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POST-DECENTRALIZATION REGIONAL ECONOMIES AND ACTORS: PUTTING THE CAPACITY OF LOCAL GOVERNMENTS TO THE TEST

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Decentralization in Indonesia was introduced institutionally in 2001, with a democratization drive promoted by international donors and by the intention of the new government to clear away the centralistic image of Soeharto. Decentralization has had some effects on regional economies and on local government administration. Compared to the period before decentralization, the share of GRDP and local government finance has increased in Java, though investment and bank borrowing have expanded to the outer islands. In qualitative aspects, decentralization has transferred not only administrative authority but also many new vested interests from the center to regions. Local governments have become more extensive economic actors in regional economies. Regional economic actors now compete actively for such vested interests and have missed the opportunity to create market-friendly regional economies. The government sector should not be a mere rent-seeking economic actor, but should play a role as a facilitator promoting private sector activities in regional economies.

INTRODUCTION

As a general rule, the purpose of decentralization, and of fiscal decentralization in particular, is to enhance the efficiency of resource allocation in line with fiscal federalism. Resource allocation is one of the three economic roles (along with income distribution and economic stabilization) of the public sector (Matsui 2003). The idea of decentralization is that local governments, which are familiar with the particular circumstances in regions, are better positioned to provide public goods and services locally than the central government, which tends to come up with uniform responses across the country. As a matter of course, it is also preferable to place in the hands of local governments the planning and implementation of development policies that reflect actual conditions in particular regions. If local governments take the initiative, armed with powers transferred from the central government, a grand design can be drawn for a more efficient allocation of resources and development of regional economies, and of the national economy as well.

Decentralization in Indonesia was essentially brought in from the outside in order to facilitate the process of democratization in the wake of the collapse of the Soeharto regime in May 1998. In the introduction of decentralization, an important role was played by foreign aid agencies, including the World Bank, the U.N. Development Program (UNDP), Deutsche Gesellschaft fur Technische Zusammenarbeit (GTZ), and the U.S. Agency for International Development (USAID). These organizations regarded decentralization as part of the democratization process, and supported the introduction and firm establishment of decentralization in a variety of ways, including the development of laws and regulations and the training of local administration officials.

Meanwhile, local governments, who had pent-up frustration with the central government, saw a golden opportunity to expand their bargaining power with the central government in the demise of the Soeharto regime, which had maintained a centralized system for 32 years. Furthermore, Soeharto's successor, President B. J. Habibie, who was called a "protégé of Soeharto," was looking for an effective means of ridding himself of the shadow of his predecessor, and at the same time saw it necessary to send a strong message to the regions outside of Java, his political bastion (and particularly to the eastern parts of Indonesia). Thus, there were domestic incentives and reasons for the positive acceptance of decentralization in Indonesia, making its introduction relatively smooth and without resistance.

However, the Indonesians accepted decentralization in a manner quite different from the democratization process hoped for by foreign aid organizations. With the transfer to local governments of administrative powers and funds that had so far been controlled by the central government, opportunities for gaining interests and rent also were transferred to regions, touching off an uninhibited race for them without central control at various levels in regions.

Local governments have a crucial role to play as actors promoting decentralization and also leading decentralization for regional economic development. The aforementioned design of fiscal federalism can be realized only when the assumption can be made that local governments have sufficient capability to develop and implement effective policies for regional economic development using powers taken over from the central government. In other words, the capacity of local governments as providers of public goods and services to local residents is of crucial importance. While local governments under the centralized system must have the capability to devotedly perform what they have been instructed to do by the central government, decentralization calls upon local governments to demonstrate the capacity to precisely and deftly provide necessary administrative services at their own initiative.

In Indonesia, which steered away from centralized control to decentralization, the government as well as foreign aid organizations were well aware that it would take time to build the capacity of local governments—a fundamental prerequisite for decentralization—and recognized the possibility of various problems arising.

However, the Habibie government and foreign aid agencies shared the desire to put decentralization in place quickly before the momentum for post-Soeharto "reform" (*reformasi*) faded away. They apparently decided to go ahead with decentralization and to solidify it by trial and error, while responding gradually to a variety of anticipated problems through such measures as the training of local government officials.

Bearing in mind the background described above, this article examines the impact of decentralization, as an institution introduced from outside, on the structure of regional economies, focusing on the following two points. The first is the capacity of local governments, which is a prerequisite for the promotion of decentralization under fiscal federalism. There is a need to consider conditions that would enable local governments, accustomed as they are to centralized administrative and fiscal management, to efficiently provide public goods and services locally as expected under fiscal federalism. The second point is the position of local governments and the private sector as players and actors in regional economies. The government sector has long been considered the principal player in regional development in Indonesia. This article attempts to examine if that perception has changed in economic activities following the introduction of decentralization, and if it has, how the changes have affected regional economies.

Before moving to the main subject, a series of recent articles discussing Indonesia's regional economies in relation to decentralization are outlined below. The problem of the excessive issuance of local ordinances (*peraturan daerah: perda*) by local governments wishing to increase fiscal revenues in the post-decentralization era was already addressed by the World Bank (2003) and Matsui (2003). An array of newly created local taxes, local levies, and third-party donations have been structurally built into regional economies as important sources of revenue for regional economic actors seeking new rent. Casson and Obidzinski (2002) point out that decentralization has created an environment that supports illegal logging in forests and illegal trade in lumber, and argue that in practice it would be extremely difficult to ban illegal logging, as it has been virtually legalized and is contributing to increasing revenues for local governments. Marks (2002) cites sandalwood in East Nusa Tenggara Province as a case of resource depletion caused by decentralization, and notes the adverse impact of rent seeking by the provincial government and the armed forces. Shidiq (2003) points to the emergence of clientelist organizations seeking new rent in the wake of the shift of funds to regions in decentralization, and argues that the rising social cost of establishing these organizations is bringing feuds among local elites to the fore.

However, there has been no research so far on the relation between decentralization and regional economies in Indonesia. On the other hand, the introduction of decentralization took place fairly recently, and some more time will be required for rigorous analysis. This article attempts to examine changes in regional economies around the time of the introduction of decentralization from both quantitative and

qualitative aspects, and present problems that need to be addressed by the new central government to be inaugurated after general elections in 2004.

I. QUANTITATIVE CHANGES IN REGIONAL ECONOMIES AROUND THE BEGINNING OF DECENTRALIZATION

Heretofore, Indonesia's regional economies have often been characterized, as in Hill (1998, pp. 21–23), by the inequitable distribution of economic activities, income gaps between regions, inequality in social indicators, the huge differences in industrial structures between Java and the outer islands, and so on. What changes have the structures of regional economies undergone since the enactment in 1999 of Act No. 22/1999 on Regional Governance and Act No. 25/1999 on Fiscal Balance between the Center and the Regions? This will be examined below, dividing the ensuing time into three periods: the period before the financial crisis (1993–97), the period of the financial crisis (1997–99) and the period for the preparation and implementation of decentralization (1999–).

In the years before the financial crisis, solid economic growth was registered for all regions (Table I). During the crisis, however, economic growth rates turned negative except for Kalimantan, with Java being hit by the steepest decline. Growth generally recovered in the period of preparation and implementation of decentralization, but it only returned to the levels of around 1997, before the onslaught of the financial crisis.

TABLE I

ANNUAL GROWTH RATE AND INVESTMENT APPROVALS BY REGION

(%)

	Indonesia	Java, Bali	Sumatra	Kalimantan	Sulawesi	Others
Average annual growth:						
1993–97	7.2	7.4	6.0	7.5	7.2	9.1
1997–99	–5.2	–7.5	–2.9	0.3	–0.6	–0.7
1999–2002	4.6	5.1	3.5	3.9	5.0	5.3
Domestic investment approvals:						
1993–97	100.0	56.9	21.8	12.6	4.1	4.6
1997–99	100.0	45.8	25.2	13.3	8.0	7.7
1999–2002	100.0	32.4	29.3	7.1	25.0	6.3
Foreign investment approvals:						
1993–97	100.0	64.7	20.5	5.6	5.1	4.1
1997–99	100.0	59.4	34.7	3.4	1.3	1.1
1999–2002	100.0	48.3	29.5	5.6	1.3	15.3

Sources: Data from BPS, *Gross Regional Domestic Product of Provinces in Indonesia by Industrial Origin* (Jakarta: BPS, various years); Investment Coordination Board, http://www.bkpm.go.id.

TABLE II

Regional Gaps by Per-Capita GRDP and Per-Capita Revenue by Province

	1995	2000	2002	Growth Rate (%)	
				1995–2000	2000–2002
Per capita GRDP (Rp 1,000)	1,934.0	1,978.9	2,079.8	0.46	2.52
(Coefficient of variation)	(0.714)	(0.860)	(0.867)		
Per capita revenue by province (Rp 1,000)	114.9	221.3	632.9	14.00	69.13
(Coefficient of variation)	(0.478)	(0.515)	(0.729)		

Sources: Data from BPS, *Financial Statistics of Provincial Government* (Jakarta: BPS, various years); BPS, *Financial Statistics of Regency/Municipality Government* (Jakarta: BPS, various years).
Note: Per capita revenue by province is obtained by dividing the sum of provincial government revenue and regency/municipality government revenue by the population in the relevant year.

Looking at regional economies in Indonesia, the overconcentration of economic activities in Java, particularly Jakarta, has often been noted previously. Looking at gross regional domestic product (GRDP) data (in nominal prices), the ratio of Jakarta to total GRDP rose from 15.8% in 1993 to 16.4% in 1997 and 16.6% in 2002, while Java's ratio also increased from 59.1% in 1993 to 60.1% and 60.3%, respectively, in 1997 and 2002. The gaps between Jakarta and Java, and other regions has shown a widening tendency since the implementation of decentralization in 2001, with changes in the coefficient of variation for gaps among provinces in per-capita GRDP supporting this tendency (Table II).

Investment, both domestic and foreign, has been on a remarkable decline after peaking in the mid-1990s. Since the financial crisis, however, while investment approvals increased on a relative basis in Sumatra, Kalimantan, and other provinces, the ratio of investment approvals in Java has been falling (Table I). Investment approvals kept dropping until 2002, but then showed signs of picking in 2003, with approvals of domestic and foreign investment soaring over the preceding year by 93.3% (to Rp 48,764.7 billion) and 49.7% (to US$1,466.84 million), respectively.

On the financial side, the ratio of Jakarta to total fiscal revenues of local governments (summing the figures for governments of provinces [*propinsi*] and regencies [*kabupaten*] / municipalities [*kota*]) fell to 10.0% in FY1999 from 11.6% in FY1993, but rose again to 11.1% in FY2002 following decentralization. The ratio of Java, including Jakarta, also rose sharply following decentralization. The concentration of fiscal funds in Java is due to an increase in the general allocation funds (*dana alokasi umum*: DAU) from the central government, which largely reflects the size of population. After the period of preparation and implementation of decentraliza-

tion, and particularly after 2001, all local governments enlarged their budgets, and the introduction of revenue sharing (*bagi hasil*) led to an expansion of the imbalance in budget scale between resources-rich and other provinces. Though the DAU were designed to mitigate this imbalance, they have not fully performed their role in closing the growing gaps in regional fiscal revenues caused by the revenue-sharing arrangement. This failure is due to a tacit understanding, regarding the shift of funds from the central to local governments, that the amount of DAU a local government receives shall not fall short of the amount provided in the preceding fiscal year. In fact, the gaps in per-capita revenue by province in terms of the coefficient of variation have been rising since decentralization (Table II). In local finance, the ratio of revenues from self-funding sources to total revenue has increased for provinces with stable sources of tax revenue such as the automobile tax, but has declined for regencies and municipalities, despite increases in absolute amounts, owing to the transfer of massive funds from the central government.

What about the flow of funds? Looking at balances of bank lending and deposits at the time of the introduction of decentralization, we see that the balance of lending topped that of deposits before the financial crisis, but that deposits exceeded lending after the crisis (Table III). Before the financial crisis, Java had the high rate

TABLE III

COMPOSITION RATIO OF LENDING AND DEPOSIT BALANCES BY REGION

(%)

	1993	1997	1999	2003
Loan:				
Sumatra	9.7	7.8	9.9	13.5
Java, Bali	83.5	86.7	82.7	75.0
Kalimantan	2.7	2.1	2.6	4.3
Sulawesi	1.8	1.6	2.5	3.9
Eastern Islands	2.3	1.4	2.2	3.2
Deposit:				
Sumatra	8.5	7.3	8.9	10.8
Java, Bali	84.5	86.6	83.8	80.1
Kalimantan	2.6	2.2	2.6	3.4
Sulawesi	2.0	1.7	2.1	2.4
Eastern Islands	2.4	2.2	2.7	3.2
Loan/deposit:				
Sumatra	119.7	113.0	40.2	61.4
Java, Bali	104.1	105.9	35.5	46.1
Kalimantan	112.5	100.1	36.2	62.0
Sulawesi	95.4	100.1	43.5	79.5
Eastern Islands	99.4	88.1	29.7	49.9
Total	105.4	136.4	36.0	49.2

Source: Bank of Indonesia (various years).

of increase in both lending and deposits, but regions other than Java began to show higher rates of increase in both areas after the crisis. Even during the period of the preparation and implementation of decentralization, Java was the sole region with a low rate of increase. As a consequence, while the deposit-to-loan rate remained just 46.1% in Java in 2003, it recovered to 60–80% in Sulawesi, Sumatra, and Kalimantan.

Java's composition ratio declined for both lending and deposits, particularly after decentralization. For lending, its composition ratio fell from 82.7% in 1999 to 75.0% in November 2003. The decline was far steeper for Jakarta (from 60.7% to 38.1%). For deposits, Java's ratio similarly dropped from 83.8% to 80.1% (and from 59.8% to 54.4% for Jakarta). From around the period of preparation for de-

TABLE IV

COMPOSITION RATIO OF LENDING AND DEPOSITS BY ACTOR

A. Lending Composition Ratio by Borrower (%)

	1999	2000	2001	2002	2003
Government sector	**7.4**	**4.5**	**5.0**	**5.1**	**4.4**
Central government	7.3	4.4	4.8	5.0	3.8
Local government	0.1	0.1	0.1	0.1	0.6
Province	0.1	0.0	0.0	0.0	0.0
Regency/municipality	0.0	0.1	0.1	0.1	0.1
Local govt enterprise (BUMD)	0.0	0.0	0.0	0.0	0.5
Private sector	**92.6**	**95.5**	**95.0**	**94.9**	**95.6**
Private	71.1	69.5	64.0	59.4	56.0
Rural banks	0.0	0.0	0.0	0.1	0.1
Individuals	21.5	26.0	31.0	35.4	39.5
Total	100.0	100.0	100.0	100.0	100.0

B. Deposit Composition Ratio by Depositor (%)

	1999	2000	2001	2002	2003
Non Resident	5.9	10.5	2.5	5.7	1.8
Government sector	**23.1**	**28.2**	**33.8**	**31.2**	**35.5**
Central government	18.0	24.6	26.0	22.5	23.4
Local government	5.1	3.6	7.8	8.7	12.1
Province	0.0	2.0	2.7	3.2	4.2
Regency/municipality	0.0	1.5	5.0	5.4	7.6
Local govt enterprise (BUMD)	0.0	0.1	0.1	0.1	0.2
Private sector	**71.0**	**61.3**	**63.7**	**63.2**	**62.7**
Private	42.8	38.9	38.1	36.9	36.3
Rural banks	0.0	0.0	0.1	0.2	0.2
Individuals	28.2	22.4	25.5	26.0	26.1
Total	100.0	100.0	100.0	100.0	100.0

Source: Bank of Indonesia (various years).

centralization, bank financing began to spread to other regions, reducing the overconcentration in Java. Meanwhile, the ratio of lending to the private sector to total lending increased from 92.6% to 95.6% in November 2003, and the ratio of deposits by the private sector to total deposits declined from 71.0% in 1999 to 62.7% in November 2003 (Table IV). Deposits increased for the government sector in recent years, particularly for regency/municipality governments, which is quite noteworthy as a post-decentralization change. This indicates that funds deposited by the government sector are increasingly being funneled to the private sector as loans. However, among the private sector borrowers, lending increased mainly to individuals, which is consistent with increases in lending in the area of consumer finance.

As seen above, there has been a definite change in the relative importance of Java among regional economies since the time of decentralization. While its ratio increased in GRDP and fiscal revenues, its weight declined in investment, bank lending, and deposits. While the gap between Java and other regions widened in terms of fiscal funds and economic activities, bank funds and business opportunities are beginning to spread to regions other than Java in relative terms, generating two seemingly contradictory phenomena. Given the lethargy in manufacturing and the rising weight of the commercial and services sectors, stagnant investment, and the rising ratio of consumer finance in bank lending, it appears that most of the funds that flowed into the regions went into consumption and broadly defined services industries, and have not contributed to a recovery in agricultural or manufacturing operations. Although decentralization facilitated the flow of funds into the local government sector, these funds have tended to finance government consumption or to go to banks as deposits, instead of financing public investment. Banks also have yet to accelerate their lending for investment purposes or for operating capital. The inflow of funds into the regions under decentralization has not served as a driving force for regional economic development.

II. QUALITATIVE CHANGES IN REGIONAL ECONOMIES AT THE TIME OF DECENTRALIZATION

As described above, though some quantitative changes have taken place, there have been no explicit qualitative changes in the structures of regional economies following decentralization. It is clear that with the transfer of power and massive amounts of funds from the central to local governments, opportunities emerged in the regions to gain a variety of interests and rents. But these changes mainly boosted consumption, rather than production and investment activities in the regions. Local governments seized upon decentralization as an opportunity to step forward as economic actors, seeking access to state assets in the regions, the transfer of control over airport and port functions to local governments, fund raising through means

such as local bonds, and, in some resource-rich provinces, the planning and implementation of ambitious projects. Though funds are beginning to flow to the regional government enterprises (*Badan Usaha Milik Daerah*: BUMD) and regional development banks (*Bank Pembangunan Daerah*: BPD), these bodies have not yet become viable agents for regional development under a medium- and long-term perspective, as it is difficult to remove intervention by local governments in management and they are not entirely healthy financially. While some signs of the emergence of new private sector business can be seen, in areas such as real estate development around regional cities, the impact of such businesses on the real economy is still limited. The real problem is a possible loss of healthy competition that began to surface after the financial crisis because of the emergence of opportunities to acquire rents from decentralization.

A. *Proliferation of Local Ordinances and High-Cost Economies*

What is most often cited as the negative impact of decentralization is the increased issuance of local ordinances by local governments. Since the introduction of decentralization, an average of more than 30 local ordinances has been enacted per year by each local assembly. Many of these ordinances are designed to increase the local governments' own sources of revenues, such as local taxes (*pajak daerah*), local levies (*retribusi daerah*), and third-party donations (*sumbangan pihak ketiga*). While there are limitations on local taxes and local levies under Act No. 34/2000, it is difficult to reverse such levies at the local level when local governments go through proper procedures to introduce them under local ordinances approved by local assemblies. These local taxes and other levies have often been criticized for hampering the revitalization of regional economic activities and creating high-cost economic structures (Regional Autonomy Watch [KPPOD] 2003; World Bank 2003). According to KPPOD, in a questionnaire survey on a total of 5,140 companies, 85% of respondents replied that 2–10% of their production costs were expenses to provide services to local government bureaucrats (*Kompas*, January 21, 2004).

However, were regional economies before decentralization really efficient, and did the introduction of decentralization actually make them costly? In the regional economies, economic actors were not guaranteed fair market competition. Rather, a handful of specified actors undertook economic activities by obtaining a variety of privileges from local governments. On the surface, local governments painted private large companies as evil, and intervened in their activities in various ways under the pretext of programs for the protection and guidance of residents for the relief of the weak. In doing so, they collected various ill-defined service charges (*pungutan*) from companies other than those with cozy ties with local governments. In other words, the problem with local taxes and levies, which are often regarded as negative products of decentralization, simply brought into the open in a systematized manner what had been practiced all along in a black box.

"Service fees" for local government bureaucrats indeed existed during the Soeharto era. When did calculate costs, companies took these fees into account beforehand. The real problem is not whether the proportion of 2–10% of cost, as cited by KPPOD, is large or not, but rather the fact that with the lack of limits on the service fees demanded by local government bureaucrats, security allowances requested by military/police, and the frequency of such demands, companies are finding it difficult to make cost calculations.

B. *Local Governments as Economic Actors*

Though decentralization is characterized by the philosophy of "from the central to local governments" and "from the government to the private sector," in reality, the most prominent feature is the central-to-local shift of funds in the government sector. For example, in some resource-rich regencies, such as Kutai Kartanegara Regency in East Kalimantan Province, local governments are initiating large-scale development projects on their own. Some local governments have also established and operate airline companies.[1] On the surface at least, more noticeable than the increasing importance of private sector economic actors in regional economies following decentralization is the desire for active involvement in economic activities by local governments that benefit from the transfer of funds from the central government.

Following decentralization, there have been an increasing number of cases where local governments have tried to assume state-owned assets in the regions and to take over the operations of state enterprises. Most notable have been demands for the transfer of control from the central to local governments of public utilities such as airports and ports. Local governments have condemned the state enterprises managing these facilities for their opaque management and imposition of unsound surcharges. There have also been cases where local governments have proposed to take over the management of airports and ports to keep them in full operation, given the concern that the planned integration and abolition of state enterprises managing these airports and ports may lead to cutbacks in their functions or a decline in services. In Banten Province, the provincial government began operating its own port, claiming that the port management by the state was inefficient. This led to an unusual situation where the state and the provincial government competed for port

[1] Among local governments that have established airline companies are Nangroe Aceh Darussalam Province, North Sumatra Province, Riau Province, South Sulawesi Province, Papua Province, and Kutai Kartanegara Regency in East Kalimantan Province. The South Sulawesi provincial government put up capital for Celebes Airlines, which flies short-distance routes within Sulawesi Island and Sulawesi Airlines, which serves the eastern parts of Indonesia. The lack of transparency about this investment from the provincial budget became a subject of discussion in the provincial assembly. Sulawesi Airlines operates joint flights with the privately owned Kartika Airlines for Papua–Jakarta and other routes. However, most of them failed to survive.

operations.[2] Jakarta is demanding control over state-owned assets in the province, arguing that the central government should provide rewards to it for providing services and shouldering costs as the country's capital, and also argues that the transfer is necessary for the sake of enhanced management efficiency.[3] The central government is balking at the transfer of state assets, which it regards as vested interests, and has adopted restrictions by enacting the central government regulation (*peraturan pemerintah*: PP) regarding port and airport management.[4] The ability of local governments to manage these assets is also being called into serious question.

While local governments have come to the common recognition that the induction of investment is essential for regional economic development following decentralization, they have also displayed a growing tendency to seek ways to make use of assets held by state enterprises and foreign-owned companies operating in their regions as sources of funding. Generally speaking, local governments, with an awareness that they lack technology and knowledge to realize development potential backed by rich resources, choose to invite "outsiders" to develop their regions, and receive a share (compensation for the utilization of resources). In other words, local governments adopt a wait-and-see approach in the belief that investment from outside will surely come to benefit from the rich resources they own. They also believe that investing companies, who possess technology and capabilities that regions do not have, are obliged to contribute to regional development and should pay third-party donations as "development cooperation fees." Even local governments in resource-rich regions that are already benefiting from the massive transfer of funds from the central government under revenue-sharing arrangements are deeply interested in coming up with good reasons to solicit funds from companies that are already operating in their regions.

These attitudes can be found in the frequent feuds between local governments and foreign-owned companies. The conflict between the central government and local governments over PT Kaltim Prima Coal (KPC), a foreign-owned coal development concern located in East Kalimantan Province, has drawn the keenest attention in connection with decentralization. When KPC was established in 1982, it took on a contract obligation to hand over an equity stake of 51% to the Indonesian side by the end of 2001, ten years after the start of operations in 1992. However, as a result of the financial crisis, differences emerged over the evaluation of the equity shares to be sold between KPC and the Indonesian side, resulting in a delay in the

[2] The Banten Province government created a local government enterprise called BUMD Banten Pelabuhan Mandiri to compete against PT Pelindo, a state-run port management enterprise (*Kompas*, October 29, 2002).

[3] *Media Indonesia*, March 14, 15, and 18, 2003. There were also a large number of cases where the municipality, newly separated from its original regency, demanded the takeover of regency assets in it.

[4] Central Government Regulation No. 69/2001 on Port Management, and Central Government Regulation No. 70/2001 on Airport Management.

stock sale. The Indonesian partners in the project included the governments of East Kalimantan Province and East Kutai Regency along with the central government. Ultimately, in July 2002, an agreement was worked out under which the central government would buy 21% and the governments of East Kalimantan Province and East Kutai Regency take a combined 30%, and both local governments established local government enterprises to purchase the shares. However, the sell-off negotiations hit a serious snag, as private companies behind the two local governments persisted in calling for the acquisition of a 51% stake in KPC. In the end, in July 2003, the foreign interests decided to sell all the shares of KPC to the Indonesian concern PT Bumi Resource and to withdraw from KPC. The incident sapped the willingness of foreign companies to invest in Indonesia, and the two local governments involved failed to gain anything from their attempts to gain profits on the sale of KPC shares and draw funds from certain private companies that stood behind them. This provided a major lesson for both sides.

C. *Management Problems at Regional Government Enterprises (BUMD)*

Since the implementation of decentralization, regional government enterprises (*Badan Usaha Milik Daerah*: BUMD) have drawn keen attention as major players in regional economies and as means for increasing revenue from own sources of local governments. However, despite high expectations, BUMDs came to be plagued with inefficient management at a level similar to or greater than state enterprises (*Badan Usaha Milik Negara*: BUMN). In fact, about 60–70% of the total of 1,600 BUMDs appear to be operating in the red.[5] Discussions had been ongoing since the mid-1980s on management efficiency and the privatization of BUMNs, but BUMDs faced far less pressure and thus lost a chance to address their management issues. The central government finally began to press local governments to improve management at local government enterprises in much the same way as it had done for state enterprises. In March 2003, Minister of Interior Hari Sabarno unveiled a policy to reorganize BUMDs into two groups: profit-oriented joint-stock companies (*perseroan terbatas*: PT) and public-interest regional companies (*perusahaan daerah*: PD).

As shown by recent statistics on BUMNs and BUMDs from the Central Board of Statistics (BPS 2001, 2002), by industry, the losses of water supply companies (*perusahaan air minum*: PAM) were by far the largest after 1999 (Table V). The after-tax losses of the water supply sector amounted to Rp 552.1 billion in 2000.

[5] Based on the remarks of Chairman Prabowo Sunirman of the Cooperation Board of Local Government Enterprises in All Indonesia (*Badan Kerjasama BUMD Seluruh Indonesia*: BKS-BUMDSI). The Board was inaugurated on June 23, 2003, and members of the caucus were appointed by the Minister of Interior (*Kompas*, June 24, 2003). According to data of the Central Board of Statistics (BPS 2002), as of 2000, 272 out of a total of 578 local government enterprises were operating in the red.

TABLE V

PERFORMANCE OF LOCAL GOVERNMENT ENTERPRISES

	Operating Revenue (Rp Million) (A)		After-Tax Profit (Rp Million) (B)		Rate of Return (%) (B/A)			
	1997	2000	1997	2000	1997	1998	1999	2000
Total	3,777,146	5,742,422	139,078	–242,974	3.7	–0.5	–23.5	–4.2
Agriculture	25,749	37,425	6,454	6,095	25.1	50.5	25.7	16.3
Mining	5,286	12,949	119	1,342	2.3	4.7	7.4	10.4
Manufacturing	86,071	101,806	445	1,755	0.5	1.6	5.3	1.7
Water supply	1,520,738	1,821,528	–17,017	–552,118	–1.1	–7.9	–29.3	–30.3
Construction	4,570	28,635	–1,404	1,070	–30.7	13.4	–3.8	3.7
Commerce/hotel	53,082	147,518	–3,973	6,534	–7.5	1.5	0.1	4.4
Telecommunications/ transportation	937	790	143	108	15.3	4.2	13.6	13.7
Financial	2,019,313	3,435,854	155,731	281,578	7.7	1.2	–24.6	8.2
Services	61,400	155,919	–1,420	10,663	–2.3	3.1	5.5	6.8

Sources: BPS (2001, 2002).

While other sectors were all in the black, BUMDs as a whole chalked up after-tax losses of Rp 243 billion due to the huge loss in the water supply sector. The water supply projects were carried out by local governments using foreign aid funds borrowed from the central government. According to Lewis (2001), the terms for borrowings by local governments were easy, possibly causing them to lose their willingness to repay the funds to the state. By province, the Jakarta Special Capital Province had the largest combined loss from BUMDs, with the figure reaching Rp 515.4 billion in 2000. This loss was offset by profits in other provinces of Java as well as in South and East Kalimantan Provinces.

The balance of lending to BUMDs, which stood at Rp 32 billion at the end of 2002, jumped to Rp 2,370 billion in June 2003 (Rp 2,340 billion as of the end of November 2003). The causes of this sharp rise in lending are not known, but improvements in management and the privatization of BUMDs, including in water supply services, are likely to become important issues in the future.

D. *The Quest by Regional Development Banks (BPD) to Become Commercial Banks*

Regional development banks (BPD) are designed to be banks of local governments with capital put up by local governments (provinces and regencies/municipalities). The role of BPDs, as stipulated under the Act on Regional Development Banks (Act No. 13/1962), is to finance investments in and the expansion and renewal of development projects undertaken by local governments or by joint ventures between local governments and private sector companies. The 1998 revision in the Banking Act defines BPDs as ordinary money-lending banks.

TABLE VI

LENDING BY BANKS

(%)

	State Banks	Regional Dev. Banks	Private Banks	Foreign Banks, JV Banks	Total
Working capital credits:					
1999	16.6	2.8	43.6	37.1	100.0
2003	29.6	6.0	50.3	14.1	100.0
Investment credits:					
1999	28.9	3.3	54.3	13.6	100.0
2003	34.2	5.2	57.6	3.0	100.0
Consumer credits:					
1999	31.5	24.0	35.4	9.1	100.0
2003	26.8	22.6	44.1	6.5	100.0

	State Banks	Regional Dev. Banks	Private Banks	Foreign Banks, JV Banks	Total
1999:					
Working capital credits	48.6	23.4	63.8	85.6	63.5
Investment credits	19.1	6.2	18.0	7.1	14.3
Consumer credits	32.3	70.4	18.2	7.3	22.2
Total	100.0	100.0	100.0	100.0	100.0
2003:					
Working capital credits	51.8	28.9	52.3	74.7	51.8
Investment credits	1.8	9.2	21.8	5.8	18.8
Consumer credits	26.5	61.9	26.0	19.5	29.3
Total	100.0	100.0	100.0	100.0	100.0

Source: Bank of Indonesia (various years).

Lending by BPDs expanded continuously until the financial crisis, but declined during the crisis from 1997 through 2000. Following the implementation of decentralization in 2001, their lending increased substantially, soaring 45% in 2001 over the preceding year. Apparently because of limitations on the quantitative expansion due to the confinement of their lending activities to their respective provinces, the ratio of nonperforming loans to total lending is lower than for other banks. Looking at lending activities by BPDs (Table VI), consumer credit accounted for 70.4% of total outstanding lending at the end of 2000 and 61.9% at the end of 2003, with much lower ratios of lending for working capital or investment than state banks and private sector banks. The ratio of lending by BPDs to total lending rose from 7.6% at the end of 2000 to 10.7% at the end of 2003, topping the ratio for foreign bank branches and joint venture banks.

At present, most domestic BPDs are seeking to go beyond being institutions owned by regional governments, to become ordinary banks and foreign exchange banks that can raise capital through other means. In fact, there are already BPDs that have raised funds by issuing bonds.[6] Bank Jabar (the BPD of West Java Province) ranks 19th among all banks in Indonesia in terms of assets (in the first half of 2003), while Bank Jatim (the BPD of East Java Province) and some others have opened branches in Jakarta (*Investor*, no. 89, Nov. 5–18, 2003, pp. 28–29). While BPDs are in a position to respond more effectively to the need for lending for regional development projects, it also needs to be pointed out that there have been frequent cases where funds have been lent to projects closely linked to the personal interests of high local government officials. As cited among reform measures for BUMDs, if BPDs convert themselves into ordinary banks and joint-stock companies, they will be less likely to become involved in cozy relations or corruption with local governments, allowing them to make independent lending decisions and establish corporate governance. In doing so, they would probably be drawn into fierce competition with state banks and private sector banks in the search for bigger shares of the lending and deposit markets.

E. *Private Sector Company Activities in Regions*

Since the introduction of decentralization, regional cities have seen the emergence of new businesses, such as small-scale restaurants and Internet-based services. In addition, there are signs of robustness in the real estate business, including the construction of shopping malls and combined residence-retail shops called "*ruko* (*rumah toko*)." With the construction of shopping malls in regional cities, many well-known stores in Jakarta and Java are branching out into regional cities, driving some local markets or small-scale operators out of business through competition. Imported luxury cars, which were once only seen in Jakarta or Surabaya, can now be seen on the streets of regional cities, and there has been a Jakarta-like spending boom among rich people in regions. On the other hand, no major changes have taken place in rural areas, with the increasing likelihood, at least in the short run, of the economic gap between cities and rural areas in regions growing wider.

In retrospect, the financial crisis has had a tremendous impact on the activities of private sector companies in regions. As in the capital region, all across the country, private enterprise groups engaged themselves in a variety of businesses using public demand such as public works related to government development projects as a launching pad. However, these corporate groups, though classified by the regions as large companies, faced difficulty in raising funds in the aftermath of the crisis, and were forced to reduce or liquidate their expanded businesses under the weight

[6] Regional development banks (BPDs) whose bonds were being traded at the end of December 2003 include five banks in Jakarta, South Sumatra, West Java, East Java, and West Sumatra (*Bank Nagari*).

of massive bad debts. This prompted a reversion to their core business operations, while they waited for a general business recovery. Meanwhile, small- and medium-sized companies in regions began to grow in the wake of the financial crisis, and sound management helped them tide over the crisis without relying on governmental protection. These small businesses were seen as potential borrowers by banks, which desperately needed to find fresh lending businesses to regain their footing. Learning from their experiences in the crisis, banks tried to avoid the high risks associated with lending large amounts to big borrowers, and became quite willing to lend money to small businesses in their search for creditworthy small- and medium-scale clients. Introducing the automatic screening of loan applications by small businesses in regions and expanding loans with movables and business operations themselves as collateral, banks went on an offensive in lending to those borrowers.

As described above, just as some small businesses in regions began to acquire competitiveness through steady and sound management, decentralization brought with it a massive shift of funds from the central government, giving rise in turn to opportunities in the regions to obtain a variety of new rents. With the weight of public works still high in regional economies, various actors with close ties to government officials and politicians competed for new rents that could be found in markups of public works costs and corruption, raising concern that Indonesia's regions might return to the unsound business climate that prevailed before the financial crisis. In the end, private sector companies in regions, including emerging small businesses that began to become competitive through sound management, were not provided with an overall environment by local government where private sector investors could act relatively freely, but were instead pressured by them to dole out "development cooperation fees" and to pay unreasonable rewards for "public services," or in some cases, were urged to form cozy relations with local governments to share rent-acquiring opportunities.

CONCLUSION: CAPACITY OF LOCAL GOVERNMENTS FOR REGIONAL ECONOMIC DEVELOPMENT

How did actors such as local governments, local government enterprises, and private sector companies react to the decentralization brought from the outside into the regions? How did decentralization and the actors' reactions to it affect the structures of regional economies? In this article we examined these issues in terms of the quantitative and qualitative changes that may have occurred in regional economies. Though our examination revealed some quantitative changes, qualitatively, there have been few major changes in the behaviors of actors or regional economic activities themselves, despite the transfer of powers and funds from the central to local governments.

Fundamentally, decentralization encourages the widening, and not correction, of

gaps between regions, because it acknowledges differences in the capacity of regions and local governments as well as in the resources they possess, and respects the initiatives and autonomy of respective regions and local governments. When Indonesia decided to go ahead with decentralization, it must have prepared itself for regional development strategies based on an economic dynamism that included widening regional gaps. However, planned economy–like policy management by local governments and the narrow-minded attitudes of local government bureaucrats seeking rents from cozy ties with specified economic actors are indicative of their intent to contain economic dynamism. There is a clear discrepancy between the ideal of autonomous local governments envisioned under the new system and the reality of the traditional behaviors of local governments.

The issue of whether decentralization is positive or negative for regional economies ultimately comes down to the capacity of local governments (and of local government bureaucrats). Local government bureaucrats think they have full knowledge of the new concept of administrative management introduced from foreign aid organizations in the name of supporting decentralization. However, the support extended so far for capacity building in local governments has tended to overemphasize the provision of knowledge and boosting academic qualifications. While the so-called participatory development approach have now gained wide understanding, the dominant approach still remains one that stresses the process of putting together and implementing development projects rather than policy planning and management. This is largely because conventional development policies adopted a project approach for all development programs. In addition, many local governments remain under the influence of "Indonesian socialism," which originated from the country's first Vice President Mohammad Hatta, and features such ideas as evil merchants, exploitation, and the need to protect farmers. As a result, they still have expectations for the inefficient cooperatives as important economic actors.

Local governments are actually having a difficult time ridding themselves of the philosophical concepts of the socialist planned economy, where local governments control economic activities as "watchdogs." Private sector economic actors, for their part, have also grown so accustomed to the old ways of seeking preferential treatment in opportunities provided by local government bureaucrats and receiving as many free rides as possible in their utilization of infrastructure. Local residents and private economic actors with no chance of receiving such privileged treatment do not think that they need public services that entail costly rewards.

What local governments must do for regional economies is not to control regional economic activities as "watchdogs" but rather develop an "arena" where private sector economic actors can compete autonomously in economic activities. To that end, they must guarantee the actors fair entry opportunities, clarify the contents and costs of necessary public services, and use ingenuity to secure self-sustainable fair competition in the "arena." To do so, local governments need to ac-

quire the capacity to coordinate, guide, and enlighten economic actors, instead of using the top-down, military-style way of giving orders and demanding obedience. Expressing this capacity in a single word, it is equivalent to the term *fasilitasi* ("facilitation" in English), first brought in by foreign aid agencies but then adapted into the Indonesian language.[7] In other words, local governments are being called upon to materialize this *fasilitasi* in practice. Given the strong continuing influence of the "socialist planned economy" approach in the minds of local government officials, however, there is concern that *fasilitasi* by local governments could easily be turned into *mobilisasi*, which means mobilization.

It will not be easy to eliminate political intervention in regional economic activities, along with opportunities to obtain rents, or alter the attitudes of economic actors such as local governments and private sector companies, including foreign-owned concerns. Regional economies can expect to develop in a more autonomous way if a variety of actors, including local governments, private sector companies, and local residents, can rebuild their respective roles in regional economies and their interrelationships, and, while working together to build an environment where they can play their respective roles, adapt the system of decentralization to the context of their own regions. Local governments must consider how to deftly *fasilitasi* this string of processes and actually deliver. This problem entails the question of how to administer the newly introduced system of decentralization, but at the same time presents the incoming government to be inaugurated in 2004 with the task of tirelessly searching for a new method of managing development policies that fits the realities of regional economies, along with local governments, which must also boost their own capacity to carry out this endeavor.

[7] "*Fasilitasi*" is a new word coined during the period of the preparation for decentralization. It is now commonly used by local governments across the country, nongovernmental organizations (NGOs), and local residents. Those who conduct *fasilitasi* are called *fasilitator*. The word *fasilitasi* is used, for example, in "*fasilitasi* designed to facilitate dialogue between parties concerned with different interests." Just like *fasilitasi*, the term "stakeholder," meaning interested parties, is also in wide use in Indonesia.

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