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Does decentralization foster a good trade and investment climate? Early lessons from Indonesian decentralization

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Good public governance has emerged as a key determinant of the economic performance of countries, in part because the quality of public governance influences both local and foreign investment decisions.[1] As table 1 shows, many countries in the Asia and Pacific region have made improvements in their government effectiveness between 2004 and 2007.

Table 1. Government Effectiveness Index

Country	2007	2006	2005	2004
Brunei Darussalam	78	77	72	59
Cambodia	21	16	18	17
China	61	58	56	57
Hong Kong, China	94	94	93	92
Indonesia	42	39	37	39
Japan	89	90	85	85
Republic of Korea	86	85	79	79
Malaysia	83	81	81	80
Myanmar	2	3	2	3
Papua New Guinea	25	22	15	24
The Philippines	56	54	55	50
Singapore	100	100	100	99
Thailand	62	64	66	66
Viet Nam	41	42	47	39

Source: Kaufmann and others, 2008.
Note: Higher numbers indicate better government effectiveness.

The progress made by many Asian countries has been achieved through the adoption and implementation of reforms and initiatives specifically designed to improve public governance. A common feature of many of these programmes is the devolution of responsibility and accountability from central government to lower government levels. This policy brief reviews the experience of Indonesia, and highlights the importance of coordination between all levels of governments for fostering trade and investment.

Indonesia's decentralization

Indonesia's administrative organization has experienced dramatic changes as a result of its national decentralization programme initiated in 2001. It abandoned its top-down centralized economic structure in favour of a bottom-up structure granting autonomy at the subnational levels (provincial, district and municipal).[2] These changes also affected the trade and investment environment.

Contrary to widely-held expectations, recent studies show that the trade and investment climate in Indonesia did not significantly improve as a result of decentralization. Indeed, studies conducted by the Committee Monitoring the Implementation of Regional Autonomy (KPPOD), USAID and The Asia Foundation (2003) and the Centre for Economic and Social Studies (2002), revealed that most regulations issued by local governments were levy-related regulations that harmed the investment climate and price competitiveness of local products.[3]

The example of Indonesia shows that subnational policies affecting trade and investment need to be examined carefully to determine their impact on national and provincial competitiveness. This brief reports on some of the policies at the subnational levels in Indonesia that have improved the trade and investment environment.

Decentralization does not necessarily improve the trade and investment climate at the provincial/ district levels

The trade and investment climate at the district level is affected by numerous factors. One of the indicators used to measure it is the Economic Governance Index (EGI), which measures local government performance across nine sub-indicators.[4] Table 2 compares the EGI score for the top 10 districts and bottom 10 districts in Indonesia. The average EGI score for the top 10 districts is one and a half times higher than the average of the 10 bottom ones.

Most of the top 10 districts are located on Java Island, specifically in East Java, where local government at the district/municipality levels and the provincial level has good coordination. Indeed, 33 mayors of districts/municipalities in East Java adopted the Improvement of Investment and Trade Climate Declaration in 2004, in which they commit to improving the investment and trade climate by reducing barriers between and within municipalities.

[1] United Nations, 2007; World Bank and Asian Development Bank, 2005.

[2] In 2008, Indonesia had 33 provinces and 465 districts/municipalities.

[3] See World Bank and Asian Development Bank, 2005; Kuncoro and Rahajeng, 2005; and Usman, 2001.

[4] KPPOD, USAID and The Asia Foundation, 2007. The nine sub-indicators are: land access and security of tenure; business licensing; local government and business interaction; business development programme; capacity and integrity of the mayor; local infrastructure; local taxes, user charges and other transaction costs; security and conflict resolution; and local regulations.

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Table 2. Best and worst districts based on Economic Governance Index

Best Ten Districts		Worst Ten Districts	
District (Province)	**EGI Score**	**District (Province)**	**EGI Score**
Blitar (East Java)	76.0	Nias Selatan (North Sumatera)	41.41
Magetan (East Java)	75.4	Labuhan Batu (North Sumatera)	41.76
Pramubulih (South Sumatera)	74.7	Rokan Hilir (Riau)	45.10
Musi Banyu Asin (South Sumatera)	74.3	Nias (North Sumatera)	45.26
Jembrana (Bali)	73.7	Rokan Hulu (Riau)	47.69
Tuban (East Java)	73.4	Bima (NTB)	48.19
Lumajang (East Java)	72.0	Asahan (North Sumatera)	48.36
Madiun (East Java)	71.5	Karo (North Sumatera)	48.36
Probolinggo (East Java)	71.5	Medan (North Sumatera)	48.56
Gianyar (Bali)	71.3	Tanjung Balai (North Sumatera)	49.10
Average	**73.38**	**Average**	**46.38**

Source: KPPOD, USAID and The Asia Foundation, 2007.

In addition, East Java recently introduced an "investment clinic" that will help both existing and potential investors. Such initiatives show that good central-local coordination and inter-local collaboration can have a positive effect on the trade and investment climate. Data provided by the Indonesian National Statistic Bureau indicate that East Java experienced positive economic growth of approximately 6 per cent in 2007, compared with the previous year.

In contrast, more than two-thirds of the bottom 10 districts are located in North Sumatera, an area that up to now has provided no integrated services for investors (such as one-stop services in which all the requirements to start a business can be obtained from one office). Furthermore, investors face extensive procedural requirements and high fees. An illustrative case from 2006 is related to the rubber industry. According to the Association of Indonesian Rubber Companies, both foreign and local investors decided against investment due to the complicated regulations in the province of North Sumatera.[5]

Local regulations can hinder investment and trade

Most regulations issued by local governments are levy-related regulations that can harm the trade and investment climate. Five studies conducted by the Indonesian Social Monitoring and Early Response Unit (SMERU) (various dates) underline the dilemma of local governments with respect to levy-related regulations. In order to finance their budgets,[6] local governments need to raise revenues, and the easiest way for them to do so is by introducing new local levy-related regulations. On the other hand, in order to attract investments they require investment-friendly policies and fiscal incentives.

Levy-related regulations also may have sectoral impacts. For example, empirical evidence shows that a new levy-related regulation on agriculture would affect agricultural production through at least two channels.[7] First, local regulations increase the distribution costs and thus the absolute prices of agricultural products. As a result, agricultural competitiveness drops both vis-à-vis other economic activities and other countries. Second, the local regulations also have an adverse impact on the selling price for farmers/producers, as traders will lower the price paid to the farmer to compensate for the fees or taxes that the traders must pay under local regulations.

Overlap and potential conflict between national and local regulations

Local regulations alone cannot be expected to improve the investment climate. A key additional factor is the coherence between local and national regulations. Indeed, some investment projects are not implemented due to conflicting regulations between central and regional governments.

Currently, in Indonesia, there are examples of investments that have been approved by the local government but have not been approved at the higher levels of government, and vice versa. For example, in 2007, the Israeli corporation, Merhav Group, negotiated a project involving a US$ 700 million investment in the cultivation of *jatropha curcas* (a raw material used for bio-fuel) with the local government of Nusa Tenggara Timur. Despite the local government's consent, the central Government opposed the project, arguing that it would have an adverse impact on national foreign policy objectives and was therefore under the control of the national Government.[8]

Conversely, a recent Rp 40 trillion investment project in the palm oil industry in West Kalimantan was threatened by conflicts with local regulations.[9] Disagreements often stem from conflicting spatial plans due to the fact that the National Spatial Plan, the Provincial Spatial Plan and the District/City Spatial Plan (RTRW *Kabupaten/Kota*) each use different criteria.

The implementation of decentralization gives local government more authority to rule autonomously. As local government is closer to the constituents and should better understand local priorities, it is expected that locally-issued regulations should be more effective. However, regulatory authority should be clearly divided, preventing any overlap or conflict between regulations emanating from different levels that could harm the investment climate. Two previous studies conducted in the United States of America[10] and Australia[11] show that a clear distribution of authority contributes to a good investment climate.

To prevent conflicting regulations, it is advisable to establish coordinating agencies. An example of an investment coordinating agency can be found in the Philippines. Based on the Integrated Reorganization Plan (IRP) of 1972, the Government of the Philippines created a Regional

[5] Based on news available on the local government website: www.sumutprov.go.id/lengkap.php?id=763.

[6] The budget refers to the Local Government Budget that finances all local government activities. The effect of new local levy-related regulations could be positive if the extra budget were used to improve trade/investment facilities.

[7] Mayrowani, 2006.

[8] Pursuant to Government Regulation No. 38/2007, the Government is competent in the five areas of national security, monetary, "*yustisi*", religion and foreign policy.

[9] Based on news on the local government website: http://disbun.kalbar.go.id/v2/index2.php?option=com_content&do_pdf=1&id=100. Accessed on 20 November 2008.

[10] Krol and Svorny (1994) analyse state regulation in some important sectors in the United States.

[11] The Australian Chamber of Commerce and Industry (2005) analysis of the constraints on Australian business investment.

Development Council (RDC) in each administrative region. One of the functions of RDC is to coordinate the monitoring and evaluation of development projects undertaken by government agencies, local government units, state colleges and universities, government-owned and/or controlled corporations and special development authorities in the region.

Moreover, the Philippines also created an Investment Coordinating Committee whose function is to review the fiscal, monetary and balance of payments implications of major capital projects, and to make recommendations on the implementation of those projects on a regular basis.

Costly, lengthy and complicated procedures remain despite decentralization

The cost of starting a business in Indonesia is still high and varies widely across districts/municipalities. On average, an investor has to spend about 77.9 per cent of Indonesian Gross National Income (GNI) per capita to start a business in Indonesia. That cost is relatively expensive when compared with Indonesian neighbours, such as Malaysia or Thailand which require costs of 14.7 per cent and 4.9 per cent of GNI per capita, respectively.[12]

The high cost of starting a business is not the only problem. Procedures for obtaining a business permit are also lengthy and complicated. Even though national regulations set the maximum length of time to obtain a Business Registration Certificate at seven days, it takes up to 108 days in Trenggalek (East Java) and 57 days in Karimun (Kepri). At the same time, there are some districts/municipalities that already provide a faster service such as Gorontalo, Luwu Utara and Pinrang, which issue Business Registration Certificates in only two days.

Table 3. Actual time required to obtain a Business Registration Certificate

Fastest Districts		Slowest Districts	
District (Province)	Time (days)	District (Province)	Time (days)
Gorontalo (Gorontalo)	2	Trenggalek (East Java)	108
Luwu Utara (South Sulawesi)	2	Karimun (Kepri)	57
Pinrang (South Sulawesi)	2	Rokan Hilir (Riau)	42
Luwu (South Sulawesi)	3	Sampang (East Java)	41
Siak (Riau)	3	Malang (East Java)	37
Luwu Timur (South Sulawesi)	4	Badung (Bali)	36

Source: KPPOD, 2007.

The cost and length of the procedure is strongly correlated to the number of steps that must be taken in order to get a business permit.[13] The more complicated procedures also result in a higher likelihood of corruption.

In conclusion, both international[14] and national empirical evidence reveals that faster and less-costly services attract investors. Therefore, if the goal is to improve the investment climate, local government should start by simplifying the procedure to obtain a business permit.

Unequal infrastructure development

The availability and quality of infrastructure (e.g., roads, street illumination, water, electricity, telephone and Internet) is recognized as a key determinant for increased investment and trade. For example, a study in the Philippines by Pernia and Salas (2005) revealed that infrastructure (measured by road and telephone density) significantly affected the investment climate.

In Indonesia, large variations exist in infrastructure across different districts and municipalities. For example, some districts/municipalities are able to repair a road in less than 10 days, while others take more than 10 months for the same job.[15]

Table 4. Number of days to repair a road

Best Districts for Time to Repair Road		Worst Districts for Time to Repair Road	
District (Province)	Time (days)	District (Province)	Time (days)
Dompu (NTB)	2	Nias (North Sumatera)	311
Lombok Tengah (NTB)	4	Nias Selatan (North Sumatera)	303
Belu (NTT)	7	Sampang (East Java)	272
Timor Tengah Selata (NTT)	8	Kebumen (Central Java)	269
Blitar (East Java)	8	Kutai Timur (East Kalimantan)	255
Luwu Timur (South Sulawesi)	8	Asahan (North Sumatera)	220

Source: KPPOD, 2007.

Another essential infrastructural component is electricity.[16] In 2008, Indonesia faced electricity shortages in many parts of the country, partially attributable to the lack of integration between local and central governments. In North Sumatera, for example, electricity cuts occurred up to five times per week. As a result, industries lost millions of United States dollars in drops in production levels and damage to manufacturing equipment.

Up until now, the coordination between central and local governments in providing public goods and services remains unsatisfactory. Often, institutions disagree on who is in charge of a particular project. For example, local governments usually do nothing to repair roads categorized as national roads as the responsibility for maintenance technically lies with the national Government. However, local government should realize that it is not in its interest to leave this problem unaddressed as it will significantly hamper its economic activities. In such a case, local government would gain from being more proactive.

[12] See "Doing business 2009" in the World Bank's Country Profile for Indonesia, 2008; p. 9.

[13] Kuncoro and Rahajeng, 2005.

[14] A study conducted by the Viet Nam Chamber of Commerce and Industry (2008) suggested that following the decentralization in Viet Nam, provinces that adopted simplified business-related administrative procedures and reduced the number of required business licences had a better Provincial Competitive Index, which measures the ability of the province to attract investments. Another study in the Philippines (Pernia and Salas, 2005) revealed that more complex procedures reduced investment attractiveness.

[15] In Indonesia, roads are divided into national roads, provincial roads, municipal/district roads, "kecamatan" roads and "desa" roads. Each type of road is maintained by the administrative subdivision it belongs to.

[16] Electricity is supplied by national company that is subsidized by the Indonesian Government.

Conclusion and policy implications

In conclusion, decentralization in Indonesia has not led to any across-board improvement in the trade and investment climate. On the contrary, as illustrated with regard to investments, most regulations issued by local government in Indonesia are levy-related and have worsened the trade and investment climate, although the negative effects could still be mitigated if revenues from the new regulations were to be used to improve trade and investment facilities.

On the other hand, a positive effect of decentralization has been that those provinces that proactively seek trade and investment opportunities now have the independence and policy-making space to do so (e.g., East Java).

Therefore, the impact of decentralization on trade depends on how well local government formulates the local regulation to boost trade.

The empirical evidence strongly suggests that coordination and coherence between subnational and national regulations are crucial for trade and investment facilitation as well as for ensuring the inclusive and balanced development of the country as a whole. In addition, a coordinated approach within a same district or region can increase the competitiveness of the region.

Furthermore, coordination among those provinces at least on one island, will reduce the distribution costs and increase the trade flow within the island, which could be followed by the economic growth of the provinces within that island.

In order to achieve better coordination, local government should explore whether an institution linking the local and national levels to provide one-stop services to investors could improve the investment climate. Moreover, improved law enforcement with regard to addressing traders' informal retribution on prices harmful to farmers could reduce the barriers to internal trade among districts, thereby improving the competitiveness of the national product.

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