing better public goods and services to local people. Post-crisis decentralization

one hand, Law 22/1999 retains decentralization spirit to enhance democracy and participation of citizens by devolving authorities. On the other hand, Law 25/1999, in several ways, still preserves the centralistic idea of fiscal balance. Accordingly, these competing characteristic has suffered the regions of having budget insufficiency to fulfil their tasks as given in Law 22/1999 because of limited funding resources orchestrated in Law 25/1999. This considerably becomes the major weaknesses of the laws and other flaws were followed to emerge.

In short, given the political situation embedded to the laws, there are at least two motives behind the laws: 1) relaxing the local demand for more power and participation in development process by giving the authority to manage their own affairs widely to avoid national disintegration; and 2) surviving the popularity of the incumbent government at that time and the legitimacy of the party behind it on the election. Besides these motives, the laws were also considered to have many flaws as they were created in a high tension political of political pressure and uncertainty. The crisis had also diminished the government capacity to take up the drafting of the laws appropriately and as a result, they were enacted without national consensus among the stakeholders. Afterwards, this condition calls for the revision of the laws in the future.

Economic background behind the Law 22/1999 and Law 25/1999

The slow growth numbers of Indonesian economy after the crisis hit in 1998 is a sign of just how badly the crisis affected the economy. It went from a boom of 7% a year prior to the crisis, up to a severe contraction by more than -13% in 1998. The economic situation in 1998 worsened considerably due to the social and political upheavals in May. The distribution network had been badly damaged; economic activities, including exports, generally disrupted; and business confidence was severely damaged. After reaching its lowest growth level in 1998, the Indonesian economy started its fragile recovery in 1999, with a positive growth number of 0.8 %. This positive growth reflects the natural rebound effects of the economy after experiencing a massive contraction.

was mainly designed to make local people and elites happy so the tendency to ask for independence can be reduced. This is reflected by the design to transfer the effective power to the district level government, not provincial. The reason was districts are too small to ask for independence, while the size of a province may be large enough to demand independence.

Main sources of GDP growth in 1999 from the demand side were household consumption and government spending, which grew by 1.48 percent and 0.69 percent respectively. Net exports contributed more to growth in 1999 compared with 1998, reflecting stronger external demand and a more stable economic and political environment. In term of investment, the growth still remained sluggish in 1999 since confidence really only began to be restored in the last quarter of 1999 and there was a lag in realization of investments. Furthermore, while the situation had stabilized, there were still economic and political uncertainties ahead so that investors looking medium and longer term remained cautious. It is obvious that in 1999 and beyond, government still struggles to stabilize the economic condition; while on the same time, it should deal with political uncertainty.

Political background behind Law 32/2004 and Law 33/2004

Soon after the 1999 election, the political tension in Indonesia gradually relieved and relatively stable. The newly elected government of President Wahid had continued the reform process. Under his administration no changes had been made in the implementation of decentralization. At this time, the local governments were enjoying their new received authorities, although there were some regions keep on dissatisfied and demanded to free from Indonesia. The unstable economic and political condition in the first period of the crisis recovery have made the Wahid's government should deal with the tension from separatism in several regions, rampant ethnic and religion conflicts and the residual problems of former East-Timor province. His unpopular policies in dealing with those problems had brought him into disputes with the People Assembly and he was impeached on 2001 by the allegation of corruption. Soon after that, vice president Megawati took the daily administration until the end of office term in 2004.

Megawati's administration was considered to be slightly successful in gaining macro-economy stability after the crisis shock even though some problems remain considerably serious. Notably, in her presidential period, there are some important events. For instance, Indonesia was preparing and conducting the first direct election in 2004. In her period also, the Law 22/1999 and Law 25/1999 concerning decentralization were replaced by Law 32/2004 on and Law 33/2004. Thus, unlike their predecessors, these laws were prepared in more stable political and economic condition.

There are several reasons behind the revision of decentralization laws: 1) The amendment of 1945 Basic Constitution by the MPR (parliament) in August 2003 has also amended the legal base of decentralization policy, which is the article 18 of the constitution; 2) the aspiration within the House of representative to include the direct election of the head of region into the decentralization laws, and; 3) the government's opinion that the decentralization practices had been carried out too far and tend to produce negative effects, especially in term of economy recovery and investment. For instance, the transfer of KKN to local level, the tightening of primordial ties, regional egoism, the appearance of the so-called "small kings" and high cost economy because of excessive local regulations are amongst the claims. Thus, the central government argued that decentralization should be rearranged to curb those negative excesses.

Logically, following better political stability than in 1999, this condition should encourage for better preparation of the laws revision. For example, there will be enough time for government to arrange public consultation with the stakeholders as decentralization policy carries the interests of different parties on national level. Furthermore, the lack of coordination between the two involved ministries can be improved this time as there were no urgent situations as had happened previously. However, it is likely that this logic does not apply in that way. Along with the preparation of the first national direct election, the government also prepared the revision of decentralization laws and accordingly, in the end of its office term, the government enacted the new laws. As a consequence, non-transparent drafting processes were also recognized to happen in the revision process. Public consultation and negotiation remain abandoned by the government and once again, made the Ministry of Interior and the Ministry of Finance became the main actors, which unfortunately remain uncoordinated, thus leaving behind the other stakeholders. Eventually, similarly with the previous laws, the new laws were implemented in a hurried manner following the end of the government's office term. The evidence is quite clear, while the fiscal balance arranged in Law 33/2004 is likely to keep the resources centralized; Law 32/2004 is also being suspiciously brought back centralization by confining the authorities of local government in the name of improving accountability. Inevitably, the laws also harvested many critics and sceptical views as happened to the previous laws.

Economic background behind the Law 32/2004 and Law 33/2004

Until 2004, the condition of macroeconomic in Indonesia is fluctuated following political dynamic movement. During the first period of the crisis (1998-2001), Indonesia has already had three presidents with different characteristics and policies in regard to respond the crisis. As reviewed before, the national election of 1999 has selected President Wahid, removing Habibie to take up the presidency until he was impeached and then replaced by his vice-president Megawati. During their administration, the economic stability was fluctuated and sometimes often showing modest growth.

The Megawati government has been considered successful to bring macro-economic stability, even though it was modest. According to the World Bank (2003), during her administration, significant progress was made in democratization, macro stability, and fiscal sustainability. Political stability, continued solid macroeconomic management, and renewed reforms supported financial market sentiments. Market confidence lifted the Rupiah from Rp.10,500 per US Dollar by the end of 2001 to levels below Rp.9,000 per US Dollar for most of the year. Growth in the first three quarters of 2002 amounted to 3.4 percent, about the same as for the year 2001, but 1.5 percentage points below that of the year 2000. However, the economic growth did not pick up and the poverty reduction programs were stalled.

As the macro-economic stability was going better, the attention was being shifted to the deteriorated investment climate. Beyond perception and rhetoric, though, Indonesia is facing fundamental problems in its investment climate, ranging from increased violence and crime, to corruption and bureaucratic delay and inefficiency, uncertainty in labor relations, and excessive taxation by some local governments. The Bali bombing undoubtedly added to concerns on security. A further threat looming on the horizon is that of a faltering infrastructure, and power shortages. Most prominently, the weak justice sector which was perceived by business sector as very crucial has forced the government to passage the Law of Anti-Corruption Commission and created the Constitution Court (Mahkamah Konstitusi), especially to gain the investor's confidence. Up to now Indonesia is still struggling to solve the problems in four major issues: economic stabilization and recovery, democratic transition and political reform, decentralization of political power, and the redefinition of national identity and some efforts to overcome those problems are being carried out simultaneously.

In a whole, as a part of the crisis outcomes, both decentralization laws are designed and implemented under the crisis recovery condition characterized by the fluctuating of economic and political instability. Thus, even though the establishment of the laws themselves becomes a significant progress in Indonesia's decentralization history, the political and economic condition in which it is embedded have made the decentralization laws needs to be improved continuously as flaws remain in their contents and implementation. The development of decentralization laws should also taking into account the progress of political and economic context in which they operate, as decentralization is only a part of a big picture of multi-dimensional reform in Indonesia which is occurring now.

The comparison between the laws

Below the comparison between Law 22/1999 and Law 25/1999 with Law 32/2004 and Law 33/2004 is presented. The comparison is based on several aspects related to the laws as follow:

1. The actors involved in the design of the laws
2. The law substantive: Legal framework, public service provision, revenues, intergovernmental transfers, borrowing, governance issues (transparency, accountability, participation)
3. The gap between the formal rules and the implementation issues

Table.1. the comparison between the laws in some aspects

No	Comparison aspect	Law 22/1999 and Law 25/1999	Law 32/2004 and Law 33/2004	The implementation issues	
				Law 22/1999 and Law 25/1999	Law 32/2004 and Law 33/2004
1	The involved actors	Mainly the Ministry of Interior and the Ministry of Finance, as the laws were issued as a respond to the crisis.	Ministry of Internal Affairs and the Ministry of Finance. Some stakeholders are contributing for some ideas, but the authority to put the items in the laws remains in the hand of the central government agencies.	Lack of public consultation and therefore, there is no political compromise.	Similar with the old laws. The reluctance of stakeholders to comply with the laws is considerable modest and often contestable if the stakeholders do not agree with the laws' contents.
2	The substantial reform a. The relationship among the tiers of government b. Public service provision (segregation of authority)	The laws eliminate the hierarchical relation between central and province governments with regional governments.	Similar structure arrangement, but regional government is now obliged to consult to the higher level government, especially in budgeting and civil service provision.	The elimination of hierarchical relation makes coordination problems, as regional governments are reluctant to coordinate their development program to either the province or to central government.	Coordination problem among tiers of government remain although in some authorities, regional governments are now have to consult with the province or central govt.
		The regional governments are bestowed with authorities other than the six authorities	The law defined the sector specific assignments for regional governments and province government. There are thirty one	The distribution of service assignment is full of vagueness. Sectoral authority is very often overlapping among each	The confinement of the sector-specific assignments is debatable, as it is often seen as a two edges sword, an attempt

No	Comparison aspect	The implementation issues	
		Law 22/1999 and Law 25/1999	Law 32/2004 and Law 33/2004
		<p>retained by central government. Many services are devolved to the regional and province as well. The decentralization is focused on the regional level while province has double role as the government length-arms</p>	<p>government affairs. The authorities also divided correspond to the each tier of government.</p>
	c. Expenditure assignment	<p>Following the authority given in the Law 22/1999. The authorities of central and province governments are defined in the government regulation.</p>	<p>Following the government affairs given in Law 32/2004 and the regulation concerning the authorities of regional governments.</p>
	d. Revenue assignment	<p>Balance fund, original local sources of revenue through local taxes and retribution collection.</p>	<p>Balance fund and original local source revenues with tax base. Similar with previous design. Limited</p>
		<p>level of government, especially between central and regional governments. As a consequence, conflicts and struggles over resources and authorities between central and regional governments are existed. There is contradiction between the law and the regulation concerning the segregation of authorities between central and local governments</p>	<p>of centralization and in the contrary, as an attempt to establish the clear-cutting accountability among the levels of government</p>
		<p>The expenditure assignments often do not follow the efficiency and externality principles. As a consequence, the services are less responsive and ineffective delivered</p>	<p>The distribution of authority is introduced through detailing sector-specific assignment, inviting sceptical argument of re-centralization.</p>
		<p>The revenue assignment fails to meet the fiscal needs. As a consequence, Local taxes are maximized</p>	<p>Strict monitoring of regional regulation establishment, especially in local taxes without</p>

No	Comparison aspect	Law 22/1999 and Law 25/1999	Law 32/2004 and Law 33/2004	The implementation issues	
				Law 22/1999 and Law 25/1999	Law 32/2004 and Law 33/2004
		Weak local tax base. No significant revenue autonomy is granted	local tax base	to generate as much as possible local income. This is disastrous for local business climate	providing wider discretion on local tax base produces more vertical imbalance and local budget deficit.
	c. Intergovernmental transfer	General allocation fund (DAU) transfer is used with wide local discretion. Special allocation fund is formed to cover earmarked purposes.	DAU is separated from basic needs, releasing DAU from civil servant salary payment. DAK remain the same.	The intergovernmental transfers still favoured the resource rich regions. Increasing horizontal inequality among the regions. The poor regions are suffering. DAU is only sufficient to fund the bureaucracy and little can be used to fund development programs.	DAU in part targets the gap between standardized expenditure needs and fiscal capacity, but problem remain in measurement. DAK is being further developed.
	f. Local borrowing	Foreign loans are also allowed under the approval of central government. The sources of regional loans: central govt loans, foreign loans, and local govt obligations	Tight monitoring and requirement for local borrowing. Foreign resource loan is prohibited to regional government.	Local borrowing once allowed, but its performance deteriorated by poor loan allocation and poor repayment	Under the new laws, it is barely functioning since many regions are not eligible.
	g. Participation	Little participation is given to the citizens.	Participation of citizens is arranged through direct	The creation of local budget often not in line	Participation of citizens is improved, but limited

No	Comparison aspect	The implementation issues	
		Law 22/1999 and Law 25/1999	Law 32/2004 and Law 33/2004
	Poorly defined channel of participation	Law 22/1999 and Law 25/1999	Law 32/2004 and Law 33/2004
	h. Accountability	<p>The head of the region is elected by the local assembly. Thus, the head of the region is indirectly accountable to the citizens through the local assembly (Horizontal accountability). Local assembly has the same power with the head of the region as executive and legislative bodies. There is potential check and balance system between legislative and executive bodies and they arrange the regional budget together.</p>	<p>election of the head of the regions. Other channels for participation are still stipulated, but not in detail.</p> <p>The head of the region is directly elected by citizens. But, the head of the region is accountable to the higher level of government, but also have to give explanation to the local assembly and the citizens (Vertical accountability)</p> <p>Local assembly and citizens can not impeach the local leader. No 'recall' system for the head of the region if he/she performs poorly. The regional budget is arranged by the executive with the consultation from higher level of government. The local assembly only have an approval function to the budget.</p>
		<p>with citizens' preference. As it can not effectively monitored by the community.</p> <p>As the laws do not instruct the local governments to disclose the performance of administration to the communities, the accountability of government is only limited to the local assembly.</p>	<p>only to information and consultation level, and not on the level of citizens' control.</p> <p>The central government's influence becomes more dominant under the new laws. Accountability to local communities is reduced. This may become the way for local government to escape from the responsibility to its community, as the head of the region is now hold accountable to the central government. This also may imply on excessive central intervention to local affairs.</p>

No	Comparison aspect	The implementation issues		
		Law 22/1999 and Law 25/1999	Law 32/2004 and Law 33/2004	Law 22/1999 and Law 25/1999
	1. Capacity (civil service)	Regions have full authority to manage the civil services. As the early stage of implementation, the gap of capacity is fulfilled by the transfer of central government staff to focal level.	Regions have to get approval from the higher level government to arrange or to promote the civil servants, thus does not have full discretion as previously.	Capacity varies greatly among regions as the development of each region is also varying; it is generally better in urban areas: technical capacity is often better than governance capacity.
				Capacity remain varies greatly. The poor capacity building efforts remain hampering the development of local capacity to exercise the authorities, since there is no legal basis for this.

Source: taken from various sources (see reference). compiled by the author, 2008.

Appendix 2:
The detail explanation of the survey.
Main survey and analysis

1. The 2005 KPPOD Investment Competitiveness of Regencies and Cities in Indonesia

KPPOD (Regional Autonomy Watch) is an institution that focuses its research and advocacy activities on the implementation of regional autonomy as it relates to economic development and investment. Since 2001, it has conducted an annual survey to rate the investment competitiveness of various regions. This survey is aimed at stimulating competition between local governments to create the best possible investment climates.

The business community also benefits from using the survey results to consider where to do business in Indonesia. The annual survey results are disseminated through reports and workshops that are held throughout the country. The positive response to these activities has enabled KPPOD to expand the number of regions surveyed each year. In 2001, 90 regions were rated; this rose to 134 regions in 2002, to 200 in 2003, and to 214 in 2004. In 2005, 228 regions were surveyed, comprising 169 regencies and 59 cities. The same regions are surveyed and rated each year, with new ones added each time.

Study Approach

The 2005 KPPOD Investment Competitiveness of Regencies and Cities in Indonesia is the fifth iteration of an exercise begun in 2001, in the wake of Indonesia's dramatic drive toward decentralization. Its goal is to serve as a guide for private investors, public policy makers and citizens, as well as a diagnostic tool to pinpoint development problems and improve policies at the local level. It seeks to evaluate, and ultimately rank, the quality of the business environment and the opportunities for investment in Indonesia's various regencies and cities. A core component of the index is an assessment of economic governance at the local level, but it also emphasizes structural factors such as the labor force and infrastructure availability and quality. As such, the KPPOD exercise is neither a classic Investment Climate Assessment (ICA), nor a pure economic governance rating.

As with all previous surveys, the 2005 exercise was conducted by KPPOD with support from the Asia Foundation. It follows the same broad methodological framework as previous iterations, albeit with minor improvements. It uses survey data, collected throughout the country from interviews with local businessmen and women to capture the perception of entrepreneurs on the local investment environment. This subjective or 'primary' data is complemented with statistical or 'secondary' data routinely collected by government, donor agencies and otherwise compiled by KPPOD. The principal originality of the KPPOD index comes from the methodology through which it was devised. The initial identification of relevant indicators, variables and factors, as well as the weighting of their relative importance, was made using the Analytical Hierarchy Process (AHP), through in depth interviews of business owners in various sectors of the economy (trade and services, manufacturing, mining, plantations etc.), as well as experts from academia and policy-making agencies assembled in focus groups. Investment

competitiveness in the regencies/cities is assessed using 5 factors, broken down into 14 variables and further analyzed through 47 indicators. The five factors are:

1. Institutional factors : capturing the quality of the legal environment for businesses as well as the quality of local government services to businesses and leadership
2. Security and socio-political factors : rating the security environment for individuals and businesses, the quality of local policy-making as well as social harmony and openness.
3. Economic factors : measuring the local economic potential and structure
4. Labor related factors : including labor productivity and education
5. Infrastructural factors : evaluating the availability and quality of transport, electricity and communication facilities for firms.

The rating factors, variables and indicators are derived from reference studies and the opinions of business leaders and economic observers. Then, using the Analytical Hierarchy Process (AHP) approach, the factors, variables and indicators are arranged into a hierarchy as shown in Diagram 1 below. (Indicators are not displayed.) The indicators and weights used in the 2005 ratings differ slightly from those used in previous years (2002-2004), though the factors and variables have not changed. The weight for each factor, variable and indicator was assigned by business and economic experts involved with the AHP research. The weightings indicate the degree of impact on investment competitiveness (see Diagram 2- 7). The change in the weightings used in 2005 compared with those used in previous years resulted from changes in perceptions of the business community about the degree of influence of the factors, variables and indicators in determining regions' investment competitiveness.

The indicators used to assess the regions' investment competitiveness were derived from secondary data (annual statistics and local regulations) and from primary data (perceptions of business leaders). The primary data on business licensing profile were collected from interviews with both government and private institutions. Each indicator is scored on a scale from 1 to 9, with 9 the highest and 1 the lowest. The KPPOD investment competitiveness overall score is obtained by totaling all of the weighted indicator scores. The city and regency scores are ranked together and then grouped into categories A, B, C, D and E; each category represents 20% of the total. For example, Category A comprises cities and regencies in the top 20%.

Analytic Hierarchy Process (AHP)

The Analytic Hierarchy Process (AHP) is a sophisticated decision aid tool. It is used primarily by business school professors and consulting companies as a way of assisting decision making in expert systems. AHP is thought to be most effective in truly expert systems, such as engineering or software development, where complicated decisions need to be made, but it is difficult to formalize the criteria. However, its adaptation to business climate surveys, in particular as a way to determine the relative importance of specific issues on business location decisions, has been unique to Indonesia.

Concretely, the exercise involves asking carefully-selected experts to answer a series of pair-wise comparisons between indicators and offering a nine-point determination of the saliency of the differences. Every indicator, variable, and

factor is compared with every other indicator, variable, and factor in a round-robin tournament. Then, a software program called “Expert Choice” is used to calculate the geometric mean for each of the different indicators, variables, and factors, which becomes the model weight.

2. Governance and Decentralization Survey (GDS)

The main objective of Governance and Decentralization Survey (GDS) study is to observe how are the practice of governance in Indonesia after the implementation of decentralization policy through Law No. 22/1999 and then revised by Law No. 32/2004. The decentralization policy which was initiated by the government since 1999 have more focused on the devolution of authorities to the regional governments in regency/municipality to give them more discretion in conducting their administrative tasks and maintaining the public service based on local aspiration and needs. Unlike the Law UU No. 5/1974 which favoured the dominant role of the central government in delivering public services to all level, Law No. 22/1999 (and further revised in Law No. 32/2004), the role has shifted to the regional governments in regency/municipality. It is expected that this important change could bring the fundamental change in the way of governance has been exercised in local level through more democratic, aspirative, openness, and accountable to the local communities.

The Governance and Decentralization Survey (GDS) is a part of the Indonesian Decentralization Empirical Analysis (IDEA) project, which is being conducted by The World Bank (WB) together with CPPS-GMU (Centre of Public and Policy Studies-Gajah Mada University). The Objectives of IDEA/GDS are:

- To compile primary and secondary data to allow the key stakeholders to better understand the decentralization process and its connection with governance over the next few years.
- To utilize empirical data based information to promote supportive and democratic policy at local government level.

GDS covers 177 local governments (51 percent of the 348 kabupaten/kotamadya existing in 2002), thereby providing one of the most extensive resources on governance and decentralization. The GDS can be linked to other Indonesian local government level secondary data (e.g., the Central Bureau of Statistics annual Socio-Economic Household Survey (SUSENAS) or the Ministry of Finances Regional Fiscal Information System (SIKD).

GDS Methodology

20 provinces were chosen from 30 using purposive sampling method and within those 150 local governments were randomly chosen from 348 kabupatens receiving DAU (Dana Alokasi Umum / General Allocation Fund) in 2001¹. Fieldwork was conducted by a network of sixteen universities around the country following centralized and decentralized survey and CAFÉ (computer assisted field entry) training. 27 kabupatens were then added as these additional districts are being evaluated by one of the WB's proposed local government governance

reform projects (Kabupaten Governance Reform Initiative Project, KGRIP) that were not covered in the original basic GDS sample (also extending coverage to 2 additional provinces). GDS was fielded in February-April 2002 for the first 150 and May-June 2002 for the additional 27 kabupatens. There are two types of respondent in this survey, non-household respondents and household respondents. In total there are 36 non-household respondents and 60 household respondents in each local government. Households were sampled as cluster of 15, reflecting 1 poor and 1 richer village, alongside with nearby health and education delivery points (puskesmas and schools). GDS was conducted using 12 structured questionnaires covering 12 aspects of local community.

3. Social Monitoring and Early Respond Unit (SMERU)

Methods and Objectives

The papers established under SMERU research mostly examines the preparations, implementations, and evaluations for decentralization that have been undertaken by regional governments. They include some of the initial implementation measures and emerging challenges faced by district and municipal governments during the process of implementing decentralization. They focuses on two areas: first, the internal processes undertaken by local governments to cope with their new powers and responsibilities, and second, whether the processes of creating public policies reflect the spirit of transparency, good governance and democracy. The papers are based on field research conducted by SMERU's research team in twelve districts and two municipalities across eleven provinces within a period of time (usually takes eighteen months).

The sample areas have been chosen to allow for a geographic spread across Indonesia. They were intended to reflect some of Indonesia's regional variations and also to permit the researchers to view the implementation of the decentralization laws both in areas where these laws are working well and also in those areas where significant difficulties and problems are emerging. The information was collected primarily through semi-structured interviews with officials at all levels of government, as well as with representatives of political parties and civil society institutions (including community organizations, NGOs, the press, professional bodies, informal religious leaders, local-level traditional leaders, village heads and members of village-level assemblies). The semi-structured nature of the research has allowed for flexibility and consistency the investigation of issues as they arise from several angles.

4. IRDA (Indonesia Rapid Decentralization Appraisal)

The Indonesia Rapid Decentralization Appraisal (IRDA) monitors the implementation of decentralization under Laws 22 and 25/1999 in order to provide independent feedback to national and local government stakeholders. This program was initiated by The Asia Foundation in 2001 and is supported by the United States Agency for International Development.

IRDA Methodology

There is a vast universe of topics that could be studied about decentralization. However, policy debates need to be clarified as quickly as possible so that key actors can take immediate actions. This is where the IRDA method is most useful. It strikes a balance between providing just enough useful information for clarifying policy debates, and making the information available in a timely fashion. Focusing on a limited but relevant set of information is more efficacious than gathering tons of information that requires months if not years to finish.

IRDA employs the appraisal method in monitoring decentralization in Indonesia. IRDA belongs to a family of rapid appraisal methods, e.g. Rapid Rural Appraisal (RRA) and Participatory Rural Appraisal (PRA), that use a range of “informal” data collection techniques such as semi-structured interviews and secondary data analysis. While the general technique is qualitative, the information gathered and analyzed is a mix of both qualitative and quantitative data. To capture the local perspective, research institutions familiar with the sites and decentralization gathered the data from the field.

The unit of analysis in these appraisals is the kabupaten/kota where substantial powers were transferred from the central government. IRDA’s main data gathering tools are key informant interviews and focus group discussions. Using various tools and techniques allows for triangulation and validation of data from various sources. IRDA’s analysis and recommendation development process is participatory. Thus, by maximizing the use of participatory methods, the very IRDA process itself helps establish dialogue mechanisms among key actors at both national and local levels. The steps taken in IRDA are as follows:

1. **Setting the Stage.** This phase sets the research agenda and defines the themes that will be covered in the appraisal. It involves the participatory gathering of information about what issues the IRDA should address, rooted in stakeholder interest. Core issues that persist remain the same from year to year, enabling the IRDA to measure progress consistently. New issues may be added in subsequent cycles, based on stakeholder inputs.
2. **Generating Guide Questions.** A peer group or small group representing the government, civil society, and private sector, along with the Foundation and some other groups working on decentralization, filters the issues and themes to formulate interview and discussion questions.
3. **Briefing Seminar.** A briefing seminar for local research partners ensures that all institutions conducting the IRDA have a common understanding of the parameters for the appraisal, the research agenda, the guide questions, and the data gathering methods. As part of the Foundation’s commitment to build local institutions, and eventually to transfer this technology to them, local research partners are engaged for the data gathering process. The familiarity of local partners with the target area is critical because they understand the site-specific decentralization issues that should be pursued, in addition to the set of guide questions.
4. **Data Gathering.** The local research partners gather information by conducting a series of multi-stakeholder, participatory workshops and consultations using focus group discussions as the primary data gathering technique. Data gathered from these inter-locking dialogues are validated and enhanced through key informant interviews and analysis of secondary data such as the local budget and local regulations passed.

5. **Local Report Writing.** Each local partner prepares a comprehensive report of all data gathered. Secondary data that support the research findings are appended to the reports.
6. **Synthesis Seminar.** The objectives of the synthesis seminar are a collective analysis of data gathered and the development of consensus based on empirical observations gathered by the partners.
7. **National Level Presentation.** The findings are then presented in a national level forum, which brings the local perspective to national attention for discussion.
8. **Local Level Public Presentation.** This stage completes the cycle by bringing back information and analysis to local governments. This is also the stage at which inputs for possible new themes for the next round are gathered.
9. **Final Report Writing.** The synopsis report integrates all inputs gathered throughout the process.

Appendix 3: Tables, figures, graphics, data

1. Table 1. The Recapitulation of the development of FDI projects distribution in Central Java 2005
2. Table 2. The cities based on regional economic sectors in 2004
3. Table 3. Overall findings of KPPOD survey
4. Table 4. Comparison of government service after decentralization
5. Table 5. Comparison of time spent to handle administrative service in government after decentralization
6. Table 6. Cost of the government service after decentralization
7. Table 7. Recent economic condition compared before decentralization in Semarang and Surabaya 2004
8. Table 8. Factors influencing the households' economic condition in Semarang and Surabaya
9. Figure 1. How involved are businesses in local policy-making
10. Figure 2. Indonesia Governance Indicators 1996-2005
11. Figure 3. Comparison of various governance indicators 1996 and 2005

Table 1.
Recapitulation of the development of FDI
projects distribution in Central Java 2005

No.	District/cities	Year 2005			
		Domestic labour person	Foreign labour person	Number of projects	Investment value US\$
1.	Region I				
	Kota Semarang	6.596	40	19	108.764.636,16
	Kab. Semarang	5.858	32	8	7.710.054,67
	Kota Salatiga	0	0	0	0,00
	Kab. Kudus	0	0	0	0,00
	Kab. Jepara	950	17	14	6.450.000,00
	Kab. Demak	112	3	1	450.000,00
	Kab. Rembang	6024	0	1	7.035.937,33
	Kab. Kendal	0	0	0	0,00
2.	Region II				
	Kab Boyolali	22	0	1	400.000,00
	Kota Surakarta	194	2	1	600.000,00
	Kab. Sukoharjo	17	15	0	0,00
	Kab. Karanganyar	0	0	0	0,00
	Kab. Sragen	0	0	0	0,00
	Kab. Wonogiri	0	0	0	0,00
	Kab. Klaten	73	4	2	800.000,00
	Kab. Magelang	4	4	0	0,00
	Kota Magelang	0	0	0	0,00
	Kab. Purworejo	203	0	1	4.148.190,17
	Kab. Wonosobo	95	2	1	500.000,00
	Kab. Temanggung	1	2	0	0,00
	Kab. Kebumen	0	0	0	0,00
3.	Region III				
	Kab. Batang	0	0	0	0,00
	Kota Pekalongan	0	0	0	0,00
	Kab. Pekalongan	0	0	0	280.000,00
	Kab. Pemalang	0	0	0	0,00
	Kota. Tegal	0	0	0	0,00
	Kab. Tegal	0	0	0	0,00
	Kab. Brebes	0	0	0	0,00
	Kab. Banyumas	0	0	0	0,00
	Kab. Purbalingga	42	9	1	5.000.000,00
	Kab. Banjarnegara	0	0	0	0,00
	Kab. Cilacap	100	0	1	250.000,00
	Total Projects	20.313	130	51	142.388.818,23

Source: regionalinvestment.go.id.

Tabel 2
The cities based on regional economic sectors in 2004

No	Sectors	Semarang (value in Million rupiah)	Surabaya (% share to total GDRP)
1	Farming	224,183	1,19
2	Mining	71,516	2,63
3	Processing industries	6,346,881	7,74
4	Electricity and clean water	407,369	7,50
5	Building (construction)	1,940,357	6,51
6	Trade, hotel and restaurant	6,000,018	8,07
7	Transport and communication	1,352,144	6,20
8	Bank/monetary institution/housing	900,416	7,99
9	Services	3,007,642	3,04

Sources: BPS Province office in Central and East Java, 2007, compiled by author

Table 3
The summary of overall scores of regional competitiveness factors
KPPOD survey in 2005

No	factors	Average value		
		cities	regencies	Cities and regencies
1	Institutions	5.26	5.48	5.43
2	Security, political and socio-cultural	6.23	6.41	6.37
3	Local economic	7.20	6.35	6.57
4	Labour	6.47	5.00	5.38
5	Physical infrastructure	6.47	5.95	6.09
	Overall score	6.39	5.92	6.04

Source: KPPOD, 2005

Table 4
Comparison of government service after decentralization in Semarang and
Surabaya, 2004

	City/regency			
	Surabaya		Semarang	
	Number	%	Number	%
Better	65	67,70%	61	63,50%
Not change	11	11,50%	13	13,50%
Worst	8	8,30%	10	10,40%
Not available	1	1,00%	1	1,00%
Do not know	11	11,50%	11	11,50%
Total respondent	96		96	

Source: Governance and Decentralization Survey (GDS), 2004

Table 5
Time spent to handle administrative service by government after decentralization in Semarang and Surabaya, 2004

	City/regency			
	Surabaya		Semarang	
	number	%	number	%
Better	62	73,80%	43	51,20%
Not change	13	15,50%	13	15,50%
Worst	8	9,50%	24	28,60%
Not available	0	0,00%	0	0,00%
Do not know	1	1,20%	4	4,80%
Total respondent	84		84	

Source: GDS, 2004

Table 6
Cost of government service after decentralization in Surabaya and Semarang 2004

	City/regency			
	Surabaya		Semarang	
	number	%	number	%
Better	53	63,10%	59	70,20%
Not change	19	22,60%	4	4,80%
Worst	10	11,90%	17	20,20%
Not available	1	1,20%	1	1,20%
Do not know	1	1,20%	3	3,60%
Total respondent	84		84	

Source: GDS, 2004

Table 7
Recent economic condition compared before decentralization in Semarang and Surabaya 2004

	City/regency			
	Surabaya		Semarang	
	number	%	number	%
Better	18	18,80%	31	32,30%
Not change	22	22,90%	18	18,80%
Worst	56	58,30%	47	49,00%
Do not know	0	0,00%	0	0,00%
Total respondent	96		96	

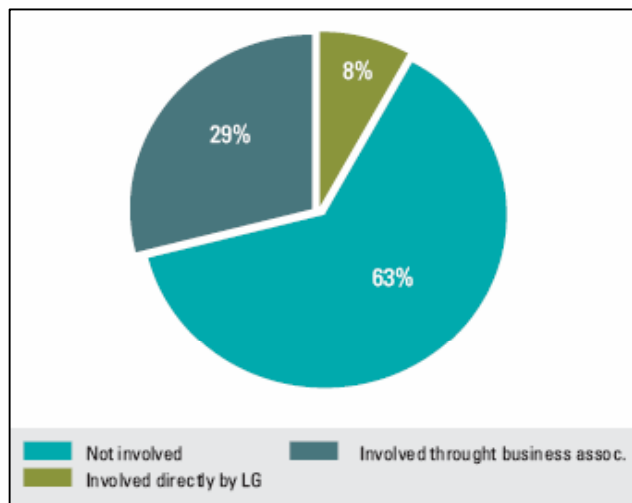
Source: GDS, 2004

Table 8
Factors influencing the households' economic condition
in Semarang and Surabaya

	Cities			
	Surabaya		Semarang	
	number	%	number	%
Have a job, increased income	12	12,60%	16	16,70%
Secure condition	0	0,00%	0	0,00%
The increasing number of worked family members	2	2,10%	9	9,40%
The increasing result in harvest	0	0,00%	1	1,00%
Obtaining aids	0	0,00%	0	0,00%
Declined living cost	2	2,10%	1	1,00%
Increased living cost	0	0,00%	0	0,00%
High staple foods price	55	57,90%	46	47,90%
Stable/declining income	17	17,90%	15	15,60%
others	7	7,40%	8	8,30%
Total respondents	95		96	

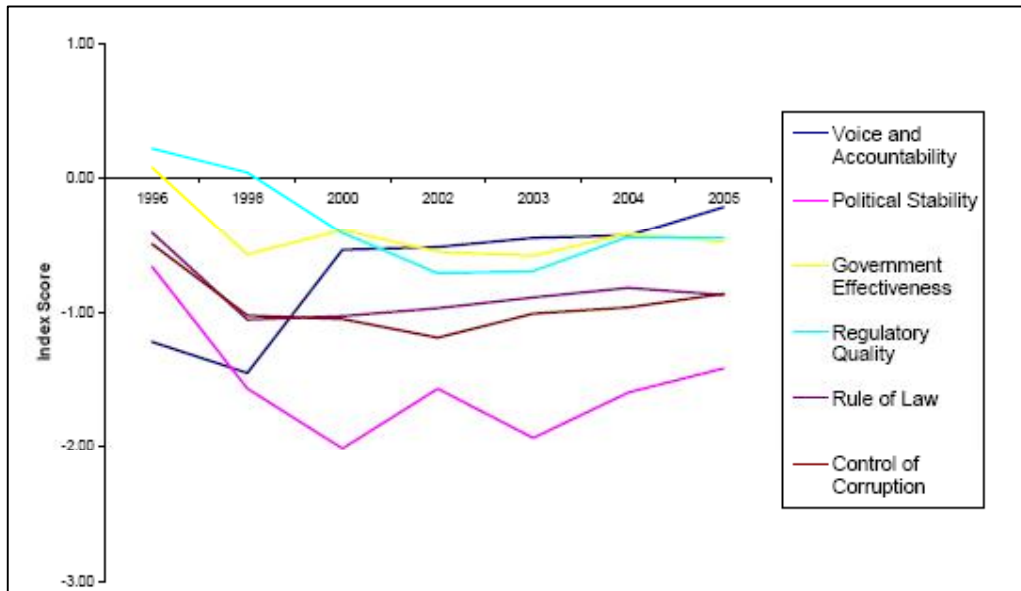
Source: GDS, 2004

Figure 1
How involved are business in local policy-making?



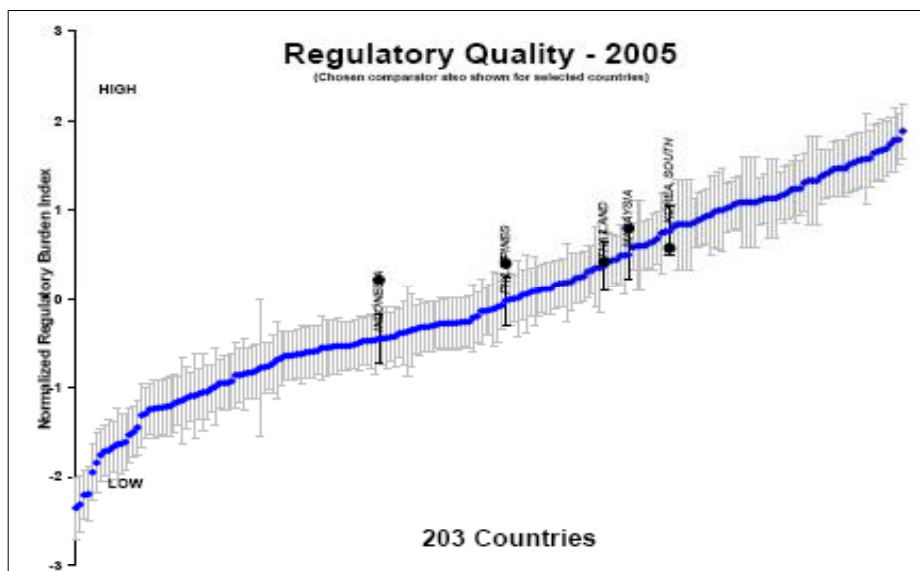
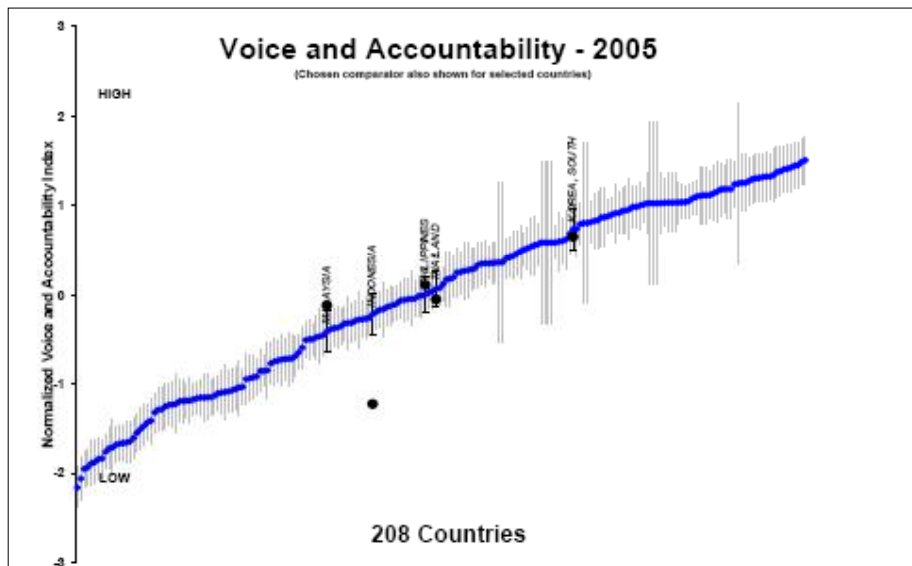
Source: KPPOD, 2005

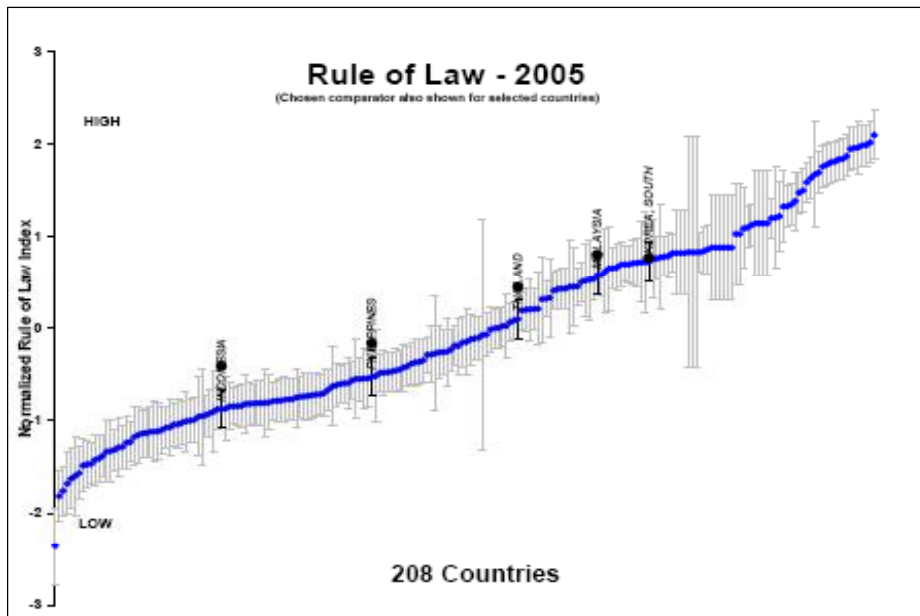
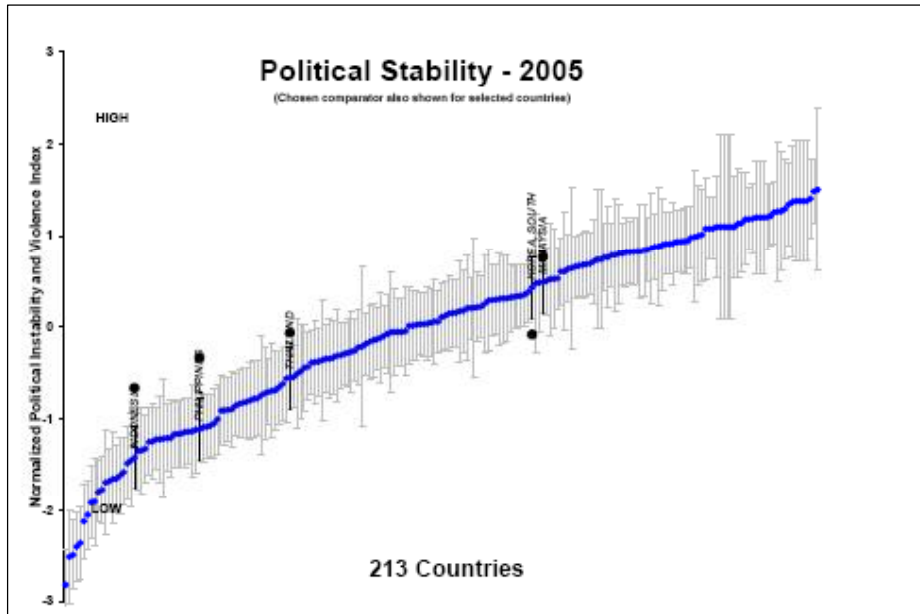
Figure 2
Indonesia Governance Indicators 1996-2005

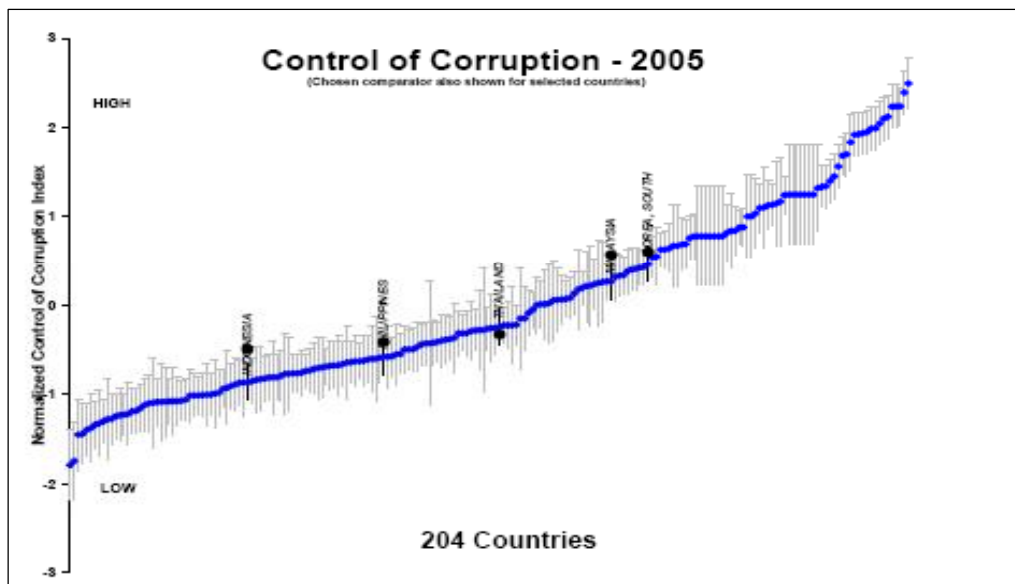
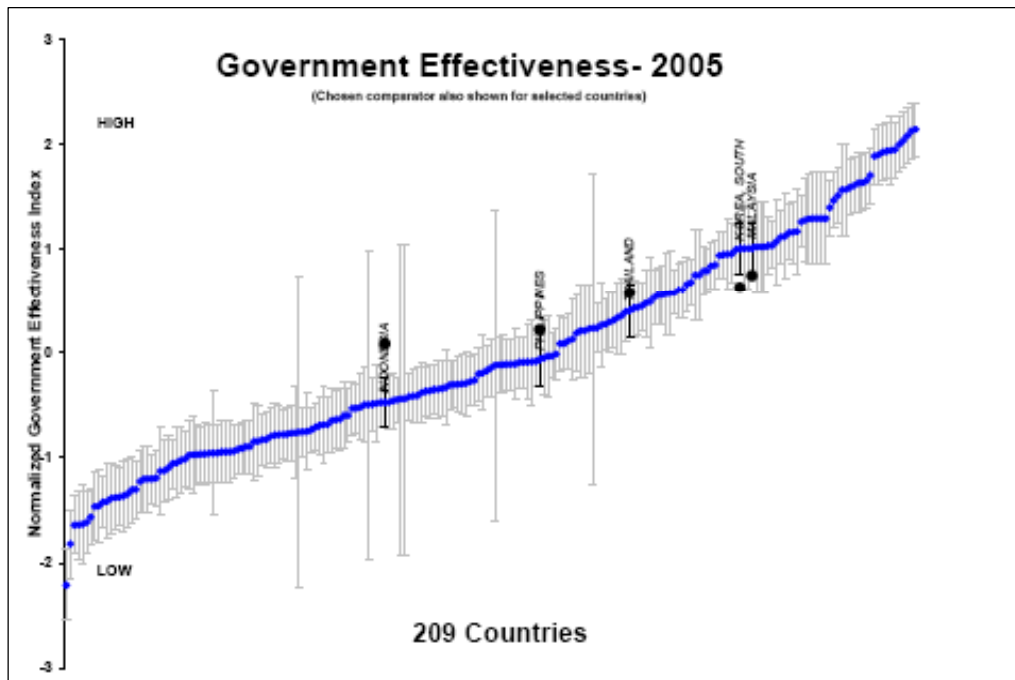


Source: Words Governance Indicators, 2005, in Perdana and Friawan, 2007

Figure 3
Comparison of various governance indicators 1996 and 2005
 (the blue line represent the trend in 2005, while the dots represent the position in 1996)







Source: World Bank's Governance Indicator (Kaufman, Kraay and Mastruzzi 2005 in Perdana and Friawan, 2007).
Data available on <http://www.worldbank.org/wbi/governance/excelgraphs>.