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Bambang Suharnoko Sjahrir, Krisztina Kis-Katos,  
Günther G. Schulze

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Department of International Economic Policy  
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University of Freiburg  
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Platz der Alten Synagoge 1

Tel: +49 761 203 2342  
Fax: +49 761 203 2414  
Email: [iep@vwl.uni-freiburg.de](mailto:iep@vwl.uni-freiburg.de)

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# Political Business Cycles in Local Indonesia

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Bambang Suharnoko Sjahrir, Krisztina Kis-Katos, Günther G. Schulze

University of Freiburg, Germany

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## Abstract

We study political business cycles (PBC) in newly democratized and decentralized Indonesia at the local level. As the timing of indirect and later on direct elections of district heads differs exogenously across jurisdictions, the political business cycle effect is clearly identified. Our data allow distinguishing PBCs for indirect and direct elections. We find significant budget cycles for discretionary budget categories at the disposal of the district head (not for the overall budget) only for direct elections, not for indirect elections. These cycles are much larger if the incumbent runs for reelection. Our results underline the conditional nature of PBC.

*Keywords:* Political business cycles, Indonesia, local elections, direct and indirect elections

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· Corresponding author. University of Freiburg, Department of International Economic Policy, Platz der Alten Synagoge, Germany, phone: ++49-761-203 2342, email: [Guenther.Schulze@vwl.uni-freiburg.de](mailto:Guenther.Schulze@vwl.uni-freiburg.de). This research has been supported by the German Ministry of Education and Research under grant number 01UC0906.

## 1. Introduction

The bulk of empirical evidence supports the notion that political budget cycles (PBC) may be found in young democracies, while there is much less evidence that voters in established democracies reward pre-election increases in spending (Brender, 2003; Brender and Drazen, 2005; Shi and Svensson, 2006).<sup>1</sup> Even in new democracies voters may not reward this (Arvate et al., 2009). We investigate PBC at the local level in Indonesia, a newly democratized and decentralized state that devolved the spending of approximately 40 percent of consolidated budget to the local level in 2001 (World Bank, 2007) and stipulated that district heads had to be elected by the local parliament and, starting in 2005, directly by the local population. Since district elections took place at exogenously determined different points in time, a PBC effect is very well identified — unlike in many other countries in which local elections take place at the same time and thus PBC may coincide with other time effects. Moreover, this is the first paper that can distinguish PBC for indirect and direct elections within the same country; it is the first paper to study PBC in Indonesia – the fourth largest country in the world.

Local elections in Indonesia are plagued by corruption, money politics, and strong patronage relationships between candidates and voters (Hadiz, 2010; Mietzner, 2010). In exchange for votes and loyalty, voters expect candidates to care for them through cash handouts at rallies, but also through other donations and provisions during election time (Simandjuntak, 2012). While many of these transfers are off-budget and illegal and have resulted in a significant number of corruption cases against district heads and provincial governors (Mietzner, 2011), there are indications that some of these donations may be on budget.<sup>2</sup>

We disaggregate the administrative expenditure to disentangle the discretionary and non-discretionary components. We hypothesize that incumbents raise their discretionary funds in election years to donate to religious and/or social institutions or activities such as places of worship (mosques), society groups or sports in order to increase their popularity. In some cases they channel these funds to finance their campaign activities. These discretionary funds, which can be spent relatively freely in contrast to other items, are budgeted as donation (*hibah*) or social assistance (*dana bantuan sosial*) under administrative expenditures, subcategory “others”.

We find that this expenditure category displays a strongly cyclical behavior—only in direct elections and especially if the incumbent is running for reelection. Thus PBC exist in Indonesia at the local level, but they are conditional on the institutional arrangement

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<sup>1</sup> Portugal is an exception to this rule; cf. Aidt et al. (2011).

<sup>2</sup> In a West Java district of Sumedang, an official of the state auditing board claimed that a significant amount of the district’s budget had been used to finance incumbent’s campaign activities in 2008 (Mietzner 2011). The Indonesian Corruption Watch (ICW) suspected that Banten’s and Jakarta’s provincial budgets had been used for incumbent’s campaign activities in 2011 and 2012 respectively (ICW 2012, ICW and LBH Jakarta 2012). ICW found that there were donations and social assistances that had been allocated to fictitious recipients or to organizations that were chaired by members of the incumbent’s family (ICW 2012).

(direct elections) and the budget category (discretionary spending). The next section presents our data and identification strategy, Section 3 contains the results, Section 4 concludes.

## 2. Data and Identification

*Endogenous variables:* We created an unbalanced panel data set for district expenditures for all Indonesian districts except for those in Aceh, Papua, and Jakarta for the period 2001-2009.<sup>3</sup> The number of districts in our sample increased from 336 to 477 due to district splitting. We use as endogenous variables overall district expenditure, administrative expenditure of the districts, and the subcategory “other” of administrative expenditure, all in log expenditure per capita. Administrative expenditure is all spending of the districts for their own administration, including capital and personnel expenditure, but excluding all administrative spending that can be assigned to a specific sector such as health, education, or infrastructure. Expenditure items classified under “other administrative expenditures” include unspecified spending, unforeseeable spending, interest payments, financial assistance to lower regions (sub-districts or villages), social assistance spending (*belanja bantuan sosial*), and donations (*hibah*). The last three spending items include discretionary funds of the district heads to provide financial assistance or to finance small scale programs benefitting core constituencies.<sup>4</sup> From 2001 to 2009, staff expenditures received on average 37 percent out of total government administrative spending, followed by spending for goods and services (30 percent), others (25 percent), and capital (10 percent). Thus “other expenditures” are a major budget item. Our main source of fiscal data is the Regional Finance Information System (*Sistem Informasi Keuangan Daerah/SIKD*) from the Ministry of Finance.

There is lack of check and balances in local governments’ budgeting and reporting process. The local governments, led by the district’s head, have the executive power to plan, execute and report the budget. The planned and realized budget must be approved by the local parliament. In practice, however, the process is lacking of transparency and suffering from poor record keeping; and internal and external audits are weak (World Bank 2007). This gives district heads discretionary scope over parts of the budget.<sup>5</sup>

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<sup>3</sup> We exclude the districts in the provinces of Nanggroe Aceh Darussalam, Papua, and Papua Barat due to the significant number of missing data and the capital, DKI Jakarta, because the districts in Jakarta are not autonomous.

<sup>4</sup> This usually happens in the form of financial assistance for places of worship, religious schools (*pesantren*), sports activities, specific villages, sub-districts or civil society groups which asked for financial assistance. The loose description of these budget items indicates how discretionary they are to local governments (see Ministry of Home Affairs decree 29/2002 article 8, Ministry of Home Affairs Regulations 13/2006 and 59/2007 article 42, 45 and 47).

<sup>5</sup> The budget is financed mostly through transfers from the center; only around 8 percent of the total revenue in 2009 is raised locally through taxes and user charges. This weakens accountability to the local populace further.

*Political cycles:* The effect of the electoral cycle is identified through the exogenous timing of the local indirect and later on direct elections (*Pilkada*), which differs across districts. After Soeharto's demise, the decentralization law 22/1999 was passed in 1999. It stipulated that regional parliaments were to be elected and that these local parliaments would elect the district heads (*Bupati/Walikota*). The incumbent – effectively appointed - district heads from the Soeharto era were allowed to serve their full terms of five years, which ended at different points in time. The revised law on regional autonomy, Law 32/2004, passed in 2004, states that district heads are to be elected directly by the district population with the first direct elections taking place in 2005; again the incumbent district heads were allowed to complete their terms, which came to an end in different years. Moreover, a number of districts split, which required the election of new district heads for the child districts, whereas the parent districts kept their old district heads. Table 1 shows the proliferation of districts and the increasing share of district heads that were directly elected. This exogenous and different timing of the first direct elections on the local level allows identifying clearly the political budget cycle effects.<sup>6</sup>

Possible political business cycle effects are captured by dummies for the two pre-election years and the election year (ELECT-2, ELECT-1, ELECT). PBC may be different for direct and indirect elections of the district heads: in indirect elections candidates need to win over a majority of the members of parliament only, whereas in direct elections a majority of the constituency is required. In a patronage democracy the latter may require much more resources. To account for this, we interacted the pre-election and election year dummies with a dummy for direct elections (DIRECT). Political budget cycles, however, are to be expected only if the incumbent seeks reelection, because in Indonesia candidates are only loosely attached to the sponsoring party and are therefore uninclined to increase election probabilities of a succeeding candidate sponsored by the same party.<sup>7</sup> Thus we collected data on whether an incumbent was running for reelection (also unsuccessfully), which is captured again in a dummy variable (INCUMBENT).

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<sup>6</sup> We constructed these data from various sources: General Election Commission (*Komite Pemilihan Umum/KPU*), Min. of Home Affairs, the Asia Foundation Indonesia, and the World Bank Indonesia.

<sup>7</sup> Mietzner (2010) argues that local elections are very personalized and that the required party sponsorship for the candidate is not built on mutual loyalty between the candidate and the party, but rather constitutes a business transaction, in which the candidate pays the party to get its sponsorship required by law.

**Table1: Proliferation of new districts and local direct elections**

Year	No. districts	District's heads who are			
		Indirectly elected		Directly elected	
		Number	%	Number	%
2001	336	178	53.0		
2002	348	208	59.8		
2003	370	316	85.4		
2004	410	392	95.6		
2005	434	248	57.1	186	42.9
2006	434	192	44.2	242	55.8
2007	434	164	37.8	270	62.2
2008	451	49	10.9	402	89.1
2009	477	74	15.5	403	84.5
2010	477	0	0	477	100

Note: The number of districts is based on the number of districts that received block grants (DAU) each year.

Source: List of bupati/walikota from Min. of Home Affairs, the World Bank Indonesia, and the Asia Foundation. Local direct election data comes from Min. of Home Affairs, KPU, the Asia Foundation and the World Bank Indonesia.

*Controls:* The cost of maintaining a functioning administration depends on the characteristics of the district in terms of accessibility and possible scale economies. We control for population size, district area, number of villages (in 100), share of villages with flat surface, share of villages that are landlocked, urbanization rate, and the log of the distance to the capital Jakarta. Expenditures for administration per capita depend on the overall district budget as measured by the log of total fiscal revenue of the district per capita; they may vary with income and education as these variables might capture the ability of the electorate to monitor and sanction excessive spending of the district governments on themselves. We include the log of real GDP per capita and the literacy rate. To account for the special situation of resource-rich districts (and to prevent a misinterpretation of the effect of GDP per capita) we include a dummy (RESOURCE-RICH) that is one if the district receives shared revenue from natural resources.<sup>8</sup> Our main source of data for all control variables is the Central Bureau of Statistics (*Badan Pusat Statistics/BPS*).

Our panel is unbalanced as districts continued to split throughout the period. As districts built up their administration, we expect capital investment to be exceptionally high and staff expenditure to lag behind since people need to be hired. To account for the effects of the creation of new districts we include four time dummies for the years before the split, one for the year of splitting, five dummies for the time after the split for parent districts and five for the new districts (results not reported). We also include year dummies to account for common shocks or time trends. Due to the splitting of

<sup>8</sup> Resource-rich districts participate in the income from natural resources through transfers from the central government; cf. Agustina et al. (2012).

districts and the strongly unbalanced panel, FE regressions are inadvisable and thus we use pooled OLS regressions. Our main result, however, is corroborated by FE regressions for the subsample of districts that did not split.

### 3. Results

Table 2 reports the results for total administrative expenditures and administrative expenditures, subcategory “other” for three different models; for our preferred model 3 we additionally report the total expenditures of the district (model 3c).<sup>9</sup>

Our first model shows a significant increase in the expenditure category “other” in election years, but not in the total administrative spending. This indicates the strategic use of the discretionary parts of the budget in election years. However, if we differentiate between indirect and direct elections (model 2), it becomes clear that political budget cycles in the subcategory “other administrative expenditures” occur only for direct elections and not for indirect elections. As the constituency need not be persuaded to vote for the incumbent in indirect elections (but only the members of the local parliament), there is no incentive for the incumbent to fund small village projects or to support sport clubs or mosques etc. in order to make voters more inclined to vote for him or her.<sup>10</sup> Not all incumbent district heads are seeking reelection, partly because they are completing their constitutional limit of two terms at five years each, partly for other reasons (e.g. running for governor, criminal investigations, and retirement). These incumbents have little inclination to increase election year spending because of their weak affiliation with potential successors. Model 3 captures this differential effect. Expenditures increase in direct election years for all districts, which is partly due to the organization of the elections themselves, the costs of which would be budgeted under “other” expenditures. In districts in which the incumbent is running, however, the election year increase in spending is about 20 percent higher than in districts in which the incumbent is not seeking reelection, which almost doubles the election-year effect. This underlines the notion that in the Indonesian system, in which the party loyalty of the district head is very weak at best, political budget cycles are pronounced only if the incumbent is a candidate in the next direct election.

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<sup>9</sup> We use the disaggregated administrative expenditure based on economic classifications of salary (staff), goods and services, capital, and others. The disaggregation is from the database for Policy and Economic Research (DAPOER) of the World Bank Indonesia.

<sup>10</sup> Members of the local parliaments may rather be persuaded by direct “cash transfers” to (re-)elect the incumbent, which would not show up in the local budget.



**Table 2: Political budget cycles in government administrative spending**

Dependent	ln Administrative spending p.c.						Overall district expend.
	Total	Category "other"	Total	Category "other"	Total	Category "other"	
	(1a)	(1b)	(2a)	(2b)	(3a)	(3b)	
ln Population	-0.081** (0.040)	0.127* (0.077)	-0.081** (0.040)	0.123 (0.077)	-0.082** (0.040)	0.120 (0.077)	-0.067*** (0.017)
ln Area	0.003 (0.015)	-0.026 (0.025)	0.003 (0.015)	-0.027 (0.025)	0.003 (0.015)	-0.027 (0.024)	0.002 (0.005)
No. of villages (in .00)	0.007 (0.012)	0.041** (0.020)	0.008 (0.012)	0.042** (0.019)	0.008 (0.012)	0.041** (0.019)	-0.001 (0.004)
Share vill. w. flat surface	-0.054 (0.061)	-0.173 (0.110)	-0.056 (0.061)	-0.177 (0.110)	-0.056 (0.061)	-0.177 (0.110)	-0.020 (0.018)
Share of landlocked vill.	-0.155** (0.074)	-0.147 (0.125)	-0.154** (0.074)	-0.151 (0.124)	-0.153 (0.074)**	-0.152 (0.125)	-0.001 (0.023)
ln (Distance to Jakarta)	-0.010 (0.017)	-0.125*** (0.034)	-0.010 (0.017)	-0.126*** (0.034)	-0.010 (0.017)	-0.126*** (0.034)	-0.002 (0.006)
Urbanization rate	0.143** (0.071)	-0.124 (0.128)	0.145** (0.071)	-0.118 (0.127)	0.146** (0.071)	-0.116 (0.127)	0.004 (0.028)
ln Total revenue p.c.	0.948*** (0.054)	1.074*** (0.101)	0.947*** (0.054)	1.064*** (0.101)	0.946*** (0.054)	1.060*** (0.101)	0.867*** (0.023)
ln Real GDP p.c.	0.048** (0.023)	0.200*** (0.041)	0.048** (0.023)	0.203*** (0.041)	0.048** (0.023)	0.204*** (0.042)	0.031*** (0.008)
RESOURCE-RICH	0.004 (0.025)	0.078 (0.049)	0.004 (0.025)	0.085* (0.049)	0.004 (0.025)	0.086* (0.049)	0.000 (0.008)
Literacy rate	-0.218 (0.177)	-1.222*** (0.320)	-0.223 (0.177)	-1.244*** (0.319)	-0.221 (0.177)	-1.241*** (0.318)	0.006 (0.057)
ELECT-2	0.005 (0.013)	0.000 (0.036)	-0.013 (0.033)	-0.005 (0.071)	0.013 (0.033)	-0.005 (0.071)	-0.024* (0.014)
ELECT -1	0.014 (0.016)	0.058 (0.035)	0.042 (0.060)	0.016 (0.108)	0.042 (0.060)	0.016 (0.108)	-0.022 (0.013)
ELECT	0.024 (0.016)	<b>0.191***</b> <b>(0.034)</b>	-0.020 (0.037)	-0.071 (0.074)	-0.020 (0.038)	-0.071 (0.074)	-0.040** (0.016)
ELECT -2 X DIRECT			0.023 (0.037)	-0.013 (0.089)	0.038 (0.040)	0.005 (0.094)	0.055*** (0.020)
ELECT -1 X DIRECT			-0.029 (0.065)	0.055 (0.116)	-0.032 (0.066)	0.028 (0.122)	0.025 (0.020)
ELECT * DIRECT			0.063 (0.041)	<b>0.385***</b> <b>(0.088)</b>	0.037 (0.051)	<b>0.271**</b> <b>(0.105)</b>	0.010 (0.029)
INCUMBENT					0.017 (0.034)	-0.060 (0.070)	0.026 (0.016)
ELECT -2 X DIRECT X INCUMBENT					-0.047 (0.033)	-0.015 (0.083)	-0.027 (0.020)
ELECT -1 X DIRECT X INCUMBENT					-0.004 (0.039)	0.085 (0.088)	-0.014 (0.024)
ELECT X DIRECT X INCUMBENT					0.025 (0.047)	<b>0.196**</b> <b>(0.098)</b>	0.023 (0.027)
Splitting year dummies	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Time dummies	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Observations	1889	1889	1889	1889	1889	1889	1889
R-squared	0.92	0.66	0.92	0.66	0.92	0.66	0.97

Note: All models are estimated by unbalanced panel data (Pooled OLS), including a constant term. Robust standard errors, clustered at the parent-district level, are reported in parentheses. Number of districts is 384. \*\*\*, \*\*, \* denote significance at the 1, 5 and 10%.

#### 4. Concluding Remarks

Our paper shows that there are significant budget cycles in the first *direct* elections in Indonesia at the local level in the category that the district head has discretion over, especially if he or she is running for reelection. This finding suggests a more disaggregated approach to PBC as we could not detect any cycle in the overall budget. The reason why we could not find PBC in the overall budget, unlike in some other young democracies, is rooted in Indonesia's political system at the local level. Parties that sponsor the district heads often do not hold the majority in the local parliament and thus could not push through an overall budget increase in election years. They would also have little incentive to do so: As the sponsorship of the candidacy is predominantly a vehicle for raising money for the cash constrained parties from the candidate, there is little loyalty between these two sets of actors and consequently only little affiliation of the district head with the party platform of the sponsoring party. Incumbents seeking reelection, however, will use their discretionary funds to increase the probability of reelection.

PBCs occur only in direct elections and not in indirect elections: This novel finding supports the logic behind PBC: Voters need to be persuaded to vote for the incumbent only in direct elections. In indirect elections in Indonesia the link between the sponsoring parties and the candidates is too weak for the incumbents to have an incentive to increase their discretionary spending. It is doubtful, first, whether this would benefit the sponsoring party as it is not clearly linked to the incumbent and, second, whether the party would reward this by reelecting the incumbent. In indirect elections incumbents have to find other means to persuade the MPs to reelect them.

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