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Governance and Poverty Reduction: Evidence from Newly Decentralized Indonesia

Sudarno Sumarto

Asep Suryahadi

Alex Arifianto

Editor:

Kathryn Sadler

Nuning Akhmadi

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For further information, please contact SMERU, Phone: 62-21-31936336; Fax: 62-21-31930850; E-mail: smeru@smeru.or.id; Web: www.smeru.or.id

TABLE OF CONTENTS

Governance and Poverty Reduction: Evidence from Newly Decentralized Indonesia

Sudarno Sumarto, Asep Suryahadi, Alex Arifianto *)

Abstract

This study is the first attempt to systematically examine the impact of bad governance practices in Indonesia on poverty reduction. Indonesia is a country that has endured bad governance for a long period, but has also sustained significant poverty reduction. Prior to the onset of the economic crisis in mid 1997, the problem of bad governance in Indonesia was apparent but mostly ignored because it was compensated for by high economic growth. The advent of the economic crisis, however, has highlighted the seriousness of the problem. This study focuses on the impact of bad governance on the poor, the people who are most vulnerable to the impact of bad governance. By assembling scattered anecdotal evidence on how past and current practices of bad governance in Indonesia have hurt the poor, this study shows that the adverse impact of bad governance on the poor is real, systematically affects many people, and undermines the efforts to reduce poverty in the country. More systematic evidence on how bad governance affects poverty reduction indicates that regions that practice better governance indeed experience faster poverty reduction and vice versa.

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I. INTRODUCTION

The Indonesian economic crisis, which has been ongoing since mid 1997, has brought attention back to the issue of poverty reduction. High economic growth during the previous three decades was successful in significantly reducing absolute poverty in the country. Between the 1970s and early 1990s, the official poverty rate was reduced by more than 50 percentage points. However, since the crisis the poverty rate has doubled, wiping out the above achievement and putting the issue of poverty reduction back into prominence (Suryahadi, Sumarto and Pritchett, 2003).

At the same time, in searching for the causes of the crisis, the issue of governance was brought into the limelight. The hypothesis put forward was that bad governance – popularly known as KKN (corruption, collusion, and nepotism) in Indonesia– has weakened the Indonesian economy, making it prone to suffer from periodic crises. KKN was a notorious trademark of the New Order regime, which was famous for tolerating petty corruption by low-level officials as a means to supplement their meager salaries as well as promoting mega corruption by twisting government regulations to support the interests of the ruling family of the New Order regime and their cronies. Often this was accompanied by collusion with businesses – domestic as well as foreign entities – at the expense of the general public. Nearing its final years, KKN practices peaked through the practice of nepotism. Family members and close friends of the ruling family were appointed in executive as well as legislative positions (King, 2000 and McLeod, 2000).

Bad governance during the New Order era and its successor governments resulted in Indonesia topping the list of the most corrupt countries in the world for a long time. However, prior to the onset of the economic crisis in mid 1997, the problem was mostly ignored. This was primarily because the economy was expanding, which was a result of the high economic growth experienced by the country. For most people, this was enough to compensate the losses and inefficiencies due to bad governance. The advent of the economic crisis, however, has highlighted the seriousness of this problem. The People's Consultative Assembly (MPR), the highest representative body in Indonesia, even issued a decree on the need to create good clean governance in the country. Efforts to achieve this, however, have so far proved difficult and elusive (Hamilton-Hart, 2001 and Sherlock, 2002).

Recent thinking on poverty reduction and governance argues that both are interrelated. Bad governance has made poverty reduction efforts ineffective (Blaxall, 2000; Eid, 2000 and Gupta, Davoodi, and Alonso-Terne 1998), while poverty reduction projects provide fertile ground for corruption (see, for example Woodhouse, 2001). The consensus that emerges from this line of thinking is that good governance is necessary for poverty reduction efforts to be effective.

The prevalence of corrupt practices such as above is hypothesized as a symptom of a political system that is centralist and monopolist. Thus, one possible way to reduce corruption is through the adoption of a decentralized political system that is participatory in nature. Because of this, many had hoped that decentralization which was implemented in January 2001 would provide an opportunity to realize good governance. This optimism was based on the consideration that regional autonomy is conceptually designed based on the adoption of good governance principles, such as democracy, participation, justice, accountability, and equality while taking into consideration the potential and diversity of regions. The problem now is whether in practice regional autonomy can introduce the above principles in Indonesia as visualized. Or will this policy serve as the continuation of past government practices that were wrought with KKN, that pessimism expressed by Hamilton-Hart (2001) and Sherlock (2002) could be justified?

This paper consists of three parts. First, it reviews the literature on governance and its links with poverty reduction and corruption, both internationally and in the Indonesian context. Then, it proceeds to show the results of our research on governance and poverty in Indonesia, compiling scattered anecdotal evidence on how bad governance has hurt the poor, as well as conducting more systematic analysis on how governance affects poverty reduction. Finally, this paper provides policy recommendations based on the findings.

II. GOVERANCE AND POVERTY: LITERATURE REVIEW

2.1. Governance

Governance is an old concept that originates from early democratic political theory which discusses the relationship between the rulers and the people they rule. For instance, in the 19th century Woodrow Wilson defined a government that practices good governance as "a government that can properly and successfully implement a given policy…with the utmost possible efficiency and at the least possible cost of either money or of energy" (cited in LaPorte 2002:3).

However, only in the past decade or so has governance gained significant attention in the international policy making arena. This was motivated by a concern that bilateral and multilateral assistance from the developed world to developing countries had failed to reach its goals (i.e. to reduce poverty and promote sustainable economic growth). This was because of the poor administrative capacity of governments in developing countries to administer these projects and widespread corruption. From this, donors concluded that good governance is essential for the success of their assistance in the developing world. Since then, they have begun linking development assistance to the adoption of good government practices by developing countries.

There are several definitions of governance that are put forward by different bilateral and multilateral lending agencies. Some of them are described here. The World Bank (1992) defines good governance as:

> *A public service that is efficient, a judicial system that is reliable, and an administration that is accountable to its public … Good governance, for the World Bank, is synonymous with sound development management … [It] is central to creating and sustaining an environment which fosters strong and equitable development, and it is an essential complement to sound economic policies.*

Furthermore, the World Bank (1992) defines three different dimensions of governance. First, the type of political regime (parliamentary or presidential, military or civilian, and authoritarian or democratic). Second, the processes by which authority is exercised in the management of a country's economic and social resources. Third, the capacity of the government to design, formulate, and implement policies, and, in general, to discharge functions.

In 1995, in a speech that outlined the United State's new policy on foreign assistance to developing countries, Vice President Albert Gore Jr., as cited in LaPorte (2002: 4), stated the five principles of good governance as including: (1) The administration of the state must be honest and transparent; (2) The administration of the state should be streamlined and as efficient as possible; (3) The government must decentralize as many functions as possible and deliver services as close to the people as possible; (4) Democratic states must make provisions for the security of their people; and (5) Democratic states must rely on an open and modern judiciary.

Meanwhile, the United Nations Development Program (UNDP, 1997) defines governance as:

> *The exercise of economic, political, and administrative authority to manage a country's affairs at all levels. It comprises of the mechanisms, processes, and institutions through which citizens and groups articulate their interests, exercise their legal rights, meet their obligations, and mediate their differences.*

Finally, World Bank economists Daniel Kaufmann, Aart Kraay, and Pablo Zoido-Lobation (1999) define governance as:

> *... the traditions and institutions by which authority in a country is exercised, including (1) the processes by which governments are selected, monitored, and replaced; (2) the capacity of the government to effectively formulate and implement sound policies; and (3) the respect of citizens and the state for the institutions that govern economic and social interaction among them.*

In sum, governance is a multidimensional concept which consists of political, economic and socio-cultural variables that determine whether public policy designed by the government can achieve its intended goals and improve welfare of its people. From the various definitions of good governance above, Kinutha-Njenga (1999) concludes that the practices considered as criteria for a country practicing good governance are as follows:

(1) The government of the country is democratically elected and promotes/protects human rights and the rule of law;
(2) There is a strong and healthy civil society movement in the country;
(3) The government of the country is able to create and implement effective public policy; and
(4) The government of the country organizes the country's economy along the premise of free, competitive, and efficient markets.

2.2. Governance and Poverty Reduction

Along with the new concept of governance, donors have also incorporated new thinking on poverty and the relations between these two variables. They recognize that poverty is a multidimensional concept and is not limited to the economic dimension alone. Beside a lack of income, the poor also suffers from a lack or a complete absence of services (public utilities, public transport, healthcare, education and credit) and a lack of participation in social, economic, and political decisions at the local, regional, and national level. Because of this, the poor often feel that they are excluded, and helpless when their rights are violated and exploited by the wealthy and the powerful (Eid, 2000).

Drawing from the experiences of more than 50 years of assistance to developing countries, developed countries and multilateral lending institutions now conclude that good governance is a necessary prerequisite for poverty reduction, because of the following:

a. Without good governance, the scarce resources available are generally not put to their best use in combating poverty. This is often due to a lack of transparency, rampant corruption, and an uncertain legal system that hinders economic growth that could help pull the poor out of poverty.

b. Good governance is necessary if all aspects of poverty are to be reduced, not just through an increase in income, but also through empowerment and an increase in the economic, political and social opportunities for the poor (Blaxall, 2000 and Eid, 2000).

To accomplish these goals, the institutions that support governance need to be reformed and strengthened. In the past decade, donors have created governance support programs that assist developing countries in reforming their civil service and strengthening their institutions, with the hope that improved governance will create an economic and political climate that will increase economic growth in these countries and eventually draw the poor populace out of poverty. For instance, the World Bank started its governance program in 1992 and the Asian Development Bank (ADB) started a similar program in 1997. On a bilateral level, USAID formally launched its governance program in 1995, and DFID (United Kingdom), CIDA (Canada) and GTZ (Germany) started their governance programs in the 1990s.

The focus of these programs are civil service reform at the central, regional and local government levels, legal and judicial system reform, legislative reform (reform of parliamentary institutions), capacity building for NGOs and other civil society organizations, government efficiency and the effectiveness reform (LaPorte, 2002 and Eid, 2000). On improving the welfare of the poor, the World Bank's governance reform program has four aims: (1) to empower the poor; (2) to improve the capacity of the poor by improving basic services; (3) to provide economic opportunities by increasing access to markets; and (4) to provide security from economic shocks and from corruption, crime, and violence (Blaxall, 2000). Donors hope that through these programs, the goals of lasting poverty reduction and improved governance in the developing world can finally be achieved.

2.3. Corruption

Corruption is defined by the World Bank as the abuse of public office for private gain. Renowned scholar Robert Klitgaard (1988) hypothesized that corruption is more likely to occur in an environment where officials have monopolistic control over state resources and a high level of discretion over who can gain access to those resources, while at the same time the mechanisms for holding these officials accountable for their actions are weak or non-existent. It is widely recognized today as a symptom of poor governance and a major obstacle to poverty reduction efforts. While in the past, some scholars argued that corruption could increase economic efficiency in countries with burdensome regulations and a dominant government role in the economy,[1] today most corruption scholars believe that it curbs economic growth, degrades social and political institutions, and hinders efforts to reduce poverty . Corruption can have adverse consequences, both directly and indirectly, especially for the poor.

There are some avenues through which corruption makes poverty reduction efforts ineffective: (1) corruption diverts funds for poverty reduction to the pockets of corrupt officials; (2) corruption twists the budget allocation away from poverty reduction to other projects more closely associated with the interests of corrupt officials; (3) corruption creates a high-cost economy as it obstructs the creation of a healthy and conducive economic environment, which is essential for the poor to work and do business in; (4) corruption jeopardizes the property rights of the poor since corrupt officials often force the poor out of their homes and off their land, so that they can be used for development projects sponsored by the developers who bribed them; and (5) corruption prevents the poor from achieving justice in court, since corrupt court officials sell their decisions to the highest bidder, which makes court decisions biased toward wealthier parties.

Corruption also hurts the poor indirectly through (1) increasing the prices of goods and services; (2) reducing incomes by way of semi-legal and illegal taxes and levies; (3) diverting support measures provided for the poor from the hands of the poor to ineligible parties; (4) creating asset-ownership inequality, since the wealthy can influence the government to pursue policies that will increase their wealth (such as favorable tax treatments and exchange rates) that are not available to the poor; and (5) discouraging the poor from making new investments or opening new businesses, because they know that the well-connected business people will always win government projects and contracts due to corruption. As a result, they cannot increase their living standards and remain poor.

It can be concluded that there have been a consensus that good governance is imperative in promoting effective poverty alleviation as well as in combating corruption.

2.4. Cross-Country Macroeconomic Studies on Governance and Corruption

During the past decade or so, there has been an explosion of literature on the impact of corruption and governance on economic growth and various economic and social indicators. These studies use cross-country data on corruption and data on the perceptions of governance collected by both commercial firms that measure political risk for their clients (such as Political Risk Services, Inc) and by international government and non-government organizations (such as The World Bank and Transparency International).

[1] This is commonly known as *the grease hypothesis*.

A landmark World Bank study done by Kaufmann, Kraay, and Zoido-Lobaton (1999)[2] found that good governance does matter in the economic outcomes of a given country. For instance, one-standard deviation increase in any one of the governance indicators caused a two and a half to four-fold increase in per capita income, a two and a half to four-fold decrease in infant mortality, and a 15 to 25% increase in literacy. This study shows with clear evidence that good governance is crucial for economic growth and improved social indicators.

Another study by Rajkumar and Swaroop (2002) found that efficiency in public spending reduced child and infant mortality, increased educational attainment and was positively related to governance. It is more effective if governance is good and less effective if governance is poor. They conclude that well-functioning public institutions are critical for translating public spending into effective services.

Several studies that have linked corruption and good governance with economic and social indicators found that there is an inverse relationship between them. Good governance increases these indicators while corruption decreases them. For instance, Gupta, Davoodi and Alonso-Terne (1998) found that an increase in corruption by one standard deviation is associated with an increase in the Gini coefficient of about 4.4 percentage points and a reduction in income growth for the bottom 20% of population by 7.8 percentage points per year. Meanwhile, Gupta, Davoodi and Tiongson (2000) found that better health and education outcomes – measured by child mortality and drop-out rates – are correlated with lower corruption, while countries with high corruption have worse health and education outcomes compared with countries with low corruption.

Finally, Huther and Shah (1998) found that decentralized countries have better governance than the more centralized countries. They show that citizen participation and public sector accountability go hand-in-hand with the decentralization of public sector decision making. Decentralized countries are more responsive to citizen's preferences in service delivery and strive harder to serve people than centralized countries. Furthermore, fiscal decentralization goes hand-in-hand with an increase in the human development index and a decrease in income inequality.

However, to conclude that decentralization per se will automatically increase public participation and accountability and result in better public services is a fallacy. A study done by Crook and Sverrison (2001) found that decentralization can be considered successful only in countries with well-established public participation schemes, where local government practices good governance and is capable of delivering good quality services to the public, and has functioning checks and balances mechanisms of both the central government and the general public. In contrast, decentralization without a local government that practices good governance and is not accountable to the public will not be successful in achieving its intended goals.

[2] This study for the first time combined the various governance and political risk indices that measure variables such as political rights, civil liberties, government effectiveness, regulatory burden, rule of law, and graft/corruption into a single index.

We can conclude that good governance practices are very important in achieving better public service management which would result in better public service delivery, an increase in economic growth, and better poverty reduction.

2.5. Empirical Evidence from Governance and Corruption Research in Indonesia

Since the fall of the New Order, there has been a lot of interest in finding out about the numerous aspects of corruption in Indonesia, such as the exact level of corruption and its implications for Indonesians, especially for the poor. There is also a strong interest to find out whether anti-corruption and good governance reform proposals implemented by the Indonesian government since *reformasi* began in 1998 has made any impacts on actually reducing the level of corruption. Many research projects on regional autonomy have focused attention on corruption and governance at the local level, since many parties fear that along with fiscal decentralization, corruption will also be decentralized from the central to the local level. Donor agencies, research institutions and civil society groups have conducted several studies on the above topics. Some of their findings are summarized below.

Research on the impact of anti-corruption reforms in Indonesia has shown that, so far, they have been ineffective in actually reducing corruption. In fact, one could argue that since 1998 corruption has actually become worse. For example, corruption has now spread into national and local parliaments, the institutions that are supposed to be watchdogs over the executive branch. While the Indonesian government has made changes that have promoted democracy and free press in the country, instituted legal reforms[3], and created greater fiscal and financial transparency, Hamilton-Hart (2001) finds that these reforms have been ineffective in actually reducing corruption in Indonesia. Furthermore, they have failed to successfully prosecute any major defendants accused of corruption. She believes that these reform measures are ineffective because corruption has become so entrenched in Indonesia that no one within the Indonesian government is really interested in seriously fighting corruption because such an act would only hurt their own rent-seeking interests.

Sherlock (2002) confirms this conclusion by pointing out that the two new bodies dedicated to monitor and fight corruption – the Indonesian Ombudsman Commission (KON) and the State Official's Assets Auditing Commission (KPKPN) – are given neither adequate funding nor effective power to conduct thorough investigations and prosecute corrupt officials by the government decrees that mandate their creations. He hypothesizes that this was done deliberately so that these commissions would simply become "toothless tigers" that will not seriously combat corruption in Indonesia and, therefore, corruption by government officials in all levels would continue uninterrupted. He concludes that without a strong political will, the creation of these anti-corruption bodies will not have any actual impact in reducing corruption in Indonesia.

[3] For example, the creation of a new bankruptcy court and the appointment of *ad hoc* judges from outside the bureaucracy.

The Partnership for Governance Reform in Indonesia (PGRI) conducted a national opinion survey on how public officials, businesses, and the public at large, perceived the level of public sector corruption in Indonesia (PGRI, 2001). The study found that 75% of the public regarded public sector corruption to be very common and that 65% of respondents reported that they had experienced corruption involving public officials. The institutions that are perceived as corrupt by the people sampled are the traffic police, customs officials, and the judiciary. The study estimated that about 48% of all public officials have received unofficial payments, with bureaucrats from the Departments of Housing and Infrastructure, Industry and Trade, and Home Affairs as more likely to receive such payments. It was also found that corruption imposes high costs upon society: up to 5% of household income was used to pay bribes to public officials and 35% of business enterprises reported that they had not made new investments due to the high costs caused by corruption.

The Institute for Economic and Social Research (LPEM – FEUI) recently conducted research on the business climate in 60 district/city governments (LPEM, 2001). LPEM conducted interviews with the owners and managers of 1,736 medium-sized and large companies. The study found that regional autonomy has increased business uncertainty and the cost of doing business at the local level (measured through the increase in unofficial payments made by businesses). It also found that the unofficial payments (bribes) made to government officials do not necessarily reduce economic efficiency but rather increase it, since businesses often have to spend more time and paperwork when they are dealing with government officials, even when they have made such payments. However, the study also discovered that the frequency of unofficial payments is lower in the districts that have better regulations and better governance, so there is evidence that good governance decreases corruption. However, the ability of the districts to generate their own revenue does not correlate with better governance, because these districts are more prone to higher levels of unofficial payments and corruption.

Another regional-level business climate survey was conducted in 2002 by the Regional Autonomy Implementation Monitoring Committee (KPPOD). It selected 90 regions (68 districts and 22 cities) and examined the business climate in these regions by measuring security, economic potential, human resources, local bureaucratic culture, the quality of infrastructure, local government regulations (Perda), and regional finances. The study used both primary sources (interviews with business executives, journalists, and economic experts) and secondary sources (news accounts and information from the public). It found that regions which attract more businesses are more likely to have better security, better local bureaucratic culture and government regulations, and better human resources, which confirms the assertion that good governance is a necessary condition for businesses to invest in a region.

Finally, a study on how public participation affects the level of corruption in local government projects, using the World Bank's Kecamatan Development Project (KDP) as a case study, shows that corruption occurred in KDP projects because of the existence of incentives and opportunities for corrupt practices. These included a monopoly over the decision-making process, lack of transparency, and low probability of getting caught and punished. People who are well informed about KDP, its goals, and are participating in its planning, are more likely to challenge corrupt practices by local government officials (Woodhouse, 2001). Thus, the study confirms that if the public is actively involved in the planning of government projects, they are more likely to exercise control mechanisms when they detect corrupt practices within these projects.

2.6. Some Possible Flaws in Governance and Corruption Studies

There are several caveats that one needs to consider when reviewing these studies. First, the data required to construct a good governance study are often hard to find (and for the prevalence of corruption, objective data are impossible to find). Even if found, they rarely satisfactorily explain all the dimensions of good governance, since as noted above, it is a multidimensional concept with multiple interpretations. Since there is no single variable that can measure governance, subjective or proxy indicators are used instead, which means that the variables the studies used are not really the ones that the studies intended to measure. As a result, an inexperienced researcher could be "fooled" by the data, that is, they may think they are measuring one thing when in fact they are measuring another, or they could think that they are measuring a direct, first order effect between two variables when in effect they are second or third order variables (Dethier, 1999:37-38) and Kaufmann, Kraay, and Zoido-Lobaton 1999:2).

On the other hand, if a study only focuses on a single country, these problems could be minimized because it is possible to focus the study on a small number of policy variables that are easier to observe. Presently, however, single country governance studies are not as plentiful as cross-country studies, even though the number of this type of study is growing (Dethier, 1999:46-47).

In regard to the studies on governance in Indonesia mentioned above, the fact that the LPEM and KPPOD studies are based on the opinions of a selected panel of experts (such as business owners, journalists, and NGO leaders) that might not be representative of the general public as a whole could cause concern. This is because some of them might have opinions that are not shared by the public at large or they may have information that is either out of date or inaccurate regarding the regions that are being studied. This may occur because they lack a comprehensive understanding of these regions. The PGRI study has greater validity because its sample is derived from the general public instead of an expert panel. However, it is only a public opinion study regarding the pervasiveness of corruption in Indonesia and does not ask more specific questions about certain aspects of governance and corruption (such as the quality of local regulations) that were questioned in other studies.

III. GOVERNANCE AND POVERTY IN INDONESIA: EMPIRICAL EVIDENCE

3.1. Bad Governance in Daily Lives: Some Case Studies

3.1.1. Pre-Crisis/Pre-Deregulation Era

Centralization was until recently considered to be a barrier for development in the regions. Thus, there have always been struggles in many regions to obtain real autonomy. One real authority for autonomous governments is in the management of local government revenue (PAD). Because of this, in the past local governments issued local laws (Perda) on local taxes, user charges, and other fees that amounted to around 200 types by 1996 (CPIS, 1996). In addition, local governments also issued local regulations regarding business practices, specifically regulations on trade and market mechanisms. Examples of such regulations include the zoning of tea sales in West Java, the orange trade monopoly in West Kalimantan, local product marketing through village cooperatives (KUD) in East Nusa Tenggara, and the prohibition on the sale of raw cashew nuts from South Sulawesi. Similar policies were also issued by the central government, such as the management of the clove monopoly through the Clove Marketing Board (BPPC) and the quota for inter-island cattle trade.

Officially, the purpose of the above policies was to protect producers or small farmers. However, in practice these laws and regulations were particularly aimed to increase local government's PAD, and intentionally or unintentionally, to protect the economic interests of certain groups. This situation resulted in the creation of a high cost economy that disturbed the business climate, lowered competitiveness, and prevented economic development in the regions. The bureaucratic management of revenue collection, with its many complications and lack of transparency, often forced people to resort to paying their obligations through unofficial means, which is more expensive and burdensome. However, sometimes taxpayers "negotiated" the real amount they had to pay. On the one hand, such practices resulted in a high cost economy, but on the other hand, they stopped some of the central and local government revenue from being channeled into their respective treasuries. At this point, poor governance which is synonymous with the prevalence of corrupt practices amongst government officials, has reached its peak, and has resulted in Indonesia being renowned as one of the most corrupt bureaucracies in the world.

A case study done by Montgomery *et al.* (2002) that focused on the agricultural sector (i.e. the sector where most poor Indonesians work) provided us with invaluable lessons on how bad governance practices had had a negative impact on the welfare of the poor before the crisis started. A snapshot on poverty in the agricultural sector shows that nationally this sector had the highest sectoral poverty rate as well as employed the largest number of poor people in the country (as of February, 1999). The agricultural sector's 1999 head-count poverty rate was 39.7%, and more than 58.4% of poor people stated that the agricultural sector was their primary field of occupation (Pradhan *et al.*, 2000). However, despite the fact that most poor Indonesians were already working in the agricultural sector, it was the only sector to absorb large numbers of the newly unemployed during the economic crisis. While other sectors shrank, employment in agriculture rose by 13% or 4.6 million people in just one year, from 34.8 million in 1997 to 39.4 million in 1998.

During the 1980s and much of the 1990s, there was growing concern about the welfare of farmers, based on the perception that farmers received an increasingly smaller percentage of the final price of their produce. As a result, incentives for farmers to continue supplying the market seemed to fall over time. One of the reasons for this was that the notion of free trade in Indonesia's domestic market did not exist. The problems fell into two categories, price distortions and non-price distortions. Provincial and district taxes (*pajak*), levies (*retribusi*), and compulsory "donations" (*sumbangan wajib*) on agricultural trade led to distorted prices. Beside these official fees, there were many unofficial fees that entrepreneurs were required to pay. Non-price distortions were created through the regulatory controls created by national, provincial and district governments on agricultural products and the trade of these products. Such regulations helped create local monopolies and monopsonies that were so deep-rooted that they disturbed business practices.

Provincial and district governments did not have the authority to tax income or assets. All of them have therefore turned to taxing the trade of primary commodities as the main source of local revenue (PAD). Generally, the prevalence of local laws formulated to raise local revenue is closely related to the low role of local parliaments (DPRD) in the drafting of these laws and the lack of civil society involvement in the decision-making process.

Local levies, or *retribusi*, had a more serious impact than local taxes. Conceptually, such levies were originally intended by the law to be a form of cost-recovery for facilities or services provided by the government. However, over time *retribusi* were extended to include compensation for the government for the extraction of non-renewable natural resources (as natural resources belong to all Indonesians). The definition of natural resources was extended to include agricultural products, which are renewable and not owned by the government. In practice, *retribusi* became a trade tax on goods shipped outside of a district. Trucks were stopped at *retribusi* posts every few kilometers along the road. Such methods of collection led to abuses and much of the money collected did not make its way into official government treasuries. The *retribusi* were charged against physical quantities traded, with no links to profitability, net income or value added. Business owners' ability to pay these fees was not taken into account.

Regarding distortive non-tariff barriers, in the past all levels of government created, inspired and supported local monopolies, monopsonies and inter-regional trade quotas for the favored few. These distortions drove wedges between farm-gate prices (driving them lower) and final market prices (driving them higher). The price difference ("rent") was to the advantage of the holders of monopolies, monopsonies, or quota rights. Benefits of these price wedges were shared with the people who granted such rights. Many were specifically created to benefit the members or cronies of the then ruling family. Table 1 provides a snapshot regarding the official objectives of such regulations (such as efficiency and value added), specific rationales, and the policy instruments that were used.

Table 1. Objectives of and Instruments for Various Regulations (National and Local) on Certain Agricultural/Forestry/Livestock Commodities

Objectives and Specific Rationales	Commodities	Policy Instruments
A. Efficiency and Value Added		
1. Market power	Oranges and nutmeg	Export quota coordinator and marketing board
2. Increase export quality	Cocoa, coffee, pepper, and vanilla	Export and inter-trade ban on unprocessed commodities
3. Infant industry	Cashews and sandalwood	Export and inter-trade ban on unprocessed commodities
4. Value added	Cocoa, cashews, and rattan	Export and inter-trade ban on unprocessed commodities
B. Equity		
1. Increase farmers' income	Cloves, oranges, and swallow bird's nests	Requirement to sell through cooperatives
2. Reduce marketing chains	Oranges, cloves, tea	Requirement to sell through cooperatives Zoning
3. Raise local revenue	Cocoa, oranges, coffee, cattle, copra, nuts, vanilla, and swallow bird's nests	Local taxes and fees
C. Resource management		
1. Population sustainability	Cattle	Inter-island quota

In practice, the ideal objectives of these regulations were never accomplished. The real impacts of these regulations were totally counterproductive as they increased inefficiencies, reduced farmers' income, increased the poverty rate, diminished export opportunities, and increased the prevalence of unfair competition. The following case studies show the real-life consequences of these regulations.

<u>*Oranges from West Kalimantan*</u> Until the early 1990s citrus production increased rapidly in West Kalimantan, from just 76,000 tons in 1988 to 199,800 tons in 1991/92. Almost all of West Kalimantan's citrus fruit was shipped to Java. In 1991, the West Kalimantan Governor issued a decree stating that PT Bima Citra Mandiri (BCM), a member of the Bimantara group controlled by a member of the then ruling family, was appointed to be the official "coordinator" of the citrus trade. All citrus trade had to pass through KUDs (*Koperasi Unit Desa*, Village Unit Cooperatives) and farmers could only sell to KUD-appointed collection-traders, who were then required to sell to PT BCM for inter-island trade. Farm-gate prices dropped drastically and the export of citrus fruit from the province fell by 63%. Angry citrus producers brought truckloads of citrus into Pontianak and dumped them in front of government offices in protest. Many citrus producers abandoned their trees and have not tended them since. In 1998 the monopsony rights granted to PT BCM was withdrawn by a Governor's decree that "encouraged" (but no longer required) marketing through KUD cooperatives, but the citrus trade has not recovered to the previous level.

Regulations requiring local processing of cocoa and cashew nuts in South Sulawesi Cocoa and cashew nuts are important export crops for Sulawesi. They are particularly important in poor isolated upland areas. For instance, in the Polmas district in the hilly northwestern part of South Sulawesi, in 1998 there were 27,764 hectares of cocoa, grown by 43,361 families, about 30% of all Polmas farming families. Polmas had a smaller area for cashew crops (2,914 ha) but it was the main source of income for another 6,700 poor upland farming families. In another poor area surveyed, the Bone district, cocoa was important for 25,192 farming families (27% of all farming families in the area), with 10,490 hectares being used for cocoa plantations. In Bone, cashew nuts were the main source of income for 11,706 families (13%) who tended 9,050 hectares of cashew trees.

South Sulawesi's smallholder plantation crop producers were faced with a regulation that required cocoa beans and cashew nuts to be processed within the province. The largest cashew nut processing factory in Ujung Pandang benefiting from the regulation was PT Citra Sekarwangi Agro Persada, part of the Citra group and also owned by a member of the then ruling family. Cashew nut buyers wanted unprocessed cashew nuts (for export to lower-cost processors in India) and were willing to pay higher prices than South Sulawesi's cashew processing factories were willing to pay. The main cocoa bean importing country, the United States, also only wanted unfermented cocoa beans. The local processing requirement in this case was not value adding but rather 'value subtracting'.

After *de facto* deregulation in 1998, the cocoa bean and cashew nut processing industries tried again to lobby the government to support high-cost local processing in 1999. They requested the government to impose a 20% to 30% export tax on unprocessed cocoa beans and cashew nuts to help guarantee supplies of raw materials to existing (favored) processing factories. By this time, elements of civil society were more vocal about the impact of government-created marketing restrictions. Many saw this move as one-sided, helping local processing firms but harming farmers and forcing down the farm-gate price received. The Cocoa Association of Indonesia (*Askindo*) objected strongly to the proposal, as did both the Indonesian Farmers Union (HKTI) and the Association of Indonesian Food and Beverage Producers. Only the Cashew Nut Industry Association of Indonesia supported the move to impose an export tax. The secretary-general of this association stated that the farm-gate price of cashew nuts was rocketing upward, benefiting the farmers, to the detriment of the processors. At least up until July 2001, lobbying by the Association had been unsuccessful although there have been no new export taxes on cashew nuts and cocoa beans.

Clove Marketing Cloves are an important commodity for Sulawesi farmers, especially in North Sulawesi, the largest clove-producing region in Indonesia. During the time the Clove Marketing Board (*Badan Penyangga Pemasaran Cengkeh* or BPPC) was still in operation, the purchasing price of cloves (determined by BPPC) plummeted, but the selling price (also determined by BPPC) to *kretek* cigarette manufacturers in Java did not fall commensurately. Although detrimental to clove farmers, such business practices were definitely profitable for the BPPC.[4] As a result, while before the BPPC era there were

[4] The financial audit report of BPPC has never been released to the public.

43,000 hectares of productive clove land in North Sulawesi, after the BPPC was dismantled only 20,000 hectares remained. This occurred because many clove farmers abandoned their plantations due to the disincentive of the low buying price.

Smallholder Tea Processing in West Java West Java is the most important tea-producing province in Indonesia. In the 1980s, PT Tehnusamba Indah, a company controlled by a crony of the then ruling family, built four tea-processing factories in West Java. Since these factories did not own their own tea plantations, they depended on raw tea-leaves produced by small tea growers. Farmers explained that PT Tehnusamba's factories offered lower buying prices than its competitors for fresh tea-leaves they grew and so they declined to sell to PT Tehnusamba. Facing this condition, in 1990 PT Tehnusamba managed to have the Governor of West Java issued a circular instructing District Heads to implement *rayonisasi* (market "zoning") for the marketing of teas produced by small growers. The District Heads in turn issued circulars making it obligatory for farmers near PT Tehnusamba factories to sell only to PT Tehnusamba, thus creating virtual monopsony power for PT Tehnusamba.

The circular from the Governor of West Java requiring this geographic market allocation for fresh tea-leaves has not yet been formally withdrawn. The district government's market-area-allocation circulars in favor of PT Tehnusamba have also not been cancelled. However, today farmers disregard these instructions and sell to whoever they want.

Inter-Island Livestock Trade Inter-island livestock trade is important for farmers in the dry provinces of West Nusa Tenggara (NTB) and East Nusa Tenggara (NTT). Most livestock from these relatively poor islands is exported to Java. In 1998, NTT had a large livestock population of 803,000 (almost all cattle). Supplying beef cattle to markets was important for more than 200,000 NTT farmers (although this is a rough estimate). In NTB, the livestock population was 470,000 and the livestock trade was a major source of income for an estimated 150,000 farmers. Most of NTB's cattle are found on Lombok, which has a livestock population of 280,000.

The livestock trade was subject to both local trade taxes and inter-island shipping quotas. By mid 1997, just before the crisis, NTT cattle farmers and traders had to pay a total of US$ 40 per head of cattle through 16 different kinds of taxes and levies, amounting to around 13% of the farm-gate price for an animal. In Lombok, NTB, farmers and traders paid 24 different taxes and *retribusi* on the trade of livestock: 3 to the central government, 9 to the provincial government and 12 to district government, totaling about $31 per head of cattle in taxes and levies, or 5% of the $570 farm-gate price of a typical animal. In Bima, Sumbawa, traders and farmers had to pay the same 3 central and 9 provincial taxes and levies, in addition to 18 district charges. In South Sulawesi traders bringing cattle from Bone to Ujung Pandang (5 hours away) had to pay 31 different taxes and levies along the road, 25 of which were illegal. Twenty of the posts charging illegal levies were police and military checkpoints. The sum paid represented about 4% of the farm-gate price. A tandem-trailer truck carrying 18 heads of cattle from Bone to Ujung Pandang had to be prepared to pay $228 in taxes and levies.

Before deregulation in 1998, the Ministry of Agriculture's Directorate General of Livestock set inter-island livestock trade quotas. These severely limited the number that could be marketed to at most 5% to 6% of the local livestock population. Each year the Directorate General issued a circular which determined maximum annual quotas for shipments from each province. He even determined which destinations could receive shipments from cattle growers (for instance, traders in NTT were not permitted to ship cattle to East Kalimantan despite high prices and a shortage of beef). In addition, while livestock (and meat) prices in Jakarta continued to rise, cattle farmers in NTT could not benefit from the opportunity. Ironically, this quota system lowered the purchasing price for cattle in Nusa Tenggara. A large price wedge between suppliers and buyers was formed, and this only benefited the inter-island shipping quota-right holders.

3.1.2. Deregulation/Crisis Era

Due to the onset of the financial crisis that has plagued Indonesia since mid 1997 and the start of *reformasi*, the new Indonesian government has corrected many of the "market unfriendly" policies described above. Such changes can be found in the deregulation policy of regional trade, such as:

1. Law No 18/1997 on Regional Taxes and User Charges that took effect on May 23, 1998.

2. Letter of Intent (LoI) as part of the agreement with the International Monetary Fund (IMF) to provide financial assistance to the Indonesian government, signed on January 15, 1998.

The two policies contain the following reforms: a) elimination of a number of regional taxes and user charges in the agricultural sector; b) free trade between islands and regions; c) elimination of the inter-provincial cattle quota; d) closure of the Clove Marketing Board; and e) end obligatory participation in the beet intensification project. The question now is whether deregulation has had a positive impact on the business community, especially farmers and other small producers.

The Impact of Deregulation

In 1999, SMERU's Regional Trade Deregulation Project conducted a study to look at the impact of the above deregulation policy (Usman *et al.*, 1999). The main findings of this study are:

a. The trade of most commodities has becoming freer as the alternatives for farmers to sell their products have multiplied. This has increased the bargaining position of farmers. As a result, there is a tendency for the profit margins for traders to decrease (89% of total case studies), with a decrease of up to 10% in 64% of cases analyzed (see Table A1 in the Appendix).

b. The number of taxes and user charges that have to be paid by business owners have decreased significantly (see Table 2), so the marketing expenses they have to pay have also decreased. This means that the burden of these expenses, which is measured through the buying prices offered by traders to farmers, has decreased.

Table 2. The Number of Local Taxes and User Fees Before and After Law No 18/1997

Description	Original Number	After Law 18/1997
Local Taxes	42	9
Fees for Public and Business Services	130	23
Licenses/Permit Fees	62	7

c. After deregulation, buying prices of all commodities studied increased by an average of 9%. In about 58% of the case studies, the buying price accepted by farmers increased proportionally by up to 10% and in 33% of the case studies they increased between 10% and 32% (see Table A2 in the Appendix).

3.1.3. Decentralization Era

3.1.3.1. Decentralization in Indonesia

Indonesia's decentralization and regional autonomy policies, which were implemented in January 2001, were based on Law No. 22/1999 on Local Governance and Law No. 25/1999 on the Fiscal Balance between the Central Government and the Regions. They not only cover administrative decentralization, but also political and fiscal decentralization. Figure 1 illustrates the basic structure of the central, provincial, and district governments' authority and functions stipulated in both laws. These laws have reversed the New Order's centralized approach. The responsibilities and functions of the district governments have by and large expanded, while those of the central and provincial governments have reduced. According to Law No. 22/1999, all authority now lies with the regions, except for foreign affairs, defense and security, justice, fiscal and monetary affairs, religious affairs, and authority over certain issues, which have remained with the central government.[5] Provincial governments have authority over inter-district issues, certain areas as delegated by the central government and matters beyond the capability of the district governments.[6]

As the emphasis of decentralization and regional autonomy policies lies with the district governments, the authority given to the districts is wide-ranging. In this respect, Law No. 22/1999 grants authority to district governments which includes authority over all matters not covered by the central and provincial governments. These include public works, health, education and culture, agriculture, transportation, industry and trade, investment, environment, land, cooperative, and labor matters.

[5] The last point has received a lot of criticism due to its ambivalent nature.

[6] The authority of the provincial governments is regulated in Government Regulation No. 25/2000 on the Authority of the Central Government and the Authority of the Provinces as Autonomous Regions.

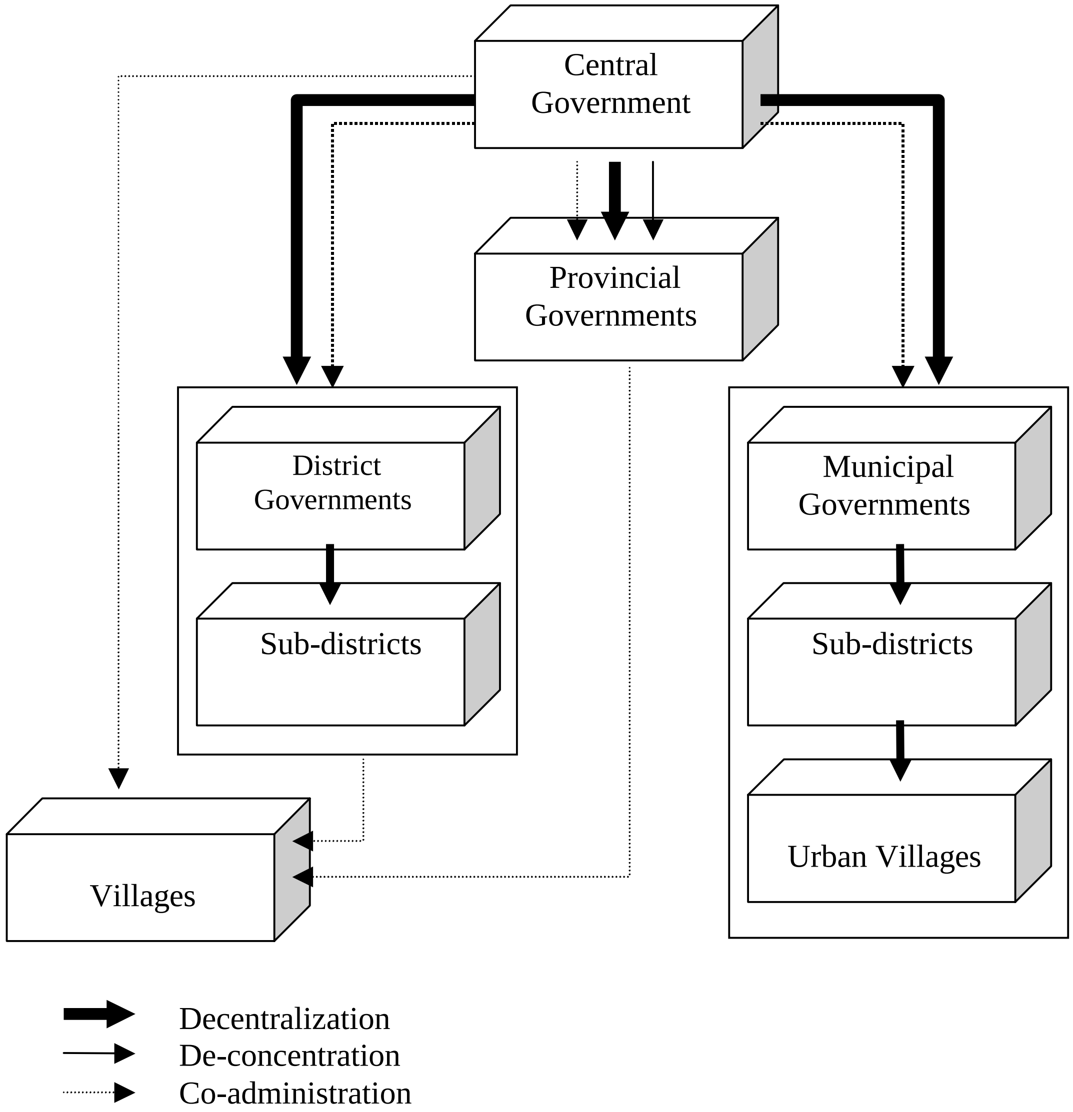
In line with the expansion of local government authority and functions prescribed by Law No. 22/1999, Law No. 25/1999 sets a new inter-governmental fiscal framework by drastically changing the disbursement arrangement. Much larger transfers in the form of ***Dana Perimbangan*** **(Fiscal Balance Fund)** replaced the Subsidy for Autonomous Regions (SDO) and the Grants to Local Governments (*Inpres Kabupaten/Kota* and *Inpres Desa*) programs. Equalization Fund consists of three parts:

a. **Revenue Sharing:** The intended purpose of this component is to overcome or reduce vertical imbalance and inequality. This component was introduced in response to the demands from the resource-rich regions for a fair share of revenues extracted from their regions.

b. **General Allocation Fund (DAU):** This is a block grant intended to equalize the fiscal capacities of regional governments to finance their expenditure. The law specifies that DAU should make up at least 25% of the central government's revenue and must be distributed among local governments by a formula which takes into account regional needs and potential capacity. In the 2001 fiscal year, DAU accounted for around 74% of the equalization fund.

c. **Special Allocation Fund (DAK):** This is an earmark grant that is developed to finance special needs that cannot be determined by the formula used for DAU allocations or categorized as national priorities and commitments.

Figure 1. Basic Structure of Government Authorities According to Law No. 22/1999



3.1.3.2 Governance in Regional Autonomy Era

Efforts to reform various market distortions that proliferated in the 1980s and 1990s gained momentum between 1998 and 2000, in particular after the fall of the New Order government. This is understandable as many of the distortions were created by or related to the then ruling family or their cronies. These reforms have had some success, resulting in improved prices received by farmers. However, despite the implementation of decentralization and regional autonomy policies – which granted substantial power to the district governments – starting in 2001 the trend seems to have reversed. Various forms of market distortions, which were previously dismantled, now have been revived. The only difference is that now most of the distortions have been created by the district governments rather than the central government as was the case in the past. This section discusses some examples of the new forms of bad governance which have had adverse consequences on the poor.

1). Regional Autonomy and Regional Taxes

Public discourse regarding regional autonomy has always been linked to the financial capability of the regions, because it is considered to be the main factor that determines the success of regional autonomy. The fact that local revenue (PAD) which is relatively small in comparison to the real financial needs of local governments stated in their budgets (APBD) has led into a biased outlook toward regional autonomy policy. Most local government officials thought that the implementation of regional autonomy would mean that the local government's ability to raise revenue would be increased significantly. Some officials even believed that with regional autonomy, all financial needs would be funded through a region's own financial resources. As a consequence, one of the major agendas of local governments in the era of regional autonomy is the creation of new local taxes to raise their local revenues as much as possible (see Table 3).

Table 3. The Number of New Local Tax Laws Passed after Decentralization in Sample Areas

District/City	New local tax laws*)
Minahasa	35
Bolaang Mongondow	21
Gorontalo	37
Karo	2
Simalungun	32
Deli Serdang	28

*) Note: The table shows the number of new local tax laws passed between 2000 and mid 2001. There is a possibility the number may have already increased or will increase in the future. For instance, the District of Gorontalo had a target to draft 75 local tax laws in 2001.
Source: Usman *et al.* 2001a, 2001b, 2002.

Based on the above conditions, many people perceive that local governments have deliberately used the momentum of regional autonomy to increase their local financial base through any means. In this regard, local taxation policy is often solely aimed to raise as much local revenue as possible and fails to take into account the possible distortion resulting from these local taxes. Politically, an increase in local revenue is very important for the regions. However, if regions use regional autonomy as an "excuse" for implementing such policies, what more through "taxing the people as much as possible," then people are more likely to oppose the implementation of regional autonomy. The case of a mass strike by public transport drivers in Padang in response to an increase in the Motorized Vehicles' Tax (PKB) is an example of the people's resistance against such policies. Since the public's critical attitudes toward the government are at an all-time high, they are more likely to reject (local) government policies that would increase their financial burden. As a result, local government efforts to increase income through increasing local taxes could become a catalyst of social unrest.

To some extent, this phenomenon can be attributed to local parliaments (DPRD). DPRD have a vested interest in the increase of local taxes, since an increase in local taxes means that the local budget allocation for DPRD expenses would also increase. This means that the salaries received and operational expenses incurred by DPRD members would increase as well.

2). Regional Autonomy and the Protection of the Local Economy

Besides the reappearance of various local taxes, the implementation of decentralization has also brought back a tendency for regions to implement protectionist economic regimes. The case of large pharmacy in North Sulawesi is one example of this trend. With the excuse to protect local entrepreneurs, the Governor of North Sulawest issued a Governor's Decree on the Establishment of Large Pharmacies in North Sulawesi (effective as of September 23, 2000), which states that:

a. Licenses for large pharmacies in North Sulawesi are only to be issued to large businesses with a central office, which own or control assets, and whose owners reside in North Sulawesi. Pharmacy entrepreneurs residing outside of North Sulawesi, even though they may own and control assets within the province, are to be accorded the status of Large Pharmacy Branches or Representatives.

b. Large local pharmacies are to be given priority in partnering with the government to acquire pharmacies with a value of up to Rp 4 billion.

c. The management of the North Sulawesi Association of Large Indonesian Pharmacies is to be comprised of members who originate from within the region.

d. Apart from the top managers, local residents are to be prioritized in the staffing of the Large Pharmacy Branches.

Based on this decree, it could be concluded that it has become very difficult for newcomers investing in large pharmacies to enter the North Sumatra pharmacy market. This example suggests that there is some justification for emerging concerns that decentralization has been plagued with 'native sons' sentiment, which discriminates against people from outside a given region.

Besides the above case, other local regulations that serve as non-tariff barriers in other economic sectors have also been implemented. One is the Governor of North Sulawesi's Decree No 27/2001, dated March 22, 2001, on the formation of a study and price-control team for coconuts, copra and their byproducts in North Sulawesi. It appears that the provincial government was forced into pursuing this policy after coconut farmers associated with the Coconut Farmers Association of North Sulawesi (Apeksu) staged a demonstration against the provincial government on March 12, 2001. The same also occurred in Gorontalo, where the owners of local fisheries proposed a protectionist policy to the government. With the excuse that competition in the fisheries industry in Gorontalo had become very fierce, they sent a proposal to the North Sulawesi Fisheries

Department[7] to tighten the requirements for new companies that wish to enter the market (in the form of a negative list or outright protection). For instance, if a new company wants to enter the market, the fishing grounds allocated should be much further away.

c. The Costs of Transporting Goods from North Sumatra to Jakarta[8]

The abundant agricultural commodities from the Karo district in North Sumatra are mostly perishable goods. Therefore, it is crucial to secure smooth and rapid distribution to maintain both the quality and the selling price at the consumer level. Consequently, farmers and traders make every necessary effort to expedite the delivery of these goods to the buyers, even if they have to pay various taxes and levies *en route*. These additional charges increase distribution costs and eventually lead to a higher price at the consumer level. Levies are determined by weighing trucks at various weighing stations along the routes.

Table 4 illustrates the number of weighbridges and the amount paid by a truck driver at each location while traveling from Kabajahe in the Karo district to Jakarta. A truck driver who regularly carries oranges from Karo to Jakarta reports that there are at least 16 weighing stations and several other checkpoints that have to be passed along the route. The table shows the number and amount of "fines" paid by truck drivers –both those who comply and those who do not comply with the weight limit at each station.

[7] The authority to regulate the fisheries industry has now fallen to the province of Gorontalo.

[8] Summarized from Usman *et al.* (2001b).

Table 4. The Costs Incurred by Truck Drivers at Weighing Stations between North Sumatra and Jakarta

Province	Number of Stations	Fines	Remarks
1. North Sumatra	4	Rp5,000 – 10,000 for each tonne of excess weight.	Per tonne of excess weight
2. Riau	2	Rp60,000, paid by all, irrespective of weight	Fines have to be paid by both complying and non-complying vehicles, in addition to road levies: -Rp2,500 (6-tonne trucks) -Rp3,500 (8-tonne trucks)
3 .Jambi	2	Rp60,000, paid by all trucks.	Plus additional road levies: -Rp2,500 (6-tonne trucks) -Rp3,500 (8-tonne trucks)
4. South Sumatra	5	A fine of Rp15,000 for each tonne of excess weight.	In addition to the possibility of being fine, there are also road levies: -Rp2,500 (6-tonne trucks) -Rp3,500 (8-tonne trucks)
5. Lampung	3	A fine of Rp15,000 for each tonne of excess weight	In addition to the possibility of being fine, there are also road levies: -Rp2,500 (6-tonne trucks) -Rp3,500 (8-tonne trucks)

Based on this table, it is estimated that the total amount in levies (official and non-official) paid to transport oranges from Kabanjahe to Jakarta ranges from Rp268,500 to Rp1,008,500. Paying the lowest amount would only be possible if the truck complies with its permitted capacity. Nevertheless, even when trucks comply with the regulations drivers frequently have to pay levies. As a result it is common for truck drivers to prefer to carry loads that exceed a truck's legal capacity. The estimated value of the load of an 8-tonne truck transporting 120 baskets of oranges (65 kg per basket), given that the farm-gate price is Rp1,800 for grade A, B, C, and D oranges, is Rp14,400,000. Hence, taxes and levies make up between 2% and 7% of the total value of the goods transported.

4) Heavy Taxes on Plantation Commodities in North Sumatra[9]

Because local governments (provincial and district/city) do not receive revenue directly from the plantation sector, the commodities produced in this industry have been the target of various levies imposed by local governments. Levies imposed on the plantation industry start at the production level and go through to distribution and marketing of products. As an example, according to the latest inventory released by the management of the Association of Indonesian Rubber Producers (Gapkindo) in North Sumatra, there are at least nine kinds of official levies imposed on rubber commodities (see Table 5).

[9] Summarized from Usman *et al.* (2001a).

Table 5. Types of Official Levies on Rubber Commodities in North Sumatra

Activities	Types of levies	Tariff and Location	Remarks/Problems
Production support	1. Land and Building Tax	Rp60,000-130,000 /hectare	Land valuation too high, annual increases
	2. Street lighting Tax	10% of total electricity used, in certain *kabupaten/kota*	Tax base is too high. Also applies to electricity generators installed on the premises.
	3. Ground and Surface Water Levies	Rp2-5.4 million/month	
	4. Disturbance/Noise Levy (*Hinder Ordonantie*)	Rp4.2 million/year in Deli Serdang Rp1.75 million/extension	
Processing	5. Charges for taking Effluent Samples	Rp450,000 /sample, limit of 3 samples/month in South Tapanuli	The official charge from the Department of Health Laboratory is only Rp44,000 /sample.
Marketing	6. Market Levies	Rp6/kg in Asahan Rp20/kg in Langkat Rp3/kg in Deli Serdang	
	7. Compulsory Contributions from Plantation Estates	Rp10/kg in Asahan	
Others	8. Levies on the logging or use of rubber trees or rubber timber	Rp300/m^3 in Deli Serdang	
	9. Compulsory Third Party Contributions	Voluntary at the provincial level	
	10. Levies from the Department of Manpower		

5) Organized Thugs in West Java[10]

Up until now, the government has been unable to resolve the problem of illegal fees imposed by both thugs and corrupt police officers. Results from SMERU's research showed that in Jonggol and Purwakarta thuggery is very common in the streets, with each truck being required to pay around Rp300,000 per year to thugs. These thugs are organized in groups that control specific areas. As evidence that a passing truck has paid the "fees", a sticker that states the code name of a group's leader is usually stuck on the truck. Trucks are also targets for illegal fees when they enter the central market in Jakarta. Fees at terminals also tend to be higher than what is officially stated due to the excuse of having to cover the salaries of part time and volunteer workers. The rampant thuggery and illegal fees that are illicitly supported by district governments and the police which demonstrates that the legal system is still weak and that there is a lack of protection, especially for the poor.

[10] Summarized from Usman *et al.* (2002).

6) Bureaucrats' Interests Above those of the Poor in Budget Allocation in West Nusa Tenggara[11]

Conceptually, the district government in West Lombok emphasizes increasing the welfare of the poor through public policy. This is done by strengthening human capital through investment in health and education as well as improving the economic conditions of the poor through "the people's economy", which correlates with the purpose of regional autonomy. However, in practice this noble mission has not been carried out as planned, and this can be seen in the budget allocation that prioritizes the interests of bureaucrats.

In Fiscal Year (FY) 2002, the West Lombok district government allocated Rp2.6 billion for official car purchases and Rp780 million for official motorbikes purchases. In addition, there was a huge increase in the allocation for the district parliament (DPRD) from Rp2 billion (equal to Rp3.8 million per month for each DPRD member) in FY 2000 to Rp3.4 billion (equal to Rp6.4 million per month for each DPRD member) in FY 2002.

At the same time, the budget allocation for general public interests that were supposed to be the main priority of the district government tend to have been ignored, for instance:

a. The allocation for village development funds which was Rp10 million in the 2000 budget was excluded from the 2001 budget, with the excuse that the government "forgot" to include it. In the 2002 budget year, money was allocated to village development funds, but up until April villages had not received the funds.

b. In 2002, the West Lombok district allocated 2.5% of its budget to the health sector, which is much smaller than the amount set in the agreement made between the Health Department and all the district heads and mayors in Indonesia in August, 2001. This agreement states that the district and municipal governments must allocate at least 15% of their budget to the health sector. According to health experts, the budget allocated to the health sector by the district and municipal governments has sharply decreased from Rp4-5 billion per year to only Rp2-3 billion per year. This decrease has had a direct impact on the services provided by community healthcare centers (*puskesmas*):

    - Distribution of medicine to *puskesmas* takes longer now than it did before regional autonomy, and the quantity of medicines shipped is more limited.

    - Each *puskesmas* receives around Rp15 million in operational funds. Previously, each *puskesmas* received Rp50 million in operational funds, which included program assistance from the central government.

    - Most of the districts in West Nusa Tenggara are classified as areas prone to malaria and dengue fever endemics. Thus, it is ironic that the district

[11] Summarized from Mawardi *et al.* (2002).

government budgets for the health sector do not allocate additional funds to handle these problems.

7). Regional Autonomy and Local Parliaments (DPRD)

In general, regional autonomy regulates the relationship between the government and the people, not just the relations between the different levels of government. In the end, people have the right to manage their own system of government according to their ways, laws, rules, and customs. Constitutionally, this is achieved through representatives in the local parliament (DPRD) that (presently) are mostly elected through political parties. However, most parties have not had the time to develop a good recruitment system. As a result, many consider the party representatives that currently hold positions in DPRD as inadequate. Even DPRD members' own perception on their authority tends to be narrow-minded and static. They feel that their functions are only to "legitimize" policies made by the executive. In other ways, some of them are still not serious about performing their duties and ignore discipline, for instance, they come late to meetings or rarely attend them at all. In some cases, DPRD decision-making processes were delayed because the number of members present was below the required quorum.

Given the above examples, it is difficult to expect DPRD to take the initiative in drafting policies that benefit the public. It is also difficult for them to fully position themselves as a group that will fight for the interests of the people they are supposed to represent. Many local laws on taxation that were approved by the DPRD indicate that the DPRD's capacity is only at the "how to tax the people" stage, not the "how to improve the people's welfare" stage. Some have also stated that the poor qualities and capabilities of DPRD members are because they were first "elected" as DPRD members not because they were really qualified, but because they were "elected with favors."

Because of these factors, many have said that current DPRD members care more about their own interests than those of the people they represent. One aspect that was scrutinized closely was regarding the increase in the DPRD's regular expenditure, especially related to the "honorarium payments" to members.

Regional autonomy has given the legislature a role more superior than that of the executive. As a matter of fact, the executive is often overshadowed by the legislature. This scenario results in the legislature having a stronger bargaining position. However, a strong legislature does not mean that the people it represents are also strong. The use of legislative powers is currently only being used to promote the legislature's own interests, not to empower the people they represent. One example that would suggest this to be true is how the DPRD in many regions is racing to increase their own salaries (Table 6).

Table 6. Changes in DPRD Members' Salaries Before and After Regional Autonomy: Observations from Selected Regions

Region	Salary Changes (%)
1. North Sumatra Province	300
2. District of Simalungun	250
3. West Sumatra Province	460
4. District of Solok	250
5. District of West Lombok	330
6. Lampung Province	286
7. City of Bandar Lampung	265

Source: Mawardi *et al.* 2002; Toyamah *et al.* 2002; Usman *et al.* 2000; Usman *et al.* 2001b

In relation to the executive, there was initially a strong impression that DPRD members tended to act arrogantly and brashly. Their control over the executive was also considered heavy-handed or excessive. However, this is acceptable to many people, because the DPRD are still in a transitional and readjustment period. Most DPRD members are people from varying backgrounds who are relatively new to politics.

The early relationship between DPRD and the executive regarding the implementation of monitoring mechanisms in the regions was initially positive. Gradually relations between DPRD and local governments have "significantly improved." Unfortunately, these improvements have a more negative connotation than positive and the final result is collective corruption by the executive and legislature alike.

3.2. The Impact of Governance on Poverty Reduction: A Quantitative Analysis

In general, it could be stated that regional autonomy policy, if properly implemented could become the catalyst for the creation of good governance that is based on democratic principles and participation. Specifically, it is the creation of governance practices that promotes openness, public accountability, rule of law, as well as the elimination of a burdensome bureaucracy and corruption. The question now is whether good governance has any relation to the successful attainment of development indicators in general, and specifically, indicators regarding the dimensions of poverty. Through his empirical studies in several countries, Turkewitz (2002) concluded that there is a strong relationship between the characteristics of a government regime and the attainment of such indicators. The main findings of this study are:

a. The more effective a given government, the lower the infant mortality rate in that country.

b. The lower the corruption rate within a government's bureaucracy, the higher the adult literacy rate in that country.

c. The better the system of law and order in a given country, the lower the infant mortality rate in that country.

d. The fewer regulations created by the government, the higher the income per capita level in that country.

In the case of Indonesia, to our knowledge, there has never been a study that specifically analyzes the relationship between aspects that are considered part of good governance practices and the above indicators. In light of this, as a preliminary study, using the results of the KPPOD study (2002) and LPEM-UI (2002) study mentioned in our literature review, we conducted a study on the relationship between culture of bureaucracy and business permit fees (as proxy for good governance practices) and reductions in the number of poor residents (based on BPS data, 1999-2002). The two analyses we conducted in this study were bivariate analysis and multivariate analysis.

3.2.1. Bivariate Analysis

Bivariate analysis (without influence from other variables) was conducted to determine the relationship between the decrease in the number of poor people between 1999 and 2002 at district/city level and one aspect of good governance as used by KPPOD (bureaucratic culture) and LPEM-UI (business permit fees). The results are shown in Tables 7 and 8.

Table 7 shows that none of the districts in the sample have a bureaucratic culture which is considered disruptive to the business climate. Most of the districts (61 out of 87) have a bureaucratic culture which is considered conducive, while the rest are almost evenly divided between those which are less conducive and very conducive.

Table 7. District Level Poverty Reduction Between 1999 and 2002 by KPPOD's Index of Bureaucratic Culture

Index of Bureaucratic Culture	Poverty Reduction (%)		Number of Districts
	Mean	Std. Dev.	
Disruptive	-	-	0
Less conducive	-3.41	31.53	12
Conducive	-6.95	60.66	61
Very conducive	-15.06	56.41	14
Total	-7.76	56.45	87

On average, in 2002 the districts in the KPPOD sample had a poverty rate which was proportionally around 7.8% lower than the poverty rate in 1999. What is interesting is that there is a clear indication that good governance affects districts' performance on poverty reduction. The districts which have a less conducive bureaucratic culture reduced poverty by 3.4% on average, while those districts with a conducive bureaucratic culture reduced poverty by around 7%, double the rate of the former group. The districts with a very conducive bureaucratic culture experienced a further doubling the poverty reduction rate. These districts on average experienced a 15% reduction in their poverty rates during the same period. While the above numbers are very interesting, their existence should be interpreted carefully, because there is a large standard deviation in the data.[12]

Using the results of the LPEM-UI study on business permit fees,[13] Table 8 shows the relationship between business permit fees and the proportion of poverty reduction in the same time period. On average, the 60 districts/cities in the sample had a 2002 poverty rate that was proportionally around 7.2% lower than the 1999 poverty rate. This analysis shows that the 15 districts that belong in the quartile I group (lowest governance index) have an average rate of poverty reduction of 2.7%. As expected, for the districts/cities that belong in the quartile II and III, the average rate of poverty reduction achieved a significant improvement, reaching 5.8% and 13.9% respectively. The unexpected finding occurred in districts/cities in quartile IV (highest governance index), which only achieved a poverty reduction rate of 6.3%. Similar to the KKPOD sample, the poverty reduction rate of poor residents above is accompanied by large standard deviations that make them statistically insignificant.

Table 8. District Level Poverty Reduction Between 1999 and 2002 by LPEM Index of Government

Quartile of Index of Governance	Poverty Reduction (%)		Number of Districts
	Mean	Std. Dev.	
I (lowest index)	-2.72	66.96	15
II	-5.94	71.53	15
III	-13.88	46.78	15
IV (highest index)	-6.34	40.94	15
Total	-7.22	56.68	60

3.2.2. Multivariate Analysis

To strengthen the results of the bivariate analysis above, a multivariate approach was exercised to control the effects of other variables. In the KPPOD report, in addition to the various indices used to rank districts, they also published district level data on Gross Domestic Regional Product (GDRP), routine and development budget, local revenues, and total population. Based on these data, Table 9 shows the regression results of change in the poverty rate on two dummy variables of culture of bureaucracy. While the results of this regression places the coefficients of all variables

[12] Statistically, the large numbers of reduction of poor residents in each district/city category and their inter-district/city differences are not significant.

[13] Because the business permits fees index used continuous numbers from 0 to 100, the districts/cities in the sample are divided into 4 quartiles.

within the expected signs, only the coefficient of the dummy variable on conducive bureaucratic culture is statistically significant. It should be noted, however, that the estimation has a relatively low coefficient of determination (10%) and F-statistic (1.46). This probably has to do with the presence of noise in the data, and the relatively small number of observations.

Table 9. Regression Results of District Level Change in Poverty on Governance Indicators

Independent Variable	Coefficient	Standard Error
Dummy of conducive bureaucratic culture	-0.0652	0.0273
Dummy of very conducive bureaucratic culture	-0.0444	0.0347
Log of GDRP per capita	-0.0128	0.0139
Log of routine budget per capita	0.0049	0.0251
Log of development budget per capita	0.0176	0.0173
Log of local revenue per capita	0.0075	0.0089
Constant	-0.3272	0.2163
Number of observations	87	
R-squared	0.0986	
F-test	1.46	

Apart from the statistical problems above, the regression results confirm the indications from bivariate analysis that the form of governance affects the rate of reduction in poverty achieved within the region. Districts/cities that have conducive bureaucratic culture have a reduction in poverty rates which is 6.5% higher than that achieve by districts/cities with less conducive bureaucratic culture. Even with a smaller coefficient value (compared with districts/cities with conducive bureaucratic culture) which is not statistically significant, districts/cities with very conducive bureaucratic culture also tend to have a higher rate of poverty reduction than districts with less conducive bureaucratic culture.

The coefficients of the other variables indicate that –with a note that these coefficients are not statistically significant– economic growth tends to enhance poverty reduction, but government budgets tend to stifle it. The coefficient of the GDRP per capita has a negative sign, which indicates that districts with a higher GDRP per capita tend to experience faster poverty reduction. This also implies that districts which strive for higher economic growth will achieve faster reductions in poverty. On the other hand, the coefficients of government budgets (both routine and development) and local revenue variables have positive signs. These indicate that taxes and government spending are counterproductive to the efforts to reduce poverty, or at least they do not contribute to poverty reduction.

Even though still indicative, the findings of this study are positively paralleled with Turkewitz's (2002) findings. In relation to this, two main points could be made. First, reduction in the number of poor residents could be made faster if governments uphold good governance practices. Second, good governance practices have to be supported with market friendly economic policies to generate high economic growth.

Related to these points, the implementation of regional autonomy actually has a positive potential to improve the conduciveness of poverty reduction policy. In addition to the reasons mentioned above, several factors that could ensure that regional autonomy is conducive with poverty reduction policies are:[14]

First, the DAU funds are distributed to the regions in forms of *block grants*. Thus, local governments have a lot of flexibility in using this fund based on their interests and priorities, including poverty reduction. In other words, regions can now act faster and more pro-actively in executing poverty reduction policies without waiting for instructions from the higher levels of government (national and provincial governments). This is important to note because the DAU determination formula consists of a variable on the number of poor people within each region. This means that the poverty reduction agenda should become the policy agenda of every regional government.

Second, investment and business permits could generally be obtained in the regions. This would make the processing time much easier and less expensive. If the business climate in the regions improves, investors will be more likely to invest in the regions. This will generate additional employment, so that those who have not improved their economic conditions due to the impacts of the economic crisis would have alternative income sources to improve their livelihood. A few districts/cities have put their business permit application processing under one roof, which is the first step towards a business permit policy that is fast, transparent, and cheap.

Third, regions rich in natural resources also receive a greater allocation of central government funds. With funds from these sources, these regions would have an easier time to make poverty reduction priorities. For instance, the District of Kutai has allocated billions of rupiah to each village in the district. If these funds are used to promote pro-poor activities, there is greater hope that the proportion of poor residents living in this district will decrease dramatically.

Fourth, locality aspects in each public policy decision force local governments to become more transparent and accountable in practicing good governance because regions no longer act as the operational executor of central government policies, thus each local government's activities can be evaluated easily by their own people. Now regions can not make excuses or seek protection from the higher levels of government.

[14] Besides positive potential, the decentralization also has negative potential in relation to poverty reduction policy. This could happen if local governments create their own centralistic policy to promote elite interests.

IV. CONCLUSION AND POLICY RECOMMENDATIONS

It is public knowledge that bad governance is a serious problem in Indonesia. For a long time the country has ranked highly on the list of the most corrupt countries in the world. Prior to the onset of the economic crisis in mid 1997, the problem of governance was apparent, but it was mostly ignored. The expanding economy due to the high economic growth was enough for most people to compensate losses and inefficiencies due to bad governance. The advent of the economic crisis, however, has highlighted the seriousness of the problem. Some initiatives to create good clean governance in the country have been put forward and tested. These efforts, however, have so far proved difficult and elusive.

In relation to these points, poor people as a group who are in the weakest position and who are most powerless in influencing decisions that affect their lives, become the group most vulnerable to the impact of bad governance. For example, when during the New Order era the government decided to create various marketing boards for agricultural commodities which would only benefit select government cronies to the detriment of the farmers, the poor farmers had no choice but to accept this. Occasional protests fell on deaf ears or, even worse, were met with suppression by government apparatus.

There were some successes in reform between 1998 and 2000, made possible in particular by the fall of the New Order government. However, these were short-lived. In 2001, when decentralization and regional autonomy policy began to be implemented, various forms of market distortions which are detrimental to the poor were reincarnated. The only difference this time is that they were mostly created by the regional governments, rather than by the central government as they were in the past. The negative effects on the poor, however, remain the same.

By assembling scattered anecdotal evidence on how current and past practices of bad governance in Indonesia have hurt the poor, this study shows that the adverse impact of bad governance on the poor is real, systematically harms many people, and undermines efforts to reduce poverty in the country. This quantitative study on the impact bad governance has on poverty reduction –using both bivariate and multivariate analyses– shows some indications that indeed regions that practice good governance experience faster rates of poverty reduction and *vice versa*. However, further studies are needed so that the relationship between good governance and poverty, in which each variable is multidimensional in nature, can be understood more clearly, comprehensively and validly.

In theory, decentralization can provide the impetus for poverty reduction and good governance because with decentralization, elements of civil society have the opportunity to monitor the way the government behaves more closely and also to bring the concerns and suggestions of the poor closer to the government. However, if regional autonomy policy is only to be exploited as a means of increasing the burden on the community without the compensation of better public services, the general public will have ample reason to oppose it. Signs of such ‘opposition’ towards local government policy are becoming more frequent. If this continues to occur, decentralization may present a serious threat to the economic and social development at the national and regional level.

Therefore, in terms of policy implication, clear guidelines need to be established at the national level to ensure appropriate regulation of markets that is not distortive and requiring the implementation of good governance practices by local governments. This should be accompanied by incentives (disincentives) and systematic reforms which will encourage (discourage) government apparatus with reward (credible threat), both at the local and central level, in practicing good (bad) governance. At the same time, civil society needs to establish a consensus and build a coalition to combat bad governance, through for example media campaigns, class action, and evidence-based publications.

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APPENDIX

Table A1. Profit Margin of Trade Intermediaries

No.	Commodity	District, Province	Before Deregulation	After Deregulation	Changes
A. Food and Horticultural Plants					
1.	Red Onions	Bima, West Nusa Tenggara	2.3%	13.2%	10.9%
2.	Potatoes	Kerinci, Jambi – Padang	14.0%	11.0%	-3.0%
		Gowa, South Sulawesi – Blkppan	20.6%	6.7%	-13.9%
3.	Oranges	Luwu, South Sulawesi – Ujung Pandang	11.5%	5.4%	-6.1%
B. Plantation and Forestry Plants					
4.	Tea leaves	Sukabumi, West Java	18.5%	12.0%	-6.5%
5.	Cocoa beans	Polmas, South Sulawesi	7.9%	1.8%	-6.1%
		Bone, South Sulawesi	6.4%	5.5%	-0.9%
6.	Coffee [arabica]	Polmas, South Sulawesi	5.6%	3.1%	-2.5%
	[robusta]	Temanggung, Central Java	3.0%	1.1%	-1.9%
		Karo, North Sumatra	18.4%	13.6%	-4.8%
		Malang, East Java	10.0%	4.8%	-5.2%
		Kerinci, Jambi	2.6%	1.5%	-1.1%
7.	Copra	Minahasa, North Sulawesi	32.9%	14.3%	-18.6%
8.	Nuts	Minahasa, North Sulawesi	27.5%	8.5%	-19.0%
9.	Cloves	Minahasa, North Sulawesi	12.5%	0.6%	-11.9%
10.	*Rajang* Tobacco	Temanggung, Central Java	7.4%	-34.3%	-41.7%
		Sampang, East Java	9.2%	3.9%	-5.3%
11.	Rubber/ Scrap	Bengkalis, Riau	18.1%	13.2%	-5.0%
	RSS	Central Hulu Sungai, South Kalimantan	7.0%	5.5%	-1.5%
	Scrap	Central Hulu Sungai, South Kalimantan	11.6%	3.1%	-8.5%
	"	Muba, South Sulawesi	30.0%	11.0%	-19.0%
12.	Cashew nuts	Sampang, East Java	5.2%	0.3%	-4.9%
13.	Cinnamon	Kerinci, Jambi	1.0%	2.0%	1.0%
14.	Candlenuts	Bima, West Nusa Tenggara: - Mataram	7.6%	7.9%	0.3%
		- Banjarmasin	26.2%	16.2%	-10.0%
15.	Rattan	Luwu, South Sulawesi	6.0%	5.3%	-0.7%
C. Fisheries					
16.	Fish	Gunung Kidul, Yogyakarta	3.1%	13.5%	10.4%
		Gorontalo, North Sulawesi	29.3%	12.8%	-16.5%
17.	Shrimp	Bone, South Sulawesi	11.1%	10.8%	-0.3%
D. Animal Husbandry					
18.	Dairy Farming	Sukabumi, West Java	28.8%	19.5%	-9.3%
19.	Cattle	Bone, South Sulawesi	12.3%	8.9%	-3.4%
		Gorontalo, South Sulawesi	31.0%	10.9%	-20.1%
		Bima, West Nusa Tenggara	11.5%	7.3%	-4.2%
		East Lombok, West Nusa Tenggara	3.8%	2.2%	-1.6%
		Sampang, East Java	12.0%	10.6%	-1.4%
20.	Duck Eggs	Central Hulu Sungai, South Sulawesi	21.2%	11.7%	-9.5%
	Average				**-6.7%**
	Median				**-4.9%**

Source: SMERU 1999

Table A2. Proportional Changes in Buying Prices Accepted by Farmers/Producers, Before and After Deregulation*)

Proportional Price Changes (PH)	Types of Farm Commodity	Sample Proportion
PH ≥ 20%	1. Nuts (Minahasa)	11%
	2. Shredded Tobacco (Temanggung)	
	3. Fish (Gorontalo)	
	4. Cattle (Gorontalo)	
10%≤ PH <20%	1. Red onions (Bima)	22%
	2. Potatoes (Gowa)	
	3. Copra (Minahasa)	
	4. Cloves (Minahasa)	
	5. Rubber/Scrap (Muba)	
	6. Candlenuts (Bima, destination Banjarmasin)	
	7. Rattan (Luwu)	
	8. Cow's milk (Sukabumi)	
0%< PH <10%	1. Potatoes (Kerinci)	58%
	2. Oranges (Luwu)	
	3. Tea leaves (Sukabumi)	
	4. Cocoa beans (Polmas)	
	5. Coffee (all regions, 5 cases)	
	6. Shredded Tobacco (Sampang)	
	7. Rubber /RSS/Scrap (Bengkalis & HST, 3 cases)	
	8. Cashew nuts (Sampang)	
	9. Candlenuts (Bima, destination Mataram)	
	10. Shrimp (Bone)	
	11. Cattle (Bone, Bima, East Lombok,Sampang)	
	12. Duck Eggs (HST-South Kalimnatan)	
	(21 cases)	
PH < 0%	1. Cacao beans (Bone)	8%
(negative)	2. Cinnamon (Kerinci)	
	3. Fish (Gunung Kidul)	
	Total	100%

Note : *) Highest value: 31,9%; Lowest value: -5,7%, Average: 8,8%; Median: 6,5%
Source: SMERU 1999