AGENCY FOR INTERNATIONAL DEVELOPMENT
PPC/CDIE/DI REPORT PROCESSING FORM

ENTER INFORMATION ONLY IF NOT INCLUDED ON COVER OR TITLE PAGE OF DOCUMENT

1. Project/Subproject Number
497-0357

2. Contract/Grant Number
497-C-00-98-00045-00

3. Publication Date
August 12, 2003

4. Document Title/Translated Title
Decentralization, Regulatory Reform and the Business Climate

5. Author (s)
1. David Ray
2.
3.

6. Contributing Organization (s)
Nathan/Checchi Joint Venture/PEG Project

7. Pagination
37

8. Report Number
PEG 126a

9. Sponsoring A.I.D. Office
ECG, USAID/Jakarta

10. Abstract (optional - 250 word limit)

This paper examines a broad cross-section of regulatory problems in local government and puts forward key principles for regulatory reform. Regulatory problems are identified and discussed at two levels: The ***first*** is at the process stage where key problems include the inability to effectively identify regulatory objectives, the lack of consideration of non-regulatory alternatives, poor stakeholder participation and the general lack of awareness of the importance of internalizing cost-benefit analysis into policy process. The ***second*** is the product of the policy process, namely the use of specific regulatory or fiscal instruments that negatively impact upon business, such inappropriately priced and targeted user-charges, trade and competition distorting taxes and charges, as well regulations that crowd-out private sector participation and/or discriminate against outsiders. Decentralization is not the main cause of regulatory problems in the regions, but does present new problems and challenges, most notably those associated with the pressure to raise own-source revenues and the new, yet problematic institutional arrangements governing the supervision of local regulations. Equally if not more important is the opportunity that decentralization brings to improve economic governance through regulatory reform. The regions should assume greater responsibility in analyzing and justifying the regulatory impact of proposed legislation, allowing the provinces to play a more active role in supervising lower level local regulations and in overseeing the development and standardization of the regulatory review process, and using economic incentives to ensure local participation in the national regulatory reform effort.

11. Subject Keywords (optional)

1. Indonesia
2. Decentralization
3. Regulatory Reform
4. Business Climate
5.
6.

12. Supplementary Notes

13. Submitting Official
C. Stuart Callison, Chief of Party

14. Telephone Number
011-62-21-520-1047

15. Today's Date
August 15, 2003

…..……..……DO NOT write below this line……..……

16. DOCID

17. Document Disposition
DOCRD [ ] INV [ ] DUPLICATE [ ]

AID 590-7 (10/88)

Decentralization, Regulatory Reform and the Business Climate

Summary paper prepared for the PEG-USAID conference on
"Decentralization, Regulatory Reform and the Business Climate,"
Borabudur Hotel, Jakarta, August 12, 2003

by
David Ray
Domestic Trade Advisor
Partnership for Economic Growth (PEG)[1]
USAID – Nathan Associates
Ministry of Industry and Trade
Jakarta, Indonesia

[1] The Partnership for Economic Growth (PEG) is a United States Agency for International Development (USAID)-funded Project with the Government of Indonesia. The views expressed in this report are those of the author and not necessarily those of USAID, the U.S. Government or the Government of Indonesia.

Table of Contents

INTRODUCTION 2
PROBLEMS IN THE REGULATION-MAKING PROCESS 3
Poor Problem Identification 3
Lack of consideration of alternatives to regulation 4
Lack of effective review of local regulations 5
Poor participation 5
PROBLEMS WITH LOCAL REGULATIONS 6
Poor use of User-Charges (retribusi) *6*
Retribusi and small business licensing 9
Trade Distortions *10*
Types of trade distorting regulations 10
Informal Exactions 12
Problems in ensuring competitive neutrality *13*
Other Problems *14*
Multiple Taxation 14
Discrimination 14
Exactions at the village level 15
Unnecessary complusion 16
DEVELOPING A NEW SUPERVISORY FRAMEWORK 16
Local Regulations under Decentralization *16*
Key problems with present supervisory arrangements 17
National Competition Policy in Australia: A Model for Indonesia? *18*
Key elements of Australia's regulatory reform program 18
Regulatory Impact Statements 19
Foundations for more effective regulatory supervision in decentralizing Indonesia *20*
Key elements of the regulatory reform program 21
CONCLUSION 23
BIBLIOGRAPHY 24
APPENDIX. SURVEY ON DECENTRALIZATION AND THE BUSINESS CLIMATE 25
Key points and conclusions from survey *25*
Introduction *26*
Results *27*

Introduction

This paper examines the many regulatory problems in local government in Indonesia and proposes simple models for regulatory reform

From the outset, it is important to stress that decentralization is not the major cause of regulatory problems in the regions. Many of the problems discussed in this paper represent nothing new and have been documented elsewhere. For example, SMERU (1999), and others identified a range of local government imposed tariff and non-tariff barriers in internal trade in the mid-late 1990s. The World Bank (1994) discusses the inappropriate use and pricing of user-charges in local government in the early 1990s. Goodpaster and Ray (2000) outline the discriminative and anti-competitive nature of many local government regulations just prior to the commencement of the autonomy process.

Decentralization nevertheless does present new challenges and pressures. For example, under pressure to raise own-source revenues local governments have turned to using a number of trade-distorting taxes and charges that were commonly found in the regions in the early-mid 1990s, but later banned though deregulation measures in 1997/98. Also under decentralization, new legislation on local taxes and charges (UU 34/2000) has led to sub-optimal arrangements governing the supervision of local regulations. As a result distorting local taxes and charges are being implemented without effective review of their regulatory impact.

Monitoring and addressing the many regulatory problems in local government and policy-making has been an important focus for the USAID Partnership for Economic Growth (PEG) project based at the Ministry of Industry and Trade. This paper draws on, and builds upon the work by PEG and MoIT counterparts and includes the many regional and desk studies carried out under the PEG-USAID banner by local research groups such as the SMERU Research Institute, BIGS (Bandung Institute of Government Studies), KPPOD (Regional Autonomy Watch), LPPPM Sawala, AKADEMIKA, REDI (Regional Economic Development Institute) as well as a number of contracted individual researchers. See table 1.

Table 1. Select PEG studies on regulatory problems in local government

Research Group / Researchers under PEG	Research Topic/Activity
SMERU Research Institute	Regional Studies: North Sumatra, North Sulawesi and West Java
Regional Economic Development Institute (in cooperation with The Asia Foundation)	Business Perceptions Survey (over 1000 small businesses)
Bandung Institute of Government Studies	Developing pro-market licensing sensitive to public interests
LP3M Sawala	Case studies on retribusi regulations in Garut and Tasikmalaya
KPPOD – Regional Autonomy Watch	Desk reviews of 700 local regulations
Frida Rustiani	Reforming business licensing in local government

The paper considers local regulatory problems at two levels:

The ***first*** is at the process level. That is the process by which a regulation (or other forms of government intervention) evolves from initial idea, to the design and review stage, through to final implementation. This includes important elements such as problem identification,

stakeholder participation, consideration of non-regulatory alternatives and internalizing cost-benefit analysis into policy process.

The ***second*** is the product of the policy process, namely the use of specific regulatory or fiscal instruments that impact directly upon the business climate. Attention will focus primarily on the use of user-charges (commonly known as *retribusi* in Indonesia) and to a lesser extent on local taxes and non-revenue raising instruments (i.e. non-tariff barriers or *tataniaga*).

Having discussed a broad cross-section of key regulatory problems in local government, attention in final section of the paper will focus on developing a simple model for regulatory reform.

Problems in the regulation-making process

Analyses on regulatory problems typically focus on regulatory outcomes (such as tax or *retribusi* regulations) and not on the regulatory process. Discussed below are a number of general weaknesses in the local policy process that often result in unnecessary or inappropriate regulation.

Poor Problem Identification

The starting point in the regulatory process is the clear identification of the particular problem that needs addressing through regulation. If there is no real problem then there is no need for regulation. This is an obvious, but often neglected point. Many local regulations are often drawn up with no clear objective, or with objectives inconsistent with their title and substance.

Commonly, local regulations are designed not to protect the public interests or to provide services, but to raise own-source revenues. In the forestry/wood sector for example, regulations are sometimes drawn up with the stated objective of ensuring sustainable forestry management but tend to focus more on revenue collection. Whilst effective supervision of forest exploitation requires a broad range of activities (e.g. that covering planting, felling, land-title, transport etc) supervisory activities tends to focus only on areas where exactions are most easily imposed, such as taxing the transport of logs, licensing chainsaws etc[2].

Such problems are also common in the trade and transport sectors. Prominent amongst the list of problematic regulations cancelled by the central government are *retribusi* charges that distort internal trade. These include licenses to import or export agricultural boundaries across sub-national borders, certificates of origin in domestic trade, licenses to load or unload road vehicles as well as quarantine and inspection charges on goods traded internally. In almost all cases it is

[2] One of many examples is local regulation 6/2001 of Kab. Garut, West Java regarding *'Retribusi Pelayanan Izin Pengelolaan Kayu Milik Kabupaten Garut'* . In one extreme, a proposed regulation on forestry management in Papua provided many pages detailing how fees and charges were to be extracted from forest users, but barely three lines on sustainabiliy issues (Proposed legislation discussed at a joint IRIS-PEG legislative drafting course in Jayapura, Papua April 2002).

difficult to determine what the actual problem is that requires regulation (i.e. there is no public interest aspect that needs protecting).

Often the starting point in the regulatory process is not the identification of particular problem that needs addressing through government intervention, rather the assumptions regarding own-source revenue in the local budget. In these circumstances each DINAS office is given a revenue quota that it must then meet typically through licensing and other regulatory activities. There is considerable pressure to respond to these demands as reaching or exceeding revenue targets is seen as an important indicator of success for DINAS officials. In some cases the most distorting regulations are drafted by the local revenue office (DISPENDA) and then forcibly imposed upon (often reluctant) DINAS officials to implement[3].

Lack of consideration of alternatives to regulation

Good regulatory practice requires that regulations must be the minimum necessary to achieve the desired objectives. This means that government action should only occur where there are no non-regulatory alternatives available[4]. Such alternatives could include self-regulation, voluntary standards or codes of practices, information or socialization strategies (such as public education programs) as well as the use of market-based solutions.

In Indonesia local governments give little consideration to non-regulatory alternatives. As a result, most tend to over-regulate. A common problem is the use of *retribusi* charges to fund so-called 'guidance and supervision' activities (*pembinaan dan pengawasan*) in key agricultural sectors such as fishing, livestock, forestry, plantations and agribusiness (see the example in box 1). The reasons typically put forward for these regulations are to ensure standards and quality control and/or to promote sectoral development. Most provide little, if any, material benefits for producers and are usually regarded as nuisance taxes. As sectoral development and product quality are clearly in the interest of producers a better solution would be for the government to leave such matters in the hands of producer or professional associations (assuming no major public interest considerations such as health of safety standards).

Box 1 Alernatives to Regulation: Cloves in North Sulawesi
In North Sulawesi, the Provincial Government in early 2002 imposed a *retribusi* charge on all exporters of *cengkeh* (cloves) and cinnamon to fund development and quality control measures. Funds collected from this user-charge were divided roughly 30-40% for the provincial government and 60-70% for district governments. Beyond this, there is little indication how the funds were used to develop the sector or to ensure quality control. If these were the real objectives of the regulation (as opposed to simply raising own-source revenues) then a number of non-regulatory alternatives may have been more appropriate. For example, producers through the operations of an association could setup their own arrangements to promote product quality, through self-regulations or information and education services.

Another example, perhaps common to every local government in Indonesia, is the legislated monopolization of public services by local government agencies or companies. As noted later, many services reserved for the public sector can be provided, in many cases more effectively, by the private sector. Examples include the provision of services associated with vehicle

[3] Based upon interviews with officials from a range of DINAS officials from a variety of jurisdictions. See also BIGS (2002).
[4] See 'Principles of Good Regulations' Office of Regulation Reform, State Government of Victoria, Australia

roadworthiness inspections, laboratory testing, as well as surveying and other procedural requirements for building approvals. Monopolization of these and many other services by the public sector typically results in sub-optimal service delivery.

There are a variety of factors behind this heavy-handed approach to government that essentially eschews non-regulatory alternatives, particularly those alternatives involving the private sector. To a certain extent this could be driven by the pressures to raise own-source revenues and, in the case of service delivery reserved for the public sector, the need to provide employment opportunities for the large numbers of under-employed civil servants at the local level. It may also be a reflection of a continuing paternalistic culture within government, ground in feelings of suspicion if not outright hostility toward the market mechanism, that instinctively seeks to regulate all economic activities, whether necessary or not.

Lack of effective review of local regulations

A critical test of government policy is its ability to generate net-benefits for the community. This is a difficult yardstick to use in Indonesia as few, if any, elements of government have internalized cost-benefit analyses into the policy making process. At the local level this might be due to a lack of capacity. More likely, however is that most local governments are simply not aware of the importance of undertaking even the most elementary forms of cost-benefit analysis before a local regulation is submitted to the legislature and then implemented.

As a result local governments often impose regulations that might generate a net benefit for government, but impose a net cost for the broader community (e.g. consumers and producers). One example is the range of charges and fees often imposed upon domestic trade in agricultural produce. These types of exactions typically generate small amounts of net revenue for government – i.e. revenue net of implementation and 'leakage' costs - but due to their distorting nature generate substantial costs for producers, in particular farmers. In some cases, the high costs of implementation, administration and compliance ensure that local exactions are unable to generate net benefits for government, let alone the broader community.

In other cases, regulations serve the interests of one sector of the economy, but impose high costs upon almost every other sector. For example the banning of sugar imports into East Java obviously benefits sugar farmers, but imposes serious costs upon downstream users (e.g. food and beverage processors etc) and, perhaps more importantly, consumers. In these and many other cases, even simple cost-benefit analyses would show that these policies generate net costs for the community and should not be pursued.

Poor participation

A theme common to all PEG studies is the clear lack of participation by stakeholders in the regulation-making process. Participation has not improved under decentralization. Of the 1014 business surveyed by REDI in 2002, only 14% responded that stakeholder participation in the policy process had improved under decentralization. Other studies report that even when consultation with stakeholders does occur it is often done at such a late stage that the regulation is already a *fait accompli,* i.e. the community has little opportunity to influence it. In addition poor

socialization after implementation often leads to a general lack of awareness and/or confusion regarding regulations. There appears to be few, if any effective feedback mechanisms regarding the impacts of local regulations. Accountability to the public vis-à-vis regulations is poor.

Box 2. Where do local regulations come from?

The BIGS (2002) study provides an interesting account of the process of developing local regulations, beginning with the initial idea, the review process, debate, revisions and then final implementation. Regulations originate from two sources: the executive (DINAS offices etc) or the legislative. Consistent with earlier findings by SMERU (1999), BIGS found that most regulations came from the executive[5]. The reasons for this, according to local parliamentarians surveyed by BIGS, are that officials from the relevant agencies have a better understanding of the problems in the field. BIGS provides an alternative interpretation that this also reflects the relative weak relationship that legislators have with their constituents and, as a result, cannot get sufficient information to aggregate the interests of their constituents into effective local regulations.

BIGS also found a number of local regulations that were not a direct result of local initiative, but were drawn from higher levels of government (e.g. central government legislation recast as local regulations such as local regulation 5/2001 governing work hours in Bekasi) or copied from neighboring jurisdictions (e.g. Kota Tasikmalaya using regulations from Kabupaten Tasikmalaya). In other cases new regulations, are often old regulations that were abolished by deregulation measures in the late 1990s, but revisited post-regional autonomy. For example, notes SMERU (2001) legislation regarding 'Plantation Company Contributions' in Simalungan, North Sumatra (essentially an illegal exaction duplicating higher level taxes) is a rebirth of the previously banned regulation no 39/1995 concerning 'Plantation Management Fees'

Problems with local regulations

Discussed below is a broad cross-section of problem regulations that tend to distort trade, investment and other economic activities. The underlying cause behind many of these problematic regulations is the perceived need by local governments to raise own-source revenues.

Poor use of User-Charges (retribusi)

Most problem regulations in Indonesia are *retribusi* not taxes. Of the 173 local regulations banned by the central government as of June 2003, 141 or almost 82 percent were *retribusi*. Using a larger sample set, the KPPOD (2002) reviewed 693 local regulations issued over the 2000-02 period, and found that 492 were problematic, 70 percent of which were *retribusi.*

This is not to suggest that *retribusi* regulations are taboo. Better targeting and pricing of *retribusi* represents an important means of improving service delivery and more generally the regional business climate at the local level. Moreover, the efficient use of *retribusi* to fund service delivery can provide much needed relief for local budgets whilst reducing dependence on inter-government transfers. Unfortunately r*etribusi* typically finance only a small proportion of public services as local governments continue to give greater emphasis to raising own-source revenues through taxes[6].

[5] See SMERU (1999) 'Monitoring the regional implementation of Indonesia's structural refomrs and deregulation program: Lessons learned to date. Report for the ASEM Trust Fund, SMERU, Jakarta.

[6] A report from the World Bank in 1994 estimates that *retribusi* charges and fees covered less than 10 percent of the outlay on public services at the Municipal level at that time. See World Bank (1994).

There are two basic types of *retribusi*, each fulfilling different functions

1. **Regulatory.** Service fees and levies to fund the issuance and administration of licenses and permits (typically where there is a clear public interest aspect that needs protecting e.g. drivers licenses to ensure road safety)
2. **Financing**. User fees to fund public service delivery, such as utilities, access to public facilities etc.

Key concepts underlying the appropriate use of *retribusi* include:

1. **User-pays**. *Retribusi*, unlike local taxes, are designed to fund specific government services and not to raise own-source revenues (a rule not generally understood nor adhered to in Indonesia). The key criterion for using *retribusi* is whether the particular government service, for which the levy is being imposed, is separable. A separable government service is one where the benefits of the service can be attributed specifically to individuals, households or businesses. In these circumstances the appropriate approach is to charge the beneficiaries. Private financing of government services on a user-pays cost-recovery basis in turn provides much needed relief for local budgets.

2. **Cost Recovery**. All funds collected though the imposition of *retribusi* levies upon service users, should be expended in the provision of those services. That is the sum of all fees should be just enough to pay for direct provision as well as an appropriate proportion of cover government overheads. Revenues necessary for cost recovery in the administration of licenses and permits are typically small, but much larger for key public services, such as utilities. Appropriate pricing is the key to achieving cost recovery (see below) and also to ensure better equity and efficiency in service delivery.

3. **Retention**. To strengthen the link between costs and benefits of payment, and to promote greater accountability and transparency, it is desirable that at least a substantial portion of the funds collected through the imposition of *retribusi* fees should be retained by the particular agency providing the service, rather than transferred to the local treasury office.

4. **Pricing**. Appropriate prices help achieve cost recovery in service delivery, and also ensure the correct amounts and types of services are provided to those prepared to pay for them. If *retribusi* are priced below cost, non-users would effectively subsidize users, and excess demand would typically result in inadequate and poor quality service provision. Moreover as cost recovery is not achieved, further pressures are placed on the local budget to fund the increased demand for the service. For both equity and efficiency reasons, it is important that prices reflect costs to the largest extent possible[7].

In Indonesia there are a number of problems that typically undermine the effectiveness of *retribusi* regulations, as described below:

[7] Protection of lower income groups, if required, should be achieved through targeting of price subsidies in such a way that not all users can get access to the service at the subsidized price

1. **No real tangible services provided**. *Retribusi* charges are often imposed on the grounds of providing a service, when no tangible service is provided, nor is one required. Earlier the example involving unnecessary 'guidance and supervision' charges was discussed. Another common problem is where the service provided is the issuance of an otherwise unnecessary license, such as a license to import commodities into a jurisdiction (e.g. *Perda* Kabupaten Jombang 6/2001), a license to load or unload road cargo (e.g. *Perda* Kabupaten. Indramayu 11/2001) or a license to sell plantation produce (e.g. *Perda* Kabupaten Gowa 15/2001). In other cases local governments impose a fee for granting contracts to the private sector, whereby firms that win contracts must then pay a service fee to the government - essentially formalizing a kind of 'reverse kickback' mechanism - but offering no material service in exchange for payment (e.g. *Perda* West Nusa Tenggara 7/2001)

2. **Lack of retention.** Monies collected through the imposition of *retribusi* charges are immediately transferred to the local revenue office (DISPENDA) and only a fraction of the original monies collected is returned to the implementing agency to fund service delivery. This reflects a general misunderstanding within government that the primary function of *retribusi* is to raise own-source revenue, not to fund service delivery. The BIGS (2002) study provides an interesting example in Bekasi where only Rp. 500 million of the Rp 1.4 billion *retribusi* fees collected by the local manpower office (*DINAS Ketenagkerjaan*) over the first nine months of 2002 were returned to this agency from the local treasury to fund service delivery. This according to the study is an important factor behind the poor quality of manpower services provided by the local government in Bekasi.

3. **There is often no public interest aspect that needs protecting**. Local governments in Indonesia favor a heavy-handed approach when governing business activities. Regulations supposedly designed to protect the public interest often represent an unnecessary and additional layer of licenses and permits to burden local producers. The instinctive approach of government is to over- rather than under-regulate. An example is the imposition of *retribusi* charges for unnecessary inspection and quarantine requirements (e.g. *Perda* Propinsi Lampung 10/2000). Also, sectors previously unregulated are now the subject of new regulations (e.g. the licensing of *becak* pedicab in Kabupaten Hulu Sungai Selatan *Perda* 5/2001).

4. **Regulations designed to protect the public interest, often have the opposite effect.** A common finding in the PEG studies is that many regulations often undermine, rather than promote the public interest. For example BIGS (2002) identifies a number of labour regulations in Bekasi, West Java that provide no real protection for workers (such as ensuring safety and health standards) but nevertheless generate employment disincentives by increasing regulatory costs. Sawala (2002) report that even when regulations are clearly designed to protect the public interest, local DINAS agencies typically fail to provide sufficient monitoring and supervision to ensure effective implementation, because of a lack of resources and manpower, and also interest.

5. **Pricing *retribusi* well below or well above that required for cost-recovery.** Throughout the archipelago, licenses and permits are being used as revenue raising instruments, i.e. priced well above that required for cost recovery. Evidence suggests that under decentralization the

costs of licenses have increased sharply. The business perceptions survey in attached appendix for example, reports that over the past 2-3 years business perceive more transparent, faster and simpler licensing processes, but considerably higher licensing costs. The misuse of *retribusi* charges for licensing and permits represents an important means by which DINAS heads can respond to internal pressures to meet own-source revenue targets[8]. For utilities and other key government services, charges continue to be priced well below marginal cost on the grounds that lower income groups need to access these services at low cost. This is neither equitable nor efficient, as it results in excess demand for services (particularly by those with higher incomes) and ultimately poor service delivery. More appropriate pricing, and better targeting of subsidies are required if service delivery is to be improved.

Retribusi and small business licensing

Retribusi licenses and fees are especially burdensome and distorting for small business activities. Formalization requires many licenses, but very few are necessary on public interest grounds. The licensing process is overly complicated requiring many unnecessary documents and approvals. Fee setting is non-transparent, lacks rationality and typically very burdensome. Often, licenses from one agency duplicate that of another, but are imposed upon the same business. Moreover, licensing often restricts expansion of small businesses into neighboring districts, as new sets of licenses (and therefore relationships with local officials) must be pursued.

BIGS (2002) note that local officials are typically resistant to efforts to simplify the licensing process. Only 20% of licenses in the areas they surveyed were issued by one-stop shop services. Moreover there has been no effort to decentralize licensing authority to lower level, and in many cases more appropriately positioned, agencies such as village and Camat offices (whose role is limited to issuing recommendation letters to higher level agencies). BIGS (2002) also notes that there is a clear lack of competence from officials issuing licenses. This problem becomes particularly serious when the official must understand technical matters, such as the likely environmental impact of a project, or the market (and other) impacts of issuing a large numbers of licenses/permits. It also prevents much needed coordination with other agencies, including those from neighboring governments (this is particularly important for example when coordinating public transport across West Java and Jakarta)

The REDI (2002) survey reports that under decentralization the business-licensing environment has more or less remained the same. There appears to be an improvement in processing time required and to a lesser extent, in procedural and cost transparency. However these improvements are offset by higher licensing costs as local governments seek to raise own-source revenues (PAD), most likely through the pricing of licenses/permits (*retribusi izin*) beyond that required for cost-recovery. One salient point illuminated in the REDI survey is that almost half the respondents report that they are still paying informal facilitation or brokerage fees to officers in the licensing-issuing agency (see appendix for summary of survey)

[8] In some cases, efforts to raise own-source revenues through licensing activities often results in the proliferation of nuisance charges that generate a net loss for the government and (due to their typically distorting nature) generate substantial economic losses for the broader community. Sawala (2002) for example identifies a number of local charges in Garut and Tasikmalaya that net less than Rp 10 million a year, well below that required to cover administration, implementation and compliance costs.

Trade Distortions

Trade distortions have been a perennial problem undermining internal market efficiency in Indonesia. As shown by a number of earlier studies, local government interference in domestic trade through the imposition of tariff and non-tariff barriers was common well before decentralization.[9] SMERU for example notes that the problem was particularly serious during the second half of the New Order period

> During the 1980s and the first half of the 1990s, Indonesia's rural sector became increasingly heavily taxed and regulated. There was growing concern about a decline in incomes of the original producers of rural products (mostly agricultural goods but they included other low value, resource based commodities, usually minor mining products such as sand, gravel, clay etc). Producers received an increasingly smaller percentage of final prices for their goods. Agricultural incomes were subjected to downward pressures, which distorted prices. Incentives to increase production decreased. The desire to produce a surplus for trade fell (1999, p.1).

Indonesian local governments are prone to tax trade as they feel that the present taxation system doesn't give them many alternatives. Local governments are mostly unable to draw local revenues from taxes on assets, incomes and value added, leaving trade as a residual and obvious target. Another reason is that it is very simple to tax trade. This is done by positioning officials at key strategic locations, such as at city and district boundaries, weigh stations, ports, bridges and crossroads. However as noted below, not all trade distorting regulations are designed to raise own-source revenues.

Types of trade distorting regulations

1. ***Import-Export Tariffs in internal trade.*** Perhaps the most common form of trade distortion is the imposition of tariffs upon goods, and sometimes services, being traded across sub-national boundaries. These can take many forms such as
    a. Trade taxes: The imposition of taxes for all commodities exported/imported across jurisdictional boundaries (Kabupaten Bima 16/2000, Lombok Tengah 5/2001)
    b. Licenses to export/import. Typically *retribusi* charges for the issuance of a license to transport goods across jurisdictional boundaries (Province of Lampung 6/2000, Kabupaten Ogan Komering 20/2001)
    c. Taxes and charges on specific commodities. Most commonly taxed commodities include fish, cattle, plantation produce and forestry products
    d. Agreements across Kabupaten governments. See box 3.

2. ***Certificates of origin.*** These regulations often have the stated objective of improving the quality of goods in circulation, or ensuring quarantine or health standards (e.g. Kabupaten Pasaman 2/2001). In reality they tend to be very distorting and unnecessarily protectionist as they impose added costs on imports into a jurisdiction, as well as through-trade. Most well

[9] See for example the various reports produced by Persepsi Daerah (1999), Tomayah (1997), Juanita (1997), Garcia (1997), Andari, Hunga and Sandee (1997), Rahma (1997), Darma (2000), Quizon, Rahma and Tomayah (1997) and the various commodity studies produced by the TIP-USAID project at the Ministry of Industry and Trade in 1996.

known of these types of regulations was the ID card for cattle used by almost every government at the Municipal level in East Java in 2000/01.

3. ***Loading/unloading fees.*** These are license fees for the loading and unloading of produce within jurisdictional boundaries, but typically imposed at key transport terminals, such as main road intersections, regional boundaries, ports, bridges etc (e.g. Kabupaten Tanggumas 20/2000, Kabupaten Ciamis 17/2001). These regulations are not driven by any public interest considerations and therefore comprise another nuisance tax on internal trade.

4. ***Third party contributions (Sumbangan Pihak Ketiga).*** The 'third party contributions' facility has become a *de facto* tax on trade in a number of outer provinces. This facility requires local business to provide 'voluntary' payments to local government. Devices ranging from subtle pressure to explicit threats of punitive action (i.e. sanctions) serve to collect this type of levy (e.g. Kabupaten Ogan Komering 5/2001, Bima 15/2001).

5. ***Road and transport charges.*** Over 15 percent of local regulations cancelled by the central government are charges imposed on road users. These charges are intended to finance road-works and maintenance, but often duplicate other taxes and charges, such as vehicle registration taxes, fuel taxes etc.

6. ***Inspections and quarantine requirements.*** These are typically disruptive, and in most cases highly unnecessary inspection requirements imposed upon a range of goods and commodities, both imported into, and produced within the region. The provincial government of Lampung for example in 2000 produced a regulation detailing eleven pages of quarantine charges for virtually all good crossing provincial boundaries (Lampung 10/2000). Meat and cattle imports are particularly prone to these types of requirements (e.g. Kabupaten Kuantan Singingi 13/2001, Kabupaten Aceh Tengah 35/2001)

7. ***Vehicle and road-safety requirements.*** These are imposed upon vehicles using regional roads and/or vessels using regional waterways in way that is often discriminative against non-locals, and also disruptive to through-trade. That is, it is difficult for road users that are not domiciled in the particular jurisdiction to obtain necessary certificates and permits, resulting in fines and other exactions when entering the jurisdiction (e.g. Lampung 1/2000)

8. ***Import bans.*** In many cases, local government actions can also distort international trade. For example in July 2002 the Governors of South Sulawesi and East Java both refused shipments of imported rice into their provinces in order to protect local farmers[10].

9. ***Other non-tariff barriers.*** NTBs such as price controls, forced monopsonies and geographical allocation of markets were very common during the Suharto period. However most were eradicated in the late 1990s following national deregulation measures. Under decentralization there have been very few NTBs emerge that distort internal trade. The rush to raise own-source revenues has meant that tariff barriers are now more common. However as the decentralization process continues there is likely to be growing pressure upon local

[10] See *'Gubernur Sulsel tolak 100,000 ton beras impor', Bisnis Indonesia*, 31 July 2002 and 'Membela petani degan strategi pengelolaan impr', *Kompas* 26 July 2002.

administrators to assist certain groups and to protect against out-of-region competition. Examples to emerge in recent years include an effective investment ban and other discriminative treatment toward non-local pharmacies in North Sulawesi, requirements to collaborate with local partners in mining (Kota Bekasi 13/2001) and forced use of government fish auctions (Kabupaten Cirebon 53/2001).

Box 3. Joint Agreement by Regents in the Island of Lombok to tax outward trade

Surat Keputasan Bersama (SKB) Bupati dan Walikota Se-Pulau Lombok No. 11/2001, 15/2001, 317/2001 and 434/2001 is an agreement between the three Regents (Bupati) of Western, Central and Eastern Lombok and the Mayor of Mataram to impose a 5% tax on all goods being sent out of the main provincial port of Lembar in the south of Lombok. An 'implementation team' comprising officers of the Western and Eastern Lombok Revenue Offices (DISPENDA) is responsible for collecting the tax. Every 6 months the local governments involved issue a schedule of base prices for 174 (mainly agricultural) products as a reference for the 5% tax. By working together to impose this tax, the Municipal governments in Lombok are effectively acting as a de facto province. The provincial government has objected to the jointly imposed tax, however due to present institutional arrangements governing local regulations (which removes the vertical relationship between the Province and lower level governments), does not have the authority to rescind the tax.

Problems:

- *The tax is regressive*. As with most forms of direct taxes/charges on domestic trade, the burden of payment ultimately falls upon the producer/farmer. Those responsible for transporting goods through the port, typically traders, adjust their buying prices to cover the 5% tax.
- *The tax undermines regional competitiveness.* Traders who cannot depress their buying prices must then either absorb the loss themselves or try to increase their selling price. Given that much of what Lombok produces is agricultural produce sold in competitive markets, a 5% increase in selling price would seriously undermine Lombok producer competitiveness in both national and international markets.
- *The tax has no legal basis.* According to Law 34/2000, taxes at the Municipal level can only be determined by local regulations. The joint agreement has no legal basis. Moreover the same law holds that local taxes cannot be imposed upon goods with high mobility (i.e. that traded across sub-national borders).

Informal Exactions

Whilst truck drivers, traders, farmers, as well as small and large businesses and others involved in domestic trade maintain report that formal exactions are problematic, it is the accompanying '*pungutan liar*' or illegal exactions they maintain are much more burdensome, as they are erratic in their imposition. The REDI business perceptions survey shows that illegal exactions are the most common cause of complaint for small business (Table 2.)

Table 2. Factors negatively impacting the business climate

Illegal exactions	262	30%
Formal Taxes and charges	113	13%
Infrastructure constraints	181	21%
Non-tariff barriers/constraints	204	24%
Lack of security	101	12%
Total respondents	861	100%

Source: REDI (2002)

Part of the problem is that, given their erratic imposition, informal exactions are difficult to pass on to suppliers and must be absorbed by reducing profits or the rate of capital accumulation. Formal exactions, on the other hand, such as the many formal taxes and charges on internal trade

discussed above are much easier to pass on to suppliers as there is greater certainty in their imposition and their costs can be incorporated into buying prices.

The REDI survey reports that the burden of informal payments appears to have slightly eased under decentralization. However increases in the burden of informal payments are positively correlated with firm size. Larger firms report greater amounts, frequency and number of exacting agencies/individuals.

Problems in ensuring competitive neutrality

Competitive neutrality is an important principle underlying regulatory reform efforts in Australia and a number of other OECD countries. It is based on the widely held view that free, rather than regulated markets provide the best outcomes for consumers and producers. The principle holds that the various forms of government intervention, such as the imposition of regulations and by-laws, the activities of departments and ministries; and the activities of government owned and run enterprises, should not unduly inhibit the ability of private sector businesses to compete.[11]

A common problem in the regions is the legislated monopolization of services by government agencies and companies. Whilst public interest considerations may make it necessary for certain services to be reserved for the public sector many others be delivered, perhaps more effectively by the private sector. Suhirman (2001) for example notes that the building planning and approval process in Bandung requires a broad range of services to be delivered by local government, including information services, technical inspections on-site, verification, surveying, boundary marking, site mapping as well as numbering and building registration. In each case, he argues, such services can be better provided by accredited professionals from the private sector.

Other examples include regulations requiring yearly vehicle roadworthiness inspections at workshops belonging to local transport and communications agencies (DINAS Perhubungan) as well as regulations requiring quarantine inspections for cattle and meat being traded across sub-national boundaries. In each case the stipulation that these inspections must be done by local officials inevitably result in poor service delivery. In Garut for example, Sawala (2002) reports that local bus drivers complain of losing three days business due to long queues outside government vehicle inspection workshops.

In these and many other cases where services are provided through legislated monopolies it is often unclear whether any service is actually carried out. Moreover long queues and supply constraints may invite rent-seeking by service providers as private sector users seek to short cut the system. An approach consistent with the competitive neutrality principle would be to allow private sector groups, say an association of accredited mechanics/workshops or laboratories, to undertake the testing and to provide some kind of standardized and acknowledged form of certification in the case of the two examples discussed here.

[11] The term 'unduly' is used here to refer to a situation where the restriction to competition cannot be justified on the grounds of protecting the public interest.

The effective privatization of a number of government services at the local level would open up new opportunities for private sector investment and inject much needed competition into the service sector. The net result would be better services, delivered at lower cost and in a more transparent and accountable manner.

An unfortunate omission from Indonesia's anti-monopoly law concerns the activities of government owned enterprises. Supported by the necessary regulations, some of the worst cases of anti-competitive behavior are those of government enterprises. The central government for example provides the necessary regulatory authority to the state-owned port corporations (PELINDO) such that they can prevent private sector ports from competing with their public ports in servicing third party cargo. Telkom, the central government owned telecommunication firm, allows local call charges for non-local (i.e. rural) users of its ISP subsidiary, TelkomNet. This prevents the development of private ISPs in rural areas where internet connections require long-distance calls. Similar violations are likely at the local level as there is now increasing pressure to tap into the profits of local government owned enterprises to raise own-source revenues. REDI (2002) reports one example in Jember, East Java where new investors requiring radio advertising must use the local government owned radio station.

Other Problems

Multiple Taxation

Many local governments are clearly frustrated at their inability to directly draw upon revenue sources within their jurisdictions such as company, income and value added taxes. As a result they often develop new taxation instruments that target these sources, but also duplicate higher-level regulations and laws. This is particularly common in regions where there are economic activities that represent a significant proportion of the local economy, but pay little in local taxes. Mining and plantations are two such activities prone to multiple taxation regimes. In North Sumatra for example, SMERU (2001) reports a number of local governments imposing illegal exactions on palm oil and other plantation companies, which duplicate higher-level company and value added taxes.

In some cases local taxes duplicate taxes from the same level of government, e.g. road taxes duplicating vehicle and fuel taxes (as noted above) and a vehicle registration fees piggy-backing the vehicle tax (West Nusa Tenggara). Other sectors where local taxes duplicate central government taxes include ports, banking, tobacco production, pharmacies (West Nusa Tenggara Province), air travel (Kabupaten Palu) and forestry (Jambi Province).

Discrimination

Governments in the outer regions are using tariff and non-tariff barriers to discriminate against outsiders. These discriminative measures take many forms. In some regions, local regulations are generating real disincentives to employing non-local labour. In Kota Pekanbaru the government is charging companies a Rp. 500,000 fee for every non-local employed. Moreover larger companies must meet a 75 percent local labour content requirement within 5 years (4/2002). In

other regions local regulations have been designed to protect local business against outside competition. In West Nusa Tenggara the provincial government is charging car rental, tourism and contracting companies using cars with non-local plates ten times the vehicle registration costs of cars with local plates (10/2001). Another example is in North Sulawesi where a governor decree seriously discriminates against outsiders in the pharmacy sector (see box 4)

Box 4. Discrimination against outsiders in North Sulawesi

According to a *Surat Keputusan* (Governor's decree) no. 4dz/03/891 dated 13 September 2000, the following restrictions are placed upon pharmacies whose management and ownership are not domiciled in North Sulawesi.

1. All non-local pharmacies must own, and not rent premises used for retail outlets.
2. Establishment of new pharmacies must be first recommended by the North Sulawesi Pharmacy Association
3. Only pharmacies whose management and ownership are domiciled in North Sulawesi can become members of the North Sulawesi Pharmacy Association.
4. All positions within large non-local pharmacies (excluding top management) must be given first priority to citizens of North Sulawesi.
5. Non-local pharmacies are expected to form partnerships (*mitra*) with local pharmacies when distributing their products in North Sulawesi.
6. All government procurement for pharmaceuticals up to Rp 4 billion in value will be given priority to local pharmacies.

The main rationale behind the decree is to ensure that non-local pharmacies (which tend to outperform local pharmacies) do not repatriate their profits out of the region. By forcing the outsiders to purchase their outlets, the local government expects that these businesses will re-invest their profits locally. According to officials interviewed, the stipulations within the decree that discriminate in favor of locals will only be required until local pharmacies can better compete with outsiders. Another rationale commonly used in the decree's defense is that it is consistent with the spirit of the Presidential Decree 18/2000 on government procurement that gives priority to local SMEs in small-scaled government procurement and contracts.

Exactions at the village level

Most discussion and analyses on problem regulations typically focus at the Municipal level, but give little attention to the distorting taxes and charges that are beginning to emerge at the village (*Lurah/Desa)* and *camat* level. According to SMERU (2001) more aggressive revenue raising efforts at the village level are closely associated with the cessation of the Village Development Assistance Program (*Bangdes*) that on average provided Rp 10 million per village in 1999/2000.

Under decentralization, Municipal level governments are also providing the necessary regulatory authority to develop new taxes and charges. In Simalungun, North Sumatra for example, the Kabupaten government has regulated for the formation and taxing authority of the *Nagori*, defined by SMERU (2001) as the 'legal community entity at the village level with the authority to arrange and organize the interests of the local community'. Throughout Sumatra, the *Nagori* have been aggressively raising village revenues, typically through exactions on agriculture such as output taxes for plantations and harvesting fees for rice farmers.

Similar measures are being taken at the village level in other parts of Indonesia. Ahmad (2003) notes that dozens of desa level governments in various kecamatan in Bogor, with the assistance of the Bogor based *Asosiasi Badan Pemerintahan Desa* (an association for local village-administrations) are developing and implementing identically worded revenue raising regulations, in some cases up to 10-12 regulations per village.

Villages are also actively imposing informal exactions upon producers. According to the REDI survey approximately 40% of respondents identified village and camat level officials as the most common source of informal exactions.

Unnecessary complusion

Many regulations compel local business to undertake certain activities. These are often well meaning but misguided attempts to generate particular outcomes for the community, such as a healthier workforce or more opportunities for SMEs, which at best represent unnecessary annoyances for local companies, and at worst, seriously distort the investment climate. An example of the former is a labour regulation (no. 19/2002) in Kota Bandung that compels companies to undertake frequent training and health checks for their employees. In each case fees are charged, but no real service provided. An example of the latter is a regulation in Jakarta (2/2002) that compels large modern retailers with a floor space of 200-500 m2 to provide at no charge 10% of total floor-space to small-scale/informal traders. For retailers in excess of 500 m2 the requirement is increased to 20% of total floor space. There is now some concern in the retailing sector that similar regulations will be implemented in other provinces[12]

Developing a New Supervisory Framework

Local Regulations under Decentralization

In 1999 Indonesia embarked on a comprehensive and ambitious decentralization program. Two laws were passed: Law No. 22 on the devolution of government authority and Law 22 on fiscal decentralization. These laws became active in January 2001.

Concerned to raise own-source revenues within this new decentralised framework, local governments have been quick to legislate new taxes and charges and other types of exactions. Before decentralization, local governments were constrained to a prescribed list of local taxes and charges as determined by Law 18/1997. As noted by SMERU (1999) and others, this helped to reduce trade and other business costs, particularly in the regions. Under pressure from local governments, Law 18/1997 was amended in late 2000 to become Law 34/2000 and as a result local governments have greater flexibility to develop new taxes and charges beyond that previously prescribed by Law 18/1997 (albeit on the basis of some vaguely defined criteria)[13].

Many new local taxes and charges that have emerged since decentralization are valid and appropriately priced. Many others however are very inefficient and distorting and often have no legal basis. In most such cases they are either user-benefit charges (*retribusi*) that provide little or no service, or service-fees, such as licenses, permits etc, that are priced well beyond that required for cost recovery.

[12] See 'Peritel dukung pencabutan perda perpasaran swasta' *Bisnis Indonesia* 11 June 2003, page 4.
[13] It is interesting to note that according to analysis by the KPPOD (Regional Autonomy Watch – a body set up by the Indonesian Chamber of Commerce to monitor the impact of new local regulations upon the business climate), almost all problem local regulations tend to be those not prescribed nor 'listed' by Law 18/1997.

Key problems with present supervisory arrangements

Under the decentralization laws the onus of determining the legality of local regulations on taxes and charges has been returned to the central government. The local government is required to submit the proposed regulation for review by the Ministry of Finance based inter-ministerial team on local taxes and charges within fifteen days of issuance. If a period of one month elapses and there is no objection from the central government (i.e. the Minister of Home Affairs) the local regulation becomes immediately effective. If however there is an objection - typically on public interest grounds, or on grounds that the local regulation duplicates or violates higher level legislation - then the regional government has one week to rescind the regulation upon notification by the center.

There are a number of problems with this system

1) **Not all local regulations are being submitted to the center.** The system relies upon compliance with article 113 of Law 22/1999 that all local regulations must be submitted to the center for review within fifteen days of issuance, but provides no facility to impose sanctions for non-compliance. Lewis (2003) estimates the compliance rate to be around 40%. In reality the inter-ministerial team receives input and information on local regulations from other sources, such newspapers, complaints from the business community, reports from donors etc.

2) **Too much of the review burden is placed upon the central government.** Given its limited resources the above-mentioned inter-ministerial team has performed credibly, providing recommendations on local regulations typically based upon sound public finance/public policy principles. Unfortunately there are simply too many regulations to review (despite many not being submitted). In a typical weekly meeting up to 20-30 regulations will be reviewed in just a few hours. The weight of numbers effectively precludes any thorough and in-depth analysis of the regulatory impact of local taxes and charges.

3) **Delays in the review process**. When a regulation is reviewed it is typically not carried out within the stipulated time frame. This complicates the rescission/revision process as the regulation in question has usually been implemented.

4) **Non-tariff barriers** *(tataniaga)* **are ignored**. Historically, NTBs (such as forced monopsonies, price controls, regional allocation of markets, quotas, investment and export restrictions etc) have been very destructive for the domestic economy. Under decentralization there are signs that local some local governments will use their new authority to discriminate in favor of locals or certain business groups/sectors. Unfortunately the inter-ministerial team formed to review local regulations only has the authority to review and make recommendations on regulations involving taxes and charges. Hence many discriminative local regulations and stipulations, such as the ban on investment in new pharmacies by outsiders in North Sulawesi, as noted earlier, remain active.

5) **Many local governments are ignoring rulings from the center on problematic local regulations.** Only 22 of the 173 regulations banned by the central government have been rescinded at the local level. All others remain active.

The above points suggest that the present institutional arrangements governing local regulations under decentralization are failing. Indonesia needs to develop a national regulatory framework, whereby the onus of reviewing and justifying local regulations is returned to regions. The review process could be based upon key legislative principles set by the central government (in consultation with lower level governments) and carried out according to established methodologies and procedures as developed in other countries, such as the 'National Competition Policy' framework that has been so successful in improving the business environment in Australia, as described in the next section.

National Competition Policy in Australia: A Model for Indonesia?

In the 1960s Australia was ranked near the top of the OECD countries in terms of per capita income. By 1990 its ranking had fallen into the bottom third. An important factor contributing to this relative decline was the regulatory environment that inhibited the ability of private business to compete in both national and international markets.

In the late 1980s and early 1990s the central and state governments in Australia began a cooperative effort to establish a legislative and institutional framework to ensure that regulations at all levels of government do not undermine the domestic trade and competition environment. This effort has played a key role in Australia's relatively strong economic performance in recent years.

Key elements of Australia's regulatory reform program

In April 1995, all Australian governments signed a number of agreements committing themselves to Australia's 'National Competition Policy' (NCP). Key elements of the agreement are outlined below

1. Establishment of the National Competition Council (NCC) The council was set up to advise the Central Government on progress by the State (and Territory) Governments toward fulfilling NCP agreements, and provide guidance on regulatory reviews.

2. Regulatory review. Australian governments have agreed to adopt a set of guiding principles when developing new legislation. Such principles ensure that a regulation that restricts competition, should be disallowed unless

- It can be demonstrated that there is a net benefit to the community (measured in cost-benefit terms); and
- The objectives of that regulation can only be achieved by restricting competition.

Governments may, however, retain restrictions on competition if those restrictions are found, after a process of review, to be in the public interest. Similar principles are applied to reviews of existing legislation. According to the NCC the objective of the legislation review program is to

remove restrictions on competition that are found not to be in the interests of the community, for example, legislation that restricts entry into markets or constrains competitive behaviour with markets.

4. Decentralized supervision. In each state an office or department for regulatory reform has been established to oversee, and provide guidance on all regulatory review activities within state jurisdictions (including that done by all agencies and departments of state and local government). See box 5 below.

Box 5. The Office of Regulation Reform, Government of the State of Victoria
The Office of Regulation Reform is critical to efforts to improve the quality of Victoria's regulatory environment and make Victoria a better place to do business. The Government has systematically introduced reform proposals concentrating on removing unnecessary regulation, and ensuring that new regulatory proposals are best practice. The Government's Regulation Reform strategy is focused on removing unnecessary or outmoded regulation, and ensuring that new regulatory proposals will deliver greater benefits to the community than any costs they impose. (Downloaded from the Office of Regulation Reform Website: www.dsrd.vic.gov/regrefrom)

4. Economic incentives to promote compliance. Fiscal incentives are used by the Central Government to ensure adherence to NCP agreements. Financial transfers from the center can be withheld if local legislation is found to unduly inhibit competition. Those transfers, known as NCP Payments, are sourced from a central fund comprising the 'gains' from regulatory reform, i.e. the benefits accruing to the central government via increases in corporate and income taxation that flows from greater economic activity following the removal of distorting State Government

5) A statement of alternatives to the regulation
6) A statement of costs and benefits associated with the identified alternatives
7) A statement as to why the identified alternatives are not preferred

(Source: Regulatory Impact Statement Handbook: Office of Regulation Reform, State Government of Victoria, Australia)

Box 6. Four major advantages of undertaking regulatory reviews in Australia

1. The competition dividend – the benefits from lower prices, more innovation and efficiency. One US evaluation found that 15 regulatory reviews resulted in changes worth $ 10 billion. But the reviews cost only $ 10 million to conduct – a payoff of 1000:1.
2. Transparency of decisions and consultation to help affected groups accept change
3. Cultural change among regulators by giving then a new mindset or framework within which to think about the costs of their decisions and how to achieve more efficient outcomes
   - Provides a framework to systematically test the relevance of legislative objectives to the contemporary environment
   - Provides a framework for assessing the relevance and value of new legislation. All new legislation that restricts competition must include a regulatory impact statement that is consistent with the principles of NCP
   - Provides a requirement that any legislation that continues to restrict competition will be systematically reviewed at least once every 10 years.
4. Substantial payments to states and territories from the Federal Government for successfully undertaking and implementing NCP regulatory reviews

Source: Guidelines for NCP Reviews, Centre for International Economics, Canberra Australia

Foundations for more effective regulatory supervision in decentralizing Indonesia

Various elements can be drawn from Australia's regulatory reform program and applied in Indonesia. These include the use of fiscal incentives to ensure compliance, returning the burden of proof to those that propose legislation, as well as developing a hierarchical and standardized system of regulatory review.

Other elements have less application. The underlying ideology is one example. Australia's reform program is grounded in the firm belief in the primacy of market forces, i.e. the view that free rather than regulated markets provide the best outcomes for both consumers and producers (unless of course regulation that restricts competition can be shown to be in the public interest).

Regulatory reform in Indonesia with the same or similar ideological basis would be politically difficult. Despite considerable progress toward economic liberalization over the past 15-20 years, there remains within the community a lingering distrust, even aversion toward the market mechanism, particularly in the regions.

Any program to promote regulatory reform would need to be packaged in such a way to be more politically palatable to legislators and bureaucrats. For example addressing the problem of trade and competition distorting local regulations could be done under the banner of 'eradicating the high cost economy' or even 'promoting national economic unity'. Both of which are politically more acceptable than a program that is seemingly designed to promote competition *per se*.

Key elements of the regulatory reform program

1) ***Returning the 'burden of proof' to the regions.*** Good regulatory practice requires that the burden of proof be firmly placed upon those proposing the legislation. That is, before legislation is passed it must be first shown that it carries a net-benefit for the community, i.e. proposals for legislation are assumed 'guilty until proven innocent'. Under present arrangements, it is left to the central government to determine *ex-post* the innocence or guilt of local regulations. This is not only inefficient, but also unnecessarily centralistic. A more efficient arrangement, and one that is perhaps more politically acceptable to the regions, is for much of the review process to be undertaken at the local level. To ensure uniform standards, local regulatory reviews would need to be carried out according to a set of established guidelines and procedures as determined by the central government, in consultation with the provinces (A successful model of such an arrangement in a decentralized setting can be found in Australia – see previous section).

2) ***Regulatory review teams at the Municipal level***. At the local (Municipal) level a core policy review team is formed and is charged with the responsibility of producing regulatory impact statements for all proposed legislation that may impose economic costs on elements of the community.

   There are already various models where such teams have been established in Indonesia. In North Sulawesi, for example the Provincial government has formed a small team comprising legal academics and retired senior public servants to review all proposals for non-fiscal regulations at the provincial level. Numerous reviews have been completed to date. Less formally, a group of legal academics at Sriwijaya University in Palembang, South Sumatra have established a 'Legal Laboratory' (*Laboratorium Hukum*) at their university to review and analyse local regulations. The group has been commissioned by a number of Municipal level governments to review their respective regulations. As yet, however, the group has been unable to develop similar relationships with the Provincial Government.

   This is a common problem in Indonesia. Despite having the greatest concentration of legal and economic expertise at the regional level, local universities usually do not play an active role in the policy process. This can be rectified to a certain extent by formalizing their role within the core review team mentioned above. Other core members of the team could be drawn from the Legal and Economics section at the Office of the Regent/Mayor. Depending on the particular regulation to be reviewed the core team would be appended with officers from relevant technical agencies (e.g. transport officials if the regulations concerns transport infrastructure matters) as well as stakeholders – those directly affected by the proposed regulation – such as consumers, farmers, small producers, civil society groups.

3) ***Regulatory Impact Statements.*** Unaccustomed to justifying proposals for legislation, local governments are likely to be resistant to any new requirements to produce impact statements and to bring outsiders into the policy process. Objections are also likely on the grounds that the regions do not have the requisite human, physical or financial resources.

It is therefore important to demonstrate to the regions that producing impact statements does not need to be a complicated and expensive affair, and that undertaking even the most elementary of reviews can generate considerable benefits for the community (and government) by way of improved regulatory process and outcomes. As noted by the OECD (1995), many of the benefits of carrying out regulatory reviews come, '…not from the precision of the calculations, but from the action of analyzing, questioning, understanding real world impacts and exploring assumption.

Initially, impact statements should focus on three simple tasks: 1) establishing the objectives of the regulation; 2) consideration of possible alternatives (including those not involving regulation); and 3) identifying winners and losers. Over time as capacity develops, and governments become more accustomed to the regulatory review methodology, policy choices can be increasingly assessed in cost-benefit terms.

4) ***Supervisory role for provinces.*** Provinces would play two important roles. The first is to provide a second tier in the review process by evaluating regulations from Municipal level governments within their jurisdiction. Those that fail the review are returned to the Municipal level. Others are submitted to the central government[14]. The second role is to work with the central government and other provincial governments to develop a standard approach to regulatory review, and to supervise and promote the regulatory review process at lower levels. In each case there would be considerable political resistance, particularly from the Municipal level governments that, since decentralization, disregard any formal vertical relationship with Provincial governments[15]

   There are obvious benefits to an enhanced role for the provinces. Provincial governments (assuming adequate human resources) would be better positioned than the central government to collect information on, and to assess the relative merits of proposed legislation within their respective jurisdictions. Closer supervision of lower level governments would ensure better compliance. With the Provincial governments filling this middle-level role in regulatory supervision, the center would no longer be swamped with local regulations to review. Only those regulations that have passed regulatory reviews at both the Provincial and Municipal level will be submitted to the center. This allows the central government more time and resources to undertake more thorough reviews, and more importantly to develop and better coordinate the regulatory review process at a national level.

5) ***Economic incentives and sanctions.*** The missing element in the existing supervisory arrangements are the economic incentives to encourage regional governments to submit legislation for review within the time specified, and to follows rulings from the center on problematic regulations. One approach would be to impose sanctions upon non-compliant regions, by reducing inter-government transfers from the center (DAU).

---

[14] Alternatively Provinces could be given final approval authority. However this might be a little premature as Provinces themselves are responsible for a number of problematic relations.

[15] Attempts have been made to restore the supervisory authority of the provinces. For example Decree 21/2001 of the Minister of Home Affiars (dated November 28, 2001) seemingly provides that authority, but excludes the authority to supervise regencies/municipalities on regional taxes and charges.

An alternative to using sanctions would be to develop positive incentives, whereby compliance would enable access to a special fund from the center (similar to the incentive model developed in Australia). In this way a new fund would be developed, perhaps as part of the special grants from the center (DAK), and allocations determined according to ratings of the regulatory climate (much like that developed by the KPPOD 2002b), as well as compliance with new procedural and institutional arrangements for regulatory review as described above. The model is similar to - and could possibly be adapted from - a planned Ministry of Finance program that seeks to rate regions according to their efforts to overcome poverty, and to reward successful regions through the use of DAK grants[16].

The rationale for developing a new fund at the center would be similar to that for the NCP payments system in Australia. Specifically, the elimination of distorting taxes and charges would generate financial benefits for the central government via increased receipts for corporate and income taxes flowing from greater economic activity[17]. These funds transferred back to the regions (on some kind of formula basis) would constitute a 'compliance dividend' that provides real incentives for local government to support, and take part in, the national regulatory reform effort.

Conclusion

This paper examined a broad cross-section of regulatory problems in local government and put forward key principles for regulatory reform

Regulatory problems were identified and discussed at two levels: The ***first*** was at the process stage where key problems include the inability to effectively identify regulatory objectives, the lack of consideration of non-regulatory alternatives, poor stakeholder participation and the general lack of awareness of the importance of internalizing cost-benefit analysis into policy process. The ***second*** is the product of the policy process, namely the use of specific regulatory or fiscal instruments that negatively impact upon business, such inappropriately priced and targeted user-charges, trade and competition distorting taxes and charges, as well regulations that crowd-out private sector participation and/or discriminate against outsiders.

The paper argues that decentralization is not the main cause of regulatory problems in the regions, but does present new problems and challenges, most notably those associated with the pressure to raise own-source revenues and the new, yet problematic institutional arrangements governing the supervision of local regulations. Equally if not more important is the opportunity that decentralization brings to improve economic governance through regulatory reform.

Key principles for reform that emphasize a more decentralized supervisory framework were discussed in the final section of the paper. These included reversing the burden of proof such that the regions assume greater responsibility in analyzing and justifying the regulatory impact of

[16] See 'Insentif buat daerah yang memerangi kemiskinan' *Kompas*, 20th June 2003, page 13.

[17] The recent World Bank (2003) report on decentralization notes that due to the deductability of local taxes in company tax reports the center ultimately pays for up to a third of the regional tax burden through lower central tax revenues (assuming a marginal corporate tax rate of 35%). For some oil companies, where the central government's take is 90% of revenues after costs, this burden is significantly higher

proposed legislation, allowing the provinces to play a more active role in supervising lower level local regulations and in overseeing the development and standardization of the regulatory review process, and using economic incentives to ensure local participation in the national regulatory reform effort.

Bibliography

Bandung Institute of Government Studies – BIGS (2002) *Merancang Kebijakan Perijinan yang Pro Pasar dan Sensitif Kepentingan Publik,* in cooperation with the Partnership for Economic Growth. Jakarta.

KPPOD (2002a) Laporan Kajian Peraturan Daerah, PEG-USAID, August 2002, Jakarta

KPPOD (2002b) Regional Investment Attractiveness: Ratings of 134 Regencies/Cities in Indonesia. In cooperation with The Asia Foundation, Jakarta.

Goodpaster and Ray (2000) *Competition Policy and Decentralization*¸ Partership for Economic Growth Project, Jakarta.

Lewis, B. (2003) 'Tax and charge creation by regional governments under fiscal decentralisation: Estimates and explanations' August, vol. 39 no.1, pp 41-56.

LP3M Sawala (2003) Laporan: Hasil Penelitian dan Pengkajian Peraturan-Peraturan Daerah Tentang Retribusi (Stdi Kasus di Tasikmalaya dan Garut), in cooperation with the Partnership for Economic Growth.

OECD (1995) *Recommendations on improving the quality of government regulation,* adopted by the Council of the OECD, Paris 9 March.

Regional Economic Development Institute – REDI (2003) *Final Report: Survei Persepsi Pelaku Usaha Tentang Otonomi Daerah dan Dampaknya Terhadap Iklim Usaha di Daerah.* IN cooperation with the Partnership for Economic Growth and The Asia Foundation.

SMERU (1999) Monitoring the Regional Implementation of Indonesia's Structural Reforms and Deregulation Program: Lessons Learned to Date, September 1999, Jakarta.

Suhirman (2001) *Desentralisasi dan Ekonomi Politik Perijinan*, Policy Paper Bandung Institute of Government Studies

World Bank. (1994) *Intergovernmental Fiscal Relations in Indonesia: Issues and Reform Options.* World Bank Discussion Paper no. 239, The World Bank, Washington D.C.

World Bank (2003) *Decentralizing Indonesia: A Regional Public Expenditure Review Overview Report*, East Asia Poverty Reduction and Economic Management Unit, June 2003, Jakarta.

Appendix. Survey on Decentralization and the Business Climate[18]

Key points and conclusions from survey

- There has been no major degradation of the business climate under decentralization. At the same time we have not seen any significant improvement. The general response from business is that the regulatory environment remains as problematic as it was prior to decentralization.

- The business-licensing environment has more or less remained the same. There appears to be an improvement in processing time required and to a lesser extent, in procedural and cost transparency. However these improvements are offset by higher licensing costs as local governments seek to raise own-source revenues (PAD), most likely through the pricing of licenses/permits (*retribusi izin*) beyond that required for cost-recovery. One salient point regarding licensing is that almost half the respondents report that they are still paying informal facilitation or brokerage fees to officers in the licensing-issuing agency.

- Most small and medium sized respondents perceive substantial increases in formal taxes and charges paid, but no change in the number of exactions, or the number of exacting agencies. This suggests local governments are extracting greater amounts of funds from existing revenue instruments as opposed to creating new ones (i.e. intensification instead of extensification). Larger firms report increased amounts exacted formally, and also greater number of formal exactions and collecting agencies.

- The burden of informal payments (*pungli*) appears to have slightly eased under decentralization, particularly in East Java, but worsening in North Sumatra and North Sulawesi. Increases in the burden of informal payments are positively correlated with firm size. Larger firms report greater amounts, frequency and number of exacting agencies/individuals. Informal exactions are most commonly imposed during transport and/or distribution. Most respondents prefer to absorb the cost of informal exactions rather than passing it on to suppliers or buyers.

- Given the structure of the sample in favor of small businesses, most respondents report no impact from minimum wage increases nor from severance pay stipulations

- The business climate has remained the same or shown a slight improvement for all sectors, except for transport. This result is consistent across a number of measures (e.g. licensing, informal exactions, service delivery, impact of local regulations etc).

- There appears to be a slight improvement in business perceptions on the impact of local regulations upon the business climate (under decentralization).

[18] Survey was carried out by the Regional Economic Development Institute in cooperation with The Asia Foundation and the Partnership for Economic Growth.

Introduction

The objective of the survey of was to gauge changes in business perceptions two years after decentralization as a means to assess whether the business climate had worsened, improved or remained the same.

Survey questions focused on four key elements:

- Licensing and bureaucracy
- Fees and charges – both formal and informal
- Labour and manpower issues
- The direction and orientation of local economic policy

The survey was carried out over two stages: July-August 2002 and October 2002 – January 2003

Sample

In total 1014 businesses were surveyed from 23 districts (*Municipal*) across 12 provinces.

Table 1 Survey Provinces and Districts

Province	Kabupaten	Kota
Lampung	Lampung Tengah	Bandar Lampung
West Kalimantan	Pontianak	Pontianak
Central Java	Demak	Semarang
Yogyakarta	Bantul	Yogyakarta
Bali	Gianyar	Denpasar
West Nusa Tenggara	West Lombok	Mataram
North Sumatra	Deli Serdang	Medan
West Java	Sumedang	Bandung
East Java	Jember	Surabaya
South Sulawesi	Maros	Makassar
North Sulawesi	Minahasa	Manado
Jakarta	-	-

- One rural and one urban district were chosen from each province. In rural areas agriculture typically accounted for around 15-20% of the regional economy
- Respondents were drawn from five key sectors in proportions (roughly) consistent with their relative contributions to the regional economy. The overall breakdown of the final sample was:

    - Trade 29%;
    - Manufacturing 22%;
    - Agribusiness 15%;
    - Transportation 11%
    - Services 23%.
- The final sample structure by firm size was 57.4% small, 35.6% medium and 7% large, where size was determined by number of employees and value of non-property assets.

Results

1. Bureaucracy and Licensing

- Most firms surveyed had at least one license relating to their business activities. Only 22% of firms had no license at all. SIUP (*Surat Izin Usaha Perdagangan*) was the most common license, held by 63% of respondents
- Five criteria were used to assess the efficiency and transparency of the licensing process:
    1. Speed of processing,
    2. Transparency in costs,
    3. Total licensing costs
    4. Procedural transparency, and
    5. Required documentation.
- For each of the five elements, responses were quantified as follows:

    Much worse -2
    Worse -1
    Same 0
    Better 1
    Much better 2

    Much of the analysis below is based upon simple averages of these scores
- Of the 1014 businesses surveyed, 932 gave one of these 5 responses listed above, another 82 responded 'don't know' or 'unsure'.
- Table 2 provides cross-provincial comparisons, based on averages for each of the five elements of the licensing climate. Note that the index in the final column is a simple average of the five elements.

Table 2. Perceptions of the Business Licensing Process: Provincial Performance
Scale: –2 (much worse) ↔ 2 (much better)

	Processing Time	Transparency in costs	Total Cost	Procedural Transparency	Documentation Required	Index
East Java	0.40	0.37	-0.22	0.40	0.14	0.21
Yogyakarta	0.45	0.28	-0.10	0.15	0.10	0.18
Central Java	0.34	0.15	-0.07	0.20	0.07	0.14
South Sulawesi	0.34	0.29	-0.18	-0.01	0.16	0.12
West Nusa Tenggara	0.32	0.20	-0.10	0.20	-0.09	0.10
Bali	0.18	0.19	-0.13	0.17	0.06	0.09
West Java	0.31	0.03	-0.28	0.12	0.09	0.06
North Sulawesi	0.25	-0.01	-0.26	0.10	-0.01	0.01
North Sumatra	0.25	-0.01	-0.26	0.10	-0.01	0.01
Lampung	0.24	0.03	-0.33	-0.03	0.10	0.00
Jakarta	0.03	-0.07	-0.12	0.05	0.07	-0.01
West Kalimantan	0.44	-0.04	-0.36	-0.10	-0.03	-0.02
Average	0.29	0.11	-0.20	0.11	0.05	0.07

- Key results
    - There appears to be a general and relatively strong improvement in licensing processing time required (except for Jakarta).

    - Less obvious and less consistent, are the improvements in procedural transparency and in cost transparency.
    - The amount of documentation required appears to have remained more less constant
- Total costs have increased, perhaps reflecting new own-source revenue raising efforts of local governments.
- The summary measure in the final column (a simple average of the 5 elements) suggests that the business-licensing climate has remained the same (i.e. close to 0) or if any, a very slight improvement. This is perhaps better illustrated in Table 3 below.

Table 3. Overall Perceptions of the Business Licensing Climate

	Much better	Better	Same	Worse	Much Worse	Unsure
Time required for processing	5.2%	24.6%	54.3%	6.5%	1.0%	8.4%
Transparency in costs	2.1%	19.5%	58.0%	10.8%	1.2%	8.4%
Total licensing costs	0.5%	11.8%	49.6%	27.7%	2.0%	8.4%
Procedural transparency	1.3%	20.1%	58.3%	10.7%	1.2%	8.4%
Amount of documentation required	1.4%	16.0%	61.4%	11.1%	1.7%	8.4%
Average	2.1%	18.4%	56.3%	13.4%	1.4%	8.4%

Using the same data and approach, this result appears to be consistent for all sectors, with transportation a notable exception with the only negative score.

Table 4. Business Perceptions by sector
Scale: –2 (much worse) ↔ 2 (much better)

Sector	Summary Index
Trade	0.10
Manufacturing	0.08
Agribusiness	0.06
Transportation	-0.01
Other services	0.07
Average	0.07

Other key results regarding licensing and bureaucracy

- Staff of the local agency (DINAS) issuing permits and licenses continue to play an important 'facilitation role' (in return for a fee) in assisting business with their license applications. Less than 46% of respondents sort out licensing matters themselves whilst over 30% pay informal fees to local government officers to facilitate their licensing applications. Other respondents use alternative means such as *Biro Jasa* (service agencies) or other kind of brokers (*calo*)
- Respondents were asked to consider the overall proportions of formal and informal fees in total licensing costs. Many respondents had difficulty answering this question as they were unsure of the precise breakdown of total licensing costs.

Balance of Formal and Informal Fees

More formal than informal fees	43.3%
More informal than formal fees	17.0%
Formal same as informal fees	10.8%
Unsure	28.9%

2. Taxes and Charges

For both formal and informal taxes/charges, respondents were surveyed regarding perceptions of the following

1. Total exaction amounts
2. Frequency/number of exactions
3. Number of collecting agencies or individuals

using the same method described above (i.e. –2 much worse ↔ 2 much better)

Results are summarized as follows

Table 5. Business Perceptions of Formal Exactions: Provincial Performance
Scale: –2 (much worse) ↔ 2 (much better)

	Total Amount	Frequency Intensity	/No Agencies	of Index
Bali	-0.24	0.07	-0.07	-0.08
Jakarta	-0.22	0.10	0.12	0.00
West Java	-0.23	0.20	0.17	0.05
Central Java	-0.29	-0.08	-0.01	-0.13
East Java	-0.30	0.20	0.17	0.02
Yogyakarta	-0.52	0.09	0.04	-0.13
West Kalimantan	-1.09	-0.07	-0.09	-0.42
Lampung	-0.46	0.20	0.21	-0.02
West Nusa Tenggara	-0.83	-0.16	0.06	-0.31
South Sulawesi	-0.34	0.05	-0.08	-0.12
North Sulawesi	-0.66	-0.17	-0.36	-0.40
North Sumatra	-0.63	-0.14	-0.31	-0.36
Average	-0.49	0.02	-0.01	-0.16

- Results:

- Respondents in general, perceive substantial increases in formal taxes and charges paid, but no change in the number of exactions, nor the number of exacting agencies
- Suggests local governments are extracting greater amounts of funds from existing revenue instruments as opposed to creating new ones (intensification as opposed to extensification).
- West Kalimantan and West Nusa Tenggara are perceived by business to have been particularly aggressive in increasing own source revenues through formal exactions

Table 6. Perceptions of Formal Exactions: By Firm Size
Scale: –2 (much worse) ↔ 2 (much better)

	Amount	Intensity	No. of Agencies
Small	-0.47	0.07	0.02
Medium	-0.55	-0.10	-0.04
Large	-0.55	-0.16	-0.31
Average	-0.49	0.02	-0.01

- Results
  - The (perceived) increasing amounts of formal taxes and charges paid are unrelated to firm size
  - Large firms on average see themselves paying an increasing number of formal exactions, to a more varied group of agencies.

Table 7. Business Perceptions of Informal Exactions: Provincial Performance
Scale: –2 (much worse) ↔ 2 (much better)

Province	Amount	Frequency	Agencies	Index
Bali	-0.04	0.04	-0.03	-0.01
Jakarta	-0.15	-0.02	-0.02	-0.06
West Java	0.13	0.36	0.13	0.23
Central Java	-0.12	-0.04	-0.14	-0.10
East Java	0.53	0.69	0.80	0.67
Yogyakarta	0.14	0.09	0.00	0.08
West Kalimantan	-0.02	0.16	0.20	0.11
Lampung	0.13	0.34	0.23	0.23
West Nusa Tenggara	-0.11	0.23	0.28	0.13
South Sulawesi	-0.07	0.01	0.12	0.02
North Sulawesi	-0.19	-0.13	-0.22	-0.18
North Sumatra	-0.18	-0.08	-0.21	-0.16
Average	0.02	0.16	0.12	0.10

- Key results:
  - The overall result suggests that the burden of informal payments (represented by perceptions of total amounts exacted, frequency of imposition and the number of collecting agencies) has eased slightly under decentralization.
  - This is driven to a certain extent by a strong improvement in East Java
  - It is also interesting to note that Lampung (known for its problematic regulatory environment) has also shown improvement
  - The problem of informal exactions in North Sumatra and North Sulawesi appears to be getting worse.

Table 8. Perceptions of Informal Exactions: By Business Size
Scale: –2 (much worse) ↔ 2 (much better)

Size	Amount	Frequency	Agencies	Index
Small	0.08	0.18	0.21	0.16
Medium	-0.12	-0.01	0.05	-0.03
Large	-0.33	-0.23	-0.17	-0.24
Average	0.02	0.12	0.16	0.10

- Results
  - Under decentralization increases in the burden of informal exactions are positively correlated with size
  - Larger firms report greater amounts, greater frequency and more exacting agencies/individuals than smaller sized firms

Table 9. Perceptions of Informal Exactions: By Sector
Scale: –2 (much worse) ↔ 2 (much better)

Sector	Amount	Frequency	Agencies
Trade	-0.06	0.16	0.16
Manufacturing	0.21	0.26	0.18
Agribusiness	0.13	0.19	0.16
Transportation	-0.26	-0.08	-0.11
Services	0.01	0.16	0.10
Average	0.02	0.16	0.12

- The problem of informal exactions appears to be worsening in the transportation sector

Common Locations for Informal Exactions

Markets and other sales outlets	37%
Main roads	25%
Factories	23%
Ports	4%
Airports	1%
Other	10%

- Informal exactions are commonly imposed during transport and/or distribution

Other results

- Respondents indicated which agencies or individuals most frequently impose informal exactions upon their businesses. The most commonly mentioned group was village (*desa*) officials (25%) followed by officials from the sub-district (*camat*) level of government (18%).Other groups included police, army, port officials, traffic officers (*DLLAJ*), and political party organizations and youth groups.

Table 10. Who carries the burden of informal exactions?

Strategy	Total	Percentage
Transfer all burden to suppliers	21	2%
Transfer some of the burden to suppliers	39	4%
Fully absorb the loss	577	57%
Transfer some of the burden to buyers/consumers	131	13%
Transfer all of the burden to buyers/consumers	42	4%
Unsure/don't know	201	20%
Grand Total	1011	100%

- Most respondents absorb the cost of informal exactions, rather than passing on the burden to suppliers/producers or consumers/buyers. This result is consistent across sector and across firm size.

Table 11. Overall Business Perceptions of Formal and Informal Exactions

	Much better	Better	Same	Worse	Much Worse	Unsure
Formal exactions (taxes, retribusi etc)						
Total amount (value)	2.3%	6.2%	35.7%	35.0%	9.8%	11.0%
Frequency (times)	3.8%	13.5%	54.0%	15.6%	2.0%	11.0%
No. of different collecting agencies	3.2%	12.7%	53.7%	18.1%	1.2%	11.0%
Informal Exactions (*pungli*)						
Total amount	8.2%	14.8%	28.5%	21.1%	4.4%	23.0%
Frequency	7.9%	18.9%	31.0%	15.9%	3.4%	23.0%
No. of different collecting agencies	7.4%	15.0%	36.3%	16.1%	2.3%	23.0%

Respondents were also asked to assess whether public services funded by formal taxes and charges (retribusi) had improved, worsened or remained the same

Table 12. Service Delivery under Decentralization

	Total	Percentage
Much worse	18	2%
Worse	110	11%
Same	583	58%
Better	257	26%
Much better	30	3%
Total	998	100%

Table 13. Perceptions of Service Delivery by Sector
Scale: –2 (much worse) ↔ 2 (much better)
Note: positive score suggests improvement

Sector	Score
Trade	0.14
Manufacturing	0.16
Agribusiness	0.29
Transport	0.06
Other services	0.19
Average	0.17

- Results
  - Of the 998 businesses responding to this question, most (58%) perceived service delivery to have remained the same whilst 29% thought that it had improved and only 13% saw it as worsening
  - The positive average score in Table suggests an overall improvement in service delivery. This is consistent across all sectors, with the transport sector again being the laggard

Table 14. Perceptions of Service Delivery by Sector
Scale: –2 (much worse) ↔ 2 (much better)
Note: positive/negative score suggests improvement/deterioration

Province	Score
Bali	0.35
Jakarta	0.26
West Java	-0.11
Central Java	0.18
East Java	0.38
Yogyakarta	-0.06
West Kalimantan	0.61
Lampung	-0.03
West Nusa Tenggara	0.09
South Sulawesi	0.44
North Sulawesi	-0.11
North Sumatra	-0.09
Average	0.17

- Surprisingly West Kalimantan records the highest score followed by South Sulawesi. Almost two thirds of the businesses surveyed in West Kalimantan responded that services under decentralization were either ‘better’ or ‘much better’

3. Labour and Manpower issues

Table 15. Impact of Minimum Wage (UMP) Increases upon Firm Productivity in 2002

	Business Size			
	Small	**Medium**	**Large**	**Total**
No impact	57%	38%	31%	52%
Very small	31%	41%	43%	33%
Moderately burdensome	10%	17%	21%	12%
Very burdensome	1%	3%	2%	2%
Positive impact	1%	2%	3%	1%
No. of firms	775	180	58	1013

- Results
  - Over half of the respondents reported no real impact, and another third reported only a small impact
  - Unsurprisingly the impact is positively correlated with size (i.e. smaller firms use casual labour, or are simply unaware of, or do not adhere to minimum wage stipulations)

Businesses were also asked about the impact of the Manpower Ministerial decree KEPMEN 150/2000.

Table 16. Impact of and response to KEPMEN 150/2000

No impact	716	71%
Greater focus on subcontracting	96	9%
Greater focus on casual employment	78	8%
Lay-offs	9	1%
Replace labour with machinery	3	0%
No new recruitment	69	7%
Other	43	4%
Total	1014	100%

- As with minimum regulations, most firms surveyed reported no impact
- For those firms impacted, there was a move toward subcontracting and casual employment, and less recruitment

4. The direction and orientation of local economic policy

Firms were asked what they considered to be the primary objective of local policy making under decentralization: the improvement of public services or to increase own-source revenues. Clearly the two should be related, that is an increase in own-source revenue should lead to better service delivery (although evidence from the regions suggests that this is not always the case). In this case our objective was to determine what businesses saw as the primary end of government policy, i.e. what is the government's first priority.

Table 17 Policy Focus: Service Delivery or Own-Source Revenues?

Strong focus on public services	28	2.8%
Focus on public services	93	9.2%
Balanced approach	268	26.4%
Focus on own-source revenues	412	40.6%
Strong focus on own-source revenues	106	10.5%
Unsure	107	10.6%
Total	1014	100%

- Perhaps unsurprisingly, firms see local governments as giving greater priority to revenue raising rather than improving public service delivery

Table 18: Impact of Tataniaga (non-tariff barriers)

Positive impact	63	6%
No real impact	339	33%
Negative impact	276	27%
Unsure/don't know	336	33%
	1014	100%

- Firms were asked about the impact of non-tariff barriers (such as price controls, forced monopsonies, quotas, export controls etc) on the business climate. As expected most firms to responded that there was no impact or were unaware of these types of business barriers. Interestingly a third responded that there was an impact (mostly negative), suggesting that non-tariff barriers remain a problem in the regions.

Table 19 Impact of Regional Autonomy upon *Putra Daerah* (local ethnic group)

Less advantage	81	8%
Same	575	57%
More advantage	186	18%
Unsure/don't know	172	17%
	1014	100%

- Firms were asked if regional autonomy had resulted in discriminatory treatment in favor of local ethnic group(s) or *putra daerah*. Most responded that putra daerah were treated as before, whilst 18% said that there was various forms of discrimination in favor of local businesses.

Other results

- Firms were also asked if cronyism under regional autonomy was more or less prevalent under regional autonomy (i.e. giving certain business people unfair advantages). Most answered that it remained as before, or were unsure.
- Firms were asked about their participation in the policy formulation and socialization process. Only 10% of firms reported greater participation under decentralization. The majority report no involvement and only come to know about new policies and/or regulations once they impact upon their businesses.

Table 20 Impact of Local Regulations/Policies upon Business Climate

Much better	23	2%
Better	204	20%
Same	496	49%
Worse	145	14%
Much worse	14	1%
Unsure/Don't know	132	13%
Grand Total	1014	100%

- There appears to be a slight improvement in business perceptions of the impact of local policies, although almost half the respondents report no change
- The most positive changes by province were in South Sulawasi, West Kalimantan and Bali. Negative changes were reported in North Sumatra, West Nusa Tenggara and Lampung.
- All sectors reported a positive change, except for transport.