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Chapter 10

How Does Fiscal Decentralisation Affect Local Politics? Evidence from Local Communities in Indonesia

Anirban Mitra and Sarmistha Pal

Summary

How fiscal decentralisation (FD) affects the selection of local leaders remains largely unexplored. We utilise Indonesia's important fiscal decentralisation to local communities in 2001 to study such issues. Using the 1997 and 2007 Indonesian Family Life Survey (IFLS) data, we observe communities practising majority voting (electoral democracy), consensus-building (participatory democracy) and also oligarchy (leaders selected by the local elite). The incidence of democracy (voting and consensus-building taken together) did not increase significantly after fiscal decentralisation. Leader selection by consensus-building declined while that by voting increased. We show that community homogeneity has been an important driver of leader selection by consensus-building. However, after decentralization ethnically diverse communities increasingly opted for choosing leaders by voting. Furthermore, voting (relative to consensus-building) communities registered higher income and development spending after fiscal decentralisation, suggesting the salience of local political entrepreneurship. In a fiscally decentralised environment, enterprising local political leaders can facilitate the aligning of economic interests in ethnically diverse communities, especially if ambient economic inequality is low.

Fiscal decentralisation involves the devolution of power to local authorities in terms of either or both of the following: (i) raising local revenue (through local taxes, etc.), and (ii) making decisions regarding the spending of revenue at the local levels. In principle, this process can be quite distinct from political decentralisation, which involves the transfer of political power to local levels of government, sometimes resulting in the creation of local tiers of government. On its own fiscal decentralization (hereafter FD) leaves local governance unchanged - specifically, the rules regarding the election or selection of local leaders are not directly affected by the FD process. So, while it is quite natural to expect a different pattern of budgetary allocations and spending at the local level following fiscal decentralisation, any potential changes in the *dynamics* of local polities are less obvious. However, this does not preclude the possibility that FD has an indirect effect on the dynamics of local governance structures. In fact, Bardhan and Mookherjee (2006) argue that these two processes are usually enmeshed:

‘Many developing countries have thus begun to experiment with initiatives to increase accountability of service providers by providing greater control rights to citizen groups. These include decentralisation of service delivery to local governments, community participation, direct transfers to households and contracting out delivery to private providers and NGOs. The programmes include a wide range of infrastructure services (water, sanitation, electricity, telecommunications, roads) and social services (education, health and welfare programmes).’

We explore the broad issue of the link between fiscal decentralisation and the dynamics of local polities with a view to identify their key drivers. We highlight the potential implications of fiscal devolution on the change in local leadership regimes and suggest how specific socio-economic factors may be relevant to explaining the flux in local leadership selection following expenditure shifts. To the best of our knowledge, this is a vastly under-researched area. While there is a rich literature on fiscal decentralisation, there has been little or no work on examining its ramifications for the organisation of local governance.

Our empirical investigation is motivated by the experience of Indonesia, a large emerging

economy. The country undertook a comprehensive programme of fiscal decentralisation at the turn of the millennium, which roughly coincided with the end of President Suharto's rule. Indonesia is also diverse along many socio-economic markers and forms of local governance, thus making it a very apt candidate for the issues we seek to explore. The remainder of this chapter is organised as follows. We begin by describing how fiscal decentralization was implemented within Indonesia, and how this change combined with the different main ways in which communities selected their local leaders. Section 2 gives a brief critical review of related literature and sets out our hypotheses. The third section covers our data and empirical analysis approaches, and section 4 presents our empirical findings.

10.1 Fiscal decentralization in Indonesia

Fiscal decentralisation in post-Suharto Indonesia has its roots in Law 22/99 and Law 25/99 enacted in January 2001. The change involved was largely an exogenous event for the communities under consideration. It gave local communities more autonomy in raising local revenues, while enforcing strict budgetary cuts on the central government leadership to supply development grants to these communities. It also granted administrative authority to local governments to hire staff and conduct local government affairs with minimum intervention from the central government. Local community governments were made responsible to the district (instead of the central) government, and the district now provided the bulk of their funds after FD.

It is fair to claim that the centre of power moved from the central government in Jakarta to the 357 districts (kabupatens), located in the district head-quarters after FD. This institutional set up allows us to study the impact of exogenously-given FD on transition of local polities within districts. Using the Indonesian Family Life Survey (IFLS) data, we consider these 312 local communities drawn from 13 provinces (representing 83% of Indonesian population) in 1997 and 2007, two years separated by the introduction of Law 22/99 and Law 25/99 in 2001,

which were largely exogenous for the communities under consideration. The communities represent the lowest level of administrative structure in Indonesia within a district that still have an independent political identity. They can be rural villages (*desas*) or urban townships (*kelurahans*). The IFLS data allow us to categorize local polities as ‘Democratic’ if the community leader is elected by voting or consensus-building among all citizens, and ‘Non-democratic’ (or oligarchic) if the leader is ‘chosen’ by a few citizens including the local elite, local institutions and/or outside influence.

Our method of characterising local political transition focuses on changes to the method of leader selection in a given community (within a district that governed them) after FD. In particular, our analysis lets us distinguish between electoral (majority voting) and participatory (*Musyawah-Mufakat*) democracies prevalent in Indonesia. The latter is a form of Indonesian customary decision-making based on deliberation and consensus-building, which has regularly been recognized in village gatherings. The terms *Musyawah-Mufakat* (together with terms: *Koperasi* and *Gotong Royong*) have to do with the obligations of the individual toward the community, the compatibility of power, and the relation of state authority to traditional social and political systems.

The method of leader selection is important in terms of policy implementation at the local level and the provision of local public goods, especially in a fiscally decentralised setting. Whether the leader of a community reflects the preferences of the entire populace or is only sensitive to the needs of a select few (‘the local elite’) is likely to determine the pattern of local public spending and thereby social welfare in the community. In fact, the greater the control over the local ‘purse strings’ (courtesy of FD) the more crucial the role of the local leadership’s preferences become, underlying the need for a fuller understanding of how community leader are selected. With the introduction of the ‘1979 village law’, village affairs were brought under the supervision and close control of higher authorities. Since 1979, the head of villages classified under ‘*desa*’ have been elected in village-level elections held every 8 years, while the heads of ‘*kelurahan*’ villages (urban/city) were appointed by upper levels of

administration. Hence, Indonesia has been a culturally and politically decentralized nation even though local leader selections may have been controlled by the central regime under Suharto. While one may debate over the *de facto* politically decentralised status under Suharto's regime, the nation was unambiguously within the tight grips of central fiscal control until 2001.

The fiscal decentralization changes led to a dramatic shift in the sources of revenues for village governments, also shown in Table 10.1. Data from the village governance module in the IFLS shows a substantial increase in the share of revenues that came from the district-level government and a corresponding decline in the share of revenues from the central government, between 1997 and 2007. In 1997, on average, nearly a third of the revenue came from direct grants made by the central government in Jakarta. By 2007, the central government's average contribution in village budgets had drastically fallen to under 7 per cent. By contrast, the average contribution from the district-level government to communities had risen from just 9 to 41 per cent between 1997 and 2007. The share of total revenues generated *within* the village itself remained roughly unchanged between 1997 and 2007.

Table 10.1 Fiscal decentralisation and Changes in Community Revenues and Spending

Variables	1997 Mean (StdDev)	2007 Mean (StdDev)
Total spending ('000 Rp) [3] on Social Infrastructure	164 (318)	1,057.2 (2633)
Physical infrastructure	75.1 (135)	1,540 (2659)
Share of spending (%) on Social Infrastructure	10.8 (11.5)	12.8 (19.6)
Physical infrastructure	65.8 (8.4)	49.9 (3.7)
Total revenue (('000 Rp) [3] from Central Government	67.3 (164)	146.6 (528)
Provincial Government	135.2 (376)	673.8 (2086)
District Government	2,214 (63.4)	523.3 (898.4)
Local income	235.5 (726)	2,393.7 (10,0961)
Share of revenues (%) coming from Central Government	32.9 (31.2)	6.6 (17.5)
Provincial Government	14.4 (29.2)	13.5 (26.8)
District Government	9.1 (18.8)	40.7 (34.8)
Local income	37.9 (37.8)	39.3 (32.6)

Source: Authors' calculation using the IFLS data sample

Note: The table summarises the average revenue and spending details (both total and as shares of the total) of the sample communities before (1997) and after (2007) fiscal decentralisation. All nominal variables are measured at 2010 price level. Std Dev = standard deviation.

Total community spending includes spending on new investment (social and physical infrastructure), maintenance of existing infrastructure and also that on paying staff salaries and transfers.

Total community revenue is generated from grants from central, provincial and district governments and also funds raised from local communities. The remaining balance is accounted for by various governmental transfers under different development programmes.

Electoral versus participatory democracies in Indonesia

Consensus building or participatory democracy has its root in *Musyawahar-Mufakat*, which is a form of Indonesian native culture of consensus-building. It has been adopted as one of the foundational philosophical theories of the Indonesian state (*Pancasila*) and become a method of decision-making in the wider Indonesian government. *Musyawahar-Mufakat* is borrowed from Islamic learning, which prioritizes a peaceful approach (*Sulh*) in settling a conflict. During Sukarno's time of the 'Guided Democracy', the 1945 Constitution included approval of *Mufakat* (unanimous consent) as the basis for decision making for the legislature. This was promoted for upholding the Indonesian identity and as a rejection of the western majority voting rule, which

allegedly drove the parties to battle for their own narrow interests at the cost of the national interests. The establishment of *Musyawarah* is an implementation of the *gotong royong* (i.e., mutual co-operation or assistance) philosophy prevalent in most Indonesian village communities. Under the Suharto government, although village heads were elected by villagers, they were generally perceived to be part of the government's state apparatus, and because they controlled the entire village government, that was in turn perceived to be part of the central state apparatus (Antlov 2000). As such, the role of *Musyawarah-Mufakat* might have been limited. The fall of the Suharto government in 1998 marked the introduction of the Reformation Era as democratization and decentralisation laws were launched. This period bore witness to (a) the provincial and district governments using their new authority to adopt local laws on a range of ethical and spiritual issues, and (b) a reawakening of customary law, based on the implementation of *Musyawarah-Mufakat*.

The 1997 and 2007 rounds of the IFLS survey asked community leaders about how a leader was selected in their area. Answers to this question were coded as: A voting, B all residents, C local elites, D local institutions and E others. Because it is not clear how the 'others' (code E) selected their local leaders, we excluded these communities from our analysis. We classify the remaining local polities as follows: 'democratic' if a leader is selected by free and fair elections with voters being all community members (codes A and B); and 'oligarchic' if a leader is selected by community elites (codes C and D) who then remain uncontested. Further, we sub-divide democratic communities into two categories: 'electoral' when the leader is elected by majority voting (code A); and 'participatory' when the leader is selected by consensus-building (code B).

In 1997, Table 10.2 shows that 36 per cent of sample communities practised majority voting and 29 per cent consensus-building; the remaining 35 per cent of communities were oligarchic. In 2007, the share of communities adhering to democracy (voting plus consensus-building taken together) changed only very slightly from 65 to nearly 68 per cent, which in turn means that the incidence of oligarchy stayed at a third of the sample communities. However, the percentage of communities opting for voting went up to 57% , and those choosing consensus building fell below

11%. In general, a higher proportion of rural communities adhered to democracy while a higher proportion of urban communities adhered to oligarchy in both years. In part, this was the result of Village Law 1979, which retained the power of the government to select leaders for urban communities. Incidence of oligarchy was more prevalent in urban communities, which further increased after FD. About 71% of sample communities tend to be politically stable. Only 91 of 312 total sample communities (i.e., about 29% of the total) saw a change in the local polity.

Table 10.2 The proportion (%) of communities using different methods to select community leaders

<i>Method of selection</i>	1997			2007		
	rural	urban	total	rural	urban	total
<i>Voting</i>	53.3	26.0	36.5	83.3	40.6	57.1
<i>Consensus</i>	31.7	27.6	29.2	12.5	9.4	10.6
<i>Oligarchy</i>	15.0	46.4	34.3	4.2	50.0	32.4
<i>Total</i>	100%	100%	100%	100%	100%	100%
<i>N of cases</i>	<i>120</i>	<i>192</i>	<i>312</i>	<i>120</i>	<i>192</i>	<i>312</i>

Source: Authors' calculation using the IFLS data sample

Notes: The original sample of communities totalled 317, but 5 cases where the mode of leadership selection could not be determined in both 1997 and 2007 were left out of the sample, leaving N = 312.

The table summarises the methods of selection of community leaders in rural and urban communities in 1997 and 2007 in our sample. We classify communities into three types: 'consensus building' among community members, 'voting' and 'oligarchies' where the leader is elected by the local elite (religious or legal leaders) or government officials. 'Consensus'= 1 if the community leader is selected by consensus building through meetings; 'Voting'=1 if the community leader is elected by voting; 'Oligarchy'=1 if the community leader is selected by few elites. Each cell represents the % of communities as a share of the column total.

Nearly two-thirds of the communities did *not* change local polity after FD and were 'stable' voting (30%), or 'stable' consensus-building (14%) or 'stable' oligarchies (19%). Moreover, there were 107 communities in 1997 which were oligarchic and the number only slightly dipped to 102 in 2007 —so there was no drastic trend towards democratisation on the heels of FD. Table 10.2 shows that about 16% of participatory democracies (i.e., consensus-building) and 12% of oligarchies had opted for majority voting after FD. There were also some instances of new oligarchies being created: somewhat under one in 20 voting communities and one in eleven consensus-building communities turned oligarchic in 2007.

The IFLS data also provide information on the *process of decision-making* used within the sample communities. As with leader selection, this could be classified into voting decisions, consensus building, and oligarchies (determined by local elites and local institutions) in both 1997 and 2007. Overall, two-thirds of the communities practised consensus-building for decision making in 1997 and 2007. The elites dominated the decision-making process in about 29% of communities. So, the use of voting remained negligible for decision making in both years. The picture does not change much even when we consider the communities where the leader was elected through voting. In other words, any change in outcomes at the community-level would essentially arise from the change in the process of leader selection rather than that of decision-making *per se*. Whether the leader of a community reflects the preferences of the entire populace or is sensitive only to the needs of a select few would determine the pattern of local public spending/development and thereby shape social welfare in the community.

Democratic processes and ethnic diversity

Electoral democracies rely on obtaining majoritarian support and thus minorities tend to get overlooked. Given this issue with electoral democracy, some scholars (e.g., Mansuri and Rao (2013), and Rao and Sanyal (2018)) have advocated direct and participatory democracy to enable forming of a consensus. However, the success of such schemes relies (too) heavily on the presence of community homogeneity. This is because discourse tends to be similar among communities characterised by similarities in language, culture and institutions. If this is indeed the case, good governance via participatory democracy would tend to be elusive in ethnically diverse societies.

And to look ahead a little to our analysis results below (section 4), we do indeed find a robust and consistent association between the extent of ethnic diversity at the community level and the changes to the method of leader selection in the wake of financial decentralization. Ethnically diverse (homogeneous) communities were more likely to choose electoral (participatory)

democracy after FD. Moreover, the emergence of new electoral democracies is significantly higher in the ethnically diverse rural (relative to urban) communities. In sum, ethnically diverse communities tend to opt for 'voting' rather than 'consensus-building' as the method for leader selection, and this phenomenon is accentuated in rural areas. Our here suggests that ethnically diverse communities recognise the futility of consensus-building (given the inherent differences) and opt for the ballot.

To explore this matter in more depth, Indonesia offers an ideal 'laboratory'. It is one of the most ethnically diverse countries in the world and consists of 1300 ethnic groups, with at least 95 percent native to the archipelago. The six largest ethnic groups make up more than two-thirds of the country's total population: they are the Javanese, Sundanese (western Java), Batak (north Sumatra), Sulawesi, Madurese (predominantly Muslims) and Betawi (native Jakartan). Minority groups who were originally migrants (such as the Chinese, Arab and Indian populations) make up the remaining 5 per cent. Additionally, our analysis shows that after FD communities, especially more ethnically diverse ones that choose electoral democracies, had greater ability to raise local incomes (both from self-reliant efforts and total income) and development spending (both total and as share of total community spending).

So, what may be the possible channels through which FD influences the observed dynamics in local polity? The core idea is the following: FD offers greater local autonomy and thus increases the perceived 'rents' (psychological, pecuniary etc.) from holding office at local levels of government. Hence, the identity of the local leader assumes extra importance. In ethnically homogeneous communities, consensus-building continues to hold sway. In ethnically diverse communities, however, the increase in 'rents' received post-decentralization exacerbates the existing differences among the various groups. Thus, consensus-building becomes untenable and there is a movement towards electoral democracy. Moreover, the high stakes (post FD) environment led to the emergence of entrepreneurial local leaders in these communities. The ones who were able to align the economic interests of the ethnically diverse groups tended to succeed and also helped raise local incomes and generated more development. This was

understandably easier where economic inequality was lower.¹ We document some evidence in support of this mechanism in terms of greater leader turnover too.

In sum, it appears that FD in Indonesia had provided an additional impetus to ethnically diverse communities to lead to a *re-organisation* of their local polities. Our analysis highlights how *entrepreneurial local leaders* in an electoral democracy may successfully align economic interests of ethnically diverse citizens after FD. These results may have wider implications for other ethnically diverse emerging economies beyond the Indonesian border.

10.2 Literature and Hypotheses

There is a burgeoning literature on decentralisation, particularly, FD. Several of these studies analyse the effects of some aggregate measure of decentralisation on public policy and development in cross-country setup (e.g., Enikolopov and Zhuravskaya, 2007). Relatedly, the substantial literature on capture by interest groups via vote buying, co-optation and patronage networks at a more local level is closer to our study.² Our finding that the dynamics in local polities relied on local politicians who can generate local income/spending decisions finds support in Besley et al. (2005), who also focus on how the identity of the local politicians affects the quality of decentralised governance.

There has been a general consensus in development economics that ethnic diversity is detrimental to development.³ This view is being challenged by more recent findings. For instance, Ashraf and Galor (2013) point out that diversity could have both positive and negative impacts on economic outcomes. The findings of Gomes (2020) in the context of health outcomes have a similar flavour. We shall see below that our analysis also supports the argument that ethnically diverse electoral democracies may promote income and development more when inequality is not too high.

The literature on political entrepreneurship is also relatively sparse. William Riker (1986)

showed how a political entrepreneur can advantageously transform existing political coalitions, especially by adding a new dimension to political debates. In this perspective political entrepreneurs are people who change the course of a policy (Schneider and Teske, 1992). We add to this literature by exploring how local entrepreneurship can help overcome collective action problems in ethnically diverse societies, thus promoting income and development in electoral democracies.

Our focus on local leadership resonates with several studies that document how the leader's identity (ethnic or gender) can matter for various policy outcomes. Earmarking political office for members from various marginalised ethnic groups has sometimes been found to be effective — in the sense of fostering their interests. For instance, Pande (2003) and Chin and Prakash (2011) provide supportive evidence in the case of India, where reservation has been in place for decades in favour of historically disadvantaged groups called the Scheduled Castes (SCs) and the Scheduled Tribes (STs). Other studies suggest that the effects may be heterogeneous within the minorities (Mitra, 2018) or may not be persistent (Jensenius, 2015; and Bhavnani, 2016). In the context of Kenya during the 1963-2011 period, Burgess et al. (2015) found strong evidence of ethnic favouritism in road-building during periods of autocracy.

Our work adds to the literature on local governmental policy in emerging economies. In ethnically diverse societies, Bandiera and Levy (2011) argue that the elite are able to distort policy in their favour, owing to the difference in ethnicity-based preferences among the non-elites. Their empirical analysis using the 1997 Indonesian Family Life Survey data showed that democratic policy outcomes were closer to the elite preferences in ethnically diverse decentralised communities. Padro-i-Miquel et al. (2014 and Ch 12 in this volume) examined the case of rural China to demonstrate that one of the preconditions for exogenously introduced grassroots democracy to be effective is the degree of community homogeneity in some vertical attribute (religion in their case) that allows better provision of public goods. Within decentralised communities in Indonesia Mitra and Pal (2021) documented that the adverse effects of ethnic diversity could be counteracted by social norms that promote cooperative behaviour. Rao and

Mansuri (2013) assessed the impact of large-scale, policy-driven efforts to induce participation in decentralised communities. They found that the participants tended to be wealthier and more politically connected, indicating a high cost of participation for the poor. Relatedly, Martinez-Bravo, Mukherjee and Stegmann (2017) showed that allowing agents of the old-regime to remain in office during democratic transitions was a key determinant of the extent of subsequent elite capture.⁴

We add to the above literature here by highlighting an important difference between ethnically homogeneous and ethnically diverse communities following fiscal decentralization — namely, their different proclivities towards participatory and electoral democracies. Our findings also highlight that local political entrepreneurship may help align the economic interests of citizens in ethnically diverse electoral democracies, thus aiding efforts to overcome the collective action problems in ethnically diverse societies, especially if inequality is relatively low.

Hypotheses

Existing literature shows specific advantages of voting (electoral democracy) over consensus-building (participatory democracy).⁵ Mansuri and Rao (2013) posit that the poor are often excluded from the process of consensus-building, raising concerns about genuine representation of all interests in this setup. We draw upon this literature to build our key hypotheses for explaining a community's choice between electoral and participatory democracy.

Ethnic homogeneity and leader selection after FD. Fiscal decentralization increases the importance of the local leader. Hence, all constituent ethnic groups take greater interest in the selection of the leader. If a community is largely ethnically homogeneous, the selection can take place by consensus-building; after all, the associated costs of discussion and deliberation are low owing to the uniformity in culture and thereby preferences over public goods, etc. Such costs, however, are substantially higher for ethnically diverse communities which might derail consensus-building. Therefore, these communities tend toward electoral democracy for

selecting leaders post-FD. This generates our first hypothesis which is recorded below.

Hypothesis 1: Ethnically homogeneous (heterogeneous) communities are more likely to choose participatory (electoral) democracy to select leaders.

Local polity and local entrepreneurship after decentralization. Following FD, the ethnically diverse communities which choose electoral democracy ‘open up’ the political space for competition. Given the possibility of higher ‘rents’ from holding (local) office in the post-FD scenario, this spurs the more entrepreneurial potential leaders into action. As a result, these communities tend to have higher local incomes and more development. Moreover, this effect is accentuated in communities where the ambient economic inequality is low — it is easier for the leader to implement better policies when the economic interests are more closely aligned. This leads us to the following hypothesis.

Hypothesis 2: Ethnically diverse communities choosing electoral democracies after FD generate higher local incomes and more development, especially when the ambient economic inequality is low.

10.3 Empirical Analysis

Our analysis is based on the community-level data obtained from 1997 and 2007 rounds of Indonesian Family Life Survey (IFLS) from a sample of 312 rural and urban communities, drawn from 13 provinces including Jakarta, Bali, Java (central, east and south), Sumatra (north, west and south), Lampung, West Nusa Tenggara and south Kalimantan representing 83% of Indonesian population.⁶ This is a particularly rich data set that provides community level information on a whole range of demographic characteristics, local governance and its public finances, citizens’ participation in planning and implementation of local development projects, as well as a range of public utilities, infrastructure and transport, health and education facilities. (See Frankenberg and Thomas (2000) and Strauss et al (2009) for the

study design and overview of the data set).

The IFLS data available for the adjacent years 1998 and 2000 reveal that there were no local elections in the sample communities during those two years. This is not unexpected as the country faced widespread economic and political turmoil during 1997-99. The first elected president (Wahhid) took office in October 1999. Things started to get back to normal from the turn of the century paving the way for Law 22/99 and Law 25/99 to be introduced officially in January 2001. Community-level elections in the post-FD period did not all take place at the same time. About 80 per cent of post-FD local elections were completed by 2003 since they involved a fair amount of administrative change as part of the new decentralisation rules (Rodriguez, 2010). Although we cannot observe the precise timing of the local elections for the sample communities, we observe the tenure of the community leaders in 1997 and 2007. Given that the term of office of a community leader has been 5 years since 2001, it is most likely that those community leaders in power in 2007 were ones selected or elected from 2002 onwards.

Following FD, the central government provided grants to district authorities using a 'fiscal needs' formula based on various district-level characteristics (Pal and Wahhaj, 2016). These factors are invariant across communities *within* the same district. By employing *district fixed-effects*, our estimation strategy compares various aspects of local polities before and after FD within a district.

The effect of community homogeneity on choice of local polity

First, we explore Hypothesis 1, about the effect of community homogeneity on local polity (voting, consensus building or democratisation) following FD. We take community homogeneity to be exogenous, because the population composition has remained largely invariant over the decade between 1997 and 2007 in the sample communities. The dependent variable Y accordingly pertains to the following three variables in alternative specifications:

- (1) democratisation (*status_v*): takes the value of 1 if a community leader is

selected by voting (code A) or consensus building (code B). It is 0 otherwise (denoting oligarchy);

(2) consensus-building (consensus): takes the value of 1 if a community leader is selected by consensus building (code B). It is 0 otherwise; and

(3) voting (voting): takes the value of 1 if a community leader is selected by voting (code A); it is 0 otherwise.

This motivates the following empirical specification in community i in district j in year t :

$$Y_{ijt} = \beta_0 + \beta_1 FD_t + \beta_2 Homog_{ijt} + \beta_3 (FD_t \times \beta_2 Homog_{ijt}) + \beta_4 X_{ijt} + \beta_5 (FD_t \times X_{ijt}) + D_j + v_{ijt},$$

[Equation 1]

Equation 1 thus allows us to identify the determinants of the likelihood of a local polity choosing a leader by voting, consensus building or more generally democratisation, thus giving rise to Model 1, Model 2 and Model 3 respectively:

$$\text{Model 1: } Consensus_{ijt} = \beta_0 + \beta_1 FD_t + \beta_2 Homog_{ijt} + \beta_3 (FD_t \times \beta_2 Homog_{ijt}) + \beta_4 X_{ijt} + \beta_5 (FD_t \times X_{ijt}) + D_j + v_{ijt}$$

$$\text{Model 2: } Voting_{ijt} = \beta_0 + \beta_1 FD_t + \beta_2 Homog_{ijt} + \beta_3 (FD_t \times \beta_2 Homog_{ijt}) + \beta_4 X_{ijt} + \beta_5 (FD_t \times X_{ijt}) + D_j + v_{ijt}$$

$$\text{Model 3: } Democratisation_{ijt} = \beta_0 + \beta_1 FD_t + \beta_2 Homog_{ijt} + \beta_3 (FD_t \times \beta_2 Homog_{ijt}) + \beta_4 X_{ijt} + \beta_5 (FD_t \times X_{ijt}) + D_j + v_{ijt}$$

The explanatory variables included in all three models are the same as listed below:

Measure of fiscal decentralization: We proxy fiscal decentralization by the binary variable FD that takes a value 1 for the year 2007 and 0 for 1997.

Measure of community homogeneity: Our key explanatory variable is ethnic homogeneity ($Homog$) of the community. In this respect, we consider two measures of homogeneity. We observe the size of the top three population groups, 1, 2, 3, in the sample communities in 1997 and 2007, which together exhaust the total community population. The median value of the largest population group across our sample communities is 91 per cent. Our first measure of

ethnic homogeneity is: $Pop1_{91}=1$ if population of the largest group in the community is greater than or equal to the median value; it is 0 otherwise. Our second index is $Pop1_{100}$ which equals 1 if population of the largest group in the community is 100% and is 0 otherwise.⁷ X contains other community characteristics that may also influence the outcome variables to mitigate omitted variables bias. These include the community's population, its geographic size (in hectares), whether it is rural or urban, and whether Islam is the main religion. We also include interactions of all these community characteristics with the fiscal decentralisation dummy FD as included in $(FD_t \times X_{ijt})$ to account for the differential effects of FD by community characteristics.

Finally, we include a set of district dummy variables D_j for the j -th district in our sample. Inclusion of these district level dummies accounts for time-invariant unobserved factors at district-level that may also influence the outcomes of interest.

FD accounts for the common shock to all districts after fiscal decentralisation. The coefficient of interest is β_3 , which is the coefficient of the interaction term with community homogeneity $(FD_t \times Homog_{ijt})$. This captures the differential effect of local homogeneity on various measures of local polities after FD , after controlling for all other factors.

Local polity and local political entrepreneurship

Next, we examine Hypothesis 2, which concerns the link between local polity and local political entrepreneurship. We measure the local entrepreneurship of the community leader by the size of local income and local development spending in the community. We proxy local income by local revenue generated from various sources. Local development is measured by spending on new social and physical infrastructure plus the maintenance of existing social infrastructure (such as schools and health facilities) and physical infrastructure (such as roads and transport connections) at the local community level.

Given that some concerns may arise about biased estimation, owing to the simultaneity between local polities and local revenue/development spending in sample communities, we use propensity score matching (PSM) methods to compute the average treatment effects on

the treated (ATT). In particular, we consider voting and consensus-building for selection of community leaders as the two possible treatments in alternative specifications; the rest are considered as control. A successful implementation of PSM methods requires that the treatment and control groups are comparable in terms of all observable covariates. We use the same set of covariates X as in Equation [1] to determine the likelihood of relevant local polities, i.e., *voting* and *consensus*. The propensity score is the probability of receiving a treatment T , conditional on the observable covariates X . The idea is to compare communities that have a very similar probability of receiving the treatment (similar propensity score) based on some observables X , but where some localities received the treatment while others did not. Thus, for a given propensity score, the exposure to treatment is *random* and therefore the treated and control units should be observationally identical.

Next, we classify our sample communities into blocks of observations with similar propensity scores for both treatment (T) and control (C) groups. Within each block of communities, the means of the outcomes (O) of interest are the natural logarithm of total local income and total local development spending. We test whether they are equal in the treatment and control groups. Thus, we derive the average treatment effect on the treated ATT for each outcome variable as follows:

$$ATT = (O_T - O_C)_{2007} - (O_T - O_C)_{1997} \quad [2]$$

We use Equation [2] to determine the ATT for local income and local development spending for the chosen treatments (*voting* and *consensus*) relative to the control in 2007 (relative to 1997).

10.4 Results

We start with the effects of community homogeneity, as in Equation [1], on measures of local polity including consensus-building, voting and any form of democratisation that includes both consensus-building and voting together. Next, we present the effects of the local polity on local income and development in our sample, as in Equation [2]. Finally, we explore some possible

mechanisms that may lie behind our results.

The effects of community homogeneity on the local polity

We begin here with Table 3, which summarises the ordinary least squares (OLS) estimates in our full sample following Equation [1]. Columns (1)-(3) show the estimates of three measures of local polities, namely, consensus- building, voting and any democratisation (status v) using pop1_91 as the relevant measure of community homogeneity. Columns (4)-(6) do the same using pop1_100 instead as the measure of community homogeneity. We focus on the estimated coefficients on pop1_91x Δ FD in columns (1)-(3) and that on pop1_100x Δ FD in columns (4)-(6). These coefficients account for the differential effects of community homogeneity on measures of local polity after Δ FD in alternative columns. Notice, the estimated coefficient on pop1_91x Δ FD is positive for consensus-building (see column (1)) and negative for voting (see column (2)) and both coefficients are statistically significant. This means that homogeneous communities are more likely to choose participatory (rather than electoral) democracies. Similar results are obtained in columns (4) and (5) using the alternative homogeneity measure.

Table 10.3 Effects of community homogeneity on local polities

(a) Homogeneity measured by a community falling above or below the mean homogeneity score (pop91)

Explanatory variables	Dependent variable showing Effects (standard errors)		
	Model 1 Consensus	Model 2 Voting	Model 3 Democratisation
FD (shock)	-0.454 (0.460)	1.001* (0.523)	-0.1633 (0.198)
pop1_91	-0.107 (0.072)	0.185*** (0.054)	0.0273 (0.040)
pop1_91xFD	0.178** (0.068)	-0.093* (0.055)	0.097* (0.052)
Constant	0.567 (0.352)	-0.256 (0.269)	1.1941*** (0.289)
Other controls	Yes	Yes	Yes
District dummies	Yes	Yes	Yes
Observations	616	616	616
R-squared	0.158	0.351	0.500

(b) Homogeneity measured by the top ethnic group having 100% or not (pop1-100)

Explanatory variables	Dependent variable showing Effects (standard errors)		
	Model 4 Consensus	Model 5 Voting	Model 6 Democratisation
FD (shock)	-0.522 (0.369)	1.021** (0.500)	-0.036 (0.158)
pop1_100	-0.107 (0.073)	0.145** (0.069)	0.112 (0.069)
pop1_100xFD	0.219*** (0.071)	-0.137 (0.088)	0.010 (0.037)
Constant	0.5482 (0.328)	-0.1481 (0.255)	1.1797*** (0.290)
Other controls	Yes	Yes	Yes
District dummies	Yes	Yes	Yes
Observations	616	616	616
R-squared	0.160	0.341	0.502

Source:

Note: All estimates are clustered by districts; cluster-robust standard errors are shown in parentheses and italics. Significance levels: *** p<0.01, ** p<0.05, * p<0.1. The table presents the estimates of local polities using alternative community homogeneity indices, pop1_91 and pop1_100, among others. Part (a) shows the estimates using the variable pop1_91, which takes a value 1 if the population share of the largest population group is greater than the median value; and is zero otherwise. Part (b) shows the corresponding estimates using the perfect homogeneity measure pop1_100 that takes a value 1 if the community has 100% population of one group only. We present estimates of three types of local polities here, namely, consensus (columns 1 in both parts), voting (columns 2) and any democratisation proxied by the Status_v variable (columns 3). Consensus is a binary variable taking a value 1 if a leader is selected by consensus building. Voting is a second binary variable taking a value 1 when a leader is selected by voting; otherwise, these two binary variables are zero. It is zero otherwise. Status_v=1 if a leader is selected either by voting or by consensus. Other controls used include community population, geographic size, if rural, if Islam is the main religion and also their interactions with FD. All regressions include district dummies too.

Next, consider the effects of community homogeneity on the likelihood of any democratisation *status v*. Recall, this variable takes a value 1 for electoral or participatory

democracy and 0 for oligarchy. Observe, the estimated coefficients on the interaction term $pop1_{91} \times FD$ (column 3) or $pop1_{100} \times FD$ (column 6) are both positive though the effect is only statistically significant when using $pop1_{91}$ (column 3). This suggests that greater (or lesser) community homogeneity significantly boosts (lowers) the probability of any democratisation (relative to oligarchy).

We also test the robustness of our findings by employing a fractionalisation measure popular in the extant literature. Using p_1 , p_2 and p_3 to respectively represent the shares of the three constituent population groups in a community, we generate an ethnic fractionalisation index $Ethfrac$ as 1 minus the sum of the squared decimal population shares of the top three ethnic groups. So:

$$Ethfrac = 1 - (p_1^2 + p_2^2 + p_3^2) \quad [3]$$

These estimates are collected in Table 10.4. Since ethnic fractionalisation is inversely related to ethnic homogeneity, we expect a reversal in terms of the signs of the estimated coefficients. This is indeed what is observed in the Table.

Table 10.4. Effects of ethnic fractionalisation on local polities

Explanatory variables	Dependent variable showing Effects (standard errors)		
	Model 4 Consensus	Model 5 Voting	Model 6 Democratisation
FD	-0.333 (0.416)	0.904* (0.514)	-0.113 (0.155)
Ethnic frac	0.308** (0.139)	-0.592*** (0.139)	-0.215** (0.104)
Ethnic fracxFD	-0.444*** (0.149)	0.344** (0.162)	-0.116 (0.111)
Constant	0.5065 (0.331)	-0.0433 (0.265)	1.2590*** (0.267)
Other controls	Yes	Yes	Yes
District dummies	Yes	Yes	Yes
Observations	605	605	605
R-squared	0.160	0.358	0.502

Notes: : All estimates are clustered by districts; cluster-robust standard errors are shown in parentheses and italics. Significance levels: *** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$. The table presents the estimates of local polity using the ethnic fractionalisation index ($ethfrac$), which is given by: $1 - (p_1^2 + p_2^2 + p_3^2)$ where p_i is the population share of the i -th group, $i = 1, 2, 3$. See also the Notes to Table 10.3 above.

Rural-urban heterogeneity

Next, we explore any potential rural-urban heterogeneity in terms of the aforementioned effects in our sample. Differential effects in rural and urban regions could arise from the fact that prior to FD, leaders in urban communities were nominated by the centre; this was not the case in rural areas.

Table 10.5. Separate rural/urban estimates of homogeneity effects on the local polity of fiscal decentralization

(a) Homogeneity measured by a community falling above or below the mean homogeneity score (pop91)

Explanatory Variables	Dependent variable showing Effects (standard errors)		
	Model 1 Consensus	Model 2 Voting	Model 3 Democratisation
RURAL communities			
FD	-1.247* (0.692)	2.085*** (0.746)	0.046 (0.151)
pop1_91	-0.228** (0.104)	0.269*** (0.090)	-0.050 (0.039)
pop1_91xFD	0.368*** (0.107)	-0.467*** (0.092)	0.009 (0.053)
Constant	0.7684 (0.544)	-0.6516 (0.433)	1.1371*** (0.169)
Other controls	Yes	Yes	Yes
District FE	Yes	Yes	Yes
Observations	255	255	255
R-squared	0.224	0.323	0.466
URBAN communities			
FD	0.279 (0.486)	0.308 (0.458)	-0.064 (0.411)
pop1_91	-0.089 (0.103)	0.143 (0.089)	0.082 (0.063)
pop1_91xFD	0.085 (0.107)	0.105 (0.131)	0.093 (0.082)
Constant	0.090 (0.394)	0.027 (0.301)	0.974** (0.401)
Other controls	Yes	Yes	Yes
District FE	Yes	Yes	Yes
Constant	0.090 (0.394)	0.027 (0.301)	0.974** (0.401)
Observations	361	361	361
R-squared	0.241	0.324	0.408

(b) Homogeneity measured by the top ethnic group having 100% or not (pop1-100)

Explanatory variables	Dependent variable showing Effects (standard errors)		
	Model 1 Consensus	Model 2 Voting	Model 3 Democratisation

RURAL communities			
FD	-1.069 (0.635)	1.851*** (0.673)	0.033 (0.149)
pop1_100	-0.112 0.2077**	0.148 (0.088)	-0.001 (0.028)
pop1_100xFD	0.208** (0.085)	-0.290** (0.110)	-0.021 (0.021)
Constant	0.684 (0.484)	-0.550 (0.355)	1.128*** (0.176)
Other controls	Yes	Yes	Yes
District FE	Yes	Yes	Yes
Observations	255	255	255
R-squared	0.202	0.299	0.459
URBAN communities			
FD	0.205 (0.453)	0.594 (0.474)	0.111 (0.320)
pop1_100	-0.206 (0.150)	0.173 (0.137)	0.414*** (0.124)
pop1_100xFD	0.330** (0.123)	-0.032 (0.094)	-0.185* (0.099)
Constant	0.0470 (0.388)	0.0260 (0.315)	0.9088** (0.379)
Other controls	Yes	Yes	Yes
District FE	Yes	Yes	Yes
Observations	361	361	361
R-squared	0.252	0.303	0.424

Notes: : All estimates are clustered by districts; cluster-robust standard errors are shown in parentheses and italics. Significance levels: *** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$. The table presents the estimates of local polity using the ethnic fractionalisation index (ethfrac), which is given by: $1 - (p_1^2 + p_2^2 + p_3^2)$ where p_i is the population share of the i -th group, $i = 1, 2, 3$. See also the Notes to Table 10.3 above.

The top halves of Tables 5a and 5b show the estimates for rural communities and the lower halves show those for urban communities. The layout of the regressions in each panel mirrors that in the baseline table (Table 3). Comparing the estimates in the (a) and (b) panels for the impacts of greater community homogeneity on the local polity after the FD shock shows ~~reveals~~ that the (full sample) results observed in Table 3 were primarily driven by effects in the rural communities.

Effect of the local polity on local entrepreneurship

We now move on to test Hypothesis 2. Table 10.6 presents comparisons of the means of different components of local income and local development spending between voting and other communities. The top panel shows the full sample comparisons, while the bottom panel refers to just the 2007 (post-fiscal decentralization) comparisons.

Table 10.6 Comparisons of mean local incomes and development expenditure in communities using voting and other communities

<i>Indices</i>	Voting communities	Other communities	T-stat
1997 & 2007			
Log (Ln) of Local income	14.73	7.53	11.020***
Log (Ln) of Self-reliant income)	9.72	4.52	8.136***
Log (Ln) development expenditure	16.73	13.49	5.812***
% Share of development expenditure in total expenditure	0.68	0.51	6.434***
2007			
Log (Ln) of Local income	16.26	12.35	4.659***
Log (Ln) of Self-reliant income)	10.38	6.92	3.527***
Log (Ln) development expenditure	18.11	16.29	3.153***
% Share of development expenditure in total expenditure	72	51	6.028***

Source: Authors' calculation using the IFLS data sample 1997-2007

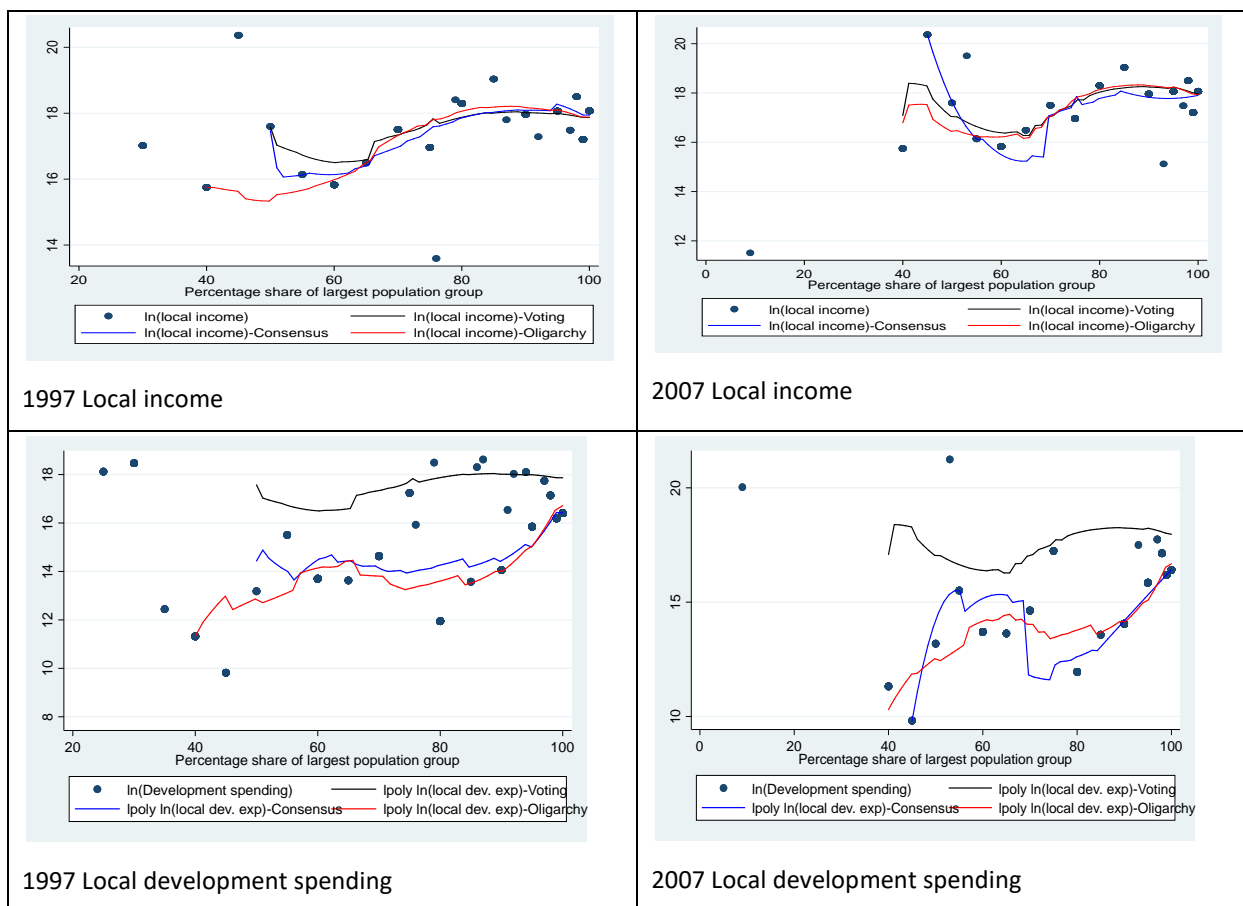
Notes: Significance levels: *** p<0.01, ** p<0.05, * p<0.1. The table summarises the mean comparisons of local income and local development spending using t-tests between voting and other communities in our sample. The top panel shows the full sample comparisons including both 1997 and 2007 while the bottom panel refers to the 2007 comparisons only.

We use the natural logarithm of income from self-reliant community sources as well as total local income from various local sources. We also employ the natural logarithm of total development spending and the share of total development spending in total community spending. It is clear that voting communities were significantly more successful in generating greater local income as well as local development spending than were consensus building communities. This pattern holds for both self-reliant efforts and total local income, and for both total local development spending and its share in the full sample as well as in 2007 (post-FD) only.

Figure 10.1 captures the variation in local income and local development spending by local polity when plotted against the percentage share of largest population group. Note, the greater the share of largest population group, the higher (lower) is the ethnic homogeneity (diversity) of the community. This is done separately for the pre-FD round (1997) and the post-FD round (2007). The patterns are distinctly different across the two periods with much of the variations seen in the high ethnic diversity (relatively smaller size of the largest population group) zone. This is

particularly evident for the 2007 round and holds for both local income and local development spending, supporting the validity of Hypothesis 2 graphically; it also justifies our use of the PSM method which is well adapted to analysing such patterns. Accordingly, we compare income and development spending in voting and consensus building communities relative to other comparable (in terms of observed characteristics including ethnic homogeneity/diversity) communities after 2007 (relative to 1997) using average treatment effects on the treated (ATT) as per Equation 2.

Figure 10.1 Variation in local income and local development spending by local polity with the percentage share of largest population ethnic group



Sources: xx

Notes: The figure shows the smooth local polynomial (Epanechnikov) of local income and local development spending against the percentage share of the largest population ethnic group for each type of local polity in 1997 and 2007

Table 10.7 contains the ATT estimates as per Equation [2] above. We define *voting* and *consensus* as two possible treatments of interest (with all remaining polities as the control) and compare the outcomes, namely, indices of income and development spending as defined above. For improved identification, we ensure that both the propensity scores and covariates are balanced between the treatment and the control groups for each outcome.

Table 10.7. Treatment effects of local polity on local income in 2007

Treatment (Type of local polity)	ln(income from self-reliant efforts)		Ln(local income)	
	<i>ATT estimates</i>	<i>T-stat</i>	<i>ATT estimates</i>	<i>T-stat</i>
Consensus	-3.183***	-2.960	-4.421***	-7.356
Voting	2.463***	4.329	2.570 **	2.139
	% Share of development spending		Ln(local development spending)	
Consensus	-0.105	-1.634	-2.388**	-2.404
Voting	0.115***	5.474	1.332***	3.934

Note: Significance levels: *** p<0.01, ** p<0.05, * p<0.1.

The table shows the average treatment effects on the treated (ATT) of local income and local development spending (both levels and shares) by local polities derived by using the propensity score matching (PSM) method. The first stage estimates generating the propensity score estimates are shown in Table 10.3 above. The reference group for each polity is the comparable control group belonging to all other polities – comparable by observed percentage share of the largest population group, village size, village population, rural/urban location, FD dummy and district dummies. ATT is the average treatment effect on the treated = $(O^T - O^C)_{2007} - (O^T - O^C)_{1997}$; T: treatment and C: control. The corresponding t-statistics are also shown.

In the case of *voting*, the top panel of Table 10.7 shows that the ATT estimate is positive and statistically significant for both income from self-reliant efforts and also total local income. This means that the extra income (total or self-reliant) in *voting communities* relative to non-voting communities in 2007 (relative to that in 1997) is positive and statistically significant at the 1% level. The corresponding ATTs for natural log of local development spending and the percentage share of development spending are shown in the lower panel of Table 10.7: both the ATT estimates here are positive and statistically significant for voting communities. In contrast, the ATT estimates of income and development for consensus-

building communities are always negative across the Table and are statistically significant for the most part. Taken together, these ATT estimates suggest that the communities which elect their local leaders by allowing everybody to vote are also the ones to have significantly higher income (both measures) and development spending (both measures) when contrasted with those communities, which employ the process of 'consensus-building' or 'oligarchy'.

These results suggest an obvious question: Why may electoral democracies be more entrepreneurial? We explore a few possibilities here using the data at our disposal. First, the likelihood of leader turnover is significantly higher in voting relative to consensus-building communities in our sample. The likelihood of leader turnover from 1997 to 2007 is 0.60 in voting communities as opposed to only 0.38 in consensus-building ones and the mean difference is statistically significant (t -stat = 5.00). A greater chance of leader turnover could be an obvious mechanism to discipline leaders, and this likelihood is significantly higher in voting rather than consensus-building communities, thus inducing or encouraging a leader to be more entrepreneurial.

Second, we examine the extent of economic inequality in voting and non-voting communities. A more unequal society with ethnic diversity may dampen a democratically elected leader's accountability, since they cannot cater to everyone. The core logic in Bandiera and Levy (2011) can be easily adapted to establish that unequal communities with ethnic diversity are more prone to elite capture. An analysis of monthly per-capita household expenditure data suggests that voting communities in our sample tend to be less unequal. In particular, the total income share of households in the top quartiles is significantly less in voting as opposed to consensus building communities: the sample average is 19 per cent for voting communities as opposed to 27 per cent for consensus communities.⁸ Similar patterns emerge when using the Gini coefficient and the coefficient of variation as alternative indices of inequality. These observations, taken together, suggest that leaders in voting communities are more likely to be entrepreneurial because they need to cater to all households in the community, which is also easier to do in less unequal communities.

Conclusions

We have examined the implications of a major nationwide programme of fiscal decentralisation in Indonesia for the structure and organisation of local political processes, an issue not hitherto explored in much detail. We offer a first glimpse into these complex inter-linkages using detailed community-level data from Indonesia, using data from 312 rural and urban communities, drawn from 13 provinces, before and after the introduction of FD in 2001.

We focused on two particular issues. First, we sought to highlight the factors that drove communities' choices between voting and consensus-building, exploring whether community homogeneity (dominance by a single ethnic group) had been a precondition for the initiation of participatory democracy (proxied by consensus-building) as opposed to electoral democracy (proxied by majority voting). Second, we studied the role of local polities in local income generation and development, exploring how the political entrepreneurship of local leaders may succeed in overcoming the collective action problems in ethnically diverse communities, especially after fiscal decentralisation.

We observe that after the decentralization changes local leader selection by consensus-building declined and that by voting increased significantly. Our analysis identifies community homogeneity as an important factor in boosting the likelihood of communities choosing to do leader selection by consensus-building. More ethnically diverse communities increasingly opted for voting as their means of selection after fiscal decentralisation. Local political entrepreneurship played an important role in this political transition after fiscal decentralisation. Our PSM analysis shows that voting communities were consistently more successful in raising local income and local development relative to comparable consensus-building communities. This highlights the significance of local political entrepreneurship in aligning the economic interests of ethnically diverse communities after FD in Indonesia. We argue that this can be attributed to the greater local accountability of leaders in electoral democracies, who must seek to cater to the everyone (including poorer households), especially when economic inequality is

moderate. In a way, our findings conjoin the literature on ethnic diversity (Alesina, la Ferrara, 2000; Ashraf and Galor, 2013; Gomes, 2020) with that on participatory developmental efforts (Olken 2010; Mansuri and Rao, 2013). While we do not claim that these empirical associations are strictly causal, the consistency of their magnitude and significance means that we cannot dismiss them as a mere statistical oddity. In fact, we choose to interpret these results as a springboard for further careful exploration of the features of local entrepreneurship, which we believe lies at the heart of such transitions following fiscal decentralisation.

Notes

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Endnotes

- ¹ It is easier for leaders to unite supporters when economic differences are lesser.
- ² For instance, see Bardhan (2002), Bardhan and Mookherjee (2006), Stokes (2005), and Larreguy et al (2017).
- ³ See (Easterly and Levine (1997), Alesina et al (1999), Banerjee and Somanathan (2007), and Collier (2008) among others)
- ⁴ See Martinez-Bravo (2014) for evidence on electoral fraud post-FD in Indonesia.
- ⁵ See e.g., Lind and Tyler (1988), Matsusaka (2004), and Olken (2010)
- ⁶ Although IFLS data are available for the years 1993, 1998 and 2000 as well, information on local politics could be found only in the 1997 and 2007 surveys.
- ⁷ About 51% of sample communities had group 1 (i.e., the largest ethnic group) comprising at least 91% of the community's population. Around 27% of sample communities were perfectly homogeneous ethnically.
- ⁸ The mean difference in the share is significant too (t-stat = 2.12).