LEVIATHAN GOVERNMENT BEHAVIOR: THE CASE OF LOCAL GOVERNMENT IN INDONESIA

Flinders Institute of Public Policy and Management

School of Social and Policy Studies, Faculty of Social and Behavioral Sciences
Flinders University of South Australia
July 2012

Ivantia S. Mokoginta

Sarjana Ekonomi, Department of Economics and Development Studies,
Faculty of Economics, University of Indonesia
Master of Business Administration, School of Business, Hawaii Pacific University
Master of Arts in International Development, Centre for Development Studies,
Faculty of Social Sciences, Flinders University of South Australia

Table of Contents

List of Diagrams

List of Figures

List of Graphs

List of Tables

Abstract

The role of institutions cannot be overlooked in the analysis of economic policy, since the characteristics of institutions shed some light on regional specific issues that might affect the effectiveness of policy implementation. While literature on fiscal federalism, under the banner of Second Generation Fiscal Federalism (SGFF), acknowledges the critical role of institutions in fiscal federalism policy, there is a lack of literature on implementation. This is the situation with decentralization policy in Indonesia. Regional proliferation has followed the decentralisation policy since 2000. It is argued in this thesis that this is an example of Leviathan government behavior. Rather than encouraging regional competition and efficient government operations as suggested by Tiebout's regional competition theory, regional proliferation has led to increasing size of government and, hence, inefficiency.

This thesis explores the role of institutions in the aftermath of inter-regional fiscal transfer policies in Indonesia. It is argued that Leviathan government behavior is the outcome of fiscal, social and political institutional settings, namely the Balance Funds transfer arrangements that create a flypaper effect, the social institutional setting that is dominated by personal rulership patrimonialism values, and the political institution that fails to produce accountable government. The implication is that the design of a decentralization policy requires a holistic approach that takes into account the characteristics of these institutional settings simultaneously to minimize the possibility of encouraging Leviathan government behavior.

Declaration

I certify that this thesis does incorporate without acknowledgement any material previously submitted for a degree or diploma in any university; and that to the best of my knowledge and belief it does not contain any material previously published or written by another person except where due reference is made in the text.

Ivantia S. Mokoginta
Adelaide, 31 July 2012

Acknowledgement

First of all, I would like to thank my principal supervisor Jo Baulderstone from the School of Social and Policy Studies for her guidance during my entire PhD candidature at Flinders. We had a very exciting, engaging and enjoyable conversation during the time of supervision. It is really interesting to see economic issues from the perspective of a non-economist. Such a small step towards bridging the differences existed between economist and non-economist when confronted with the same issue. Nevertheless, we have started this long cross discipline conversation and hopefully it is going to continue indefinitely.

I would also like to thank my co-supervisor, Victor Pontines from the Flinders Business School. Thank you for helping me to make sense out of the econometric model. It is really a challenge to use econometrics to understand issues that are external to economics. However, I might do this again in the near future. Also my thanks to my former supervisors Noore Alam Siddiquee from the School of Social and Policy Studies and Alaric Maude from the School of Geography. Our brief encounter at the beginning of my PhD candidature helped me shape the thesis to become the way it is. To Jeni Thomas, thank you for editing my thesis.

Finally, my gratitude goes to my family and friends. To my husband, thank you for allowing me to take our daughter to Australia. She is a great joy to be with. To my professor, Susanne Schech and my friend, Gaynor Bryant, I can easily adopt Adelaide to become my second home. Also to Ida Widianingsih, Novi Kurnia, Agus Bambang Irawan and Adib Abdushomad, it has been a pleasure to know all of you while away from home. We did have a good laugh together.

Chapter One
Introduction

The history of global economic philosophy can be divided into three different eras. The first era of economic philosophy is the classical liberalism in the 18th century, mostly in Europe and North America. The principle of liberalism is that individuals should be free from any restraint to express their egoistic drives (Hunt, 1981). This basic philosophy was translated into economic liberalism by Adam Smith when he published his book on The Wealth of Nations in 1776. Economic liberalism stems from a free-market mechanism where capitalists and laborers are free to express their self-interests to earn maximum monetary returns. Only by allowing them to do so, would the allocation of capital and labor be mostly efficient.

The principle of individual freedom is also adopted in the political sphere where the people are basically against the government in general. Under this notion, the role of government, according to economic liberalism, is limited to cover certain areas including security, national defense, and public works and institutions, such as hospitals, fire departments, and military and police forces that are unprofitable for private businesses to operate (Hunt, 1981, p.46). During this era, the role of government was welcomed as long as it benefited the capitalists, such as stabilizing economic conditions (Samuels, in Hunt, 1981).

The industrial revolution that took place between the late 18th and early 19th centuries strengthens the economic liberalism under free-market competition. It is argued that the principle of free-market competition where the forces of market demand and supply were guided by invisible hands to serve the self-interested capitalists to earn maximum profit that led to efficient production activities. It is also argued that the industrial revolution that came later was the greatest achievement of these self-interested capitalists to maximize their profit by inventing technology and knowledge that produced the most efficient production operation to maximize profits (Hunt, 1981). Based on the classical liberalism principle, the United States enjoyed high economic growth contributed by several key industries such as textiles, chemicals and machinery between 1899 and 1927 (Hunt, 1981, p.153).

The liberalism principle applied to economic growth combined with limited government interventions led to a free-fight market competition that resembles the principle of Darwinian survival of the fittest. It is argued that since endowment factors such as knowledge, wealth and intellect are not equally distributed among individuals, the parties that own the most of these factors would likely win in the competition. It means unequal distribution of wealth when the winners will hold most of the wealth and assets in the economy. It is argued that this unequal distribution of wealth led to the Great Depression in 1929 as explained below.

The second era of economic philosophy is Keynesian economics. In 1929, an English economist, John Maynard Keynes, published a book, *The General Theory of Employment, Interest and Money*. Keynes proposed the concept of circular flow to explain the causes of the Depression (Peters, 2001). The basic principle of the concept is economic equilibrium where the total or aggregate spending of all economic units, namely households, businesses and government should be equal to the total or aggregate production to ensure the prosperity of the economy. This was not the case when the Depression occurred in 1929.

According to the concept of circular flow, the Great Depression was caused by a situation where the aggregate spending fell behind the aggregate production. This situation occurred since business spending or investment and household spending declined significantly. Unequal distribution of wealth and income in the economy leads to decreasing aggregate spending since it is argued that the rich generally save more than the poor. The savings are the leakage in the circular flow that causes the contraction of aggregate spending. The implication is the accumulation of business inventories and, hence, the decline in profits. This situation forces business retrenchment by cutting production and, hence, employment. High unemployment causes the household spending to decline. The end result of this repercussion effect was the Great Depression of 1929 in the United States when the stock market crashed and unemployment was high.

The basic principle of Keynesian economics is re-distribution of income by increasing government spending in the economy to maintain the equilibrium. However, in order to do that, the government needs revenues. Keynes proposed taxation to tab on the savings of the rich and use the proceeds to provide public works such as the constructions of airports, dams, post offices, courthouses, roads and bridges (Peters, 2001). It is argued that these works create employment and, hence, increase the household spending. This was one of many strategies of the New Deal policy package under President Roosevelt for economic recovery in the United States. The role of government in the economy became stronger as armament industries that created employment were established by the United States government as the Second World War began.

The role of government in the United States, as well as other developed countries, continued to increase significantly especially after the Second World War was over. Peters (2001) proposed some factors that contributed to the growing of the government role. This research highlights a factor proposed by Peters, namely the decline of late capitalism or the market failure argument which was relevant to the downfall of classical economic liberalism previously discussed. This concept rooted from Marxism that argues when the market fails to produce social goods for the people, the government has to step in by increasing spending, particularly on welfare programs.

While this argument is true for the Marxist, it is also valid from the point of view of the liberal government. The result is increasing public administration and bureaucrats to manage the programs during peacetime in the liberal countries. Peters (2001, p.11) argued that both Marxist and liberalist government agree that as the role of government continues to increase, the spending eventually overcrowds the productivity of the market system. The Armey curve explains this phenomenon (see Section 2.3, p. 88). By 1970s, developed countries such as the United States and England experienced inefficient government operation, highly regularized market and stagflation. However, the Marxist and liberalist government disagree in their proposal of remedy, while Marxist proposes the end of capitalism; the liberalist does the revival of market mechanism (Peters, 2001, p.12).

The revival of market mechanism in the 1970s marked the beginning of the neo-liberalism principle or the third era of economic and political history. By 1970s the role of government had become the source of market inefficiency due to their policies and regulations that hindered market competition. In addition, the increasing government roles caused budget deficits that required more taxation that further distorted market mechanism[1]. England revived the market mechanism with, among others, privatization during the Thatcher administration and the United States proposed less corporate taxation during the Reagan presidency. These economic strategies are later known as Thatcherian economics in England and Reaganomics in the United States. The end results of the policies under the neo-liberalism principle are significant budget cuts to improve fiscal discipline, less government intervention in the economy and greater market mechanism.

The principle of neo-liberalism was later introduced to developing countries, particularly in response to the debt crisis in Latin America. In 1989, the Washington Consensus that described economic policies as a standard reform package to address the debt crisis was established. The consensus was prepared by three institutions, namely the International Monetary Fund (IMF), the World Bank and the Treasury Department of the United States. The package covered several general policies which were (Williamson J., 2002).

- stabilizing macroeconomic foundation including fiscal discipline by setting-up priorities in government spending and introducing tax reform;
- opening domestic market to international trade and investment by promoting trade and foreign direct investment policy reform, property rights protection;

[1] In market mechanism, price serves as a tool to direct resources allocation since the fluctuation of prices points out to scarcity. It is argued that, increasing the price of a particular goods indicates over-demand for the goods. If this situation occurs, available resources would be directed toward producing the goods to restore the price to its equilibrium level where its demand equals supply. Taxes imposed on businesses distort the actual price upward and this will give a false signal to allocate resources available in the market. The implication is that the market might produce goods that are not needed by the consumers. In other words, taxes could create market inefficiency.

- promoting market mechanism domestically by allowing the interest and exchange rates to be determined by market, privatization and deregulation.

These economic reforms spread to political reforms as the package demanded a more liberal type of government.

Even though the Washington Consensus was established in response to the debt crisis in Latin America, the principle of economic and political neo-liberalism introduced in the consensus was carried out to other developing countries. Within this context, it is argued that the principles of neo-liberalism is transferred by international organizations such as the IMF and World Bank to developing countries as part of the agreement in conjunction with aid or loans provided by these organizations. This is the case with Indonesia.

In 1997, Indonesia experienced an economic crisis. The crisis began when the domestic currency, IDR, depreciated significantly against the USD. The implications were a massive government budget deficit due to the increase in the interest and installment payments of foreign debt in the USD denominator and currency speculation that further depreciated the domestic currency. As government deficit increased, spending cuts became the only option for the government. These reductions occurred in the areas of infrastructure development such as roads and irrigation canals and welfare programs, particularly in health and education sectors. As welfare programs were severely reduced, the economic crisis spread into social and political unrest.

The currency depreciation also affected the costs of imported raw materials used by businesses. As imported materials were expensive, businesses had to increase prices. However, as prices increased, their sales volumes declined. This caused the accumulation of business inventories and. forced the businesses to reduce production level and, hence, profits. As an attempt to minimize losses, business retrenchment that led to unemployment was unavoidable. Increasing unemployment reduced the household purchasing power.

As sales and revenues declined, many of the businesses could not pay their debts to the bank. Some even declared bankruptcy. This situation led to bank financial insolvency and, hence, people's confidence toward banks. As people's confidence declined, a bank rush occurred. In order to prevent financial insolvency and further rush, banks increased their interest rates on loans and deposits. However, these banks were unable to channel the funds on investment. This situation led to bank insolvency and a further decline in people's confidence toward banks.

In order to prevent banks from bankruptcy, the government injected some funds to improve their financial conditions. The decision put more pressure on the government's already deficit budget. However, some of these banks finally declared bankruptcy and, therefore, contributed to further increase in unemployment. As businesses collapsed, the stock market followed. By 1998, the economic crisis had triggered social and political unrest caused by the increase in unemployment and inflation combined with diminishing welfare programs.

On 31^{st} of October 1997, a letter of intent between the Government of Indonesia and the IMF was signed as part of the IMF's economic recovery fund. The three main agendas of the letter were (International Monetary Fund, 1997, p.3):

- strengthening macroeconomic foundation including

- restructuring the financial sectors
- introducing structural reforms.

While the first and second agendas proposed economic reforms, the third agenda could also spread to political reforms, including a decentralization policy or regional autonomy as is explained below. The aims of the structural reforms were to promote greater transparency in policy making and competition to support economic restructuring programs necessary to promote growth and to implement measures on poverty alleviation programs (International Monetary Fund, 1997, p.10). In addition, the government of Indonesia should accelerate the reforms by promoting trade and investment reforms, privatization and deregulation reforms (International Monetary Fund, 1997, p.10). As such, it can be inferred that the letter of intent carried the mission of the neo-liberalism principle introduced by the Washington Consensus which promoted more market mechanism and reduced government intervention in the economy.

While the letter of intent did not include regional autonomy or a decentralization proposal as part of the agendas, the idea of neo-liberalism principle at the time when the people's trust in the government diminished had triggered regional autonomy or decentralization policy in Indonesia. The political rhetoric for decentralization arguments that are consistent with the neo-liberalism principles are:

- the role of the central government at the regional level will be less so that it promotes efficient government operation,
- regional proliferation that followed the decentralization policy will promote regional competition and, therefore, government efficiency at the local level,

- regional autonomy will put the center of the decision making closer to the people and, therefore, can better promote democracy and reduce poverty alleviation.

1.1 DECENTRALIZATION POLICY IN INDONESIA

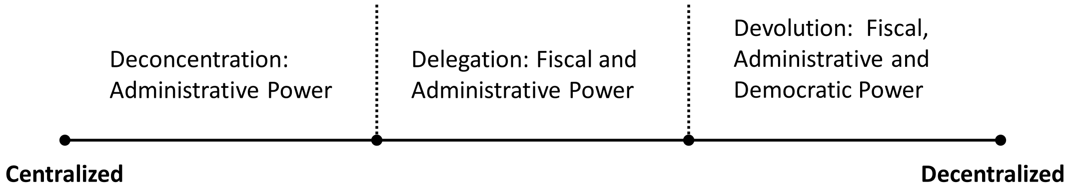
Decentralization can be understood as a process of power transfer from the central to sub-national government level. As such, decentralization encompasses three stages (Smith, 2002, p.389). The first stage is *deconcentration* stage. This stage refers to the transfer of functional or administrative authority to field officers of central government departments and agencies. Second is *delegation* stage. This process refers to the decentralization of executive authority to semi-autonomous agencies headed by appointees of the central government. Third is *devolution* stage that refers to transfer of political power, fiscal resources and quasi-legislative power to territorial governments. The three stages differ in terms of the authority level in decision making transferred by the central government to the sub-national governments[2].

As a process, decentralization moves along the centralized-decentralized continuum (Fesler, 1968). The process begins with deconcentration, or pseudo-decentralization at one end of the continuum, to devolution at the other end of the continuum. However, the process does not assert that in reality the decentralization process in all countries should start with deconcentration and end up with devolution. Rather, it describes the

[2] The basis of decentralization typologies is the delegation of governmental functions or the extent of discretionary authority granted by the central government to sub-nationals. While market decentralization might be another form of decentralization, it does not refer to the delegation of governmental functions or the extent of discretionary authority granted by the central government to sub-nationals as the other three forms of decentralization suggest. Since this thesis is about the delegation of governmental functions to sub-nationals, market decentralization was not considered relevant. The typology of decentralization in the thesis is a hybrid typology eg. devolution is a combination of administrative and fiscal decentralizations whereas devolution is administrative, fiscal and political decentralizations.

extent of discretionary authority granted by the central government to sub-nationals. Diagram 1 describes the process.

DIAGRAM 1 CENTRALIZED-DECENTRALIZED CONTINUUM[3]



Sources: Derived from Fesler (1968); Smith (2002); Morrison (2004)

Diagram 1 shows that the kind of power transferred to sub-nationals determines the degree of decentralization implemented by a particular political system. At the end of the spectrum, a full decentralization is accompanied by a transfer of administrative, fiscal and democratic power. The latter refers to a full political authority of sub-national government to make decisions suitable for its area. The authority includes the ability to elect members of a local government body that comprises the head of sub-national government and members of the local assembly.

Devolution could also be perceived as a process to improve public accountability. Since different regions will have different preferences and pattern of demands for public services, locating the decision making process in the hand of local governments will likely improve public service provisions (Smith, 2002). In addition, since decentralization breaks down the national area into smaller manageable regions (Fesler, 1968), it could improve representation and information circulation through the local network (Morisson, 2004, p.4). In other words, true decentralization could improve

[3] The continuum is not meant to describe a linear progression through which a country progresses. Rather, it describes the differing extent of discretionary authority granted by the central government to sub-nationals. Hence, the extent of discretion is at the highest in devolution since it includes administrative, fiscal and political authority.

public accountability by enhancing local governments' responsiveness to meet the needs of their constituents.

Indonesia has undergone various stages of decentralization since the Dutch colonial time (see Section 4.1.1). The decentralization policy during the Dutch colonial time resembles the deconcentration stage when the role of sub-national governments was limited to administrative functions such as managing agricultural areas and the supply of labor for the interest of the colonial rulers. It is argued that the *priyayi*-peasant relationship was established by the Dutch colonial ruler to sustain the flow of economic rents generated from these areas (see Section 4.2.2, p. 166).

The delegation stage in the decentralization process was implemented during both the Old and New Order regimes when the government transferred a limited sum of funds and administrative power to the region (see Section 4.1). Since the local people did not have the power to elect the head of local government, the political power remained in the hands of the central government. The differences of the delegation process between the two regimes are the Old Order regime government granted autonomy to the local government to develop their own development programs. This was not the case found during the New Order regime since the role of local government was to manage and implement development programs and the funds attached to the programs proposed by the central government. However, during the Old Order regime, the central government did not transfer sufficient amount of funds to the local government to implement the authority (see Section 4.1, p. 123). As a result, the implementation of local government initiative programs was limited.

Finally comes the devolution stage of decentralization policy. This is the case of decentralization policy that has been implemented since 2000 (see Section 4.1.1). The implementation of administrative decentralization is the authority of most governmental functions (except security, defense, international relations, religious affairs, judicial system, and fiscal and monetary policies) granted by the central government to the second-tier government level. The second-tier government level in Indonesia is *Kabupaten* or Municipalities and *Kota* or Districts. Law 22/1999 on Regional Government guided the transfer of governmental functions from the central to the local governments.

Five years later, the central government increased the democratic power to the local level by introducing Law 32/2004 to amend Law 22/1999. While the Law 22/1999 allowed the local assembly to elect the head of local government and the constituent to elect the members of local assembly, the Law 32/2004 initiates a direct voting mechanism to elect the head of local governments and members of local assembly (see Section 4.2.3). It is argued that the direct voting mechanism provides a political tool that can be used by local constituents to impose political sanction to improve the performance of the local government.

The central government grants the financial power to the local governments by transferring some funds to finance the local governments' expanded functions. The fund is known as Balance Fund that consists of a block grant, specific grants and revenue sharing from taxes and non-taxes. This fund is expected to cover the spending needs of the local governments. To support the fiscal transfer arrangements, the central government introduced Law 25/1999 on Balance Funds to guide the implementation of inter-regional fiscal transfer arrangements in Indonesia. The law became effective in 2001. In 2004, the central government introduced Law 33/2004 to amend Law 25/1999. The new law modifies the transfer arrangements stated in the amended law (see Section 4.1.1, p. 135).

To improve fiscal capacity of the local governments the central government introduced Law 34/2000 on Local Taxes and Charges. The law provided some guidelines on the types of local taxes and charges that the local government can collect. By collecting local taxes and charges, the local governments could reduce their fiscal dependence on inter-regional fiscal transfer from the central government. As such, theoretically in the long-run, financial sources for public goods provisions at the local level should mostly be generated locally rather than depending on fiscal transfer. The sources include revenues from income tax, local taxes and charges including general sales tax and other revenue derived locally.

Since the enactment of the Law, local governments have introduced a range of new taxes and charges. Some of them are the reinstatement of those that had been cancelled by the central government due to tax inefficiency in the 1980s (Devas, 1988). Lewis found that by the end of fiscal year 2001, more than 1,000 local taxes and charges, mainly on primary goods and factors of production, had been issued by the local governments. These taxes and charges might harm the local economy since it is argued that they increase the cost of production (see Section 5.2, p. 220). He also found that only about 40 percent of the total is legal while the rest do not have the central government's approval as required by law (Lewis, 2003).

Lewis (2003) found in this study that despite the local governments' argument that increasing taxes and charges are required to cover their fiscal needs, a nationwide study did not find any support for such an argument. In addition, a later report also suggests that the local governments in the ten highest taxes and charges group are not necessarily those that provide the best public services required by local businesses (Regional Autonomy Watch, 2008). It is argued that as the local governments keep creating new taxes and charges without significantly improving public services provision, Leviathan government behavior may arise (see Section 1.5).

One study demonstrated that many of these local taxes are costly to administer (Lewis, 2006)[4]. To constrain the local taxes and charges that are argued to harm local economy, the central government introduced Law 28/2009 on Local Taxes and Charges to amend Law 34/2000. The purposes of the new law are to improve guidelines and mechanism control in creating local taxes and charges (see Table 15, p. 225). This new law became effective on 1st January 2010. Section 5.3 also provides a brief analysis of the impact of the new law on disciplining the local government in creating local taxes and charges.

In summary, the year 2000 was not the first time that Indonesia implemented a decentralization policy. As previously explained, the country has always been managed under the decentralization principle. However, the stages and, hence, characteristics of the decentralization policy that was implemented in each governmental era differs. While it is not possible to accurately indicate the position of decentralization policy implementation in the centralized-decentralized continuum described in Diagram 1, it can be argued that the characteristics of decentralization policy in Indonesia are

---

[4] In his paper, tax administration includes identifying taxpayers, assessing tax liability, collecting taxes and enforcing tax payment (Lewis, 2006, p.213).

moving toward devolution as the central government granted more administrative, fiscal and political powers to the local government.

1.2 Why this Research is Needed

While there is a range of studies in the area of decentralization in Indonesia, study in Leviathan government behavior has been neglected. In general, studies on decentralization in Indonesia have followed two broad areas. The first area was the public finance, where the focus of analysis was on the government budget from both the revenues and expenditure sides and the way the budgeting policies affect equity. Some examples of studies in this area are a comparison study between the former and current inter-regional financial transfer (Silver, et al, 2001) the impact of the block grant on horizontal equity (Lewis, 2001) the impact of current inter-regional financial transfer arrangement on the local government fragmentation (Fane, 2003) and vertical equity (Lewis & Chakeri, 2004), and the creation of the local taxes and charges post-decentralization policy (Lewis, 2003). Overall, none of these studies addresses the way the inter-regional fiscal transfer affects the local government behavior.

The second area was the political aspects of decentralization policy to understand the political institutional structure of decentralization and its related consequences on the Indonesian political environment. Some examples of this area of study included the problems and prospects of decentralization policy (Alm, et al, 2001) and some reviews on political, fiscal and economic incentives for regional proliferation at municipal and district levels (Fitrani, et al, 2005).

While the study by Fitrani, et al (2005) covered wider areas than that found in the study by Alm, et. al (2001), both studies did not include the role of social values in the analysis. In addition, both studies did not explain the role of regional proliferation on government efficiency or Leviathan government argument. Testing the efficiency argument is important since it is part of the decentralization political rhetoric of neo-liberalism. This thesis attempts to test this issue or to identify and establish the behavior among local governments in Indonesia post-decentralization era. As will be explained in Chapter Four, Leviathan government behavior is a concern since it leads to rent seeking activities and, hence government inefficiency (see Sections 4.2.1 and 4.3).

To address this issue, this research uses an institutional theory. According to the theory, individual behavior in general was the outcome of three institutional settings that included economic, social and political settings (North, D.C., 1991). As such, Leviathan government behavior could also be the result of a particular institutional setting. Since this research focuses on inter-regional fiscal transfer arrangements in Indonesia, it limits the analysis of economic institutional setting on fiscal transfer arrangements.

By using an institutional theory, this research proposes these following contributions. Firstly is to provide a holistic approach in understanding Leviathan government behavior by developing a model. The institutional model that was developed in this research provided information about the way social, political and fiscal institutional settings interact to influence local governments' behavior. It is argued that these settings consist of regional specific issues that might differ from the region where fiscal federalism framework is originally constructed. By understanding the setting, any proposal to improve regional fiscal policies should also consider other non-economic factors such as the social values and the political structure where the policy is implemented.

Secondly is to propose an expanded analysis on the way Leviathan behavior should be understood. In other words, this research attempts to identify some regional specific issues that might contradict the assumptions attached to the original fiscal federalism framework (see Section 2.2.2). It is argued that the regional specific issues can shed some light to understand the reasons fiscal federalism policy might fail to deliver expected results which is efficient government operation. This becomes the research contribution to the theoretical level of public economics, particularly on fiscal federalism area.

1.3 Objective of Research

This research objective is to understand the way Leviathan government comes about and identifying some ways to constrain the behavior. This research defines Leviathan government behavior as the monopolistic behavior of local governments to exploit local businesses by collecting taxes and charges to finance rent-seeking activities. The analysis of Leviathan government behavior starts with understanding the way fiscal institution stimulates the behavior. The social and political settings become the external factors of the fiscal institutional setting that might intensify or moderate the behavior. The focus of this research is broken down into the following research questions:

1. To what extent and in what ways do the institutional settings contribute to the Leviathan government behavior?
2. How does the Leviathan government behavior affect local businesses?

1.4 LEVIATHAN GOVERNMENT BEHAVIOR

Thomas Hobbes introduced the term Leviathan government to describe the behavior of authoritarian government or rulers observed during his time. Brennan and Buchanan (1980) adopted the term and used it to refer to government behavior aimed to maximize revenues and, hence, rents by extracting taxes and charges beyond those needed to undertake basic responsibilities as public services provider. Using the term Leviathan behavior introduced by Hobbes, they referred the behavior as the natural government behavior or the government state of nature that arises if political and social controls were absent from the society.

Accepting this argument, Brennan and Buchanan (1980) further suggested that Leviathan behavior might intensify under certain conditions. Public services that were concentrated in particular areas resemble a monopolistic rather than a competitive market. The monopolistic market might constrain factors of production mobility such as capital mobility across jurisdictions. This condition might present an opportunity for the government to demonstrate Leviathan government behavior in those particular areas.

In this research, Leviathan government behavior is associated with revenue maximization by collecting more taxes and charges to accumulate rents. As such, this research defined rent-seeking as "… [a] behavior in institutional setting where individual efforts to maximize values generate social waste rather than social surplus" (Buchanan, 1980, p.4). In this definition, social waste was associated with the opportunity costs of transferring resources from one party to another. Since these resources (taxes and charges) could otherwise be used for productive activities, rent-seeking induces allocation inefficiency and hence lowers the welfare condition of the society (Tullock, 1967). If the level of welfare is measured by the availability of output for the society, the reduction of production lowers the level.

Based on this explanation, social waste caused by rent-seeking emerges not because of the resources transfer but, because of the productions that are foregone because of the transfer. Corruption is one form of rent-seeking activity. However, the activities may take in various other forms such as bureaucratic inefficiency that might include managerial inefficiency, over-employment, excessive salaries and fringe benefits, technical and allocative inefficiency[5] (Conybeare, 1982). This research uses the Armey curve to measure government efficiency (Vedder & Gallaway, 1998). This research argues that rent-seeking emerges as the actual government size exceeds the optimum size. The discrepancy between these two sizes represents the rents or surpluses (see Section 2.3).

This research perceives Leviathan government behavior as a fiscal issue (Brennan & Buchanan, 1980). However, it also argues that social and political issues contribute to Leviathan government behavior (see Sections 4.2.2 & 4.2.3). To identify and establish the extent that these issues contribute to the behavior, this research develops a framework that draws on various theoretical positions outside public economics literature. As such, this research perceives Leviathan government behavior as a multifaceted issue.

This research uses an institutional analysis to understand economic, social and political factors that underpin the behavior. North defines institutions as rules of the game that constrain human interaction. In his

[5] Technical efficiency concerns the level of technology, eg. capital as opposed to labor intensive technology, employed in the production process whereas the allocative efficiency refers to the allocation of the factors of production uses in the process. Technical and allocative efficiencies are achieved when the technology uses and the allocative of resources correspond to the lowest total costs per unit of output.

definition, the institutions comprise economic, social and political institutions (North, D.C., 1991, p.97). Based on this argument it can be inferred that Leviathan behavior is the outcome of interactions among these three institutions. In this research the rules of the game are represented by the inter-regional fiscal transfer arrangements, the structure of the social value system and the political environment in Indonesia (see Sections 4.2.2 & 4.2.3).

This research draws on both institutional economics theory that encompasses the traditional institutional economics or the Veblenian approach and the new-institutional economics. The Veblenian approach introduces the sociological aspects of institutional theory. The aspects are represented by the value system and social wealth variables in the model. Traditionally, these variables are used within sociology. As such, this research uses a cross-disciplinary approach since it expands the boundary of economic analysis by introducing variables that are external to economics. However, the methodology applied in this research is economics methodology that stems from positivist research philosophy (see Section 1.5)[6].

The institutional theory used in this research adopts the paradigms of human action (praxeology) or purposeful actions and social rationality to understand the reasons some societies are unresponsive to the implementation of the mainstream economic policies (see Section 2.1)[7]. To establish the reasons, this research uses institutional theory. This theory follows a structural-functional analysis where the structure of institution

---

[6] My background in economics and time and money constraints are the reasons for selecting the methodology.
[7] Mainstream economics refers to new-classical economics and Keynesian. The former is also known as microeconomics whereas the latter as macroeconomics.

determines individual behavior[8]. The analysis aims to understand the capacity of political and social institutions in facilitating economic changes. The variations in the capacity across societies might become the reason the mainstream economic policy provides different results when implemented in different society.

1.5 PHILOSOPHY OF THE RESEARCH

This research draws on a general systems thinking (GST) method. The method consists of systems thinking and design thinking. As an application of systems thinking, the method provides boundaries of inquiry about the way of thinking applied in understanding and working with systems (Banathy, 1996, p.155). In other words, this research used GST as a way to organize thinking to understand systems. The term *organized thinking* refers to a way of thinking systematically to understand order and pattern of "…interacting units or elements that form an integrated whole intended to perform [a] *function*" (Skyttner, 2005, p.57). In this research, these interacting elements are the fiscal, social and political institutional settings that form an order and a pattern or an institutional design to establish Leviathan government behavior.

As design thinking, the concept of holism inherent in systems thinking accommodates various theoretical positions. The concept of holism in systems thinking refers to viewing and understanding a system based on its elements, perceiving the behavior of the system as a whole or the cause-effect relationship of its elements and explaining the functions and roles of the elements within the system boundary as a whole (Ackoff, 1981 in Banathy, 1996, p.159). The concept of holism that applies to various

[8] The structural-functional analysis that follows the modernization theory was developed in the United States of America after the Second World War (Leys, 1996).

theoretical positions is consistent with the cross-disciplinary approach used in this research.

In this research, the holism concept refers to the institutional setting of Leviathan government behavior. This setting comprises smaller institutional settings, namely fiscal, social and political institutions that make up the institution of Leviathan government behavior. Each setting represents a particular role that contributes to the behavior. The elements in each setting describe the function carried out by each setting. These elements explain the cause-effect relationship within each setting. However, to understand the reason Leviathan government behavior arises, all institutional settings have to be understood as parts of the whole Leviathan government behavior. In other words, Leviathan government behavior is the outcome of interconnecting, interdependent and interacting of three institutional settings.

In developing the design, different disciplines are required to understand the complex nature of cause-effects relationships within and across each institutional setting within pertinent Leviathan government behavior institution. In this research, these positions include public economics, public policy and management, political science and sociology. These theoretical positions were used to explain the inter-relationship of fiscal, social and political institutions to explain and establish Leviathan government behavior.

The outcome of systems design thinking is a model. This model can be used to identify a problem situation and a design solution as a system or a network of phenomena (Banathy, 1996, pp.18-19). In this research, the model is used to demonstrate relationships of variables that contribute to Leviathan government behavior and explain some aspects that encourage local governments in Indonesia to demonstrate the behavior. The former refers to identify a problem situation and the latter leads to a design solution or policy proposals on constraining Leviathan government behavior in Indonesia.

This research used positivist research philosophy as the primary philosophy to develop and test the model. This philosophy is consistent with the economic methodology applied on this research. Positivist philosophy stems from the perception that reality is represented by a generally excepted construct known as theory or framework. The philosophy applies a positive-deductive process that tests the extent the theory can explain the reality. In this process, the framework is represented by a system of equations or mathematical modeling.

In this research, modeling was used to establish the way the three institutions interact to explain Leviathan government behavior (see Section 2.2). Based on this model, this research proposed a set of hypotheses that were tested using Indonesian data. The purpose of the test was to identify the extent that the model could establish and explain Leviathan government behavior in Indonesia. This part of the research used a quantitative research approach (see Section 3.2). However, econometric modeling has some limitations including it requires aggregative data and ignores behavioral aspects at the micro-level (see Section 1.6).

However, there was other information that could not be obtained by using only the primary research philosophy. This information was the socially constructed environment on Leviathan government behavior from the perspective of local businesses in Indonesia. For this purpose, this research also used interpretative philosophy as a secondary research philosophy. This philosophy applied inductive logic to understand local businesses' experiences on Leviathan government behavior. The information about local business experiences was used to support and complement the research findings gathered from the positivist research philosophy. This part of the research required a qualitative approach.

Based on the above arguments, this research used dual research philosophies as a simultaneous methodological triangulation (Morse, 1991). The philosophies comprise positivist and interpretative research philosophies. These two philosophies have different epistemology paradigms. The ontological view of the positive philosophy is a single objective reality based on a value-free framework. In this research, the framework is stated as a mathematical model and a set of hypotheses that should be tested on a large size data set or samples. The test uses a structured statistical method to ensure that the characteristics of samples represented those of the population.

On the contrary, the ontological view of interpretative philosophy is of multiple realities resulting from individual's construction of his or her reality. As such, understanding social reality cannot be value-free since the investigator and the object of study will be interactively linked to formulate a mutual inquiry (Sale et al, 2002). A purposeful sampling of articulated respondents is sufficient since the samples are not meant to represent a large population. As such, the term articulated respondents in this context referred to the ability of them to provide important or relevant information to the research goals.

Since the research phenomena of the approaches differ, these philosophies should not be used for cross-validation but more importantly to enrich the research findings. For this reason, each philosophy will address different research questions of the same topic inquiry (see Section 1.2). The first question was addressed by using the positive research philosophy whereas the second question was addressed by the interpretative research philosophy. As such, the used of simultaneous methodology was not meant for cross-validation or duplication of results. Rather, it provides additional information that could not be obtained by using a single research philosophy.

Based on the argument above, this research had explanatory, descriptive and some degree of explorative inquiries. The explanatory inquiry established a causal relationship among variables across as well as within institutional setting of Leviathan government behavior. A system of equations or model developed in Chapter Two explained the causal relationship in the system. The model was tested on Indonesian data by using econometric technique. The technique applied inferential statistics or hypothesis testing (see Section 3.2). Explanatory inquiry was part of the quantitative research approach. The time frame used for this inquiry was a cross-section.

Descriptive inquiry established the institutional setting of Leviathan government behavior in Indonesia from different perspectives. The main purposes of using this inquiry were to support and complement the findings derived from the explanatory inquiry (see Chapter Five). Descriptive inquiry used, processed and analyzed government reports and publications, statistical data and studies to identify and establish the setting (see Chapter Four). Furthermore, the descriptive inquiry in this research applied to local government or districts and municipalities nationwide so that information obtained from this inquiry explained a nationwide situation. By gathering information from both explanatory and descriptive inquiries, this research aimed to identify and establish whether the model developed also applied to the institutional setting of Leviathan local government behavior nationwide. As such, the descriptive inquiry cross validated the analysis obtained from the explanatory inquiry.

In addition, one of the complementary aspects was related to identifying whether the structure of local government revenue was consistent with the assumption of the structure according to the fiscal federalism theory developed in the United States (see Section 2.2.2). Figure 3 (p. 136) indicates that the structure was dominated by Balance Funds or the inter-regional fiscal transfer arrangements rather than local taxes and charges. This is not the case embedded in the assumption of fiscal federalism where the local or sub-national government spending equals the total local or sub-national government revenues from local taxes and charges. This assumption is also embedded in the Brennan-Buchanan hypothesis (see Section 2.2.2).

When the main source of local government revenues is the inter-regional fiscal transfer arrangements, identifying Leviathan government behavior should also account for the structure of total government revenues. As such, this research used an alternative hypothesis to test the Leviathan government behavior (see Section 5.1.4). The alternative hypothesis requires three steps of analysis, which are as follows.

The first step is analyzing the impact of inter-regional fiscal transfer arrangements on the structure of total local government revenues in the sense whether the arrangements encourage local governments to collect more taxes and/or charges. The second step is to indentify whether the additional local taxes and/or charges increase the government size. The third step is to identify whether the increase in the government size exceeds the optimum level. It is hypothesized that Leviathan government behavior is confirmed when the inter-regional fiscal transfer arrangements encourage local government to collect additional taxes and/or charges, use the proceeds to increase the government size and the increase in the size exceeds the optimum level of government size (see Sections 5.1.3 & 5.1.4).

Exploratory inquiry was part of the qualitative approach. The purposes of using this inquiry were to understand the business environment constructed from the local businesses' point of view and to complement the research findings obtained from the explanatory inquiry (see Chapter Five). The complementary part referred to testing the factor of production mobility assumption that underpinned Leviathan government behavior as explained by fiscal federalism framework (see Section 2.2.2). The time frame used in this inquiry was a cross-section based on focus group discussion conducted on 20 January, 2010.

These three research inquiries provided a simultaneous methodological triangulation where the analysis obtained from the explanatory inquiry became the main reference for the other two inquiries. This triangulation technique was consistent with abductive ontological view on providing answers to a single research inquiry. As explained above, this research used explanatory, descriptive and a small part of explorative inquiry to address Leviathan government behavior in Indonesia (see Chapter Five).

1.6 Limitations of the Research

This research has some limitations. Firstly, the indicators used to measure the institutional setting are selected based on data availability considerations. While some data particularly on fiscal variables are readily available and academic consensus to use indicators to measure these variables are also available, aggregative data for social and political variables are not (see Section 3.2). The implication is that even though the social and political proxies are selected in a way so that the fitness of each proxy to the setting would be maintained, these proxies might be contested. In addition there is a risk where the estimated results of the model might be biased in the case the proxies are not suitable measurements for the variables. The descriptive inquiry explained in Chapter Four is used to cross-validate the information obtained from the estimated results of the model.

Secondly, it is not the intention of this research to propose an optimal level of government size. Rather, the intention is to identify the magnitude of the rents in Indonesia. The optimal size is measured for this purpose so that the magnitude of the rents is derived by identifying the discrepancy between the actual and the optimal size. This research uses Armey curve to identify the discrepancy (see Section 2.3). In this research, the accumulation of the rents might be attributed to corruption, government failure or inefficient public policies and spending allocations (see Section 4.3).

Thirdly, due to data availability when the data were processed, this research used data published in 2007. As a result, the estimation results of the model in the quantitative part were a snap shot of what was happening in 2007 in 243 districts and municipalities. Since this research used cross-sectional data, it does not explain the process of institutional adjustment that is proposed by an institutional approach.

Furthermore, since this research used data published in 2007, the estimation results obtained from the model did not capture the changes proposed by Law 33/2004 since the changes were implemented after 2007.

However, this research discussed some changes in the institutional setting after 2007 by using secondary data and descriptive statistics. The aim is to give an overview to the extent that the institutional settings have been changed since 2007. In addition, the results that derived from the qualitative part are applicable in the areas under study only. This part provided illustrative examples of the impact of Leviathan government behavior in Indonesia.

Fourthly, this research does not discuss social consequences of policy proposals explained in Chapter Two (see Section 1.6). The focus of this research is to identify and establish the existence of Leviathan government behavior in Indonesia by using an economics methodology. However, the cross-disciplinary nature of this research introduces ideas that link economics to other disciplines, such as sociology, political science and public policy management. These links can be used to identify social consequences of policy proposals implementation. Identifying the consequences could become a topic for further studies.

1.7 SYSTEMATIC PRESENTATION OF THE THESIS

This report proceeds as follows. Chapter Two develops the framework to understand the institutional perspectives of Leviathan government behavior. By addressing each institutional setting and explaining the way the settings interact, the discussion gives some insights in understanding the institutional factors that underpin Leviathan government behavior. This framework becomes the basis to develop a model that represented the institutional setting that influences Leviathan government behavior.

At the end of Chapter Two, the framework is translated into a diagram or mind-map. The diagram is used to develop a system of equations or a model that describes the way the institutional settings shape Leviathan government behavior. Based on the model, this research proposes a set of hypotheses to test the extent the model can explain the institutional setting of Leviathan government behavior in Indonesia.

Chapter Three explains the research method. This chapter elaborates the way this research carried out the quantitative and qualitative approaches to answer the research questions. This chapter is divided into two sections. The first section explains the technicality of explanatory inquiry under a quantitative approach and the way statistical inference was applied to test the hypotheses. The technicality of the explorative inquiry is part of the second section. This section explains the way the qualitative data were collected.

Chapter Four explains the experience of Leviathan government behavior in Indonesia. The design of the inter-regional fiscal transfer arrangements and the implications of the arrangements on the local government fiscal structure are discussed. This chapter also explains the social and political context that might contribute to Leviathan government behavior in Indonesia. Some historical perspectives that shape contemporary Indonesia are also explained and discussed to understand the social and political background that intensify Leviathan government behavior in Indonesia.

For these purposes, this chapter uses, analyzes and discusses secondary data, studies and reports collected from various sources. Examples of the resources are government publications, statistics office publications and studies by NGOs and scholars in related areas. The information derived from the publications include the extent the inter-regional fiscal transfer arrangements influence fiscal structure of the local governments and the level of capital mobility that could provide preliminary information on Leviathan government behavior in Indonesia. In addition, the role of social and political issues in Indonesia provides background information on the way these issues intensify Leviathan government behavior. This information verifies and complements the research findings on the institutional setting of Leviathan government behavior in Indonesia derived from the quantitative research part (see Chapter Five).

Chapter Five tests the model developed in Chapter Two to identify and establish Leviathan government behavior in Indonesia. As such, the system of equations or the model and hypotheses were tested on Indonesian data. The test used econometric technique which basically follows inferential statistics. Before using the estimated model to test the hypotheses, the model was tested for reliability and validity. The purpose of using these criteria was to ensure that the data derived from the samples used in this research represented those of the population. In other words, the estimated parameters in the model are relatively stable when tested by using different samples derived from a particular population. In this case, the population is all local governments comprised of districts and municipalities in Indonesia.

This chapter also presents the findings from the qualitative research part. The focus group discussion was conducted on 20 January, 2011 in the office of Chamber of Commerce, *Jawa Barat* Province chapter in *Bandung* Municipality. The participants were business owners and/or practitioners in *Bandung* Municipality, *Bandung* District and *Cimahi* Municipality. The analysis of this part used explorative inquiry technique to identify the impact of Leviathan government behavior on local businesses. In addition, the information derived from the interview shed some light on some factors that constrain capital mobility across jurisdictions.

Chapter Five discusses the findings obtained from all three different types of research inquiries. The findings are presented and discussed by using a triangulation technique to identify and establish Leviathan government behavior in Indonesia. This chapter also presents some specific issues in Indonesia that might contradict the basic assumptions of fiscal federalism theory. The issues are related to the capital mobility across jurisdictions, the revenue structure of local governments, the prevailing social values system and the political issues in Indonesia. Finally, Chapter Six presents the conclusions and contributions of this research to public policy, public finance literature and identifies direction for further studies.

SUMMARY

Since the enactment of Law 34/2000 on Local Taxes and Charges, the local governments created various new taxes and charges. Despite the argument that these governments generated taxes to cover their spending needs, study on this issue did not support the argument. As such, there was an indication that rent-seeking could be the reason for generating local taxes and charges. This research argues that as the local government collects taxes for the purpose of generating rents or surplus, Leviathan government behavior arises. The argument is valid as long as the total government spending is fully financed by the total local taxes and/or charges. In this case, the Brennan-Buchanan hypothesis can be used to test the Leviathan government behavior. However, when the revenues are dominated by inter-regional fiscal transfers such as in the case of Indonesia, the Brennan-

Buchanan hypothesis is not valid. For this reason, this paper also develops an alternative hypothesis (Section 2.2.2).

The aims of this research are to identify and establish whether Leviathan government behavior had occurred among the local governments in Indonesia and why it did. In this research, the local governments refer to districts and municipalities. For this purpose, this research used institutional analysis and general systems thinking to understand the way social, political and fiscal institutions interact to shape Leviathan government behavior. As such, any policy to constrain the behavior should address economic as well as non-economic factors proposed by the model. These factors represent a country specific issue that might contradict the assumptions attached to fiscal federalism theory. Identifying and establishing these factors become the contribution of this research to understand Leviathan government behavior.

This research used a simultaneous triangulation methodology. This methodology stems from two research philosophies, namely positivist and interpretative philosophies. The ontological view of this philosophy is abductive. As such, this research used explanatory, descriptive and some degree of explorative research inquiries. However, since the main research philosophy was the positive philosophy, this research used explanatory inquiry as the main tool of inquiry.

In this research, descriptive and explorative inquiries supported and complemented the analysis on Leviathan government behavior in Indonesia obtained from the explanatory inquiry. The descriptive and explorative inquiries were particularly useful in identifying and establishing some regional specific issues that might work against the fiscal federalism framework. These issues might shed some light on the reasons fiscal federalism does not always provide results when implemented in developing countries such as Indonesia.

Since this research used explanatory inquiry as the main inquiry, a model was developed and tested to provide a comprehensive systemic approach in understanding the way the setting stimulated Leviathan government behavior. The model described causal relationships within and across the three institutions. Based on the model, this research proposed a set of hypotheses on Leviathan government behavior. The model and hypotheses were tested on Indonesian data to identify and establish Leviathan government behavior in Indonesia.