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Indonesian decentralisation, corruption and its impact on Foreign Direct Investment.

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Abstract

Reformasi is the Bahasa term for the three year period of post Soeharto reforms that transformed Indonesia's centralised autocratic political and administrative system into a highly decentralised democracy. One major *reformasi* initiative was devolution of responsibility for core government services to almost 300 third tier municipalities, regencies and rural districts in one nationwide 'big bang' process. My thesis is that 'big bang' decentralisation gave rise to pervasive regional corruption which has had significant adverse impacts on the origin and disposition of Indonesia's inward Foreign Direct Investment (FDI). Poor policy implementation was a contributor to regional corruption, but above all this study finds regional corruption was attributable to impacts of 'big bang' on the country's institutional settings. As a result, centralised and predictable Soeharto era corruption that coexisted with successful economic development was fractured. It was replaced by decentralised and unpredictable corruption and maladministration that now contributes to Indonesia's underperformance as a beneficiary of FDI. The result is that FDI from developed countries has diminished substantially, technology transfers have reduced, exports of high value processed manufactures, as a proportion of exports have declined, and Indonesia is now more dependent on volatile mostly unprocessed natural resource exports.

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Introduction

President Soeharto's resignation in May 1998 was Indonesia's second tumultuous leadership change in its sixty-five years of post-war Independence. First was the overthrow of President Sukarno in 1965. The Sukarno coup d'état was followed by a period of extreme violence that resulted in the death of several hundred thousand alleged communists and leftist supporters. Those events inaugurated the three decade era of autocratic rule by President Soeharto (Scott 1985, p. 244). My research centres on the less violent but similarly momentous transition that followed the end of Soeharto's Presidency at the height of the Asian Financial Crisis.

A brief but intense period of reform, known locally as *reformasi* followed Soeharto's resignation. The process transformed Indonesia's political and administrative system from one of the most centralised to one of the most decentralised systems in the world and reestablished Indonesia as a democracy after thirty-two years of autocratic rule by President Soeharto (Hofman & Kaiser 2002, p. 2). The reforms were pervasive. In little more than two years Soeharto's successor President Habibie passed sixty laws that restored political party autonomy, overturned labor union restrictions, returned press and media freedoms, reinstated electoral democracy and above all initiated the 'big bang' decentralisation program (Seymour & Turner 2002, p.36). 'Big bang' took effect on 1 January 2001 and devolved wide-ranging political, fiscal and administrative responsibilities from Jakarta to almost 300 new, poorly prepared third tier regional administrations (Hofman & Kaiser 2002, pp. 6-8).

My hypothesis is that pervasive regional corruption and maladministration resulting from Indonesia's 'big bang' reforms has become an enduring nemesis to the country's economic development. I argue that although the reforms were essentially consistent with transition theory, poor implementation and devolution of responsibilities to third tier administrations transformed corruption in Indonesia. 'Big bang' reforms fractured centralised Soeharto era corruption practices that were not inconsistent with economic development into pervasive decentralised corruption that has adverse impacts on inward Foreign Direct Investment (FDI).

There are four steps in my analysis beginning with a review of the theoretical foundations supporting decentralisation as an appropriate policy in a post authoritarian transition state. Second is an examination of the process by which 'big bang' decentralisation was implemented in the regions and third is an assessment of the regional outcomes of decentralisation, especially the emergence of pervasive corruption and associated maladministration.

The fourth section assesses the impact regional corruption and maladministration has on inward FDI depending on the type of investment proposed. Recent scholarship has demonstrated that FDI location selection by multi-national enterprises (MNEs) is influenced by different factors, depending on its type. The three investment types used in this paper are *resource seeking*, *market seeking* and *efficiency seeking* ventures (Samford & Gomez. 2014, pp. 470-472). My thesis is that regional corruption has least impact on *market seeking* FDI but its impacts on *resource seeking* and *efficiency seeking* FDI are significant and constitute what I call Indonesia's 'decentralisation nemesis'.

The *reformasi* decision to devolve power away from Jakarta was not surprising as there was at the time strong dissatisfaction with centralised control over the regions. That control originated in a 1974 statute which authorised Jakarta to appoint strong regional governors and effectively removed all autonomy from the regions (Booth, 2014, p. 33). When *reformasi* began in 1998 armed secessionist movements in Aceh, East Timor and West Papua were extreme examples of regional dissatisfaction. Such dissatisfaction was also evident in former Soviet states and *reformasi* policy makers had witnessed decentralisation being implemented during the 1990's as a central tenant of post authoritarian transitions in former Soviet countries. Hutchcroft cites a 1994 World Bank study in which sixty-three transitional countries were in the process of transferring political power to local administrations. Performance of significant functions by locally elected subnational governments was presumed to foster democracy, achieve greater fiscal responsibility and provide better accountability for government services (Hutchcroft 2001, p. 23). Development theorists saw Indonesia as an ideal prospect for decentralisation, as its extensive geographic area and large, diverse ethnic and cultural population satisfied the key theoretical criteria (Alm et al 2001, pp. 84-85).

Despite the scholarly expectations of decentralisation, this paper will provide empirical support for the view that some significant outcomes from its implementation in Indonesia have not been fulfilled. The paper will examine why the 'big bang' approach was adopted rather than sequencing the process by region or function. It will also examine why decentralisation was directed to a newly established third tier of government and not the existing second tier provincial administrations. Scholarly sources will identify missteps in the implementation process across the now more than five hundred regional administrations. For example, Ahmad and Mansoor (2002, p. 6) highlight the failure to provide requisite training and capacity building within regions before functions were delegated. Likewise Green (2005,

p. 4) examines the origins of fiscal mismanagement that arose from the delegation of local expenditure functions without the delegation of matching revenue generating responsibilities.

Endemic regional corruption is one outcome of decentralisation that is not contested by scholars. McLeod observed that Indonesia was already identified as one of the most corrupt countries in the world during the later years of the Soeharto regime. The author portrays corruption as Soeharto's giant patronage franchise, which extended to all levels of government and to major elements of the private sector. Yet despite the pervasive corruption Indonesia maintained strong economic growth during the Soeharto era (McLeod 2000, p. 99). But 'big bang' decentralisation diffused power and authority away from Soeharto's authoritarian system and produced a different corruption regime. Ari Kuncoro described it as the end of "one-stop-shopping" for corruption benefits. That was replaced by a fragmented process in which government officials from national to local as well as military, police and legislative members pursued uncoordinated bribe taking activities. Kuncoro adapts the term 'overgrazing the commons' to illustrate the scale of corruption arising from this transition (Kuncoro 2006, p. 14).

Details of the history and theory of regional corruption and maladministration in this paper provide the basis for a subsequent empirical research project on regional FDI in Indonesia. Such a study would validate the outcome of this research assignment and be based on a recently published paper by Samford and Gomez (2014). That paper details the results of a ground breaking study on the application of Global Value Chain (GVC) theory to investment decision making by multi-national corporations in subnational regions of Mexico. Previous scholarship on FDI decision making has only focused on investment location decisions made by MNE's in deciding between one country and another. The Samford and Gomez study has extended the application of GVC theory to an assessment of the basis on which MNE investment site selections are made between different regions within a country.

The Mexican study established that while levels of regional corruption and maladministration influence the location of some forms of FDI it also demonstrated the potential benefits to regions from achieving and maintaining acceptable governance standards (Samford and Gomez 2014, pp. 479-485). Having regard to the close parallels between Mexico and Indonesia in terms of decentralisation history, size of their respective economies, their Transparency International corruption ratings, and the annual value of FDI, the Samford and Gomez paper opens the prospect for a similar study of regional FDI in Indonesia.

This paper makes two contributions to the study of corruption and corruption impacts on FDI. First it provides an application in practice of de Vaal and Ebben's (2011) theory of impacts institutional changes have on corruption outcomes. Devolution of responsibility to regional governments in Indonesia fractured the outcome certainty of centralised Soeharto era corruption and replaced it with uncertain regional corruption that is more deleterious. Previous studies have not examined the corruption transition in the light of this institutional impact theory. Second, it applies Samford and Gomez's (2014) research methodology on sub-national Mexican FDI to an assessment of Indonesia's post Soeharto inward FDI flows. While my paper does not replicate the empirics of the Mexican study it is the first application of those research findings to the likely impacts of regional corruption on types of FDI in Indonesia.

Terminology, structure and method:

Before proceeding further it is opportune to define the major terms used in this paper. Use of *'decentralisation'* is based on the World Bank definition and is taken to mean the transfer of authority and responsibility for government services and requisite expenditure and revenue from the central government to lower levels of government (Alm et al 2001, pp. 84-85). In Indonesia it was Law 22/1999 that decentralised all functions to the regions except for defense and security, foreign policy, monetary and fiscal policy, and judicial and religious affairs. The term *region* denotes Indonesia's third tier of government and includes the now 505 administrations variously referred to in the literature as municipalities, rural districts or regencies. '*Deconcentration'* is the term used when central government functions are performed by offices of the central government located in the provinces and regions but where responsibility for the functions remains with the central government (Alm et al 2001, p. 84).

Definitions of *'corruption'* are varied and contested. I follow Khan (1996, p. 684) and reject both of the usual normative definitions of it being either 'deviations from the ethical norms' or 'actions that harm the public interest' because they both define away the prospect of there being beneficial corruption. Instead, I adopt Khan's more inclusive definition of corruption as 'deviations from the formal rules governing the allocative decisions of public officials in response to offers to them of financial gain or political support' (Khan 1996, p. 684).

Likewise, *'global value chain'* (GVC) theory is a construct for which there is no resolved definition. Neilson (2014, pp. 40-44) provides a broad explanation of the transition of GVC from its origins in dependency theory to its present application in the assessment of the impacts of trans-national outsourcing or FDI decisions by MNE’s. The concept of global value chain theory used in this paper provides a basis for analysing capitalist decision making processes and assessing the opportunities or constraints those decisions create for different people or in different places (Neilson 2014, p. 40).

My study method is based on secondary sources. A review of the academic literature is provided in Chapter One in order to provide a basis on which to assess the merits of the ‘big bang’ policy which had been delegated to a team of Indonesian political science academics. The review is restricted to pre-implementation scholarship to avoid using hindsight to assess the merits of their recommendations. Chapter one also provides a review of relevant corruption and foreign direct investment literature in order to ground my later analysis of the impact those issues have had and are having on economic developments in Indonesia. Implementation of decentralisation is assessed in Chapter Two. It draws on scholarly sources to identify significant weaknesses in the process. My assessment is that those weaknesses are central to the ‘decentralisation nemesis’ that becomes apparent later in the paper. Chapter Three examines the outcomes once decentralisation became operational. Here the sources are more diverse and I take the opportunity to contest some of the positive endorsements of decentralisation outcomes that have appeared in the literature. The final Chapter relies more on empirical studies to highlight the impacts of regional corruption on the delivery of government services and examine changes that have become apparent in Indonesian FDI since decentralisation became effective in January, 2001. A brief conclusion ends the paper.

Chapter 1 Decentralisation, regional corruption and Foreign Direct Investment

The theoretical foundations:

This Chapter provides the foundational theory for three key elements of my thesis, decentralisation, corruption and the impact corruption has on foreign direct investment. All three issues are contested by scholars but there are two reasons to focus on these theories. The first is that these theories would have informed the seven person team of mostly western trained Jakarta academics who were instrumental in both the formulation and implementation of the 'big bang' policy[1]. The second is to position my paper within the context of the alternative theoretical perspectives in the literature. Decentralisation theory is my primary focus because my thesis is that regional corruption and its FDI consequences derive from the devolution of political, administrative and fiscal powers to the regions.

For consistency with the theoretical guidance available to the academic policy makers at the time, my analysis of decentralisation theory is restricted to scholarship that predates implementation of 'big bang' in 2001. Decentralisation research perspectives have advanced since 2001 and awareness of the limited state of theoretical and empirical knowledge at that time has modified my initially critical view of the Indonesian policy and its formulators.

Corruption 'arrived' as a topic of scholarship during the 1990's. That was due in part to its emergence as an issue in studies of decentralisation in post authoritarian Soviet countries but more particularly because of the supposed ability of new perception indices to measure corruption. Corruption measurement assumptions stimulated transnational studies of sources and impacts of corruption. The third theoretical issue addressed in this Chapter is recent research on the impact of regional corruption and maladministration on investment site selection decisions by multi-national enterprises (MNE).

Decentralisation theory:

> *"Decentralization measures are like some potent drug: when prescribed for the relevant illness, at the appropriate moment and in the correct dose, they have the desired salutary effect; but in the wrong circumstances, they can harm rather than heal".* (Remy Prud'homme 1995, p. 201)

[1] More details of the role of 'Team Seven' are provided in Chapter 2.

The term decentralisation is often used imprecisely in the literature. In this paper it is used synonymously with the definition of *devolution* in public administration scholarship. In that context *devolution/*decentralisation occurs when a central government distributes nominated functions and capacities to regional authorities across a country. The outcome is that authority and responsibility for physical operating needs, staffing, policy directive, and funding is devolved to a lower level of government (Hutchcroft 2001, pp. 30-31).

Decentralisation has engaged authors since territorial governors, viziers and satraps exercised authority in the regions of historic empires from Egypt to Persia. Treisman traces the origin of scholarship on multilevel forms of political authority to tri-level functions in a Greek city described in Aristotle's *Politics.* More relevant today are post Westphalian nation-state development theories by such notables as Hobbes, Montesquieu, Leibniz and authors of the US Constitution. For Treisman the individual rights and government accountability set out in post-revolutionary US and French statutes provide the foundations for advocacy and criticism of political decentralisation to the present day (2006, pp. 6-11).

Support for decentralisation in the form that is relevant to Indonesia's 'big bang' was initiated by economists, political scientists and management theorists during the 1970's. It developed in response to the prevailing economic 'stag-flation' and criticism of 'big' government. Structuring government functions 'closer to the people' was expected to produce economic, political and administrative benefits arising from greater accountability and more effective decision making by elected local officials (Ramesh 2013, pp. 1-2).

Writing in the European journal, *Synthesis*, Chancal Sharma observed that by the late 1980s economic efficiency considerations gave rise to an "obsession with curtailing the economic role of the state". Privatisation was positioned as an end point of government decentralisation. Sharma quotes Paul Smoke's (2001) view that fiscal decentralisation and local government administration had become the dominant issues in development literature (Sharma 2004, p. 2). By the late 1990s there were three different orientations to decentralisation scholarship - political structures, administrative functions and fiscal accountability - each with a separate but related decentralisation literature. What follows is an analysis of the status of academic theory in each of those aspects of decentralisation in the period preceding Indonesia's decentralisation.

Political decentralisation:

The objective of political decentralisation is for central governments to vest elected sub-national governments with public decision making authority in the expectation that better informed local representatives will be more responsive to the needs of local voters (Litvack & Seddon 2002, p. 2). Sharma cites a 1998 World Bank paper that summarised an array of reasons for implementing decentralisation. Reasons varied by region - in Africa it was the arrival of multiparty political systems; in Latin America the deepening of democracy; in Eastern Europe it was the transition to democracy and a market economy; better service delivery to large populations was the motive in East Asia; in South Asia accommodation of diverse ethnic and regional needs and in the Balkans, efforts to address ethnic tensions (Sharma 2004, p. 5).

The transition to democracy in formerly authoritarian states, especially former Soviet countries, was the focus of 1990's political decentralisation research. The core premise was that decentralised authority would lead to democracy and electoral accountability following decades of autocracy and centralism. This scholarship had application in Indonesia because policy makers addressed essentially the same transition following the sudden resignation of President Soeharto in 1998 (Pickvance 1997, p. 129).

Treisman (2006, pp. 12-15) summarises theorists' wider expectations as follows: local political authority would bring policy innovation based on awareness of local needs and there would be a more equitable distribution of public resources. In addition, political activism and enhanced civil society participation would mean more responsive government while new constitutional checks and balances would protect group rights and personal freedoms against central government abuse. More specifically, local political engagement was represented as providing a basis on which ethnic conflicts could be defused by accommodating specific needs of geographically concentrated minorities. Each of these theoretical considerations was relevant to the decentralisation ambitions in post-Soeharto Indonesia.

A caveat to the theoretical ideal of political decentralisation is provided by Hutchcroft (2001, p. 26) who made a clear distinction between authority and power. His point being that authority only provides the formal status for the role of a political official. But it is the application of the power vested in that authority that must be analysed to establish the operational reality. The author cites a study by Rudolph and Rudolph (1979, p. 198) to highlight how officials may pursue "values, interests, and goals of their own choosing" which diverge from formal authority. Of particular relevance to Indonesia is Hutchcroft's observation that strong patrimonial features in a society "undercut the formal rationality of structures of authority" (Hutchcroft 2001, p. 27).

Administrative decentralisation:

The goal of administrative decentralisation is to transfer "responsibility for planning, financing and managing certain public functions from the central government to subordinate levels of government" (Litvack & Seddon 2002, p. 2). World Bank expectations from the process were better social welfare, improved labour productivity, higher employment, more entrepreneurship and better infrastructure maintenance (World Bank, 1975).

During the 1980's neoclassical economists and public policy analysts addressed the issue of which services to decentralise and what were best practice implementation procedures. In a late 1980's paper Rondinelli et al. concluded that neither of those disciplines alone provided a 'comprehensive theoretical or methodological solution'. Rondinelli's paper was the first comprehensive political-economy theory of decentralisation. It addressed the spectrum of political, economic, administrative and financial issues that need to be managed in order to achieve desired policy objectives. The authors identified five core issues to be resolved in a comprehensive decentralisation process – policy and program design, service selection, service delivery mechanisms, financial arrangements and political structures (Rondinelli et al, 1989, p. 58). Later studies of post authoritarian transitions in Eastern Europe led other scholars to add two further decentralisation issues to that list, viz accountability for process outcomes and the role of decentralisation in the democratisation process (Pickvance, 1997, pp. 130-131).

Fiscal decentralisation:

This is the most contested element of decentralisation theory. That regions must have fiscal resources to implement their delegated political or administrative responsibility is not contested. As there are no examples in the literature of decentralised responsibilities being fully funded from local revenue sources, academic debate has focused on the scale and basis of centre to region revenue-sharing arrangements. Theoretical positions range from models where revenue-sharing is fixed by statute and central government power is minimised, to examples where regional authorities have uncertain fiscal entitlements and national governments retain influence over deployment of the funds in the regions (Garman et al 2001, pp. 206-207).

Central to the debate is the risk posed to national financial management. Smoke (2001, p. 4) cites Musgrave's 1959 'seminal work' on fiscal federalism to identify the core public sector fiscal responsibilities as being macroeconomic stability, income redistribution and allocation of public services functions. Smoke supports the premise that accountability for macroeconomic stability must be retained centrally. In his view developing countries, especially those dependent on agricultural exports are exposed to volatile markets that require prompt and informed national policy responses. Furthermore any delegation of responsibility for control of money supply to regional administrations would compromise national economic management (Smoke 2001, pp. 4-5).

Smoke also concludes that there is no sound case for devolving responsibility for income redistribution to the regions because local fiscal resources are limited and strong resistance by elites to local financing imposts would be expected. In his view the potential for major benefits from fiscal devolution would result from local administrations having responsibility for determining priorities for delivery of government goods and services in their region (Smoke 2001, pp. 5-7).

Empirical evidence of poor fiscal coordination and overlapping tax collections had been published in the 1980's. Kornai (1980, 1986) had constructed a 'soft budget constraint' theory to demonstrate the impact of central government bailouts of inefficient regional enterprises in socialist economies. Qian and Roland later adapted Kornai's theory to circumstances in fiscally decentralised countries where central budgets were imperilled by bailouts of profligate regional governments (1998, pp. 1143-1145). Prud'homme agreed. He advocated limits on regional government expenditures as a proportion of total government expenditure and opposed all but minimal delegation of taxing powers to regional government (1995, pp. 205-207).

Bahl (1999, pp. 2-3) on the other hand theorised that delivery of improved public services by regional administrations would create a 'user pays' capability and would open opportunities to impose a range of local fees, licences and levies. In his view the outcome would be greater 'revenue mobilisation' in developing economies. Moreover he conjectured that local imposts were a more efficient source of revenue than national income tax and value added taxes on which national governments typically relied. Another proposal that posed a threat to national macroeconomic management arose from Treisman's theory that regions be authorised to offer subsidies and concessions to attract investment projects and other new economic developments. The principle was that foregone revenue would be recompensed by post development tax collections and result, over time, in a net national economic benefit (Treisman 2006, pp. 15-16).

Two points conclude this review of decentralisation theory as it would have been understood by Indonesian policy makers before its implementation in practice in 2001. The first is that nothing in the literature asserts that all three forms of decentralisation must or should occur simultaneously. Smoke proffers a process for successful devolution based on phased implementation as regional capacity is built and that priority be given to sectors and functions likely to succeed quickly (Smoke 2001, p. 31). The second is the almost total absence of commentary in the literature on possible corruption outcomes. An exception was Prud'homme who noted that 'few-if any' empirical studies had been conducted on corruption arising from decentralisation. Nevertheless he theorised that decentralisation would foster corruption because there were fewer constraints on local than national politicians and bureaucrats (Prud'homme 1995, p. 211). Both the failure to phase implementation of decentralisation in line with regional capacity and the largely unforseen prospect of regional corruption arising from poor implementation have particular relevance to subsequent developments in Indonesia.

Corruption theory:

> *Corruption is a crime of calculation, not passion.*
>
> *Robert Klitgaard, 1998*

Good governance, including control of corruption, was central to the structural adjustment conditions imposed on Indonesia during the 1997/98 Asian Financial Crisis (AFC). The International Financial Institutions (IFI's) - International Monetary Fund (IMF) and World Bank (WB) – imposed exacting structural adjustment requirements in return for financial support during the crisis. The IFI governance conditions were based on the premise that corruption could be measured and controlled was a contentious issue in corruption studies at the time of the AFC and remains so today. As detailed in this section it was not until 2011 that scholarship was progressed in a paper which positions corruption in a broader institutional setting. The study provides a theoretical explanation for the observation that in certain circumstances corruption is not antithetical to economic growth but can co-exist with strong economic performance (de Vaal and Ebben 2011). Soeharto's 'patronage franchise' was such a circumstance.

Corruption has long been a topic in literary texts but none is more damning of the practice than Dante's 13th Century decree that bribers be placed in the lowermost parts of hell (Dimant 2013, p. 4). Contemporary focus on corruption by scholars was stimulated by the passage in 1977 of the US Foreign Corrupt Practices Act. Enacted in the chastened post-Watergate era in response to revelations of extensive bribe paying by Lockheed sales executives, the law prohibited representatives of American corporations from bribing foreign government officials. Yet notwithstanding the adverse competitive impact the law had on US companies, one scholar opined that corruption was viewed by the academy until the 1990's as "sleazy, ambiguous and impossible to put into meaningful mathematical models" (Krastev 2003, p. 110).

The core issues were scholarly disagreement on the definition and the measurement of corruption. Krastev provides examples of three alternative definitions that have various degrees of acceptance within the academy. They range from a normative assessment of actions that fail to meet accepted public interest or public opinion standards to a market based analysis of behaviours that are outside the norms of market transactions. But the most widely accepted and World Bank endorsed definition of corruption is 'actions that abuse public office for private gain' (Krastev 2003, p 113). Tanzi refined those definitions by separating what he termed "petty" or administrative corruption where public officials abuse their power to extract payoffs and "grand" or political corruption where legislative, executive or judicial powers are abused for advantage (Tanzi 1998, p. 565).

But the definitional debate continues. In a 2012 paper Banerjee et al. define corruption as "the breaking of a rule by a bureaucrat (or an elected official) for private gain". The authors claim this definition is more nuanced because it incorporates such acts of nepotism (illustrated by an improper allocation of a contract for kudos but not money) or "stealing of time" by employees who are paid but do not attend the workplace (Banerjee et al, pp. 6-7). While seemingly semantic the value of Banerjee's definition for my study is its focus on rule breaking. An objective test whereby rule breaking actions for monetary or non-monetary reward are deemed corrupt excludes issues arising from subjective and normative judgement of acts based on typically western moral or ethical standards. The rule breaking distinction is important in the Indonesian context as it distinguishes corrupt acts from traditional patronage largess.

Measurement of corruption is no less contested. It became central to corruption studies following publication by Transparency International of a Corruption Perception Index in 1995 and another by the World Bank in 1997. Both indices ranked countries in order of their *perceived* level of corruption based on subjective assessments by corruption experts - usually foreign and usually western. Though not published as empirical measures of corruption the indices were soon taken as such and became the basis for academic analysis of transnational corruption. The data was used in wide ranging regression studies on sources and impacts of corruption in developing countries (Treisman 2007, pp. 213-215).

New theories variously represented that corruption was limiting economic growth, reducing foreign investment, preferencing FDI to less corrupt countries, disproportionally impacting the poor, and distorting public investment because governments pursued projects from which corruption returns were highest (Tanzi, 1998, Rose-Ackerman, 1999, quoted in Krastev 2003, p. 116). Both Treisman and Krastev discredit these theories by pointing to the absence of genuine empirical data on corruption itself. Both challenged the merit of a corruption perception survey. They questioned what in fact was demonstrated if successive annual surveys showed that corruption had increased in a particular country. Did it mean there were more corrupt transactions per person, or more people were involved in acts of corruption, or was it just general public opinion that there was more corruption, or perhaps there was a perception that corruption had moved to a higher level of decision makers? (Treisman 2007, pp. 215-216. Krastev 2003, p. 113).

Another critic of anti-corruption theory and IFI good governance policy was British academic Mushtaq Khan whose work demonstrated that good governance was not a necessary precondition for economic development. Khan rejected the IFI's development prescription and identified thirteen high growth countries including post war Japan, Taiwan, South Korea, Singapore, China, Botswana, Indonesia and six others where development success had occurred despite corruption and other good governance shortcomings. These results contradicted much of the prevailing academic theory and the IFI policy prescription that corruption control was a prerequisite for strong free market economic development (Khan 2007, pp. 9-14).

In a paper titled “A house of straw, sticks or bricks?” Norwegian scholar Andvig also rejects the empiricist’s conviction that corruption could be measured and its development consequences managed. He asserts that questionable empirics had made corruption ‘real’ and enabled it to enter the political domain. In turn that fostered a naïve expectation that corruption could be controlled by public policy (Andvig 2005, pp.1-8).

An important advance in corruption theory with specific application to my thesis appeared in a 2011 paper by de Vaal and Ebben. The authors go beyond the assumption in previous studies that the relationship between corruption and economic growth is independent of a country’s institutional settings. Their paper examines the “web of formal and informal institutions and distortions that determine the way economies function” and posits that corruption is integral to those interdependencies. Consequently any study of the effects of corruption in a particular society must take account of its institutional settings because as they note, “corruption will have different effects in different institutional settings” (de Vaal and Ebben 2011, p. 109).

Space does not allow for a detailed recap of this theoretical construct but de Vaal and Ebben’s focus on the differences between centralised and decentralised corruption make their work relevant to the outcomes that followed Indonesia’s ‘big bang’ decentralisation. De Vaal and Ebben illustrate their argument with references to changed effects in circumstances where corruption is either centralised or decentralised. Where corruption is centralised, as my thesis contends it was under President Soeharto, corruption becomes institutionalised and plays a part in achieving national objectives. But when corruption is decentralised, as occurred after the ‘big bang’, outcomes are uncertain and disconnected from national development objectives (de Vaal and Ebben 2011, p. 112). My paper will posit that uncoordinated regional corruption has occurred in post Soeharto Indonesia and is central to the question of a ‘decentralisation nemesis.’

Finally, in the context of my thesis it is notable that although scholarship on the subject of corruption and decentralisation is expanding, it remains very limited. An Econlit database search reported in Fjeldstad’s 2004 review of the literature identified only 20 references to the topic in the period 1991 to 2003 (Fjeldstad 2004, p.2). My search of the same database identified 118 articles published in the decade since 2003 from. Some of that material is referenced in an assessment of the outcome of Indonesia's decentralisation in Chapter Three.

Corruption and its Impacts on Foreign Direct Investment - The Theory:

Details of the impact corruption and its associated maladministration have on regional politics and delivery of government services are set out in Chapter Three which reviews the outcomes of decentralisation. But because corruption impacts on FDI are central to my thesis this section provides the theoretical context on which my examination in Chapter Four of its impact on FDI location decisions is based. This section begins with the development of theory on the role of FDI in a developing economy. It then outlines the recent advent of studies on the effects corruption has on foreign investment location decisions by MNEs.

The emergence of FDI as a major factor in the post-Cold War *globalisation* process was anticipated in a 1994 study titled *Towards a Theory of International New Ventures.* The study envisaged the emergence of small organisations as competitors to the large, vertically integrated corporations that previously dominated cross-border manufacturing and marketing (Oviatt & McDougall 1994, p. 51). Oviatt and McDougall's New Ventures Theory demonstrated that existing theories did not accommodate the reality of small new firms in the global marketplace and challenged existing internationalisation paradigms. This influential study introduced two new elements to FDI scholarship. The first was to identify companies focused on using resources and selling their output in multiple countries and the second was to demonstrate that such ventures did not need to own the production resources in order to internationalise their business (Oviatt & McDougall 1994, p. 52).

New Ventures Theory foresaw the way in which homogenization of distant markets together with availability of reliable, efficient transport and international communications would provide opportunities for new and smaller competitors. Their sustainable advantage against international competition would rely on possession of a unique asset (brand, know-how, technology) that was internationalised through strategic control, but not necessarily ownership, of essential production and delivery capabilities (Oviatt & McDougall, 1994, pp. 51-54).

FDI scholarship was then strongly advanced with insights from Value Chain Theory following a 1999 Sussex University workshop on 'Spreading the Gains from Globalisation' and its follow-up conference at Bellagio, Italy. The Bellagio conference title was 'The Value of Value Chains: Spreading the Gains from Globalisation'. Papers from these conferences strongly impacted FDI studies. Globalisation was characterised as a functionally integrated process with activities dispersed internationally and required the application of Value Chain scrutiny (Gereffi et al 2001, p. 3). Value Chain established its credentials during the 1980s by transforming intra-corporate efficiency in western economies after its publication by Michael Porter in 1985. Porter represented manufacturing and service organisations as a series of inter-related sub-systems with inputs, transformation processes, outputs, marketing and sales, and ongoing services. His process was to subject each sub-system to intense individual assessment in order to optimise operating costs and profits (Porter 1985, pp. 11-15).

Proceedings of the Bellagio conference, which adapted the Value Chain process to FDI sub-systems, were published as the Handbook for Value Chain Research. It concluded that the issue for governments and corporations is not *whether* but *how* one engages in the globalisation process. What distinguished globalisation from earlier internationalisation of trade was 'functional integration between internationally dispersed activities' (Gereffi et al. 2001, p. 3). For developing countries such as Indonesia the issue was how to engage with this dispersed manufacturing activity and secure expected benefits of better jobs, less income inequality, and access to new technologies (Kaplinsky & Morris 2001, pp. 101-102).

A major constraint on the ability of a developing country to engage in the globalisation process and benefit from FDI is the ability of the economy to integrate knowledge intensive activities. Kaplinsky & Morris noted that developed countries had retained the intangible, knowledge intensive functions such as design, R&D, logistics and finance. High-end production functions were contracted out to the literate, process manufacturing middle income countries such as China or South Korea that were directly integrated into the global production chains. But, in what the authors term *immiserising growth,* poorly educated low income countries such as Bangladesh became dependent on price competitive subcontract functions that exploited their abundant low cost labour (Kaplinsky & Morris 2001, pp. 101-104).

Corruption seems not to have been a major focus of FDI scholarship until publication in 2000 of a paper by Smarzynska & Wei. Their study, based on data from joint ventures established during the 1990's between western and local enterprises in former Soviet countries, examined how corruption impacted the composition of FDI projects. Unsurprisingly, the study established that corruption had a significant impact on both the make-up and operational activities of FDI ventures. It established that there was an inverse relation between the level of corruption in a host country and the level of technological sophistication involved in FDI projects. If high levels of corruption were evident then FDI ventures were restricted to low technology operations. Concern for security of high technology intellectual property and know-how resulted in such manufacturing investments only proceeding as wholly owned projects or as joint ventures in less corrupt countries (Smarzynska & Wei 2000, pp. 1-14).

Further studies on the impact of corruption on FDI soon followed. One study established that corruption does not deter FDI entirely but it does impact the source of FDI origination (Habib & Zurawicki 2002, pp. 291-296). Using both an OLS regression model and a PROBIT model the authors established that the absolute difference in the level of corruption between the home and the host country largely determines the source of FDI participants. In essence the study found that investors domiciled in countries with low levels of corruption were much less likely to invest in countries with high corruption while investors familiar with corruption at home are more likely to invest in corrupt countries abroad (Habib & Zurawicki 2002, p. 303).

Empirical and theoretical studies during the early 2000s refined aspects of the corruption-FDI relationship. In a study of data for 7 years from 40 countries John Zhao and others examined the influence of low transparency as a separate variable to corruption as a factor impacting FDI. While acknowledging a possible weakness in their proxy for measuring transparency the analysis confirmed the hypothesis that low transparency had a significant adverse impact on inward FDI. The authors theorised that low transparency implies exposure to “hidden agendas” and vague policies that represent unquantifiable risks that deter foreign investors (Zhao, Kim & Du 2003, pp. 46-47).

Not every study in my review of the corruption-FDI literature found corruption to have an adverse impact on potential investors. Writing in the Journal of International Political Economy, Barassi and Zhou examined FDI investment patterns between 1996 and 2003 for 20 OECD countries from which investments were directed into 52 host countries. Contrary to previous studies this paper established that corruption is not adverse to FDI in all circumstances (2012, p. 303). In this study corruption is shown to facilitate FDI when a MNE already has a well-established presence in a host country should there be an increase in the level of corruption. The findings were that investors with an established stock of FDI investments were disposed to increase their presence in that country at the same time as new investors were deterred. The authors argue that corruption in this situation can be a ‘wheel greaser’ for existing investors but a ‘wheel-sander’ for new investors (Barassi & Zhou 2012, pp. 308-309).

The final paper in this review of the theoretical basis of my thesis is the first study to examine the impacts of corruption on FDI at the sub-national or regional level. Published earlier this year by Samford and Gomez the paper examines Mexican foreign investment data for the decade to 2009 and adds two substantial new elements to scholarship on governance and FDI. In addition to being one of few studies to analyse FDI in a sub-national context the paper also disaggregates foreign investments into three categories based on the purpose of the investment viz. *market seeking*, *efficiency seeking* or *resource seeking*. *Market seeking* is defined as investments destined to provide tradeable goods, or non-tradeable goods or services (insurance, banking, telecommunications, etc.), to the local market; *efficiency seeking* are ventures that utilise low input costs as part of a global value chain production process and *resource seeking* projects are FDI investments that develop mineral, hydrocarbon or agricultural resources for export (Samford & Gomez 2014, pp. 468-471).

The study methodology enabled the authors to determine what impact, if any, selected local variables such as corruption, violence and political party policies had on location selection by FDI investors in Mexico. The paper established that there are distinctly different priorities for foreign investors depending on which category of investment is proposed. *Market seeking* investors are drawn to locations that enable access to large population centres. The unexpected finding is that few other issues impinge on decision making by market seeking investors. A high crime rate or history of labour unrest did not impact on location selections. For globally integrated *efficiency seeking* investors minimising input costs for transport, infrastructure and labour determined the location priorities (Samford & Gomez 2014, pp. 470-471).

The Mexican study found that *efficiency seeking* investors have extracted significant discretionary concessions and incentives from pro-business regional administrations. The authors noted the potential for inter-regional competition for FDI to result in a “down-to-the-bottom-race” with examples of free real estate and excessive infrastructure cost exemptions being granted to secure FDI projects. For *resource seeking* projects the primary requirements are social stability, consistency in government policies and efficiency in government administration. These investors displayed low tolerance for nepotism, corruption, government inefficiency and political instability. The authors attributed these priorities to the capital intensive long term nature of resource project developments (Samford & Gomez 2014, pp. 485-487).

Conclusion:

The opening section of this Chapter provided an assessment of the theoretical context in which advisers to the Indonesia government made the historic recommendation in 1998 to decentralise extensive powers to new third tier regional administrations. At the time most political scholars were focused on the benefits of more responsive service delivery and greater political accountability of locally elected administrations. That was reflected in the scholarship on political, administrative and fiscal decentralisation reviewed above and provides the basis for evaluating the actual implementation process in the next Chapter.

Chapter Two will reveal implementation shortcomings and my paper argues they were instrumental in the emergence of widespread regional corruption. Corruption theory and its relevance to the location and make-up of Foreign Direct Investment detailed in this Chapter provide the foundations for analysis of those issues later in my paper.

Chapter 2: Decentralisation – implementing the 'big bang' policy

This Chapter provides an understanding of the circumstances in which Indonesia's historic decentralisation policy became law and was implemented in the thirty months from President Soeharto's resignation in May 1998 to commencement of regional autonomy in January 2001. Central to my thesis of decentralisation induced corruption being the nemesis of FDI is the liberal scope of powers delegated to the ill prepared regions and the unduly short timeframe allowed for its implementation. Explanations for those decisions range from pursuit of political advantage from the reformist mantle to decisions forced by circumstances at the time. IMF imposed cuts to government expenditures combined with a wave of unemployment caused by corporate and bank failures had triggered persistent civil unrest. Furthermore armed secessionist movements were active in several provinces. Irrespective of the cause my assessment is that the liberal scope and inadequate implementation of the reforms combined to facilitate the widespread regional corruption that adversely impact Indonesia's FDI inflows.

That a country with a population exceeding two hundred million people inhabiting over six thousand islands and emerging from thirty-two years of autocratic government should have embarked on such an audacious decentralisation program was very ambitious and, not surprisingly, its outcomes are equivocal. But some other aspects of the broader *reformasi* program were successful. As noted in the Introduction, legislation to restore political party autonomy, reinstate press freedom and enable labour union to operate was ratified. Furthermore electoral democracy was restored, political prisoners were released and anti-corruption efforts initiated (Seymour & Turner 2002, p. 36). As a result, and notwithstanding the financial crisis, a surge in unemployment and widespread civil unrest at the time of President Soeharto's resignation there was not a repeat of the extreme violence that accompanied Soeharto's ascent to power in the 1960s.

Context:

In an insightful paper written several years before Soeharto's resignation US academics Paul Smoke and Blane Lewis[2] examined efforts to improve the fiscal accountability of Indonesia's provinces. Their paper details largely unsuccessful attempts to *deconcentrate* delivery of infrastructure and urban development projects to provincial administrations during the 1980s

[2] Lewis served as an adviser to the Indonesian government during and after the *reformasi* period

(Smoke & Lewis 1996, pp. 1281-1282). Those failures had built public awareness of inefficiencies in infrastructure planning and financing attributable to the prevailing fiscal centralisation. The authors had observed pressure on provincial administrations to accommodate increasing demands for infrastructure arising from urbanisation associated with the growth of manufacturing and calls for better public services as disposable incomes and living standards improved. As a result there had been some 'gradual and selective' delegation of powers to subnational administrations but it did not include any form of political decentralisation (Smoke & Lewis 1996, pp. 1283-1284).

That 'gradual and selective' delegation of powers was subsumed in the 1999 'big bang' process but this insightful paper's value to my thesis derives from its emphasis on the history of decentralisation programs failing to achieve their objectives. Tellingly, the authors attribute the limited success of these initiatives to two complimentary issues. The first being a failure to tailor programs to 'context-specific processes by which feasible and sustainable outcomes could be achieved' and the second being initiatives that are:

> "far too comprehensive and inattentive to the complex institutional realities that logically govern the extent to which, and the pace at which, decentralisation can occur…" (Smoke & Lewis 1996, p. 1281).

Though written in advance of Indonesia's 'big bang', but informed by awareness of the outcome of decentralisation programs in other post-authoritarian transition countries, the Smoke and Lewis paper presages the precise shortcomings that were to emerge in Indonesia's decentralisation program.

Prior to 1998 Indonesia was a unitary state in which there was no clear distinction between the service delivery functions for each level of government. When Vice President Habibie succeeded Soeharto in May 1998 he lacked electoral legitimacy and needed to quell the persistent rioting and civil unrest that had brought down the former President. As US academic Benjamin Smith observed Habibie faced demands from 'activists, separatists, regime loyalists, and the international (donor) community' (Smith 2008, p. 212). Seeking to distance himself from the Soeharto legacy and position himself as a reformer President Habibie announced in his first week in office that general elections, officially not due until 2002, would be held by June 1999. The new election would be based on revised electoral legislation where restrictions on the formation of new political parties were withdrawn and parliamentary seats reserved for the military were minimised and in time eliminated (Crouch

2010, p. 47). Electoral reforms extended down to both the provincial and regional levels of government where legislative representatives first became popularly elected in 2001 and direct elections of regional executives began in 2004 (Lewis 2010, p. 649).

Seeking popular support and re-election in 1999, Habibie's majority Golkar government also lifted press and media restrictions, removed trade union controls and released a large number of political prisoners. Habibie had established a team of advisers to prepare the legislative program for electoral reforms. Known as Team 7 these mostly western trained political science academics[3] maintained their individual full-time academic positions and managed within a “handful of months” to draft the electoral reform legislation required to satisfy the President’s commitments (Smith 2008, p. 221). But Team 7 pursued a further reform agenda and based on interviews with Team 7 members, Smith recounts that the initiative to decentralise Indonesia’s political system came from this group. The initiative was pursued by leading members of the Team who had ambitions for regional autonomy because, like President Habibie, they were not Javanese but native of South Sulawesi (Smith 2008, p. 221).

On completion of their electoral reform mandate Team 7 proceeded to prepare draft policy documents and legislation for decentralisation. The draft legislation was modelled on a 1992 bill prepared by the Ministry of Home Affairs which provided limited taxing powers to major cities and regencies. Provisions in the 1992 legislation were tightly drawn to ensure provincial governments did not secure fiscal powers that would have compromised the central government’s ability to control secession minded provinces. In order to overcome this historic objection to decentralisation, the Team 7 proposal bypassed the provinces and delegated powers to city, municipal and rural administrations (Smith 2008, p. 222). Other authors agree that granting autonomy to the provinces would have positioned several of them to pursue sovereign independence (Seymour & Turner 2002, pp. 40-41).

Ryaas, the leader of Team 7, secured Habibie’s support for the draft decentralisation legislation in late 1998. By supporting the legislation Habibie was able to present himself to the electorate as the first reformist and not the last authoritarian president. The historic legislation for transition of extensive political, administrative and fiscal power to the regions was introduced to the parliament, debated and passed into law just six months later in May 1999 (Smith 2008, pp. 221-222).

[3] Four of the seven were University of Illinois political science graduates, three of whom also obtained doctorates in the US. Another was a US Law graduate and two held local academic qualifications (Crouch 2010, p. 79).

Two Laws, Nos. 22 and 25 of 1999 devolved to the regions responsibility for all previously central government powers except for issues of international politics, security and defence, foreign policy, monetary and fiscal policy, justice, religious affairs and ‘other fields’. Smith illustrates the scale of ‘big bang’ by noting that over 2 million civil servants and 16,000 facilities (schools, hospitals, etc.) were transferred from central to regional government responsibility. More than 40 percent of total government expenditure and over 60 percent of the national development budget also passed to the regions (Smith 2008, p. 212). Notwithstanding his reform credentials President Habibie was defeated in the 1999 election. But his successor, President Wahid, soon appointed the head of Team 7, Ryaas Rasyid to his cabinet as Minister for Regional Autonomy with responsibility for implementing the ‘big bang’ legislation. Ryaas in turn appointed his academic colleague and Team 7 deputy as his ministerial deputy (Smith 2008, 227).

The ‘big bang’ legislation was passed during a turbulent time in the *reformasi* transition. Secessionist demands in Aceh and communal violence in Maluku and Poso had intensified following approval in February 1999 of the East Timor independence referendum. Communal violence in Ambon and West Kalimantan had also displaced tens of thousands of residents (Seymour & Turner 2002, pp. 36-37). Financial Crisis reform demands by the International Monetary Fund and World Bank had put the administration under pressure to reduce government spending cut consumer subsidies and remove trade and labour protection regulations. Corporate debt defaults were widespread, unemployment had risen sharply and social unrest followed the forced closure of thirty eight banks in March, 1999 (Boediono 2002, pp. 388-389). In summary, this was the context in which the process of planning and authorising Indonesia’s ‘big bang’ decentralisation came to completion in mid-1999.

Implementation:

Adoption of the ambitious nation-wide common implementation date for ‘big bang’ was at odds with orthodoxy at the time. Extensive Decentralisation Briefing Notes prepared by the World Bank in 1999 set out details of the multidimensional aspect of political, fiscal and administrative decentralisation (Litvack & Seddon 2002, pp. 9-10). Had Ryaas and his staff at the Minister for Regional Autonomy been aware of this paper and the scale of the requirements needed to concurrently implement such a program it would have challenged their resolve. Other scholars had also advocated greater caution. Respected US academic Paul

Smoke had proposed that functions only be devolved as regional capacity was built and preference be given to sectors and functions likely to succeed quickly (Smoke 2001, p. 31). Similarly Ahmad & Mansoor cite an IMF Working Paper that emphasised the necessity for appropriate sequencing in order to achieve the objectives of better service delivery and improved government accountability. As with Smoke the IMF prescription was for functions to be transferred from central to regional administrations only when local capacity to deliver the function was available and only then should requisite revenue be transferred (Ahmad & Mansoor, 2002, p. 6). But perceived political advantage, widespread unemployment and civil unrest arising from the AFC along with threats of secession meant that is not what happened in Indonesia.

Establishment of the Ministry of Regional Autonomy in 2000 with Ryaas Rasyid as the responsible Minister signalled the start of implementing the 'big bang' legislation. Seymour and Turner were early scholars who questioned if it was appropriate to delegate responsibility to third tier regional administrations. They accepted that better service delivery and improved government accountability was the official reason for delegating authority to the three hundred third tier regional administrations, rather than the twenty seven more substantial second tier provincial governments. Yet for Seymour and Turner by-passing the established provincial administrations raised doubts (subsequently confirmed) about the 'intellectual capacity' in the regions to accept the new responsibilities. These authors also cite an unpublished paper by Brodjonegoro and Asunama (2000) who foresaw how a weakness in the 'big bang' legislation would enable further subdividing of regional areas in order to expand patronage opportunities (Seymour & Turner 2002, pp. 40-41).

Until the legislation was modified in 2004 regional governments had total responsibility, without limits or conditions, for providing education, health, public works, agricultural development, land management, environmental control, cultural affairs and the associated human resource management requirements (Seymour & Turner 2002, p. 38). One scholar reckoned that the regions had become responsible for more than seven hundred new tasks (Usman 2001, p. 7). A particular uncertainty in the 1999 legislation was an 'other fields' category of responsibility retained by the national government. A default interpretation provided the foundation for central government control of national planning policy, national standards for services such as education, health and the environment, together with national technology development and heritage conservation issues. Finally, a lack of certainty concerning responsibility for transport, communications and natural resource development projects created tension between regional and central government officials working to implement the legislation (Seymour & Turner 2002, pp. 38-44).

Important to my thesis is evidence of widespread corruption early in the ‘big bang’ implementation phase. Not infrequently, examples of corruption arose with the transfer of personnel from central to regional administrations. Gross discrepancies arose between the headcount on the national payroll and the actual staff in the region. This highlighted the prospect of ‘phantom’ employees which is an issue examined in more detail in the next Chapter (Usman 2001, pp. 13-15). At the regional level poorly defined role requirements for regional officials and weak or non-existent external performance assessments resulted in local executive and legislative officials acting like ‘little kings’ without deference to a central authority or the local electorate. Widespread lack of accountability measures for service delivery outcomes and no external financial audits enabled ‘elite capture’ of many regional government administrations (Hofman & Kaiser 2002, pp. 10-11).

Writing in 2005 Keith Green opined that corruption in Indonesia had not decreased and may well have increased because of decentralisation. Inadequate preparation enabled poorly qualified local officials to occupy positions of significant authority and use their position to extract bribes for decisions previously controlled by central government officials (Green 2005, pp. 5-7). Moreover the number of untrained officials capable of corruptly extracting inducements bloomed after ‘big bang’ due to a fifty percent increase in the number of local government districts. In the three decades to 1998 the number of regions was essentially fixed at 292 but by 2004 it had increased to 434 (Fitrani et al. 2005, p. 58) and now exceeds 500 (Hill & Vidyattama 2014, p. 70).

Furthermore the pre-existing local government officials were effectively Jakarta appointees and their corrupt practices were integral to the ‘Soeharto patronage franchise’ (McLeod 2000b, p. 151). For Crouch decentralisation of authority inherently decentralised corruption because civil servants were underpaid and relied on unofficial payments to supplement their income. Once the discretion of senior officials to award contracts, grant licences or confirm any decision that required a signature passed to the regions so did the opportunity to extract corrupt payments (Crouch 2010, pp. 96-97).

Overall the ‘big bang’ fiscal provisions were assessed by World Bank officials from the outset as ‘far from ideal’ (Hofman & Kaiser 2002, p. 12). This assessment was based on ‘international evidence’ that fiscal dependency, where regions received a high proportion of their revenue from the central government, has an inverse relationship to the quality of local governance. In Indonesia more than ninety percent of regional revenue was transferred to the regions from national government revenues (Hofman & Kaiser 2002, p. 13). In addition to the adverse governance implications the World Bank opined that obligatory central government distributions and retention of resource revenues by the regions had left the central government with inadequate authority and financial capacity to ensure national development priorities were implemented (Hofman & Kaiser 2002, p. 12). Support for the acuity of this view is provided in the following Chapter.

Legislation to enable greater revenue raising from increased regional taxing capabilities was passed in 2000. But Law 34 of 2000 resulted in a surge of inefficient 'nuisance and predatory' imposts being levied in the regions (Hofman & Kaiser 2002, pp. 12-13). By the end of 2001 more than one thousand new taxes and charges had been introduced by regional administrations of which more than half were implemented in contravention of the criteria set out in the enabling legislation (Lewis 2003, p. 177). Lewis points to the central government's administrative failures and also refutes attempts by some regional administrations to justify the taxes on the basis of legitimate fiscal need (Lewis 2003, p. 178).

In summary, having regard to the direct engagement of academics in formulating and implementing the 'big bang' reform it is appropriate to question the extent to which scholarship on decentralisation informed the implementation program. As shown above the adventurous 'big bang' implementation approach was not the expectation of decentralisation scholars. Although political decentralisation did proceed on the premise that regional authority would produce democracy, electoral accountability and better service delivery following decades of autocracy and centralism which was in keeping with the expectations of Pickvance (1997, p. 129) and Treisman (2006, pp. 12-15).

Some of the administrative decentralisation shortcomings may have been avoided had due regard been paid to the writings of Rondinelli et al, (1989, p. 58) and Pickvance (1997, pp. 130-131) in which key issues had been identified. The focus by Rondinelli et al on the necessity to ensure accountability for process outcomes could have restricted the spread of corruption within the regions. Outcomes would also have been different had Team 7 been guided by the scholarship on fiscal decentralisation. As noted in Chapter One Qian and Roland had identified potential risks to central budgets by the actions of profligate regional governments (Qian & Roland 1998, pp. 1143-1145). Similarly, Prud'homme had counselled against both undue regional government expenditures as a proportion of total government expenditure and the delegation of taxing powers to regional government (Prud'homme 1995, pp. 205-207).

My assessment is that 'big bang' implementation deficiencies have continuing consequences. The following Chapter will illustrate that corruption and generally inadequate service delivery in the regions are two such outcomes.

Chapter 3: Decentralisation – the outcomes.

> *"Overall, decentralisation has massively transformed the face of Indonesia and its politics, but it has proven to be neither the nemesis feared nor the saviour anticipated by its advocates."* (Mietzner & Aspinall 2010, p. 16)

This Chapter examines the outcomes of 'big bang' decentralisation in Indonesia and provides the basis for substantiating my claim that one of those outcomes is an enduring 'decentralisation nemesis'. My thesis contests the conclusion quoted above by illustrating that endemic 'decentralised' corruption that arose in the regions following 'big bang' is an impediment to inward FDI and thus to Indonesia's future economic performance. The Chapter begins by assessing the outcomes of political, administrative and fiscal decentralisation against the theoretical expectations presented in Chapter One. The second part of the Chapter details the changed character of post 'big bang' decentralised corruption and its pervasive presence in the regions.

The methodology for assessing corruption and its impacts is fraught with the previously discussed complexity of how or if it is possible to measure corruption. Consequently, there are no accessible primary sources and all corruption assessments in the secondary literature are dependent on the contestable corruption perception measurement process. Because my thesis centres on regional corruption it is dependent on corruption data and commentary at that level. KEMITRAAN[4] a specialist Indonesian anti-corruption NGO is an important source of such material. Finally there are two particular secondary sources that contribute to the way in which I answer my central question. First is the de Vaal and Ebben (2011) thesis of centralised and decentralised corruption, because it facilitates a distinction between corruption effects before and after devolution. Second is the Samford and Gomez (2014) study on regional FDI in Mexico which provides a methodological template for a similar study in Indonesia.

Assessing the outcomes of Indonesia's 'big bang' is necessarily an unscientific process. There are no undisputed measures by which the outcomes can be judged, so assessments are mostly subjective. In addition with little more than a decade since implementation there is probably insufficient data on which to base a considered opinion of the outcomes. Such subjectivity is reflected in the range of opinions published to date. In a 2010 paper Aspinall

[4] *See:* http://www.kemitraan.or.id/

notes that international commentators and foreign governments generally provide positive assessments of Indonesia as a democratic, post-authoritarian success story. Whereas academics and local activists frequently provide gloomy evaluations of Indonesia's low quality democracy and highlight institutional capture by vested interests as well as endemic regional corruption. Interestingly, Aspinall concludes that the perspectives of both the optimistic commentators and pessimistic scholars are correct (Aspinall 2010, p. 32).

His judgement is that patronage and corruption are the price of success in removing the threat, real or perceived, from secessionist, military and religious forces and enabling the re-emergence of civil liberties, robust media freedom and openly contested multi-party elections (Aspinall 2010, p. 32). But his judgement is not unconditional and carries the following caveat that accords with my thesis:

> "poor governance is often the midwife of authoritarian reversals, and while Indonesia has yet to produce its Alberto Fujimori, Thaksin Shinawatra, or Vladimir Putin, Indonesian democracy is not yet out of danger" (Aspinall 2010, p. 34)[5].

Blane Lewis, a US academic and adviser on fiscal decentralisation to the Indonesian Government noted 'a general consensus among observers and analysts' (Lewis 2010, p. 649) that decentralisation had been implemented without major disruptions but it had not delivered satisfactory public service outcomes. It is significant, in terms of my paper, that he also observed there was less accord about why that had been the outcome (Lewis 2010, p. 649).

An example of the contestability of decentralisation assessments is provided in my review of a recent paper by Marcus Mietzner (2014). The context is his claim that decentralisation in Indonesia has 'worked' because it ameliorated secessionist demands. Mietzner's concept of 'worked' is based on a 'macroscopic lens' test (Mietzner 2014, p. 62) of decentralisation being the process by which Indonesia survived as a nation-state. Mietzner's premise is that 'big bang' was implemented at the height of the Asian Crisis to placate secessionist ambitions in various provinces. Yet, from the outset he acknowledges 'most serious foreign scholars believed that a territorial break-up was unlikely' (Mietzner 2014, p. 45). Apart from his assertion that 'many observers' (2014, p. 45) were concerned about disintegration, there is no substantiation in the article, or other sources accessed in my research, to validate the

[5] This caution is prescient in light of the revocation by Parliament on September 26th 2014, of direct election of regional officials, of which more in Chapter Three.

contention that territorial integrity was the foremost objective of the Team 7 decentralisation planners.

The only examples of concessions made to accommodate secessionist elements were post *reformasi* initiatives in Aceh (2005) and Papua (2003 & 2010). As noted in Chapter Two, secession fears did cause devolution of 'big bang' powers to regional rather than provincial governments but secession fears themselves did not account for the pursuit of decentralisation itself. If survival as a nation-state was the singular test of 'big bang' having worked or not, then by default it worked. But in my view Mietzner's narrow consequentialist assessment of decentralisation is incautious and unwarranted.

A broader but similar premise for judging decentralisation is provided by Edward Aspinall. His judgement is that 'big bang' was the means whereby at least three objectives were achieved of which appeasement of secessionist forces is but one. Aspinall equates the issue of maintaining territorial integrity with two other important achievements; 'buying off' the military to avoid its intervention in political affairs (at least for the present) and absorption of Islamist groups that had campaigned for introduction of *shari'a* religious practices (Aspinall 2010, p. 20).

Aspinall provides a different basis for assessing the means by which the three outcomes were achieved. In his judgement 'patronage and corruption provided the oil to grease' the pacification of disparate political forces in post Soeharto Indonesia (Aspinall 2010, p 21). On that basis decentralisation was the medium but corruption the means by which Aspinall's three objectives were achieved. I contest the view that achievement of the significant objectives identified by both Mietzner and Aspinall are justified at the cost of endemic regional corruption and that the outcome for Indonesia is a potential, if not yet actual, Faustian bargain.

Not surprisingly in view of the short period since 'big bang' there are few detailed studies and limited empirical data on the consequences of decentralisation. Nevertheless the following sections examine the studies that are available and positions their conclusions against the theoretical expectations of political, administrative and fiscal decentralisation established in Chapter One.

Political decentralisation:

In broad terms political decentralisation theory at the time of 'big bang' envisaged the outcome for post authoritarian Indonesia would be better informed and more responsive local government decision making. Actual experience of the process is limited to elections in 2004 and 2009 (disregarding 2014) so scholarly assessments of the outcomes are limited in number and conditional in their judgement. In addition there were amendments in 2004 and 2008 to the original 'big bang' legislation. Elements of regional autonomy were reduced by the imposition of a supervisory role for provincial governments and requirements imposed for direct election of regional executives.

Details of the amendments are not material to my paper but both were adjudged by Buehler to have enhanced the quality of local democracy (Buehler 2010, p. 272). Notwithstanding those amendments Buehler asserts there are still important flaws in the electoral process. He points to the fact that many lower socio economic groups are rendered ineligible to nominate as candidates for regional elections by the need to have completed high school education. The most extreme example of the impact of this provision cited by Buehler is the exclusion from candidature of 90 percent of the citizens in South Sulawesi, one of the Indonesia's largest provinces. Likewise minimal state funding of political parties and prospective rewards of office have engendered a culture of 'money politics' that excludes all but elites from participation in elections. Buehler cites a study which established the average campaign outlay by successful district and municipal candidates in 2005 was $1.6 million. The author also points to weak legal and social sanctions against corruption including situations where voters are unable to expel corrupt officials for want of sufficient alternative 'clean' candidates (Buehler 2010, pp. 273-277).

Proliferation or "blossoming" of new regional administration areas is also cause for concern when assessing the outcome of Indonesia's political decentralisation. "Blossoming" has seen the original 294 'big bang' regional divisions sub-divided into 510 electorates by mid-2013 (Hill & Vidyattama 2014, p. 70). Various motives are put forward to explain this process including claims the original regions were too large or too dispersed for effective representation, or there was a need to create more homogenous ethnic or religious jurisdictions. But most frequently the motivation is pursuit by elites of government funded patronage and rent seeking opportunities. Creation of each new district provides new employment opportunities and access to new construction projects for associates of the promoters (Fitrani et al. p. 66).

Despite initial enthusiasm for *reformasi* there are now indications of stagnation and even reversals in political rights and civil liberties in Indonesia. Details were presented in Freedom House reports in 2006 and 2010 and in a 2009 World Bank Governance Indicators report. Mietzner cites those reports in a 2012 paper which examines efforts by 'conservative factions in the elites' to reverse the democratic initiatives (Mietzner 2012, p. 210). The paper provides examples of legislation designed to weaken powers and independence of the electoral commission ahead of the 2009 elections and strenuous efforts to diminish the scope of the Corruption Eradication Commission following successful prosecutions of high profile politicians in 2008 (Mietzner 2012, pp. 212-214).

Stronger evidence of a democratic reversal was provided by passage of a law in the National Parliament in late September, 2014 to scrap direct elections for regional leaders. Deliberations go back to 2009 and centre on the cost of holding direct elections for provincial, regional and sub-regional officials along with assertions that once elected these officials fail to cooperate with national government development ambitions (Chen & Priamarizki 2014, para 2).The new law returned Indonesia to pre-2005 provisions where mayors, regents and provincial governors were appointed by regional legislatures. *The Guardian Australia* (2014) opined that the old system "had returned generations of corrupt and inefficient administrations beholden to the country's equally graft-ridden political parties". The same article quoted Thornley of the Asia Foundation as saying the bill was "a blunt political manoeuvre to return electoral authority from the people to party leadership" (*The Guardian Australia*, 2014). Writing in the *The Jakarta Post,* Parlina (2014) noted that President Yudhoyono, who does not have power to veto the law, had undertaken to initiate a new bill to nullify the recently passed legislation (Parlina, 2014).

Separately, signs of waning enthusiasm for the democratic process are apparent in voter turn-out numbers for national parliamentary elections. Enthusiasm for the first democratic election in three decades was reflected in a 93 percent turn-out in 1999, but participation has fallen consistently in every election since and was down to 67 percent in the election earlier this year. At that level it is below the turn-out in faltering democracies such as Thailand and the Philippines (International IDEA 2014). But despite the generally unfavourable assessment in the literature of the political outcomes of 'big bang', Mietzner highlights that there is in the regions a high level of popular support for decentralisation (Mietzner 2014, p. 47). In a 2008 poll by Democracy International a significant majority of village and regional level respondents rated their local leaders as ‘accountable’ and local government services as ‘good quality’ (Mietzner 2014, pp. 48-49). Mietzner explained the contrasting assessments by noting that the judgement of citizens, unlike scholars, was based on more than bureaucratic performance. The author attributes the positive assessments to re-emergence of local ethnic identities and traditional forms of village management as well as a revival of *adat* or customary law (Mietzner 2014, pp. 51-56). Lewis is less generous and concludes that positive local assessments result from low service level expectations of the citizens. His concern is that the result provides little incentive for local administrations to improve and deliver better service outcomes (Lewis 2014, p. 151).

Administrative decentralisation:

Improved social welfare, greater labour productivity, higher employment, more entrepreneurship and better infrastructure maintenance were identified in Chapter One as the outcomes from administrative decentralisation that were anticipated in the theoretical literature which informed ‘big bang’. But because the range of services provided by the 500 plus regions is so large there are few generalised assessments of outcomes from administrative decentralisation. One example that is available is trans-national testing of education performance, which Lewis cites to illustrate the poor relative performance of Indonesian students. International Student Assessment (PISA) tests in 2003 and 2006 revealed that students were ranked in the bottom decile in science, reading and mathematics (Lewis 2010, p. 650). Despite the poor outcomes Lewis cites survey results showing 86 percent of households were ‘satisfied’ or ‘somewhat satisfied’ with the primary education system and only 7 percent had ever complained about education standards (Lewis 2010, p. 650).

In a later paper Lewis observes that delivery outcomes in health, education and infrastructure have been ‘decidedly mixed, at best’. While immunisation levels across the regions had improved on pre *reformasi* levels, malnutrition and maternal mortality levels had not improved (Lewis 2014, p.143). Unemployment and poverty reduction outcomes also failed to fulfil the expectations of decentralisation theory with the former assessed as having deteriorated in a World Bank report cited by Mietzner (2014, p. 48) and the later relatively unchanged in a different study by Ilmma & Wai-Poi (2014, p. 129).

However, the greatest failings from decentralisation are evident in infrastructure services. Local road conditions have deteriorated, households with access to safe water supplies have declined from 50 percent to 48 percent and inadequate power supplies are a constraint on local business development (Lewis 2014, p. 144). Lewis refutes claims of inadequate funding being the cause of these outcomes and points instead to inefficient and ineffective local expenditures by regional administrations as the source of poor service outcomes. To highlight his point Lewis demonstrates that regional administrative costs (staff and overheads) in Indonesia as a proportion of total regional expenditures are five times greater than international best practice (Lewis 2014, p. 145).

Fiscal decentralisation:

Chapter one disclosed that theorists held disparate views on fiscal decentralisation, especially its contingent impact on national financial management. Fundamentally its role is to ensure fiscal resources are available to implement the political and administrative responsibility delegated to the regions. Yet as Fadliya and Ross McLeod note control of major sources of tax revenue have been retained by the central government and regions are dependent on transfers from the centre for most of their funding needs (Fadliya & McLeod 2010, p. 3).

A more recent analysis of post 'big bang' fiscal management issues is presented in a paper by Blane Lewis who has the benefit of being an adviser to the Indonesian government on these issues 'for many years' (Lewis 2014, p. 135). Lewis's analysis of local government revenue and expenditures from 2001 to 2009 draws attention to a wide range of issues. Education is the largest category of expenditure and accounted on average for about 30 percent of regional government outgoing while infrastructure outlays amounted to 20 percent and health services average only about 10 percent. General overheads and 'other' costs accounted for the remaining 40 percent of the budget (Lewis 2014, p. 142). Lewis points out that staff costs account for almost half of the total service delivery payments which, as noted above, is multiple times the norm for international best practice. His unsurprising observation is that the regions in Indonesia spend too much on administration and personnel and not enough on improving service delivery standards (Lewis 2014, p. 145).

Lewis points to two other notable anomalies in his analysis of finances in the regions. The first is a remarkable, but unexplained, annual cycle in which local governments stockpile revenue receipts until the last quarter of each financial year. As a result there is a cyclical pattern in which substantial portions of total outlays are concentrated in the final months of the year. The second is that in a country with deficiencies in core infrastructure such as power, water, roads and ports, for which local governments are primarily responsible, not all revenue is expended each year. As a result substantial and fiscally wasteful reserves have been accumulated by the regional administrations (Lewis 2014, pp. 138-139).

Firman attributed the reserve accumulations to weak institutional capacity that precludes local governments from utilising the available development funds (Firman 2009, p. 150). A study by Hill (2007, p. 27) estimated that regional reserves amounted to more than US$10 billion. Although none of the above authors highlight the point the cyclical bunching of annual expenditures and failure to fulfil annual development plans is detrimental to the national economic performance. The scale of the impact is significant because sub-national governments account for about 50 percent of total Indonesian government spending. These fiscal inefficiencies are consistent with outcomes anticipated in decentralisation theory.

Decentralisation and corruption:

This section will show that ‘big bang’ had the effect of transforming corruption in Indonesia from its institutionalised central role during the Soeharto era to a decentralised uncoordinated role in the regions. As a result the national economic surplus is being eroded, service delivery hindered and regional democracy diminished.

One scholar who foresaw the potential for these adverse outcomes from ‘big bang’ was Larry Diamond who wrote:

> “Shifting discretionary financial authority from the central to the local level may simply shift the locus of clientelism and corruption from the central to the local arena, making these problems even tougher to control (Diamond 1999, p. 244).”

In the literature reviewed for this paper scholars agree that a new and dispersed form of corruption emerged in the regions of Indonesia following decentralisation. Chapter one of this paper provided a review of de Vaal and Ebben’s theory on the impact changed institutional settings have on corruption. That theory made two contributions to the literature. The first was to incorporate corruption into the intrinsic fabric of formal and informal institutions of an economy and the second was to highlight how corruption has different effects depending on the institutional setting in which it occurs (de Vaal and Ebben 2011, p. 109).

The authors illustrated their theory with reference to economies in which corruption is either centralised or decentralised As a consequence this theory provides insight to why corruption in Indonesia under the centralised Soeharto franchise co-existed with, and potentially aided, Indonesia's economic performance. The explanation being that centralised corruption in a stable political setting (as existed in Indonesia for three decades) provides sufficient property protection to sustain long term economic development even if formal legal protections are deficient. As the authors observe 'producers can hedge the risks of uncertainty, knowing whom to bribe to secure production' (de Vaal and Ebben 2011, p. 112). My thesis is based on the application of this theory to 'big bang' decentralisation which will be shown to have removed from corruption the certainty of outcome that existed during the Soeharto era. Consistent with de Vaal's theory, details from the literature will confirm how changed institutional settings have produced pervasive corruption which has compromised the local accountability and good governance expectations of decentralisation theory.

Less than a year after 'big bang' the first reports of abuse of power by regional governments appeared. The foremost regional economic journal of the time, the Far Eastern Economic Review reported in December 2001 on possible bankruptcy of Tiambang Timah, the world's largest tin producing company (Djala 2001, pp. 29-30). The article outlined how newly empowered regional officials on Bangka Island near South Sumatra had allowed an estimated 6,000 miners to operate on Timah leases and corruptly facilitated the sale of illegally mined tin onto the world market. As a result Timah had incurred large operating losses because excess tin production had depressed world prices below the company's cost of production. The article warned that regional autonomy had created "lawless fiefdoms" and that the law was not being upheld in the provinces (Djala 2001, pp. 29-30).

Further confirmation of regional corruption came in a 2003 article by Gary Bell who wrote that 'decentralisation of powers had led to a decentralisation of corruption' (Bell 2003, p.125). His further assessment was that decentralisation had made corruption both unpredictable and unreliable. Unpredictable because regional officials were extracting illegal fees, taxes and bribes and unreliable because legal uncertainties in the delegation of powers to the regions had resulted in contested authority between different levels of government (Bell 2003, p. 125).

As early as 2005 Hadiz and Robison wrote of pervasive money politics and political violence in the regions. Their assessment was that decentralisation had failed to achieve the goals of liberal democratic practices and market reforms because “an illiberal form of democracy (was) already consolidated and entrenched” (Hadiz & Robison 2005, p. 231). In their view the new political parties, parliaments and elections had enabled Soeharto era predatory interests to reorganise and ‘hijack’ the new democratic institutions. The authors attributed this adverse outcome to weak civil society capabilities resulting from authoritarian prohibitions during the Soeharto era. Three decades of restrictions on press freedom, political party activity and rights of assembly had disempowered middle and working class civil society and left it unable to contest the new political opportunities when they became available (Hadiz & Robison 2005, pp. 231-233).

The transition from centralised to decentralised corruption did not alter Indonesia’s already poor standing on the Transparency International Corruption Perception Index. Hechler et al. cite the Transparency International ratings of perceived corruption to confirm that the adverse Soeharto era corruption status had been maintained in the years after ‘big bang’. Hechler also points to Indonesia’s judiciary as being amongst the most corrupt institutions in Indonesia. Judges continued to be subject to the influence of ‘case brokers’ or ‘black lawyers’ as they were under Soeharto. The paper concludes that there is no effective separation of powers in Indonesia as the judiciary is incapable of keeping the national or regional executive or legislatures in check (Hechler et al. 2011, p. 52).

Despite being less than a decade after ‘big bang’ was implemented Aspinall refers to a ‘burgeoning scholarly literature’ in which decentralisation is identified as the source of predatory local behaviour. He cites examples where scholars have identified local parliaments as sites for corrupt deal-making and bribery of electoral officials designed to compromise electoral integrity. Other examples were collusion by legislators and officials to defraud state budgets and the improper award of contracts and licenses to selected associates (Aspinall 2010, p. 27).

Detailed empirical evidence of regional corruption was documented in a study by Blunt et al. following personal interviews with more than 200 Human Resource Management officials during 2011. This study sets out a litany of malpractices including; widespread job buying; few genuine job descriptions; nepotism; unqualified professional appointments; 'fit and proper' job testing belittled as 'fee and prosper' opportunities; failure to conduct staff performance assessments; staff promotion based on 'achievement in irregular income generation'; jobs being retained beyond regulated retirement age; expense claim abuses and most startlingly an estimate of around one million or seven percent of payrolls being 'honorary employees' who are not subject to standard terms of employment. These details, as well as evidence of bribes paid to secure academic and trade qualifications, job transfers and promotions provide the clearest evidence of widespread and deeply entrenched corrupt practices (Blunt et al 2012, pp. 71-72).

Difficulty overcoming corruption is reflected in reports by KEMITRAAN, a donor funded good governance, anti-corruption NGO inaugurated as a UN Development Program in 2000. The organisation's online Profile notes the difficulties in combatting corruption because of 'a lack of commitment and the poor condition of the existing bureaucracy' (KEMITRAAN 2013, p 11). The organisation has developed a methodology for producing an Indonesia Governance Indicator which ranks the governance performance of each province based on a range of governance arenas. In the 2012 survey not one of the provinces achieves a rating better than 'fair' and the governance of nine provinces was rated as 'poor'.

In summary, it is possible to accept the opening Mietzner & Aspinall assessment of decentralisation not so far being either the nemesis or saviour anticipated by its advocates (2010, p. 16). But based on details in this Chapter (and personal experience in the region), my assessment aligns with the wisdom of Aspinall's observations of poor governance being the 'midwife of authoritarian reversals' and Indonesian democracy not yet being 'out of danger' (Aspinall 2010, p. 34). My conclusion is that the ability to overcome wayward regional government practices will determine the outcome. If not, Indonesia may well succumb to the looming nemesis of endemic corruption and accept the Faustian bargain of weak democracy and continuing exploitation by reinvigorated Soeharto era elites. One consequence of failure to constrain regional corruption and maladministration is the impact it has on Foreign Direct Investment which is examined in the next Chapter.

Chapter 4: Decentralisation - the impact on Foreign Direct Investment

> *"The empirical evidence on the relationship between inbound MNE activity (FDI) and the formal institutions of national governance is clear. Good governance helps to attract FDI, and bad governance repels it"* (Dunning & Lundan 2008, p. 314)

Dunning's assessment of the governance risk to foreign direct investment from bad governance and Aspinall's counsel on poor governance being midwife to authoritarian reversal, quoted in the previous Chapter, are consistent with my thesis of corruption and maladministration looming as Indonesia's decentralisation nemesis. The basis in theory of FDI's contribution to a developing economy and its origin in Value Chain decision making by MNE's were set out in Chapter One. FDI benefits arise from capital inflows, improved balance of payments, better jobs, less income inequality, and the spill over of new technologies to host country suppliers. Those benefits can foster economic growth and support social development, but recent scholarship reviewed in this Chapter demonstrates FDI is sensitive to governance conditions and such positive outcomes are not inevitable.

There are two sections to this Chapter. The first is a summary of recent scholarship on Indonesia's inward FDI relative to other East Asian countries. It shows that Indonesia is not a preferred location for foreign investors and is designated as a 'default location' for FDI in one paper. The section also provides reasons for that description and assessments of the impact the paucity of FDI is having on Indonesian exports. The second section reviews the limited scholarship on the role sub-national governance plays in FDI location decision making by MNEs. FDI is important to Indonesia's economic development and this section examines impacts on FDI flows that are reliant on powers now vested in Indonesia's 500 regional administrations.

FDI in post 'big bang' Indonesia:

A study of FDI flows to developing East Asian countries during the thirty years to 2009 by Robert Lipsey and Frederick Sjoholm provides the empirical foundation for a review of Indonesian FDI. The data facilitates a comparison of both the flow and the stock of Indonesian FDI before and after decentralisation in order to identify the changes that have occurred. Based on the recognised measures of trans-national foreign investment positions; *FDI stock as a percentage of GDP* and *FDI inflows as a proportion of Gross Capital Formation* the paper illustrates that pre and post decentralisation, Indonesia (and the Philippines) have consistently ranked as, or near to, the lowest FDI beneficiary in the region. Table 1 highlights both the slow growth in the stock of FDI as a potential source of future wealth generation in Indonesia as well as the widening gap in the level of engagement in trade globalisation when compared to other Southeast Asian countries (Lipsey & Sjoholm 2011, pp. 36-40).

TABLE 1 *Stock of Inward FDI as a Percentage of GDP*

	1990	1995	2005	2009
Vietnam	25.5	34.5	58.8	57.1
Malaysia	22.6	31.2	32.2	39.0
Thailand	9.7	10.5	34.3	36.2
Philippines	10.2	13.7	15.2	14.5
Indonesia	**7.0**	**9.3**	**14.4**	**13.5**

Source: UNCTAD in Lipsey & Sjoholm 2011, p. 38

Similarly, Table 2 illustrates the limited contribution FDI inflows made to Indonesia's capital base during 5 year periods before and after *reformasi.* The numbers demonstrate that FDI inflows after decentralisation have done little more than regain the level of inflows achieved during the last decade of the Soeharto era. At the same time FDI is significantly adding to capital formation in other countries in the region, albeit at a slowing rate because of the overall growth of the capital base in those countries.

TABLE 2 *FDI Inflows as a Share of Gross Capital Formation*

(period averages)

	1990-94	1995-99	2000-04	2005-09
Vietnam	34.4	26.0	11.2	16.5
Malaysia	20.0	16.2	11.6	13.6
Thailand	4.3	8.9	13.9	14.5
Philippines	7.9	8.6	7.3	11.1
Indonesia	**3.9**	**5.7**	**-2.4**	**6.1**

Sources: UNCTAD, World Bank in Lipsey & Sjoholm 2011, p. 39

An even more significant insight to the paucity of foreign investments in Indonesia comes from econometric modelling by Lipsey and Sjoholm which compares the actual and predicted stocks of FDI in the major East Asian economies in 2005. The model is based on actual economic performance metrics during the five years to 2005 that is integrated with a series of standardisation adjustments to reflect the specific economic characteristics of each country. While the authors qualify their modelling the study concludes that in 2005 actual FDI stocks in Indonesia were over 40 percent below what their analysis had predicted. Only the Philippines performed more poorly while Malaysia with a 23 percent underperformance also did not reach the model's predicted FDI stock level (Lipsey & Sjoholm 2011, p. 46). Why Indonesian FDI stocks and inflows underperform those of other Southeast Asian countries is central to my thesis and the Lipsey paper provides potential explanations for that outcome.

Lipsey's beginning hypothesis is that Indonesian is considered to be an FDI default location for MNEs because foreign investment in Indonesia is concentrated in sectors where there are few locational alternatives. In essence firms choose other countries when they have an alternative. Support for that proposition is based on data for US investments in Indonesia which highlights the dominant role of mining and resource specific low-tech manufacturing ventures (Lipsey & Sjoholm 2011, p. 47).

For example, in 2007 mining projects and the processing of tobacco, textiles, leather, wood and paper products accounted for more than 60 percent of American FDI in Indonesia. Production of chemicals is the only substantial source of US high tech manufacturing and that was centred on Indonesian gas and oil production. Lipsey and Sjoholm note that Indonesia had negligible engagement in the most beneficial high value machinery manufacturing and high tech componentry production. That contrasts with nearby Malaysia where the manufacture of high value machinery, computers and electronics componentry accounted for more than 50 percent of US FDI (Lipsey & Sjoholm 2011, p. 47).

Pursuing the issue further the authors establish that Indonesia's poor educational standard, high level of perceived corruption and inadequate physical infrastructure are substantial contributors to its FDI underperformance (Lipsey & Sjoholm 2011, pp. 42-43). The significance of those deficiencies is that since *reformasi* primary responsibility for each of those issues rests with the 500 plus regional governments and indications are that many regions have difficulties fulfilling those responsibilities. That is significant because, as explained below, any shortcomings are likely to inhibit future FDI inflows. Such an outcome would further substantiate my ‘decentralisation nemesis’ proposition.

Education standards are central to various aspects of development theory as well as FDI. But its role in relation to FDI is the impact it has on host country employment. Education and training extend the range of potential FDI employment and improve labour productivity. A 2007 World Bank study illustrated the contribution of education to development of workforce skills and demonstrated that even basic manufacturing requires literate and numerate employees (World Bank 2007, pp. 180-181).

Shortcomings in Indonesia’s educational attainment provide an insight to its FDI underperformance relative to other East Asian countries. Lipsey cites a 2010 study by Barro and Lee to compare the educational standards in East Asia and demonstrate the extent of Indonesia’s underperformance. Of the adult population, Indonesia had the lowest level of tertiary graduates (1.4 percent), lowest average years of schooling (6.2) and highest proportion with no education (17.3 percent). All other countries in the study had superior education standards headed by South Korea with 16.2 percent tertiary graduates, 11.9 average years of schooling and only 3.6 per cent uneducated (Lipsey & Sjoholm 2011, p. 52).

Several aspects of corruption in Indonesia have already been considered and its impact on regional FDI is addressed in the following section. Lipsey and Sjoholm maintain it is difficult to know how damaging corruption impacts are on FDI although he cites a paper by Wells (2007, p. 354) for anecdotal reports of corruption causing many firms not to invest in Indonesia. Reasons given for avoiding Indonesia were concern for exposure to home country anti-corruption regulations and difficulty dealing with the arbitrary regional regulations which give rise to corruption (Lipsey & Sjoholm 2011, p. 55). The predominance of resource and low-tech investments since the onset of decentralised corruption is consistent with the findings of Smarzynska & Wei (2000) cited in Chapter One. That study illustrated the inverse relation between corruption levels and the technological sophistication of FDI ventures.

The third contributor to Indonesia's FDI underperformance identified by Lipsey and Sjoholm was infrastructure. Shortcomings in Indonesia's infrastructure were featured in *The Economist* when a banking executive complained of inadequate roads, inefficient air- and sea ports, less than 20 percent of the population with piped water and only 2.5 percent of households with a sewer connection (The Economist, 12/9/2009, pp. 11-12). Clear signs of Indonesia's underinvestment in infrastructure are also documented in a 2012 World Bank paper by Shiro Armstrong and Sjamsu Rahardja. This study details how infrastructure spending has fallen from more than 8 percent of GDP in the mid 1990's to less than half of that since 2000, except for a brief surge to about 6 percent of GDP in 2007-08 (Armstrong & Rahardja 2014, pp. 22-23).

Being 'the world's largest archipelagic state' (Basri & Hill 2011, p. 104) may explain part of the infrastructure deficiency but the ensuing logistics costs disadvantage Indonesia against competing countries in the global value chain process. Indonesia's disadvantage is illustrated by ranking 75th in the 2010 World Bank Logistics Performance Index compared to FDI competitors Malaysia which ranked 29th, Thailand 35th, the Philippines 44th and Vietnam 53rd (Basri & Hill 2011, p. 105). Inadequate technical capability in regional governments, limited regional administrative capacity, poor inter-government cooperation, difficulties acquiring land for development as well as corruption and regulatory failures are noted by Lipsey and Sjoholm as 'some of the main causes of failing investments in infrastructure' (Lipsey & Sjoholm 2011, p. 54).

By 2010 the Indonesian government was aware of the need to redress the country's poor performance in attracting FDI. An FDI Strategy Paper prepared by the Investment Coordinating Board acknowledged that Indonesia had 'fallen dramatically off the blistering pace set by its economic competitors' (BKPM 2010, p. v). One issue highlighted in the report was the adverse impact on new investments of more than 5,000 regional bylaws or *perdas* that taxed or adversely impacted company operations (Maryono 2009).

Indonesia's implementation of the ASEAN China Free Trade Agreement in 2010 also focused attention on trade barriers imposed by local governments. Bachtiar traced awareness of the potential adverse impact of *perdas* on trade and investment back to pre decentralisation advice by the IMF. Despite successful early efforts to restrain these imposts by regional governments most restrictions were removed by the passage of Law 34/2000.

While Butt and Parsons observe that the extent to which the *perdas* have discouraged local and foreign investments is contested, their impact was sufficient for the national government to make some attempt in 2009 to limit their impact. Law 28/2009 sought to improve the regional investment climate and minimise ‘problematic’ regulations. However, the Butt and Parsons paper highlights major weaknesses in the drafting and enforcement of that Law. Indications are that many prior tax imposts were simply recast as ‘commission’ for services and weak enforcement has enabled regional administrations to avoid the obligation to report the existence of *perdas* to the national government. While as many as 1,700 regional laws have been invalidated indications are that *perdas* in various alternative forms continue to have an adverse impact on existing and potential local and foreign investors (Butt & Parsons 2012, pp. 93-95).

Given the numerous impediments to FDI investments in Indonesia, some of which prevailed before decentralisation, how is it possible to illustrate what has changed since 2000? One answer is provided by examining the make-up and destination of Indonesia’s merchandise exports because there have been pronounced changes in both aspects of Indonesia’s trade since that date. These changes were detailed in a recent paper by Jeffrey Neilson (2014).

Neilson’s paper showed that the value of processed manufactures has fallen from almost 60 percent of exports in 2000 to below 40 percent in 2010 and resulted in an increased dependence on mostly unprocessed agricultural and mining exports. Confirmation of Indonesia’s growing reliance on mining and low-tech manufacturing exports is evident in a fall of merchandise exports to high income economies. Between 1990 and 2010 merchandise exports to developed economies fell from 90 percent to 63 percent while exports to developing East Asian countries, especially China, increased by 17 percent to 23 percent (Neilson, 2014, pp. 49-50). More troubling for Indonesian policy makers is the fact that employment in manufacturing which grew by 6 percent in the five years to 1996, grew by less than 1 percent between 2000 and 2008 (Basri & Hill 2011, p, 94). These findings illustrate Indonesia’s increased export dependence on low value added, more volatile natural resource markets and falling participation in buoyant global markets for finished and semi-processed goods. These trends have substantial long term economic significance and evidence the need for regional administration policies and practices that improve Indonesia's stock and inflow of FDI.

FDI and regional maladministration:

This final section of the Chapter is an examination of the limited literature on the impact regional administrations have on location selection by foreign investors. It centres on a paper by Steven Samford and Priscila Ortega Gomez that analysed the impact regional variables, including corruption and maladministration, had on the location of FDI ventures in Mexico (Samford & Gomez 2014). The purpose of this section is to further validate my thesis on adverse FDI impacts from regional maladministration and to demonstrate the potential to adopt this research methodology in a study of the same issues in Indonesia.

Broad parallels in the circumstances of Mexico and Indonesia provide a basis for adapting the Samford methodology to such a study. Both countries have a large population though Indonesia with almost 250 million people[6] is over twice the size of Mexico. Both countries have had net annual FDI inflows of the order of $US 20 billion[7] in recent years, though inflows to Mexico during the early 2000's far surpassed flows to Indonesia. Both are middle income economies with Mexico having a GDP per head of $US 10,300[8] in 2012 and Indonesia less than $US 4,000[9] per head. Furthermore both countries are in transition from centralised authoritarian to highly devolved regional political administrations. Samford describes Mexico before 1990 as a 'hyper-centralized political order' with 'party control over all levels of government' (Samford & Gomez 2014, p. 473). Since 1990 substantial political and administrative responsibility has been devolved to Mexico's 32 states. These regional divisions equate in many respects to Indonesia's 33 provinces although, as described in Chapter One, most power in Indonesia is vested in the 500 or so regional administrations.

[6] *Source:* World Bank <http://www.worldbank.org/en/country/indonesia>
[7] *Source:* World Bank <http://www.worldbank.org/en/country/indonesia>
[8] *Source:* World Bank <http://www.worldbank.org/en/country/mexico>
[9] *Source:* World Bank <http://www.worldbank.org/en/country/indonesia>

Based on ten years of FDI data from thirty two Mexican states the Samford study provides a unique combination of three aspects of FDI literature. The first is its focus on sub-regions as the beneficiaries of FDI which contrasts with prevailing studies that ignore regional distribution of FDI and examine the issue only from an aggregate national perspective. The second is an analysis of three separate types of FDI in categories titled – *resource seeking*, *market seeking* and factor cost motivated *efficiency seeking* investments. The third is an analysis of the impact sub-regional political and economic conditions had on FDI location selection in Mexico (Samford & Gomez 2014, pp. 468-469).

While Dunning (2008, p. xxv) and others had recognised there were different types of FDI investments (including an additional *strategic-asset seeking* type), Samford's investigation observed that flows of FDI investments when examined by type have no correlation. The authors therefor inferred that the uncorrelated investment patterns were indicative of different motives for each type of investment. Their premise was that *resource seeking* investments are initiated to secure control of resources not readily available in the home country especially mining and agricultural produce. *Market seeking* investments were to enable MNE's to locate facilities for production of tradeable goods or for delivery of services (banking, utilities, transport, etc.) to the local market. While *efficiency seeking* FDI was motivated by input cost minimisation as part of an integrated trans-national production process (Samford & Gomez 2014, pp. 470-472).

As the purpose of the Samford study was to identify the factors influencing sub-national FDI site selection for each type of investment their methodology began by eliminating from consideration elements of the national political and administrative regime that were common to all states. The process confirmed the common application of issues such as national taxation, currency, trade and regulatory regimes across all of the states. It also excluded from the model potential impacts of electoral provisions and service delivery obligations that were common to all states (Samford & Gomez 2014, pp. 474-475).

In order to establish what factors were likely to affect investment location decisions the authors identified from FDI literature the factors that were recognised as influencing cross-national FDI flows. The premise being that national level determinants of FDI were appropriate for testing as elements in regional site selection preferences within Mexico.

The modelling is extensive and includes the following factors and their representative proxy measures as regression variable. Five economic factors were identified for inclusion in the modelling process from the national level survey of FDI determinants. The economic factors and relevant proxy were – market size (state GDP), local wealth (income per capita), local factor costs (mean salary), level of human capital (mean education level), and resource availability (actual resources). Also included in the model were factors to reflect political stability within the states and for patterns of pro business or pro labour political party dominance. These factors were based on actual elections during the ten year study period (Samford & Gomez 2014, pp. 476-477).

Safety and security of employees and assets is a factor in FDI location decisions and that was factored into the Samford model using crime rates per 100,000 residents. Production risk from labour stoppages was covered by including data for actual strikes during the study period. Corruption was acknowledged as potentially adverse for FDI and its influence was included with index scores for each state taken from a National Index of Corruption. Finally state government inefficiency was incorporated using results from a Mexican Institute for Competitiveness Index of Government Efficiency and Effectiveness (Samford & Gomez 2014, pp. 478-479). In an end-note the authors acknowledge 'well-known concerns with indices of this sort' but justify the selection on the basis they 'capture the reputational quality of the state government' (Samford & Gomez 2014, p. 491).

Having assembled these variables the authors created statistical models for the 32 states of Mexico and were able to identify the dynamics that have most influence on FDI investors in each type of investment and can be presumed to influence their FDI site selection. In broad terms the authors concluded that *market seeking* investors have a predictable focus on market size and were essentially indifferent to issues such as high local crime rates or a strong labour union presence. *Efficiency seeking* investors on the other hand were deterred by crime and corruption but positively motivated by fiscal incentives such as land grants, service cost subsidies, staff training assistance and a history of stable pro-business local administrations. High capital intensity and long pay-back periods were believed to explain why *resource investors* have a low a tolerance of crime, corruption and government inefficiency in their FDI site selection (Samford & Gomez 2014, pp. 485-489).

While the findings of the Samford study are unique to Mexico this analysis of FDI drivers at the sub-national level provides the foundational methodology on which a similar study of FDI in Indonesia could be constructed. The specific contribution Samford's paper has made to my thesis is to demonstrate why scholarly studies of FDI should be disaggregated by type. Past scholarship has treated FDI flows as homogenous yet this analysis showed distinct and uncorrelated variations in annual FDI flows by type of investment. The inference being that motivation for each type of investment was substantially different and analysis based on aggregating all FDI masks the effects of unrelated variables. Likewise, analysis of FDI investment flows on a sub-national basis has the potential to identify the impact of relevant variables within individual regions (Samford & Gomez 2014, pp. 469-471). Apart from its contribution to scholarship such studies offer potential for substantiating effective policy making initiatives by regions seeking to attract particular types of FDI.

Findings in the Samford study are consistent with my observations of FDI in Indonesia. As resident chief executive of an investment management business based in Singapore I observed a wide range of corruption impacts on foreign owned enterprises. The most substantial recent examples related to mine ownership disputes and intimidation. Two widely reported cases involved multi-billion dollar loss of value by shareholders of Australian company Intrepid Mines Limited[10] and Rothschild backed Bumi plc[11]. Less widely known examples were reported by Michael Bachelard in the Sydney Morning Herald[12]. In November, 2012 he recounted how five Australian exploration companies were faced with local hostilities which company executives concluded were essentially about extortion. Triangle Pase executive John Towner stated "someone thinks we're making an absolute fortune and they think they can come in and take it over until it runs out". Such experiences have a history going back to the 2001 Tiambang Timah tin mine case cited in Chapter Three. These actual and anecdotal events since decentralisation have in my assessment significantly diminished the likelihood of Australian exploration companies pursuing ventures especially in certain regions of Indonesia.

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[10] *See:* West, M 2012, 'They stole our mine!', *Sydney Morning Herald*, 19 December, <http://smh.com.au/business/mining-and-resources>
[11] *See:* Brown, C 2013, 'How Rothschild lost to Indonesia's king coal', *The Conversation,* 28 February, <http://www.businessspectator.com.au>
[12] See: Bachelard, M 2012, 'Miners finding Indonesia a tougher ask', *Sydney Morning Herald*, 7 November, <http://smh.com.au/business>

In summary, high level research shows that factor inputs for essentially all of the Samford model variables are available for the 33 provinces of Indonesia including governance measures from an Indonesian Governance Index published by KEMITRAAN[13]. Conduct of an analysis of Indonesian FDI using the Samford model would provide better understanding of why post *reformasi* flows of FDI have underperformed expectations. Such granular sub-national analysis of FDI flows by type in Indonesia would illustrate examples where local political uncertainty or regional corruption and maladministration have adversely impacted the FDI decision making of MNE's.

[13] *See: kemitraan.or.id*

Conclusion

After thirty-two years of Jakarta centric autocratic rule President Soeharto's resignation during the Asian Financial Crisis initiated a second episode of far-reaching change in Indonesia's post-independence history. Though more humane than the 1960's overthrow of President Sukarno the civil and political consequences of the 1998-2001 *reformasi* program were equivalently transformative. Within little more than thirty-two months Soeharto's centralised autocracy was replaced by electoral democracy at all levels of government from President to National Parliament, provincial and regional administrations.[14]

Many other profound changes were implemented during this brief, liberal reform period. Most Soeharto era restrictions on NGO, political party and trade union activities were removed, political prisoners freed and civil liberties restored. From this panoply of reorganisation my paper has analysed the origin and consequences of 'big bang' political, administrative and fiscal reforms. These far-reaching reforms devolved responsibility for delivery of around seven hundred government services from the national to new third tier regional administrations (Usman 2001, p. 7). Regions became accountable for more than 50 percent of total government expenditures including education, health, public works, land and environmental management. The transition was effected nationally on January 1, 2001 (Seymour & Turner 2002, pp. 36-44).

My research centres on one particular consequence of the 'big bang' reform which I titled the 'decentralisation nemesis'. Identifying the source of the nemesis as the pervasive decentralised corruption that originated from fragmenting of the Soeharto era 'patronage franchise' was one aspect of my hypothesis. The other was to demonstrate the threat the nemesis posed to Indonesia's inward FDI and its flow-on effects to different types of investments. While some scholars have claimed that Indonesia's decentralisation delivered neither a nemesis nor saviour (Mietzner & Aspinall 2010, p. 16), my assessment is that such a judgement is premature.

There is scholarly accord on the emergence of pervasive corruption and maladministration in regional Indonesia since decentralisation. When that outcome is combined with emerging scholarship on the negative impact corruption has on inward FDR I conclude it is imprudent to declare there is no 'decentralisation nemesis'. My research points to significant adverse

[14] Direct election of regional officials was reversed by a bill passed into law by the National Parliament at the end of September, 2014. That may be challenged when the newly elected parliament begins deliberations.

changes in the scale and disposition of FDR that have and will continue to impinge on Indonesia's economic development. My dissertation progressed through four components to illustrate the merit of my conclusion.

As it was mostly western trained academics who were responsible for formulating and implementing the decentralisation program, Chapter One provided an assessment of the academic theory accessible by the authors in the late 1990's. Development theory at the time was centred on the transition to democracy of post authoritarian states that had for the most part been former Soviet countries. That context had many similarities to the situation in post authoritarian Indonesia and provided counsel for decentralisation of political, administrative and political responsibilities.

Because of its applicability to the later development of my hypothesis the opening Chapter also provides an overview of scholarship on corruption theory and separately on studies of the impact corruption has on FDI. Particular attention is addressed to a Samford and Gomez (2014) paper which provides the first empirical study of inward FDI decision making dynamics by MNEs. Based on 10 years of sub-national Mexican data, the study identifies key influences on FDI location selection which vary according to whether it is a *market*, *efficiency* or *resource seeking* FDI investment.

The context in which the 'big bang' reforms were implemented in Indonesia undoubtedly influenced the policy outcomes. Chapter Two begins with a review of the uncertain political circumstances President Habibie faced when he succeeded President Soeharto. The International Monetary Fund had imposed harsh reforms as a consequence of the AFC, unemployment had soared following corporate and bank failures, civil unrest was wide-spread and armed secessionist were active in several provinces. Habibie's initial responses were to call an early Presidential election and appoint a team of seven Jakarta academics to formulate a reform program.

Team Seven, as it became known, formulated both major electoral reforms and the 'big bang' regional autonomy policy. Enabling legislation for the decentralisation reforms was drafted and approved by the parliament in just six month (Smith 2008, pp. 221-222). Ryaas Rasyid, the leader of Team Seven took responsibility for implementing the 'big bang' legislation when appointed Minister for Regional Autonomy. Little more than two years after parliamentary approval, responsibility for delivery of core government services passed from the national government to almost 300 new, poorly trained regional administrations.

Several aspects of implementing the 'big bang' policy are highlighted in Chapter Two. First was an examination of the decision to devolve extensive responsibilities to the third tier regional level of government. That decision was based on concern, real or illusory, that secessionist capabilities would be heightened if those powers were devolved to the more capable provincial administrations. Second was to surmise why responsibility for all devolved functions should begin in all regions on the same day, despite scholarly counsel to the contrary. Pressure to address mounting unemployment and civil unrest combined with political kudos from the reform initiatives appear to have driven that choice.

In addition there were two notable shortcomings in the implementation program. The first was inadequate training and resources for the scale of the responsibilities being devolved to the regions and the second was a failure to impose adequate fiscal or job performance accountability on the regional administrations. Both of these deficiencies are cited as contributing to the subsequent onset of corruption.

Outcomes from the implementation of 'big bang' are addressed in Chapter Three. Within a year of its implementation one outcome recognised by scholars and media observers was the emergence of pervasive regional corruption. Corruption had been a reality in Indonesia before 'big bang' and had coexisted with strong economic development and steady inward FDI. But, as demonstrated by de Vaal and Ebben (2011), institutional changes such as those introduced by decentralisation removed the certainty of outcome that had characterised corruption under Soeharto. In its stead came uncoordinated and uncertain regional corruption.

Corruption adversely impacted each of the political, administrative and fiscal outcomes in the regions. Limited state funding of political parties created 'money politics' and resulted in all but the elites being able to stand for election. In addition the patronage driven 'blossoming' or subdivision of political districts has seen the number of regions increase from near 300 to over 500. Corruption and patronage are reflected in the commensurate duplication of staff and administration expenses. Shortcomings in the delivery of government services are well documented and extend across education, health and especially infrastructure. Blane Lewis, a US scholar and Indonesian government adviser, highlighted financial mismanagement by noting that regional staff and overhead costs in Indonesia were five times greater than accepted international best practice for delivery of such services (Lewis 2014, p. 145).

Chapter Four illustrates the persistent under-representation of inward FDI flows to Indonesia relative to other developing East Asian countries. In a detailed study, Lipsey and Sjoholm

(2011, pp. 42-55) sustain a hypothesis that Indonesia is a default location for FDI. Poor education standards and inadequate infrastructure are identified as contributory causes in addition to the costs and uncertainty of corruption and arbitrary regional regulations. Economic modelling in the Lipsey and Sjoholm (2011, p. 46) study indicates that stocks of FDI in 2009 were more than 40 percent below what modelling had predicted. Furthermore post 'big bang' sources of FDI from developed economies have fallen sharply and current inflows are from lesser developed countries, mostly in the ASEAN region. For Indonesia the potential outcome is weak exports of high value manufactures, poor technology transfer, lost employment opportunities and increased dependence on low tech manufactures and volatile agricultural and resource exports.

Future research and final comments:

These insights to Indonesia's FDI situation warrant further analysis and this paper provides the conceptual foundation for a further detailed empirical study on the impacts of regional corruption. Such a study was beyond the scope of this project but the potential to gain understanding of the impact corruption has on both the type of FDI Indonesia may attract and its regional location would add to the literature and have potential policy implications. The recently published Samford and Gomez (2014) paper on sub-national corruption and maladministration in Mexico and its impacts on the siting of FDI ventures provides a methodological template for the conduct of such a study in Indonesia.

In conclusion, my paper has shown that the while generally consistent with the theory at the time, devolution of extensive political, administrative and fiscal responsibility to the now 500 Indonesian regions has been a limited success. In particular 'big bang' reforms that disrupted the previously centralised Soeharto 'patronage franchise' (McLeod 2000, p. 99) have resulted in the onset of widespread and decentralised corruption and regional maladministration. Those corrupt practices are a significant impediment to Indonesia's economic development and constitute what I have called its 'decentralisation nemesis'.

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