

# **IMPROVING GOVERNANCE IN INDONESIA**

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## **Introduction**

The essence of governance in modern societies is a mix of all kinds of governing efforts by all manner of social-political actors, public as well as private; occurring between them at different levels, in different governance models and orders. These mixes are societal 'responses' to persistent and changing governing 'demands', set against ever growing societal diversity, dynamics and complexity. Governing issues generally are not just public or private, they are frequently shared, and governing activity at all levels (from local to supra-national) is becoming diffused over various societal actors whose relationship with each other are constantly changing.

## **From government to governance**

Response to diverse, dynamic and complex societal issues require involving previously uninvolved partners, looking not only at the market as seems to have been an almost universal response in recent years, but also looking at 'civil society' actors, as seriously governing partners. The 'why' of modern governance can be best explained by an awareness that governments are not the only actors addressing major societal issues; that besides the traditional ones, new modes of governance are needed to tackle these issues; that governing arrangements will differ from global to local and will vary sector by sector. In diverse, dynamic and complex areas of societal activity no single governing agency is able to realize legitimate and effective governing by itself. The challenge for anyone involved in governing and governance is to make governing interactions productive.

In times of change and uncertainty organizations must continually innovate and reinvent themselves in order to survive, adjust, and improve the quality of their performance. Leaders of all institutions and especially of the state—the sovereign political entity of national governance that emerged more than three hundred years ago—must rethink institutional goals and purposes, redefine missions, reformulate plans and policies for achieving objectives, reassess the most effective ways of implementing those policies and plans, and reevaluate performance continuously in order to improve standards of living for, and the human potential of, their citizens. During the twenty-first century, reinvention will become an essential process for political

and administrative leaders in governments that seek to adjust to the rapid changes in their economies and societies brought about by globalization and technological innovation.

Globalization has transformed the functions and roles of the state. Overall, the course of change points to a shift of focus away from hands-on management and the direct production of services and goods and toward strategic planning. Decentralization, debureaucratization, and deregulation are adding to the importance not only of the state but more and more of local government. Increasingly, the state is acting as a link in processes of planning, consultation, negotiation, and decision-making involving diverse governmental and nongovernmental organizations at different levels of governance. The state is the hub of activities connecting multiple partners and stakeholders from varied fields, regions, cultures, occupations, professions, and interests.

### **Local governance**

*Local government* refers to specific institutions or entities created by national constitutions, by state constitutions, by ordinary legislation of a higher level of central government, by provincial or state legislation, or by executive order to deliver a range of specified services to a relatively small geographically delineated area. *Local governance* is a broader concept and is defined as the formulation and execution of collective action at the local level. Thus, it encompasses the direct and indirect roles of formal institutions of local government and government hierarchies, as well as the roles of informal norms, networks, community organizations, and neighborhood associations in pursuing collective action by defining the framework for citizen-citizen and citizen-state interactions, collective decision making, and delivery of local public services.

Local governance, therefore, includes the diverse objectives of vibrant, living, working, environmentally preserved self-governing communities. Good local governance is not just about providing a range of local services but also about preserving the life and liberty of residents, creating space for democratic participation and civic dialogue, supporting market-led and environmentally sustainable local development, and facilitating outcomes that enrich the quality of life of citizens.

### **Indonesia's decentralization "big bang"**

In the case of Indonesia much of the responsibility for public services was decentralized in 2001. The process was based on three basic laws 1) regional autonomy; 2) fiscal relations; and 3) regional government taxes and fees passed between 1999 and 2000. Not surprisingly, the process has been a work in progress and both the regional autonomy and fiscal relations laws were amended in 2004 to provide more clarity while the critical government regulation on functional assignments (central, provincial and district) was only completed in 2007 and the amended version of the Law

on regional government taxes is still pending. A second phase of decentralization in 2006 increased financial transfers to the regions by 50 percent, followed by a further 15 percent in 2007. Indonesia's roughly 440 local governments now undertake nearly 40 percent of public spending with most services provided by kabupaten governments who are responsible of approximately 75 percent of the total spending.

The basic decentralization laws provide that more natural resource revenues are to be retained in the regions where the resources are extracted. As resources (especially oil and gas) are concentrated in only a few regions, the process of decentralization has increased regional inequality and, with rising energy prices, the inequity is more pronounced. Fiscal balance funds (especially the General Allocation Grant or DAU) have, however, been designed to compensate for this and the evidence is that the DAU is assisting to equalize financial capacities. By any criteria, regions, even the poorest, have received large increases in transfers in recent years (most now have surpluses) and the challenge has moved to spending wisely.

### **How decentralization works in Indonesia**

Perceptions about how decentralization is working vary. Claims about poor education and health outcomes, especially malnutrition, abound. Infrastructure deficiencies are observable and businesses list local government procedures as one of the chief impediments to investment. Comprehensive surveys of perceptions indicate, however, that satisfaction with service delivery is improving. When asked about whether things have improved in the last two years, over 70 percent of public service users indicate that they believe that there have been improvements in health and education services, 56 percent in administrative services and 45 percent in police (not decentralized). This matches another survey two years earlier that had a similar outcome.

Nevertheless, despite amendments and regulations designed to address legal ambiguities, the framework governing the division of roles, responsibilities and resources between the national and local governments (including between provinces and regencies) remains ineffective and incomplete. The central government continues to spend significant amounts of resources on local government tasks and, it is not always clear who is in charge of certain key public services. Moreover, a clause in the regulation turns over responsibility for detailing service responsibilities to central departments themselves. There have been recent efforts, including a new regulation on deconcentrated spending, that are designed to address the confusion of roles but experience indicates that the longer the ambiguity about function exists the more entrenched it becomes. An improved functional division among the different levels of government would promote greater clarity, more accountability, higher quality and more efficient service delivery.

## **Fiscal decentralization**

Sub-national expenditures at both the province and regency level are dominated by administrative spending (usually for salaries for the administration, local parliament, buildings etc) at close to 30 percent of budgets. By contrast best practice according to the world bank is usually closer to 5 percent. As a result, much of the DAU is earmarked for financing civil service wages. This eliminates the incentive to address civil service costs (and shift spending to capital expenditure and other areas) and reduces the share of the DAU available for fiscal balance. The challenge is how to strengthen the equalizing impact between own-source and natural resource revenues and empower sub-national governments to find the optimal combination of inputs (size of workforce, capital, intermediate inputs and outsourcing) for public service delivery.

The use of the special autonomy grant (DAK) has been growing rapidly from less than USD500 million in 2005 to USD2.3 billion in 2008. This reflects a conscious decision to reduce deconcentrated spending but, aside from increasing the amounts, the government's strategy for using this important instrument should be more clarified. In particular it would be important to clarify priorities, including its use for poverty reduction and the achievement of minimum standards.

Unlike most decentralized countries, Indonesia has not transferred significant tax power to local governments, distorting incentives and creating an unhealthy dependence on transfers from the center. In particular, the central government administers the relatively efficient property tax including setting rates and evaluations although it provides 92 percent of the proceeds to regional governments as part of its transfers. The statutory rate is 0.1 percent to 0.2 percent which according to the world bank is one of the lowest in the world and enforcement is weak. The Amendment to Law 34 on Regional Taxation represents an opportunity to address some of the difficult issues in own source revenues. In particular, the Law moves from a negative list on taxes and fees to a positive list of preferred revenue sources. This should restrict the proliferation of uneconomic local government interventions, which on average have administration costs of 50 percent and some of which have costs above yields.

Local and provincial governments, especially in-urban areas, have a key—role in public investment, particularly in the infrastructure sector where the needs are great. Borrowing for infrastructure and other projects is virtually non-existent with total outstanding sub-national debt at 0.14 percent of GDP. To increase sub-national government access to credit the government needs to revise on-lending and on-granting regulations to facilitate support for local infrastructure finance and service delivery, to address overly complicated rules and such provisions as those that limit borrowing for non-revenue producing projects.

It will also be important that the central government continue to build credibility on its willingness to use intercept mechanisms for sub-national governments that again fall into arrears. Finally, while regional governments can now borrow in anticipation of increasing sub-national financing needs, especially for urban infrastructure, the government should address the issues that continue to constrain the development of market-based sub-national bonds, including rules about securitization, and procedures to address fiscal distress and bankruptcy. On the sub-national government side, local governments will need to improve transparency including submission of externally audited statement.

### **Regulatory framework**

Despite the increased responsibility of sub-national governments, and a regulatory framework for regional public financial management, Indonesia still needs to put in place system designed to effectively deliver transparency, accountability and efficient development. Most regions need to improve technical capacity and human resources to implement reforms. Sub-national governments are obligated by law to report certain fiscal and financial information to the central government but are not required to make this available to the public and most do not.

The devolution of political authority to local governments has also posed challenges for the investment climate. Post-decentralization the initial reaction was often to increase charges on local businesses and trade. Inconsistencies as well as the sheer number of local regulations have made doing business more difficult in many places. Kabupaten (districts) have, at times, used their newly acquired powers to issue excessively stringent local labor regulations or target businesses with a plethora of new local taxes, levies and fees. In fact, the costs, delays and inconvenience of business licensing is one of the most commonly mentioned criticisms of the local investment climate. Although illegal, restrictions in the movement of goods across district and provincial borders still exist and impose additional costs and delay to the distribution of goods, interfere in domestic trade and undermine internal market efficiency. Incomplete regulations at decentralization and the tug-of-war between the center and the regions on issues such as investment approval, land and the like affect the "bankability" of investments and have been a factor in the slow recovery of investment post-crisis. Finally, businesses have to face corruption in the regions as they do at the center.

### **Capacity problems**

As local level democracy spreads, there are signs that enlightened leadership is increasing and a number of local governments are beginning to address service issues, excessive regulation and policy deficiencies with a focus on improving the investment climate. These "second generation" local governments often have a better of understanding of business needs and higher levels of responsiveness to citizen

demands and their successes are being noted. Nevertheless, the process of clarifying and shifting responsibilities and building capacity at the local level has been slow. There are a number of reasons. *First*, views on appropriate models of decentralization are continuing to involve, in part based on how the situation has played out. *Second*, the roles and responsibilities of central government institutions are still to be brought into line with the new reality between and within ministries, raising bureaucratic tensions and resistance as budgets and status shift. *Third*, incentive problems resulting from the existing framework (e.g. the high share of transfers and a lack of transparency) and, *fourth*, the slow process of creating local government capacity after more than 30 years of centralized decision making. The concern is that a process that stalls during this transition will end up with vested interests building up around an inefficient equilibrium with reduced accountability and efficiency and severe governance problems.

Capacity problems at the local level remain. Regional governments have had difficulty spending increased resources and surpluses have built up in most sub-national governments, with especially large surpluses in natural resource endowed regions. While the situation is improving, sub-national governments have not had experience in dealing with businesses and typically lack understanding of what it takes to create a good business environment.

### **Transparency, monitoring and evaluation**

In addition to addressing administrative and regulatory issues, improving decentralization outcomes requires increasing the capacity and accountability of local governments. The accountability of local governments to their constituents is crucial for the success of regional autonomy but, by necessity, developing new accountability relationships and systems takes time. One approach would involve improving performance by providing additional financing for sub-national governments that met established criteria i.e., with respect to financial and other reporting or, more ambitiously, on service provision (i.e. health and education outcomes or even road maintenance). The central government could provide this support through the DAK along with complementary technical assistance in the specified area.

An improved system for monitoring of sub-national governments would provide incentives for good performers and technical assistance for those lagging behind. A credible performance system would provide transparency, attract investors to strong regions and provide a basis for an allocation system based on performance and needs. Despite the increased responsibility of sub-national governments, Indonesia does not yet have a sound system of sub-national fiscal and financial reporting to facilitate systematic monitoring and evaluation. In most middle-income and high-income countries the financial performance of local governments is measured by rating agencies and performance measurement mechanisms create competitive and political

pressures. An improved system of reporting that reliably captures the performance of local governments and provinces would represent a positive development.

### **Towards good governance**

The judiciary and associated law-enforcement agencies are perhaps the weakest link in Indonesia's governance and accountability system. In the three decades prior to the crisis, the legal system had been weakened by inadequate funding, ineffective procedures and inconsistent decision making. That led to a systematic demoralization and "deprofessionalization" of key players and the legal system, which has, in turn, hampered efforts to reform and improve these institutions.

Following reformasi, there had been encouraging signs that the government and justice sector institutions were open to reform. A number of independent judicial review and oversight mechanisms had been established, including the Judicial Commission, a Prosecutorial Commission to oversee the AGO and a Police Commission. Other bodies that have been established include a Constitutional Court, an Anti Corruption Court, the KPK and an Ombudsman's Office.

Some new institutions, such as the Constitutional Court and the KPK have been successful. The creation of a number of new institutions has, however, resulted in an overlap of jurisdictions and competition between these new institutions and those whose interests lie in maintaining the status quo. In this environment, the process of creating a normative framework at the national level with an appropriate system of checks and balances is likely to be a long-term process, especially when undertaken through trial and error.

Indicators of corruption in Indonesia slowly improving. Most global corruption surveys still place Indonesia near the bottom but most also indicate that the situation has improved in the last five years. For instance, the World Governance Indicators standardized Control of Corruption measure for Indonesia rose from -0.97 in 2003 to 0.77 in 2006, raising Indonesia's percentile rank globally from the 14th percentile to the 23rd. Large-sample firm level surveys of Indonesia's investment climate indicate similar improvements. The percentage of firms citing corruption at the local level to be a severe obstacle to doing business fell by nearly 12 percentage points between 2003 and 2007. Perceptions regarding corruption at the national level improved even more markedly, with the percentage citing it as a severe obstacle falling by over 20 percentage points.

### **Institutional reforms**

Adapting the institutions and mechanisms that govern the functioning of the state and shape state-society interactions will take time and not be easy. Institutional reforms and process transformations by their very nature are complicated undertakings.



Building consensus around more easily implemented but contentious reforms can also be a lengthy process. There are no simple or universal recipes or models for how to do this-the particulars of the model will necessarily vary from context to context.

And so the approach to reforms may be as important as the substance of the reforms themselves. Whether the task is civil service reform at the national level or improving service delivery at the local level, much trial and error and institutional adaptation is required. The approach often involves piloting reforms - selected from a menu of reform options that hold some promise, but the particulars of which need to be "field-tested" – on a small scale or in a clearly demarcated realm (a region, a ministry, a sector or sub-sector), monitoring and evaluating them carefully and using these assessments to adapt and improve the design of reforms and determine when and how to scale them up.

Though it is important to recognize that institutional reforms take time and it is often advisable to take a step-by-step experimental approach, maintaining a sense of urgency is critical throughout the process. That is because without a continued sense of urgency there is a risk that Indonesia's hard-earned reform momentum might stall. Indonesia has shown commitment to reform, but significant obstacles to change remain. There is a risk that the reform effort will languish as even committed reformers are overwhelmed by the extent and complexity of the task of pushing forward institutional reforms and putting in place new ways of doing things in the face of entrenched organizational cultures and behaviors. The task is especially challenging when, as is often the case, the implementation of institutional reforms relies on the very unreformed systems and processes that are themselves the object of change. Those who benefit from the existing system can use those distortions to politically derail efforts at serious institutional reform. Broader political dynamics can also intervene when the electoral imperatives of coalitional and money politics undermine incentives and efforts to strengthen the accountability of state institutions.

## **Conclusion**

In conclusion, a sustained focus on governance and transparency can help by restoring confidence in the legitimacy of public processes and institutions and building a consensus for continued reforms. If Indonesia can maintain a sense of urgency in furthering its governance transition, it has the potential to become a dynamic, competitive and inclusive middle-income economy.

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